Memorandum to the Communities and Local Government Committee from the Association of Corporate Treasurers (ACT).

January 27 2009

We are pleased to respond to the recent request to provide evidence to the Committee relevant to its consideration of the topic of local government investments.

We remain available to the Committee to make further inputs as required.

ACT contact information is at the back of this memorandum.

Summary

- We set out the types of arrangements and associated governance matters generally found in large non-financial companies for the investment of temporary liquid funds. We hope this is a useful comparator for the Committee.
- The ACT is not in a position to comment on existing governance practices within local authorities.
- We consider the question of risk management in investing funds on hand and the setting of counterparty credit limits and diversification rules for this.
- A corporate treasurer's priorities for treasury operations staff involved in short-term investment are (i) security, (ii) liquidity and, last of all, (iii) yield. S L Y.

1) About the ACT

1.1 The Association of Corporate Treasurers (ACT) is a professional body for finance professionals working in treasury, risk and corporate finance. Through the ACT we come together as practitioners, technical experts and educators in a range of disciplines that underpin the financial security and prosperity of an organisation.

1.2 UK based, we are also the world's leading examining body for treasury, providing the benchmark qualifications for Associate Member (AMCT) and Member (MCT) which can lead on to Fellowship. We provide continuing development through training, conferences and publications – including The Treasurer magazine.

1.3 "Treasury" is used in a much wider sense in non-financial companies than it is in local authorities.

2) Local government investments

2.1 We are not familiar with current governance of or within local authorities and so are not in a position to comment. We think it might, however, be helpful if we outlined to you the kinds of arrangements for investment of short-term liquid funds that would normally be found in a large company.

2.2 A little more broadly, we are in advanced discussions with CIPFA about cooperation on treasury education in local authorities.

3) Corporate investment of liquid funds

3.1 Liquid funds in most companies will generally be regarded as temporary, short-term funds even if they are expected to persist for some years. The

reason is the contingent requirements for their use generally in the business or to take advantage of opportunities which arise. Significant funds locked up in medium or long-term and illiquid investments would be likely to change the risk characteristics of the company in ways which may be expected to diminish firm value.

4) Context and governance

4.1 Companies' specific arrangements are, of course, contingent on their specific needs and history. Some specific features will be common, however.

4.2 A large company will usually be organised with a holding company with operating subsidiaries involved in various businesses in various geographies around the world. The subsidiaries may themselves have business units in various locations.

4.3 While some small arrangements may be needed locally, most companies will arrange funding, provision of risk management products and liquid funds investment for the group and its business units from the holding company or a central treasury company set up for the purpose.

4.4 The controls and information systems, voice recording, etc. needed for the full range of treasury operations can be expensive to set up and this, together with requirement for expertise, qualifications and experience among the staff involved usually make it unattractive to carry out the activities in the individual locations. The very largest companies may have treasury centres in different time zones – commonly Europe (UK), the Americas (US) and Asia (perhaps Japan, Singapore or Hong Kong).

4.5 Where small local arrangements are needed, they are normally confined to a narrow range and operate under restrictive rules with minimal local discretion.

4.6 The Group Treasurer will usually report to the holding company Finance Director and be accountable to a Finance Committee of the main board though in some companies the board may not delegate to a Committee.

4.7 The internal audit function and specialists from the external auditors will add to their normal review function particular review of the treasury operations and, along with scheduled activities, this will include various "surprise" visits to wherever treasury operations are carried out, activity with counterparties, etc.

4.8 The Finance Committee of the Board will recommend to the Board, on advice from the Treasurer and Finance Director, financial policies for the company. Usually, monthly reports will be made to the Finance Committee and summaries will be included in the reports for the main board. At most meetings, the Finance Committee will question the Treasurer and less often the Main Board will want to see the Treasurer as well.

