Ask the experts:

Navigating choppy waters

Arthur Burgess and Stephen Pugh look at the lessons of Northern Rock, while Martin Cade looks at the wider lessons to be learnt from the liquidity crisis.

Arthur Burgess was Treasurer of British Gas from 1987 to 1999 and has until recently been involved with the ACT in various capacities on publications and editorial

There are at least three aspects of the Northern Rock saga that immediately spring to mind as lessons for treasurers. They are not, one is bound to observe, new lessons, but lessons that have been forgotten.

First, regarding quality of assets: if your assets are risky or of poor quality, then that is what they are. No amount of financial engineering or cutting them every which way will improve their intrinsic quality. In the vernacular, you cannot make a silk purse out of a sow's ear: if you take all the Granite out of the Rock you may be left with only sand. With monetary assets this principle is especially relevant, because the risk can so easily and evidently convert into a loss.

Second, the caveat "Don't borrow short and lend long" has long stood as a pillar of sound money in banking. At any rate, if you have no alternative, then monitor your exposure with care and manage the maturity profile through the derivatives market to preserve your overall liquidity. This applies also to a corporate borrowing book.

Third, a lesson for today is the power of the media. As I walked through Cheltenham at ten to nine on a Saturday morning in March I saw a queue outside one of the major building societies. I said to my wife: "Can you imagine the damage I could do to ZZZ plc [I won't name the institution just in case] by taking a photograph of that and sending it to the redtops?" The caption writes itself: "On Saturday morning, a queue waiting to get their money from…"

Of course, the media cannot be blamed, but management of the media is a key factor in this story-hungry world. Drip-dripping bad news in gobbets and dithering by regulatory authorities created a media storm which probably resulted in speculation that things were in fact worse than even the actual worst case scenario.

It happens so fast and so easily that any manager must tread sure-footedly to stay ahead of the ravening hordes.

CARTOON: ARTHUR BURGESS

Stephen Pugh, Finance Director of Adnams and chairman of the ACT's Policy and Technical Committee

My first reaction on being asked what the lessons of Northern Rock were was to advise that it's best not to be in the wrong place at the wrong time.

Only a year ago Northern Rock was being hailed as a great success. Its policy of funding its mortgage business with an unusually high proportion of wholesale market finance was seen as aggressive, but it was also thought to be a sound strategy to which the markets assigned a high value. With all this praise, the management of Northern Rock may have felt that the fates subsequently conspired against them in a most unfair way.

Nonetheless, Northern Rock was the only failure at the time, which strongly suggests that it was the specific circumstances of the business model that created the problem. Whatever the outside world may be saying, it is the job of management to ensure that the business is robust.

Prior to the run on the bank, management had acknowledged some treasury failures. They offered mortgages linked to base rate and funded themselves at Libor.

However, they had not hedged the difference between these rates during the period between offer and completion of mortgages. But it was not this level of treasury management that created their problems; that came from a failure of liquidity. The dire news from the US on the state of sub-prime mortgages caused a loss of confidence and a drying up of the wholesale capital markets on which Northern Rock was so dependent.

Northern Rock might still have felt that it was writing sound business and so should have had a reasonable expectation of receiving funding for it. However, the fact that it was up to 70% exposed to wholesale market funding when building societies are unable to exceed 50% implies that others had identified a risk that Northern Rock felt able to live with.

The lesson of Northern Rock for treasurers is that a failure to manage liquidity risk can be catastrophic, and that catastrophe can strike almost immediately. A prudent approach and suitable backup facilities are essential. Treasury in banks is central to their business and treasury failures may consequently be worse than failures in non-financial companies. The very public nature of queues of depositors is not something that non-financial companies have to contend with, but unexpected failures within established sources of funding may be.

Martin Cade, Senior Manager, Northern Financial Services, Deloitte & Touche

Cash is the life blood of any business and this has been highlighted in particular by the global disruption in the financial markets throughout the second half of 2007 and into 2008.

While the turmoil was initially confined to the financial services sector there is growing evidence that it is spreading to other sectors of the economy, as organisations seek to refinance or raise extra debt finance.

The Financial Services Authority (FSA) is currently in the process of refreshing its rules and guidance to the financial services sector regarding liquidity management and the prudential regime that sits around the operational aspects of liquidity risk[1]. Although the FSA's thoughts are directed towards the financial services industry, there is much of interest for the corporate treasurer too.

The FSA's conclusions in its discussion paper are that:

- A move to a more principles-based approach founded on existing high-level standards would be appropriate;
- The responsibility of banks' board and management needs to be re-emphasised;
- The application of qualitative requirements (for example, for stress-testing) needs to be toughened;
- Qualitative liquidity requirements, within a mismatch framework, are necessary; and
- There remains a need, at the short end, for a buffer of highly liquid assets and that the quantitative regime around this should be extended to a greater number of banks.

COMPANIES, FINANCIAL AND CORPORATE ALIKE, FAIL BECAUSE THEY RUN OUT OF CASH. RECENT EVENTS HAVE PROVIDED US WITH A STARK REMINDER THAT CASH, MORE THAN EVER, IS KING.

A tougher regulatory approach by the FSA can only point to continued tough times ahead for the corporate treasury, which will itself need to refocus on its own liquidity management processes.

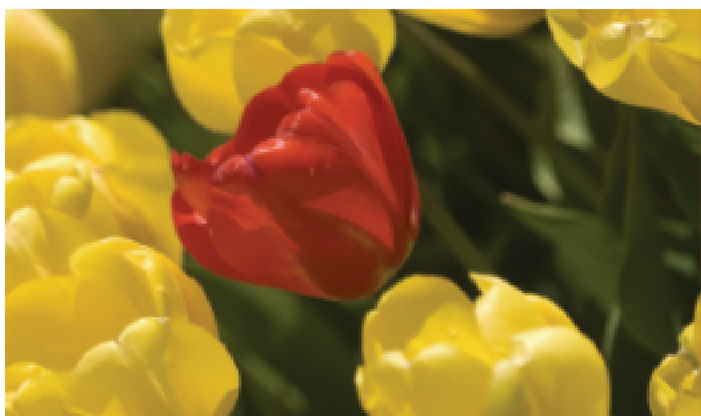
To that end, the improvements suggested by the FSA might actually be relevant to the corporate community too, particularly as they codify what is typically considered best practice. For example:

- The articulation by the board of a clear liquidity risk appetite;
- The implementation of a liquidity stress-testing framework and a contingency funding plan;
- An assessment of the extent to which commitments from the providers of funding would actually be honoured during a severe stress;
- A reappraisal of the company's investment policy and the trade-off between yield and liquidity; and
- The importance placed on counterparty relationships in their role as providers of finance.

In addition there are likely to be commercial issues which arise from these changes which will affect the corporate treasurer. A re-evaluation of liquidity risk within the banking sector may ultimately give rise to the need for banks to hold more liquid high-quality assets to mitigate the short-term effects of a demand to repay their liabilities. This represents a cost (in terms of a lower interest margin) that is likely to be borne by the sector's customers. There may also be a general restriction in the amount of credit available and the current difficulties in accessing the securitisation market as a form of finance can only heighten this.

Companies, financial and corporate alike, fail because they run out of cash. Recent events have provided us with a stark reminder that cash, more than ever, is king.

[1] *DP07/7 Review of the liquidity requirements for banks and building societies*



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