The treasurer's take

PETER WILLIAMS REPORTS ON AN ACT WORKING LUNCH TO OFFER NON-EXECUTIVE DIRECTORS THE TREASURY PERSPECTIVE WHEN ASSESSING THE RISK STATUS OF BANKS.

Non-executive directors may not be responsible for a company's relationship with its banks on a daily basis but in this period of heightened corporate concern over financing and liquidity they need to be aware of the key banking issues.

In the latest of the ACT's series of events for non-executive directors, John Grout and Martin O'Donovan, the director and assistant director respectively of the ACT's policy and technical committee, led a discussion with non-execs to examine some of the topics that boards should be addressing. Also on the panel was Marc Palley, head of the banking and capital markets group at Berwin Leighton Paisner, and the session was introduced by Stuart Siddall, chief executive of the ACT.

Banks have been the major source of finance for companies, especially for mid-tier businesses. But as Grout reiterated, after the boom of 2007 and early 2008 the volume of bank loans and total loans has collapsed, and many companies have had to turn to the corporate bond market to make up the shortfall. The bond market is often restricted to larger corporates, but the European high-yield market has seen a leap in new issue activity in the second half of 2009 and early 2010.

Treasurers will be keen to emphasise to non-execs that the days of easy credit are over, for the foreseeable future at least. As credit became scarce, so cost went up. And although spreads have come down again since the days of the post-Lehman crisis, non-execs must understand that financing costs are greater than they were.

Anecdotal evidence suggests that bank lending is improving. But Grout told the meeting that while there may be a tiny bit more liquidity splashing around, the banks are still rerating risk and making significant tweaks to the terms on which they lend, focusing in particular on covenant amendments and defaults. In general, it is still the case that mid-tier businesses and small and medium-sized enterprises (SMEs) are struggling to access capital.

Borrowing money remains a vexed problem, but corporates with surplus cash need to consider with an equal amount of care the issue of where to place their funds. Grout asked the non-execs at the meeting whether investment return was the prime issue determining where deposit funds were placed. Is size the only consideration or are there other factors?

While treasurers are familiar with the three-letter acronym SLY, Grout examined the thinking behind the chant of security, liquidity and yield, and explained why the SLY order is vital when a business is considering where to place its surplus funds. While non-execs can be reassured that their companies make deposits with banks that have, at a minimum, a good investment-grade rating, Grout suggested that that was only half the story.

LESSONS FROM ICELAND. In terms of counterparty risk a bank's credit rating tells only part of the story. Non-execs should appreciate that a company needs to have in place a process of checking reports and credit alerts.

The importance of this process in good risk management is illustrated by the collapse of the Icelandic banks in 2008. During spring 2008 the Icelandic banks' credit ratings were falling – from A to BBB – and were "on watch". Many local authorities in the UK had deposited money with the banks: in January 2008 the total figure stood at more than £2bn; by October 2008 (when the Icelandic banks ceased to trade) that figure was just over £950m.

In the year to October 2008 18% of local authorities had removed all their deposits in Icelandic banks as they matured. The subsequent Audit Commission report on the collapse notes that there examples of good practice among local authorities that had an explicit understanding of the balance between risk and reward, regular policy review, well-trained staff and a use of a wide variety of information. By contrast, the approach of some other local authorities was poor, indicating weak governance and an over-reliance on external advice. It's a story with lessons for corporates, not just local government.

TIME FOR A HAIRCUT? The meeting also discussed the idea from the US that wholesale depositors should "take a haircut" if a bank goes under with their money in the vaults. Ideas include wholesale depositors receiving, say, 85p in the pound in the event of a particular bank collapse. Bank collapses are rare: prior to Northern Rock, no UK bank had failed for a decade. And even when banks do go under, depositors often receive a large percentage of their money back, although it can take a long time. If a board isn't keen on the idea of taking a haircut or waiting indefinitely before getting its hands back on its own cash, then treasurers should redouble their efforts to check the credit rating of the bank.

It is not just a question of corporates being prudent and going for the most highly rated banks. Only one European bank has an AAA rating, and corporates will need to have an ongoing relationship with a bank before deposits will be accepted. In the past it was common to think that a bank was a bank was a bank but recent events have shown that not all banks are the same.

The volatile market conditions have also underlined the fact that a credit rating is no more than a ratings agency's considered opinion of a borrower's willingness and capacity to make payments of interest and principal in a timely fashion. Non-execs should be aware of the pitfalls. A credit rating opinion refers to the probability of default, and is not a reflection of price or market liquidity; if a crisis breaks, then a credit rating will be unable to keep up with rapidly changing events.

A credit rating is an opinion, never a guarantee, and care needs to be taken over the legal status of the investing entity. A branch of a foreign bank will normally have the same credit rating or legal status as its parent but this is not always so; in particular, US parent banks do not have to support their foreign branches. A subsidiary company operation will not have the same legal status as the parent bank and therefore may have a different rating, if indeed it has any rating at all.

THE MOST OBVIOUS WAY TO EMPLOY SURPLUS CORPORATE CASH IS TO REDUCE CORPORATE BORROWINGS, ESPECIALLY AT A TIME WHEN THE SPREAD BETWEEN INTEREST PAID AND INTEREST EARNED IS SO SIGNIFICANT.

Box 1: Treasury reaches out

The ACT is holding a regular series of events for non-executive directors on treasury and financial strategy. The event reported in this article was hosted by law firm Berwin Leighton Paisner and looked at the topic of dealing with risky banks.

Two previous events both took place in October 2009. The first was also hosted by Berwin Leighton Paisner and was open to members of the Association for Non-Executive Directors and Chairmen and the Non-Executive Directors Association. The second briefing was part of PwC's programme of events for non-execs.

The events are aimed at enabling non-execs to gain an insight into the key treasury questions they should be asking at both strategic and routine levels and what reasonable answers might look like.

The briefings also form part of the ACT's strategy to communicate the importance of professional treasury qualifications within mid-tier, and not just the largest, companies.

All events have been informative and well attended. If you or a colleague is interested in future events, please contact Louise Tatham at **ltatham@treasurers.org**

SECURITY IS THE KEY. According to O'Donovan, it is not possible to overemphasise the importance of security when searching for an institution in which to place funds. He also noted that the most obvious way to employ surplus corporate cash is to reduce corporate borrowings, especially at a time when the spread between interest paid and interest earned is so significant.

Non-execs should also be aware that working capital balances can build up and should be taken into account along with longer-term monies. Corporates need to limit the amount of money they want to place with any one institution. O'Donovan suggested as a rule of thumb that non-execs should ask themselves how much money could be lost for it to constitute an absolute disaster for the company – perhaps 0.5% of revenue or 2.5–5% of assets. The overall strategy needs to be part of a board-approved policy and there should be regular reporting from the treasurer (perhaps via the FD) to the board, with agreed controls, information systems and audit in place.

The lesson from the working lunch, which took place on 4 February, is that everyone has become more credit-conscious but treasurers need to work with others in the organisation including non-execs, to work out what that means in practice and how it impacts the business.

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