The Association of Corporate Treasurers

# Briefing note:

## Corporate investment of liquid funds

London, March 2009

Rev: V1 Updated May 2009: Para 6.1 iv): clarification; Para. 10.1: new edition of book published.

July 2009: Para 6.1.iv footnote 2: European MMF Definitions

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## The Association of Corporate Treasurers

The ACT is the international 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.

The ACT defines and promotes best practice in treasury and makes representations to government, regulators and standard setters.

We are also the world's leading examining body for treasury, providing benchmark qualifications and continuing development through education, training, conferences, and publications, including The Treasurer magazine.

Our 3,500 members work widely in companies of all sizes through industry, commerce and professional service firms.

For further information visit www.treasurers.org .

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

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# Corporate investment of liquid funds

## 1) Introduction

1.1 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.

## 2) Context and governance

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

2.2 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.

2.3 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 or companies set up for the purpose.

2.4 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).

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

2.6 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.

2.7 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.

2.8 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, regular 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. Where there is no Finance Committee the Main Board will itself carry out the role.

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

## 3) Investment of liquid funds

3.1 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 periodically, commonly 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.

3.2 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.

## 4) Principles of liquid funds investment

4.1 The old mantra is security, liquidity, yield – in that order – SLY for short. After all the treasurer's job is to provide funds in the right amount in the right place at the right time.

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

4.3 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[1] with some use of corporate commercial paper. In normal times, banks and liquid money market funds dominate but CP investment can be large for the companies which use it.

4.4 The company would normally set a credit limit for the counterparty.

4.5 A second level of protection will be sought from a reasonable diversification of the investment if it is other than very small.

4.6 The company will pay attention to the liquidity of its investments. Liquidity is the idea of the ability of the investor to realise the value of the investment at short notice and prior to its maturity if the need should arise.

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

4.8 This approach to investment security is not designed to be event-free under all circumstances but to be such that, systemic failure apart, a credit event, while damaging, unwelcome and embarrassing, is unlikely to be catastrophic to the overall liquid asset portfolio or the company/group overall.

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[1] It is important to distinguish these from enhanced yield funds with greater credit and liquidity risks which are not suitable for investment of temporary liquid funds – see 6.1iv)6.1iv)).

## 5) Counterparty credit limits

5.1 A credit limit will be set for the company's entire group's exposure to the counterparty, whichever units, holding company or subsidiaries etc. were incurring the exposure and whether the exposure arose from investments, derivatives, letters of credit or guarantees, day-light (intra-day) exposure on payments, or howsoever. For practical and control reasons, separate credit limits within the overall company group limit will usually be set to be used by each company group member.

The counterparty credit limit would be set for that particular (obligor) legal entity – paying attention to its own circumstances, for example how/if it is regulated and by what regulator and its own credit rating. If dealing with more than one entity within a group, credit limits would be set for each and for the group overall. A guarantee from other parts of the group may be sought.

Ownership apart, other connectedness between counterparties would require an overall limit to be set for that factor – for example an overall limit for counterparties from a particular jurisdiction.

Some companies include in their group credit limit exposures those arising in their related parties (non-consolidated joint ventures or pension fund exposures, for example) while others may have separate risk limits for such entities. If the latter, regular attention to the total potential exposure is essential.

5.2 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".

5.3 As investors, 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 often mark for a bank a much smaller credit limit than the bank would mark for the company.

5.4 A counterparty limit set (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 counterparty. (We discuss the use of credit ratings in the companion briefing note "Bank counterparty credit assessment for companies" – see 10.1.)

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.

The limit will take account of both the probability of default by the counterparty and the expected extent of loss if default should occur.

5.5 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.

