Past the worst

WHAT ARE THE KEY ISSUES FACING FTSE 250-SIZED COMPANIES? A RECENT ACT LONDON REGIONAL GROUP MEETING FOCUSED ON AVAILABILITY AND COST OF FINANCE, CREDIT RISK IN DERIVATIVES AND OTHER INSTRUMENTS, AND BANK RELATIONSHIPS. **WILL SPINNEY** AND **DAVID WILSON** WERE THERE.

To begin the meeting, feedback was given from the ACT Annual Conference (ACTAC), which provides a useful barometer for issues and concerns in treasury. The feeling was that normality is gradually returning to the banking market following the virtual collapse during the credit crisis. Lending terms are shifting back towards five years and documentation is also relaxing a little back to what might be considered normal.

AVAILABILITY OF FINANCE AND ITS COST Participants at the meeting tended to share the feeling at ACTAC. Although all agreed that the availability and cost of finance had improved since the Lehman collapse, some companies are finding that negotiations with banks for finance and ancillary facilities are still tortuous. One participant noted a continuing shortage of overseas banks to provide competition.

There was a lot of discussion around the implications of possible future regulation of banks. Tighter controls on both liquidity and capital have implications for the pricing of loans, so businesses can expect to pay more for borrowing: Some potential new requirements on liquidity are very strict. In addition, there is some concern that governments, as major borrowers, might crowd out the private sector.

One particular implication of these factors is that standby facilities could remain relatively expensive, or even increase in cost, which would encourage companies to over-fund in non-bank markets and hold cash instead. However, the current differential between long-term borrowing rates and cash deposits makes this strategy an expensive one too. It seems peculiar that such regulation might to some extent invert the banking model – encouraging corporates to lend to banks.

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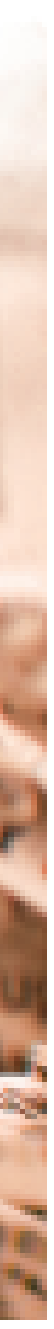
Another possible unintended consequence noted by some observers is that increasing the banks' cost of capital could lead them to undertake riskier activities in order to meet their shareholders' required return. As one might expect, regulators around the world, with politicians looking over their shoulders, have differing views and regulations will fluctuate for some time yet.

Another subject that featured in the discussion was non-bank finance, a debate that the ACT is contributing to at a high level. For larger corporates, the bond markets have been providing substantial liquidity, and the London Stock Exchange initiative in launching a retail bond market was noted. Indications from ACTAC, and at least one participant at the meeting, are that private placement funds may now be accessible by mid-size corporates. And, of course, the equity markets have become more generally supportive of firms. Private equity firms may also be prepared to invest in smaller companies for yield, although in some cases they will require an equity kicker.

Trade finance has also become generally more important and is one area where banks are keen to help businesses, along with leasing and supplier finance. There was a clear statement at the meeting, from someone who knows, that the UK banks which received state funding are taking their commitment to maintain lending to corporates very seriously; their main problem is finding the right opportunities at the right price.

The issue of cost of finance as against its availability was also raised. The point was made that, while a treasurer may not like to tell the chief executive that the cost of finance is going up, an even more career-limiting response would be that no money is available for that deal of a lifetime. Also, despite the historically high margins for borrowing, risk-free rates have been so low that some companies have been able to raise funds in the bond markets at the lowest rates in a generation.



CREDIT RISK IN DERIVATIVES AND OTHER INSTRUMENTS Before its meetings the London Regional Group conducts mini-surveys on the topic in question. On the subject of credit risk in derivatives, the survey revealed that about half of respondents were now required to post collateral against credit positions. Regulators are threatening to enforce this requirement for all derivatives, a move which the ACT is opposing. One participant reported a demand for collateral against bank guarantee and bonding lines, which in some cases could be very large. Furthermore there are areas, such as BACS limits and daylight exposures, which may in future attract a charge for capital or collateral. The experiences of participants were mixed, with some able to resist collateralisation but others finding that banks just would not deal without it; one treasurer even reported that a long-term relationship bank was insisting on collateral despite already holding a floating charge. In short, what you have to accept and what you can bat away all depends on your negotiating position.

