Post Sub-prime: The Impact on Treasurers Managing Liquidities

François Masquelier, The European Association of Corporate Treasurers (EACT)

What has been the impact of the sub-prime crisis on treasurers managing surplus liquidities? This crisis has considerably modified investor behaviour as well as the investment products on offer. This article will tackle the first lessons of the aftermath of the crisis, as well as the consequences for money market funds.

Nobody can dispute that non-financial companies have accumulated excessively high cash war chests in the past few years. According to some studies, a quarter of major European companies have more than €100m of liquidities to place in the short-term. Treasurers have become very cautious in terms of investment duration. Some might think that they manage liquidities as if they had to be permanently capable of taking out billions of euros from one day to the next. CFO's often struggle to precisely define the horizon of liquidity investment. This makes the task all the more delicate for a treasurer who cannot, from now on, benefit from market opportunities and from the possible steepening interest yield curve.

It is a shame not to be able to better define the need for treasury to optimise investments, but they have all accumulated liquidities through over-reaction and excessive caution in recent years. The share of surplus is often unequivocally linked with real needs. Many decided to buy back shares, thus benefiting from the weaknesses of share markets. Others have been tempted to invest their surplus, keeping in mind the fear of sooner or later being penalised by the famous 'goodwill impairments' in IFRS. The fact remains that investing your funds in the short-term, even if rates of interest have increased, destroys value (in general) for those whose operational activities are more lucrative and remunerative. A rich person's problem you think? Undoubtedly...

Context

In this context of liquidity overabundance, the sub-prime crisis has come to knock on Europe's doors. It has indirectly affected all of the monetary fund market. However, liquidities invested in money market funds (MMFs) have never achieved such levels. It is estimated by IMMFA that, in May 2008, a total of €400bn (US$620bn) was invested in MMFs, in other words an increase of around 35% compared to last year.

Globalisation and interconnection between all financial markets make the management that ensues more and more complex. Diversifying risks is sometimes similar to increasing them. MMFs present this advantage of risk diversification, professional management, security (in principle) and, under normal circumstances, a response to market volatility. There has therefore been a growing demand for them in the last few years. But what is certainly lacking is a sufficiently clear and precise definition of what a 'pure' MMF is (in the strictest sense of the word, in other words genuinely in the short-term and easily re-sellable).

Treasurers: Investment Strategy Problem
The difficult equation that the treasurer faced was how to maximise interest income while:

- Diversifying risks.
- Remaining very liquid.
- Favouring main bank relationships.

Wanting to remain liquid is praiseworthy but represents a cost (failure to earn interest) and is a long way from being optimal. A lot perform badly by wanting to remain too liquid in their treasury management. Often strategies and objectives aren't aligned or very adequate. It's a subject that CFO's may have neglected too often in Europe. Last summer's events reminded everybody that this market could present considerable risks because of a lack of visibility on certain funds qualified as dynamic, or even because fund managers were frantically searching for a higher return. Very high returns should have warned investors about what the underlying risk really was. With a minimum of common sense, how can you not be worried about seeing a monetary fund significantly beat the reference index? A lot were too naive or blinded by the returns offered, believing they had found the real management gem.

This crisis also involved a more particular focus by internal audit committees on managing liquidities and the reports that ensued. It was necessary to increase how often these reports appeared, develop their content more beforehand and explain the adopted strategies more clearly. In the past, corporates have certainly neglected this aspect of reporting to management and the quality of information supplied to the CFO.

Customer/Investor Behavioural Change
In light of the huge shifts in the market over the last year, MMF users have set off on a triple flight:

- Flight to quality.
- Flight to transparency.
- Flight to liquidity.

This is the new credo for investors. Treasurers are looking to diversify their investments to reduce their counterparty risks. In continental Europe, we have been able to notice a certain return to 'classic' bank deposits, although this in no way involves reducing the credit risk. Quite the contrary, it involves concentrating the credit risk on a single debtor. Certainly a deposit is simpler and more transparent than an MMF, but it offers a distinctly lower return. It's true that some banks, especially at the end of last year, were sometimes led to somewhat overpay the offered return to attract new liquidities and refinance themselves. The more 'dynamic' treasurers (notably in France) abandoned aggressive management (even limited to a reasonable alpha) to concentrate on a more sensible strategy, exclusively based on 'treasury-style' MMFs that are purely monetary. Some of those who were already more careful preferred to turn to simple bank deposits. Furthermore, in keeping with the cautious tone, the UK seems to have turned to sovereign funds with compulsory type underlying assets issued by sovereign issuers (bond/gilt/bund funds).

European treasurers are also looking to classify their assets in IAS 7 (cash and cash equivalent). This highly accountable approach aimed at maximising the net cash situation or minimising the net debt involves investing in sounder funds with a shorter than average maturity (i.e. less than 60 days). Others courageously decided to invest directly in underlying assets (such as commercial paper, obligations or paper in the short-term) with all the risks and follow-up this involves.

To increase the effectiveness of the management and the return, treasurers have made huge efforts in the past few months to increase the predictability of incoming and outgoing funds. They have made huge progress in strategically managing their working capital. The ultimate objective is obviously to reduce the volatility of markets and financial income. This can notably go via diversifying portfolios and diversifying underlying assets. But the increase in liquidities, which isn't drying up, also involves having more suppliers and sometimes turning to other MMFs (to avoid exceeding limits fixed internally). An acknowledged indirect consequence is also to see that a number of them focus on the main banks with which they have privileged, significant relationships. The three-month euro deposit has been very popular lately, given the higher slope of the curve and the behaviour of the rate curve.