4.9 The financial policies will include provisions regarding the investment of liquid funds.

5) Investment of liquid funds

5.1 Absent tax or other barriers, the obvious first uses of liquid funds in any unit are to repay, perhaps temporarily, funding from the group or to lend them to

the rest of the group. Various cash-pooling and “sweeping” systems are used to achieve this, operating daily. The advantages are minimisation of costs paid to external lenders, credit exposure to external deposit takers and other counterparties and operational risk in subsidiaries. Funds are usually made available to subsidiaries only as needed – explanations being needed for variances against budgets/forecasts/operating plans.

5.2 Companies need to manage external credit exposures arising from liquid funds together with other credit exposures to the same or related counterparties from other activity and they have to take account of credit support and set-off arrangements.

6) Principles of liquid funds investment

6.1 The treasurers’ mantra is security, liquidity, yield – in that order – SLY for short.

6.2 The security aspect is the counterparty’s ability to repay the investment, on time and in full.

6.3 Many types of investment are in principle available involving many possible counterparties. In practice, non-financial companies mostly use banks, government bills and liquid money market funds. (It is important to distinguish the latter from enhanced yield funds with greater credit and liquidity risks which are not suitable for investment of temporary liquid funds.) In normal times banks and liquid money market funds dominate.

6.4 The company would normally set a credit limit for the counterparty and this would apply to the entire group’s exposure to the counterparty, whichever units, holding company or subsidiaries were incurring the exposure.

6.5 A second level of protection will be sought from a reasonable diversification of the investment if it is other than very small. Diversification would usually be among banks (and with attention to the home regulators of the banks). To achieve more, second hand, diversification, companies may use liquid money-market funds and this also partly delegates the credit assessment, the fund assessing the underlying investments, the company just having to assess the fund.

6.6 This approach to investment security is not designed to be event-free under all circumstances but such that, systemic failure apart, a credit event, while damaging, unwelcome and embarrassing, is unlikely to be catastrophic.

6.7 Liquidity is the idea of the ability of the investor to realise the value of the investment prior to its maturity if the need should arise. It is secured by the willingness of the counterparty to repay, with appropriate interest adjustment, early, the opportunity to sell the investment to someone else or to use the investment as security for a borrowing. Overnight investments, US and UK treasury bills and also liquid money-market funds which have daily liquidity, can normally be regarded as fully liquid. (Money market funds have some greater risk because of the maturity profile of their underlying investments although, in normal circumstances, the managers are able to offer same day liquidity.) Longer term investments, week fixed, 30 days, 3 months, etc. are less liquid.

6.8 Credit Uncertainty increases with the maturity/duration of the investment and the lower its liquidity. An investment’s maturing will require a re-investment

decision. Particularly for less liquid investments, such as bank deposits, investment period limits may be set which vary with the obligor's credit standing and subject an overall maximum maturity limit policy.

6.9 The desired liquidity profile of investments will be influenced by the company's strategy and its expected cash flows and potential cash flow volatility, the availability of alternative liquidity, for example undrawn committed bank lines, expected needs to react to credit events among counterparties and tolerance for liquidity risk.

6.10 Put simply, increased yield on the short-term investment can be achieved by accepting higher credit risk (default premium) or by accepting lower liquidity (liquidity risk).

6.11 Companies will usually manage interest rate risks – here the yields on reinvestment of maturing investments – using derivatives, allowing investment maturity to be dominated by credit and cash flow considerations. This is not open to local authorities.

6.12 Yield comes last in the treasurer's priorities.

7) Counterparty credit limits – credit limits for banks

7.1 A simple list of approved investments without a system of limits runs the risk of adverse selection as junior operations staff may tend simply to take the highest yields available from investments on a simple "approved list".

7.2 Relative to banks, non-financial companies have small balance sheets and a narrow range of short-term investment counterparties. They have neither the systems nor the volumes to justify more counterparties. Accordingly, they will normally mark for a bank a much smaller credit limit than the bank would mark for the company.

7.3 The counter-party limit set for a bank (which covers all forms of credit exposure, not just liquid fund investments) will usually, and subject to a maximum exposure limit, be derived from an approach which starts with the credit ratings of the banks. Again, limits are set so that the expected loss from a credit event, while regrettable, is not disastrous.