The problem with collateralisation is the cashflow volatility it creates, because the variation in the value of the derivative is unlikely to match the underlying cashflow. Although margin calls can produce cash for a corporate, this can't be relied on, so some form of backup would be needed for calls against the company. One participant noted that a threshold amount in a credit support agreement can be used, although this reduces the administrative burden more than the risk of serious cash outflows. Another technique for managing the administration of collateralisation is to minimise the number of counterparty banks so that the relationship is better and there is more netting.

The discussion of collateralisation was wide-ranging. The prime concern for treasurers is that the cost of transacting derivatives might dissuade companies from hedging exposures. One example cited was exposure to a net investment in foreign currency: this could be hedged with debt in the relevant currency, but synthetic currency debt (a sterling loan coupled with a currency swap) could be significantly more expensive. And if a corporate undertakes an interest rate swap to safeguard its ongoing cashflows, this objective will be thwarted by margin calls.

The irony is that the proposed enforcement of collateralisation, primarily intended to restrict banks from taking large positions with each other, will have little impact on most banks (which actually maintain a small overall net position) but a detrimental impact on corporates hedging commercial exposures. Nevertheless, to keep things in perspective:

- banks have to charge for the capital utilised in uncollateralised derivatives;
- where corporates are worried about their banks' credit, two-way collateralisation is a good thing; and
- companies that hedge commodities have been trading on exchanges with margin calls for many years.

BANK RELATIONSHIPS The final subject covered was bank relationships, clearly linked to the availability and cost of both finance and derivatives. The traditional comparison of transaction versus relationship approach was described. The evidence from ACTAC was that the relationship approach was generally adopted by treasurers and favoured by banks, and that it had been effective during the credit crisis.

Nevertheless, there is evidence of some banks adopting a more transactional approach. The main symptom of this change is that banks are pricing loans fully, whereas the traditional relationship philosophy is that banks will discount lending margins to get privileged access to fee-earning opportunities. It is not clear what obligation treasurers would then have to favour lending banks. One of the results of the mini-survey was that two-thirds of respondents would not pay a margin over market to their relationship banks.

One of the chief difficulties with the traditional relationship banking model is that it is not usually clear where the balance of risk and reward truly lies. Treasurers vary in their monitoring of what business their banks are transacting with them, and banks vary in their ability to assess how much they are earning from clients overall. One observation was that some banks are binary in their decisions: they will either lend or not lend, regardless of the total earnings from the client, which is scarcely a sophisticated approach.

On the other hand, there was an astute comment that while in most parts of a company people pay close attention to supplier management (to make sure that key suppliers are adequately remunerated to stay in business), this does not necessarily apply to the providers of finance and banking services. The problem will not get any easier with regulators changing the cost of capital, which affects not only loans but also FX deals and even BACS limits.

Perhaps deposits will become more prominent as part of the relationship equation, given that the banks make a lot of money from them. However, if concentrated, deposits potentially give rise to counterparty risk for corporates and, from a regulatory point of view (individual liquidity adequacy assessments), deposits of under three months are no use to banks when stress-testing their liquidity.

As a result, a full and frank discussion between bank and corporate on the approach of each side was a strong recommendation of the meeting to improve transparency: perhaps this is the real definition of relationship banking.

This part of the discussion also touched on regulatory proposals to split banks into “safe” and “racy” parts, if anyone can decide what those are. If this split happens, there will be obvious implications for relationship banking in the future.

WHERE DO WE GO FROM HERE? Looking back, the meeting covered a lot of ground in just 75 minutes, and touched on issues relevant to corporates of all sizes. A clear message is that treasurers will need to keep tabs on – and, more proactively, contribute to – proposed regulatory reforms, which are being driven by politicians and civil servants, and fraught with unintended consequences. One might wonder also how far non-bank lending will permanently displace bank lending. Is it sensible in the long run to put the primary burden of funding corporates onto bond investors, who rely mainly on rating agencies (somewhat discredited by recent events) rather than the banks, whose key skill is to make credit judgements?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The rate stuff

MARTIN O’DONOVAN REPORTS FROM A RECENT DUBLIN REGIONAL GROUP MEETING THAT EXPLORED THE INCREASINGLY TIMELY TOPIC OF HOW TO GET A CREDIT RATING.

Treasurers like to share their experiences and expertise with other treasurers, as is clear from the international co-operation between national treasury associations. In that spirit the Irish Association of Corporate Treasurers (IACT) and the ACT Dublin regional group held a joint breakfast meeting in May at which Standard & Poor’s explained the process of getting a credit rating and how best a company can present a case to its bankers.

