Making the decision to switch treasury sides

Thinking of making the move from a corporate treasury environment to a financial institution one? Gil Rosen highlights the differences between the roles.

Changing sides? Sounds decidedly unethical doesn't it? I did change sides once while watching rugby at Twickenham when Wales was looking decidedly iffy after 10 minutes, but then nobody knew I had started by supporting Wales in the first place, so that doesn't count.

What I am talking about is changing sides in treasury management – going from a corporate environment to a financial institution, or in my case, to a building society. Coming from a corporate, what did I have that a building society needed? What did I find that was different when I got there? And what did I gain from a building society that has enhanced my experience?

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A different ball game

Before 1986, building societies had a virtual monopoly in providing finance for people to buy their homes. They raised their own funds by attracting retail savings through their branches, added a few hundred basis points on what retail savings cost them, and lent it out to house purchasers. Although there were hundreds of building societies they more or less acted as a cartel and mortgage queues developed when retail funds were slow in coming in. Then two key events occurred:

- the 1986 Building Societies Act allowed building societies access to the wholesale funding market and derivatives markets; and
- other entities such as banks and centralised mortgage lenders entered the mortgage market and real competition began.

The majority of building society people, especially in the medium to small societies had spent all their careers in that environment, which meant they had little experience of wholesale funding management, derivatives or foreign exchange. A number of mergers were also taking place, so that societies grew quickly and had a greater need to access these newly available markets. Therefore, people were recruited from the corporate sector to bring the expertise that was then needed with them.

I joined the building society industry at the beginning of the 1990s with the naive thought that "treasury management is treasury management and only the product changes", but I had quite a culture shock. Building societies are closely regulated by the Building Societies Commission (BSC) – now part of the Financial Services Authority (FSA). Although never dictating exactly how a building society should be managed, the BSC nevertheless issues guidelines contained in formal documents issued to all societies called Prudential Notes on topics such as liquidity, financial risk management, solvency and new Initiatives, detailing best practice. The skill in interpretation is knowing the difference between 'will' and 'should', and 'may like to'.

Gil Rosen

Building society treasurers need to know their Prudential Notes thoroughly because they have to not only produce policy statements detailing how they are going to manage the various areas of their responsibilities, but their policy statements must be approved by their boards and finally by the BSC.

I combined mine into one document grandly entitled *Treasury Management Policy Statement*. The statement has to incorporate all ratios and limits laid down by statute – for example, the 1998 Building Societies Act which amended but did not replace the 1986 one stated that at least 50% of a society's funding must be raised as retail deposits, or shares – that is, a society can go to the wholesale markets for up to 50% of its funding requirements – and those which are compulsory under the relevant Prudential Note.

One example is that the Prudential Note on liquidity requires that societies hold what it defines as 'prudential liquidity' as a proportion of its total liquid assets and details what type of instrument and its residual length to maturity qualifies as prudential liquidity, but leaves the society to set its own maximum and minimum levels (and total liquid assets for that matter).

However, regardless of the levels set, the Prudential Note states that no more than 20% of prudential liquidity can be held in the form of other building societies liabilities. But if a society's holding of other building societies' liabilities does exceed 20% of prudential liquidity, the excess can be counted as 'other liquid assets' within its total liquid assets, provided the total of prudential liquidity remaining is within the limits set by the board.

I haven't finished yet – on top of that, the Prudential Note requires that a minimum of the equivalent of 3.5% of the total of both retail and wholesale funding be held as prudential liquidity which will mature, or be capable of being realised (with the exception of floating rate notes), within the following eight days. However, a simple spreadsheet for dealers provides an easy way to check how each deal affects ratios and limits, and a formal daily report ensures that limits are not breached.

Formal procedures

The formality of building society procedure is another difference that is encountered. If a treasurer wants to become involved in an aspect that the society has not done before – to launch a medium term note (MTN) programme, for example, or to invest in mortgage-backed securities – a comprehensive report needs to be presented to the asset and liability committee.

This needs to describe the exact nature of the transaction, how it will be managed, why it needs to be done at all, how the systems will deal with it, an account of the risks involved and how they will managed, and the controls that will need to be put in place.

This needs to be ratified by the board (depending on the procedures laid down in the policy statement) and then the BSC needs to be informed.

The great advantage this has is that the treasurer has to be thoroughly convinced that this new initiative is necessary and beneficial to the society before trying to convince others, which prevents costly experiments from being launched.

The main benefit in experience a building society treasurer has over most corporate ones is in the management of the treasury portfolios. Most corporates are either cash-rich, or have a permanent funding requirement, so the management of the portfolio is on one side of the balance sheet, or the other. Building societies, with the requirement to keep adequate liquidity to be able always to meet their commitments, and the need to access wholesale funding to supplement retail inflows, have large portfolios on both sides.

Mismatches between maturities on either side need to be managed effectively so that exposures can be measured and risk of loss through interest rate movements minimised.

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Being a mutual organisation, a building society cannot raise equity, so the main source of its capital is the profits it generates each year, which go into its reserves.

It is imperative, therefore, that enough profits are always generated to support the growth in the business, although raising subordinated debt and issuing permanent interest-bearing shares are also a possibility.

Even provisions for non-performing mortgages have to come out of current profit and not reserves, and the BSC takes a dim view of a society that appears to be heading for a loss in which case a merger will be arranged!

Dynamic simulation

It is important, therefore, to ensure that adequate balance sheet risk management systems are in place to measure, monitor and manage exposures in the balance sheet in order to protect net interest receivable from adverse movements in interest rates. Gap Analysis is one way to do this, but it provides only a static view of the balance sheet at a given date. I felt that to manage apparent exposures in the future, when these exposures may not prove to be exposures at all with the passage of time, was risky in itself, so I installed a system using dynamic simulation which first creates the current position balance sheet and then, by using interest rate forecasts, current business strategy and balance sheet growth envisaged by the business plan, runs up to 300 simulations and produces the probable net interest receivable over any given period in the future. The effect of new strategy or products on income is clearly forecast and any problems are highlighted well in advance so that corrective action can be taken.

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Always interesting

With just these few examples of life in a building society treasury, you can easily see the steep learning curve required, but it does mean the environment is always interesting and dynamic. The building society treasurer also needs to assist in financial product development, which is another difference from the requirements of a treasurer in a company.

By using structures created by yield curve shapes, or equity derivatives, new retail savings products can be developed. For example, I developed one of the first step-up savings bond six years ago, which was commended at the time as being 'even better' than a similar offering launched by a major bank. Considering I had done the swap to hedge the bond with that particular bank, I was quite amused.

The final big difference is the fact that a building society's 'shareholders' are members who have invested their savings to be looked after by the society in return for a payment of interest. Corporate shareholders invest in companies hoping to increase their capital and for a payment of a dividend from the profits that they expect to be made.

The theory is that equity investors should only risk the money they can afford to lose, while building society savers sometimes put in all they have. The building society treasurer therefore should avoid taking excessive risks with portfolios with the hope of making windfall profits, because what can go up, can just as easily go down. ■

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