The limit may vary with the maturities of the exposures.

7.4 We have been concerned that much discussion of the use of credit ratings in the media has been very superficial.

7.5 In any case, credit standings can change very quickly and it is important to be responsive and to have up-to-date assessments to hand to permit prompt adjustment of limits and, possibly, protective actions.

7.6 The Appendix briefly discusses assessment of bank counterparties.

Appendix

Bank counterparty credit assessment for companies: brief comments

[Based on an elementary presentation to ACT students, Investing Surplus Cash,]

1) Assessing bank credit risk from scratch is difficult and time consuming.

2) Starting with the conventional, analyst-driven credit rating of the bank[1] is a great help. But it is important to look well beyond the published three character rating.

   2.1 Such ratings are forward looking opinions in a limited sense. They take account of the discussion by the credit analysts with the management of the bank about its plans and forecasts. The credit analysts will have stress-tested the forecasts against likely developments and the effects of the normal business cycle so, conceptually, investment grade ratings, particularly stronger ratings are normally relatively stable.

   2.2 Subscribing (rather than relying on the freely available abbreviated ratings) gives access to the ratings report written by the analysts that provide more nuanced information and the opportunity to talk to the analysts about the report. It also enables you to stay up to date rather than relying of out of date rating opinions.

   2.3 It is very important to have attention to the “outlook” indicated by the rating agency. In the case of banks, rating agencies may provide a “stand alone” rating as well as a rating which takes account of possible government support. Of course, the rating and the outlook for the government (for which “own currency” and “foreign currency” ratings are usually available) are key factors.

   2.4 Rating agencies may publish a “loss given default” rating for weaker credits but are unlikely to be available for the type of counterparty envisaged.

   2.5 Careful attention to credit rating details can be most helpful even though the ratings do not pretend to be updated in anything like real time. But, particularly in times of systemic perturbance, banks can fail quickly if confidence is lost.

3) Analyst driven ratings can be supplemented by other information – but for risk averse investors this should never be used to *raise* the credit limits you set.

   3.1 “Model driven” or “market implied ratings” or a combination of them are available. Market implied ratings may be updated much more frequently than analyst driven ratings.

   3.2 Model driven ratings are based on a purely statistical analysis of published data. Market implied ratings use observed market prices for, for example, credit default swap pricing for the obligor, movements in its equity price and the prices of its bonds, all of which are related in some way, to credit standing. These pricing signals, like the underlying price movements can be very volatile, with false signals but they can provide a wake-up call for investors.

   3.3 As well as the ratings based information discussed above, use other sources for information about counterparties. At the lowest level, you can read the financial newspapers and set “Google alerts”, and Reuters and Bloomberg feeds to pick up news stories and comments from all over the world about your counterparties.

4) Credit limits will be set based on the credit assessment, the maturity of the intended investment, the risk appetite of the company, etc.

   4.1 Credit limits should be regularly reviewed but also be subject to prompt reconsideration whenever it is felt desirable. No authority should need to be sought to *reduce* a credit limit (and report the decision).

[1]It is important, when discussing ratings, to distinguish between sovereign, corporate, bank, and structured finance ratings.

TREASURY, RISK AND FINANCE PROFESSIONALS
ACT

Contact information

Stuart Siddall
Chief Executive
T: +44 (0)20 7847 2542; E: ssiddall@treasurers.org

John Grout
Policy & Technical Director
T: +44 (0)20 7847 2575; E: jgrout@treasurers.org

Martin O'Donovan
Assistant Director - Policy & Technical
T: +44 (0)20 7847 2577 ; E: modonovan@treasurers.org

The ACT's approach to policy issues is set out in our Manifesto (www.treasurers.org/technical/manifesto)

ACT
51 Moorgate
London EC2R 6BH, UK
Telephone: 020 7847 2540
Fax: 020 7374 8744
Website: http://www.treasurers.org

The Association of Corporate Treasurers is a company limited by guarantee in England under No. 1445322 at the above address