The beauty of a credit rating is how the agency’s opinion is summed up in the rating category. This headline simplicity has its conveniences but to stop there is to misunderstand the real work done in reaching that assessment. There are, in fact, various forms of issuer rating – corporate, financial strength and counterparty, and various forms of issue rating covering bonds, programmes, bank loans or recovery ratings for higher risk issues. The current levels are one thing but it is the outlook (positive, negative, stable or developing) which is crucial, as would be any creditwatch warning of a possible near-term change.

Timothy Poole, director of client business management, EAME, for S&P, demonstrated from S&P’s published information how the various key financial ratios typically matched up to specific rating levels. For example, for US industrials a debt/EBITDA ratio of 1 puts the company at AA, 2.3 times at BBB, and 3 times at BB. Treasurers may like to deal only with banks rated A- or better, but looking at the global distribution of ratings, less than half of S&P’s ratings are in the investment-grade section of BBB- or better; the most common rating level is just a single B.

But looking at averaged financial ratios does not tell the complete story. In reaching its credit rating opinion S&P weighs up the combination of business risk profile (the nature of the business and the market for the company’s product or service) and financial risk (the structure and dynamics of the P&L, cashflow and balance sheet). A company with a significant financial risk and an excellent business risk profile might come out at A-, but the same financial risk profile in a merely satisfactory business risk environment could see the rating drop to BB+.

The rating agencies are clearly conscious of the damage to their reputation from the financial failures during the crisis but over time the relative risk taken from cumulative default rates correlates very well with the rating levels. That said, S&P aims to set ratings so they do not change too frequently. It rates through the economic cycle so that the default percentages in any year vary. Pre-crisis speculative-grade defaults were running at a very low level of 1% to 2% whereas at the end of 2009 they were up to 11.75%; in 2010 they are expected to fall back to 8.7% in the base case scenario.

To gain a rating, a company will need to organise a meeting with senior management and provide information on its corporate profile (its organisation, governance and strategy) and operating profile (business segments, outlook, competition, key risks and financials). The volume of information may seem daunting but S&P maintained that everything it wanted to see should be material that the company produces anyway in the course of its normal reporting cycle. The ACT supports that view and advises that getting a rating need not be overly burdensome and is well worth doing. With the access to bank finance likely to be constrained in the future, more and more companies should be thinking about the capital markets and hence about ratings.

Looking forward, the 60 or so treasurers from the IACT and ACT present at the meeting heard about the ways in which S&P is modifying or developing its approach. For speculative-grade ratings and outlooks, it is adjusting its time horizons to emphasise two years and one year respectively. It is placing greater emphasis on short-term considerations, focusing on long-term factors where they are reasonably predictable. Its analysis will focus more on the level of certainty and the impact and shorter-term threats and opportunities to the business risk assessment. And, as is well recognised by everyone now, liquidity is key.

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The ACT has published guides to credit ratings in its International Handbook and on its website at www.treasurers.org/node/5949 and www.treasurers.org/node/3941

Box 1: Treasury management in Ireland

In relative terms, treasury management is a particularly important activity in the Irish economy. This stems from Ireland's position as a major financial hub via the International Financial Services Centre, the presence of many leading global multinational corporations, and the fact that Ireland has one of the most open trading economies in the world. With the US and UK as two of the country's biggest trading partners, foreign exchange risk management takes on added importance. In this environment, treasury associations have much to contribute. The ACT in Ireland is well represented with over 110 members and more than 20 students, and has started to look at increasing its programme of activities.

In addition to the ACT, Irish based treasury professionals are also supported by the Irish Association of Corporate Treasurers (IACT). Given that many treasurers have membership of both the ACT and IACT and the members of both associations have common interests and needs, we have agreed to collaborate with IACT to ensure treasury issues are well understood by the corporate and financial sectors. This co-operation includes sharing technical knowledge, hosting regular members meetings (open to both sets of members) every 4-8 weeks and sharing members' different experiences. In this way we expect treasurers in Ireland to make a growing contribution to Irish corporate life, economy and the ACT. Collaboration will ensure that the strength of both institutions can be leveraged to maximum effect. Hearing first hand from financial service providers is a prime example of this.

It is also gratifying that ACT chief executive Stuart Siddall and members of the ACT policy and technical team met members recently in Dublin. The ACT can play an important supporting role for its members in Ireland which we can build on in the future.

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