## 6) Diversification

6.1 Diversification would usually be by obligor/guarantor and by type of obligor as well.

A portfolio would commonly be built up from the following investment types.

i) **Banks** (and with attention to the home regulators of the banks) (see 10.1 below).

ii) Some companies seek diversification away from the financial sector (see also iv) below,), and perhaps some yield enhancement while sacrificing some liquidity, by buying **corporate commercial paper** directly from the issuers' dealers.

iii) Today, given the availability of the type of money market funds discussed in iv) below, few companies invest directly in **government (treasury) bills**.

iv) To achieve more, second hand, diversification, companies may use **liquid money-market funds**[2] which provide same day investment and liquidity but access to income generated by the longer average duration of the fund's investments. This also partly delegates the credit assessment to the fund assessing the underlying investments with the company just having to assess the fund.

(a) It is necessary to undertake initial and continuing due diligence on the funds' investments, be selective about the funds used, look for a powerful fund sponsor and limit total investment in any one fund to a small proportion of total fund size and an absolute amount.
(b) Such funds invest in a number of underlying investments, giving diversification.
(c) Such funds usually have a high proportion of investments in financial sector obligations, limiting sectoral diversification. However many funds include 10-15% of investments in corporate obligations and some go up to 30 or 35%
(d) Some funds, majoring on investment in government bills in the relevant currency (for US funds US government obligations) with perhaps 80% in such obligations may be seen as having lower risk but show a lower return.

Do not confuse liquid money-market funds[2] –.which seek to provide a constant net asset value through utilisation of amortised cost accounting – with other money market funds which seek to provide high income through a longer dated/higher risk portfolio and which provide a variable net asset value by relying on mark-to-market pricing.

## 7) Liquidity

7.1 Liquidity is secured by the willingness of the counterparty to repay, with appropriate interest adjustment, early, the opportunity to sell the investment to someone else at a fair price or to use the investment as security for a borrowing or in a repo. Overnight investments, US and UK treasury bills and

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[2] Such funds, rated AAAm from Standard & Poor's, Aaa/MR1+ from Moody's and AAA/V1+ from Fitch, in Europe follow the IMMFA (Institutional Money Market Funds Association) Code of Practice (http://www.immfa.org/About/Codefinal.pdf). They are all "Short term" MMFs under the European Fund and Asset Management Association money market fund classification (http://www.efama.org/). In the US, similar funds are types of "2a-7" funds and one stage of due diligence is to check that the funds' policies at least correspond to the IMMFA Code.

also liquid money-market funds which have daily liquidity, can normally be regarded as fully liquid. (Liquid money market funds (see 6.1iv) above) have some greater risk because of the maturity profile of their underlying investments although, in normal circumstances, the managers are normally able to offer same day liquidity.)

Term investments, week fixed, 30 days, 3 months, etc. are less liquid. Banks are normally willing to break time deposits, for a fee. Commercial paper may be repurchased by the bank through which it was issued (or another dealer on the issuer's programme) at a small spread unless the paper has been downgraded since original purchase. In difficult markets liquidity disappears and, if achievable at all, breaking/selling these investments may be costly.

7.2 Credit uncertainty increases with the maturity/duration of the investment and the lower its liquidity. An investment reaching its maturity 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 to an overall maximum maturity limit policy. In times of uncertainty, investment period limits tend to be reduced.

7.3 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 balanced against the returns which can be expected.

## 8) Yield

8.1 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.

8.2 Yield comes last in the treasurer's priorities – all the time and not just during financial crises – but, within that context, some attention is paid to it as otherwise all would invest only in short treasury bills.

## 9) Set off

9.1 It is important to consider the effects of any netting or set-off agreements with the counter-party and, where there is such an agreement or agreements their applicability and enforceability and the need for gross and net limits.

## 10) Other sources

10.1 Attention is drawn to:

- The companion guidance note, "Bank counterparty credit assessment for companies" [available from http://www.treasurers.org/investingcash].

- The Treasurer's Global Guide to Investing Cash, from HSBC Global Asset Management in association with the ACT, Guy Voizey (Ed.), WWCP Limited, Milton Keynes, 2009 [ISBN: book 987 1 899518 24 1; CD ROM 987 1 899518 25 8]

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Rev: V1: Updated May 2009: Para 6.1 iv): clarification;
Para. 10.1: new edition of book published
July 2009: Para 6.1.iv footnote 2: European MMF Definitions