There has again been a renewal in demand and interest for online trading platforms (whether single-bank and owner or even multi-bank portals). The idea is to simplify processes, secure them, interconnect them (interface) as well as develop reporting capabilities.

Everybody has revised their internal policies to again fix products authorised for short-term investments more accurately and strictly. The ensured interest income has become more significant than the hope for excess returns. It could be said that a majority of treasurers in Europe have been overcautious.

Banks/Fund Manager Behavioural Change

European banks have turned increasingly towards funds with the AAA credit rating type. Likewise, as touched on earlier, banks now favour pure treasury funds in the US meaning of the term (no longer investment-style, but treasury-style). They adopt distribution more than capitalisation net asset value (NAV), similar to providing a more UK-style product. They reduce or exclude asset-backed securities (ABS) type underlying assets in their portfolios. Here, a number of the smallest 'players' have, at least temporarily, disappeared from the market. Major institutions have deliberately decided to reduce the number of products offered. They have finally favoured contacting their customers, especially in the 'hottest' post-crisis periods to reassure them and answer their numerous questions. As always, a crisis has one thing going for it - it allows behaviour to be modified and processes to be improved. More virtue and transparency were certainly not a waste of time in this case.

Need for a Better Definition of 'MMFs'

According to the Institutional Money Market Funds Association (IMMFA), it is necessary to define exactly what the name 'monetary fund' covers. Its chairman, Donald Aiken, encourages trade associations, including the European Association of Corporate Treasurers (EACT) and international regulators, to look into this definition. This would avoid errors and misunderstanding among investors. We shouldn't confuse a 'real' MMF with another similar fund but with a higher risk profile. It is unfair and even dangerous to claim that the risk would be the same when the duration of underlying

investments is longer (greater than three months) and that the return on investments is clearly greater than the reference indexes (e.g. EONIA, EURIBOR, LIBOR).

Position of the EACT

The position of the EACT is not fundamentally different from that of the IMMFA. Transparency and clarity should be brought in to avoid past negligence and errors of judgement regarding the underlying asset risk incurred on the simple basis of a somewhat usurped name. The EACT, just like any number of national treasurer associations, thinks that distinguishing a 'pure' MMF (treasury-style - with the AAA-type rating) from other cash funds or so-called MMFs is absolutely crucial. Turning to 'pure' monetary funds with an AAA rating (IMMFA funds) has shown during the crisis that it was possible to guarantee liquidity while offering a solid return greater than the EONIA index (for euro funds).

Treasurer associations generally think that more automation of input and transaction processing processes is needed and that we must encourage the market to develop online trading platforms, without favouring one or the other for the moment. We don't doubt that turning to such computing solutions will soon be a best practice. Treasurers are waiting for efficient interface-ready solutions, totally multi-bank and, ideally, free.

Treasurers who have less experience in investing in MMFs will have to learn this type of management, its functioning and inherent risks, but also adopt strategic models like those used by the major financial institutions. The suitable method to combine income (to be maximised) with risks (to be reduced) will remain a tricky equation to resolve. They must define the objectives and then adapt their strategy to these. But in any case, they will have to inform their CFO of the risks of this management adopted for liquidities. There again, having a better understanding of your financial obligations and future needs, as well as 'cash-out/in', allows you to maximise liquidity management. This occurs beforehand via an excellent cash forecasting process. Finally, managing different currencies provides a greater dimension and complexity in managing liquidities.

Conclusion

It is obvious that treasurers have modified their behaviour as far as short-term treasury investments are concerned. They have become extremely cautious - 'once bitten, twice shy' as the popular saying goes. Diversification and the best knowledge of the products you invest in have become essential. You need to align the strategy with sought-after objectives and inform the management of the choices made, to avoid any inconvenience or unpleasant surprises. Concentrating risks on simple bank deposits doesn't seem to be the solution to our problems. Worst still, this increases the risk. Who can say today that the (bank) credit risk is purely theoretical when everyday you hear about the abysmal losses recorded by the financial sector?

Better defining your investment policies and improving future flow forecasts are both keys to managing liquidities in the short term. Treasurers must abandon 'dynamic management' that now and then could be compared to 'dynamite management'. The right allocation of funds is a skill to which a number of treasurers must still inure themselves against. Sometimes they have not been rich for long

enough to fully master this management and have sometimes had to confront the pangs of market volatility and the indirect consequences of the sub-prime crash.

The misuse of the term 'MMF' has been one of the major reasons for this situation and the losses shown by some companies in managing their liquidities. Paradoxically, managing a surplus of liquidities has become almost more complicated than managing a bank debt.

The fact remains that in order to learn, nothing is more efficient than practicing this management, with great caution. Often investment policy and objectives weren't sufficiently in line with one another. Expectations were obviously disproportionate and the risks taken were too great and underestimated.

In the time of growth markets, treasurers were shielded. When the markets slow or reverse, treasurers were sometimes surprised by what they thought were dynamic but were in fact potentially very dangerous trends. A treasurer's experience is sometimes made of pitfalls that they must master and avoid. But this market has certainly become more virtuous. Isn't that already a satisfaction at the very least?