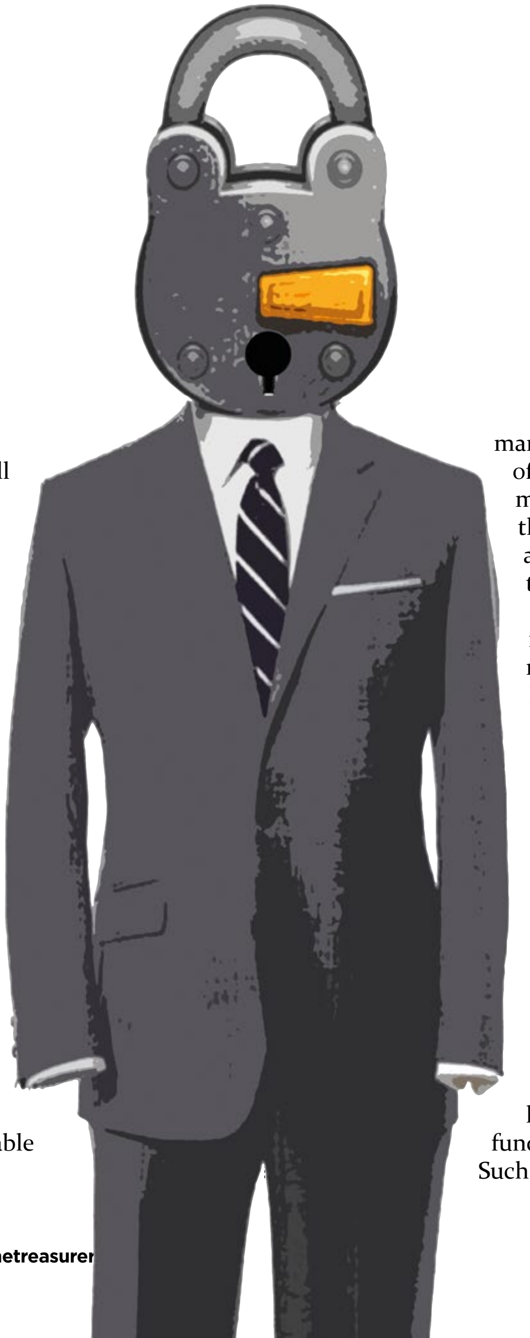
Safety first

Following the launch of the ACT's Certificate in Treasury Fundamentals, Doug Williamson explains the treasurer's most fundamental responsibility, and the essential behavioural skill you need to fulfil it



The primary duty of the treasurer is to safeguard the organisation's money at all times. For this reason, the ACT's motto is 'Prosperity through stewardship'. The recent Icelandic banks saga shows why.

Don't catch a cold

In 2008, Icelandic banks were offering depositors interest rates significantly higher than those available from other banks with similar credit ratings at the time. The Icelandic banks collapsed and went into receivership on 7 and 8 October 2008, leaving substantial amounts of overseas investors' funds frozen and at significant risk of loss, including £1bn invested by English local authorities.

The UK Audit Commission found that a number of local authorities and others had breached official guidance and their own internal treasury management rules, by continuing to invest in Icelandic banks after the banks' credit ratings had been downgraded below acceptable levels.

These ratings downgrades and other available information should have prompted treasury managers to review the creditworthiness of the Icelandic banks. Better treasury managers recognised the risks and managed them appropriately. Others either did not appreciate the risks, or underestimated their importance.

Some investors responded by making fewer new deposits, but did not actively manage deposits that had not yet matured. It is sometimes possible to break a deposit before maturity. Some banks charge a fee or a penalty to return funds, but others do not. There was a general reluctance to break deposits, or ignorance of the facility to do so.[1]

Don't go bankrupt

The priority for the treasurer is the safety (security) of the amount invested. We must get all our money back on time when the investment matures, to meet our payment obligations. If we don't, we may go bankrupt.

We can go bankrupt if we hold other longer-term assets, or if we get our invested funds back eventually, but only after a delay. Such a delay can be fatal for the organisation.

Be SLY

Expanding on the guiding principles for short-term investment, they are security, liquidity and yield. These three principles are often abbreviated to 'SLY'. The order of the three principles is important. Security is the overriding priority.

Security

There are two main risks to the security of investments. These are counterparty risk and market price risk.

Counterparty risk is the risk that the counterparty will not meet their obligation to repay the principal and interest in full and when due. Market price risk is the risk that on any sale prior to their maturity, investments may be worth less than expected.

As a general rule, short-dated instruments carry lower market price risk and lower counterparty risk, compared with longer-dated instruments. It is safer to invest shorter term.

Liquidity

Liquidity is the ease of converting an investment into cash at any time prior to its maturity, without unduly affecting its value.

The most liquid investment is an 'on demand' bank account, for example, a deposit account. For investments other than bank accounts, liquidity requires a deep and active secondary market in the instrument.

The depth of the secondary market can be assessed by the difference between quoted buying and selling prices, known as the 'bid-offer spread'. Generally speaking, the narrower the spread, the more liquid the market.

Yield

Provided security and liquidity objectives have been satisfied, only then can the treasurer properly seek to optimise yield. There is a trade-off between yield and security and liquidity. If, for instance, liquidity is an overriding priority, some further sacrifice in yield will have to be accepted.

Treasurers should be extremely suspicious of apparently high-yielding investments that claim to be, or appear to be, low risk. There is usually a catch.

Too good to be true

Turning back to the local authorities investing in the Icelandic banks, the unusually high rates of interest being offered should have sounded loud warning bells for all investors.

Sophisticated investors were already aware of the high levels of risk in investing with these banks, and they were wisely steering clear. This was why the Icelandic banks were compelled to offer such high yields, to try to attract increasingly desperately needed funds.

Resist pressure

The UK Audit Commission suggested that local authority treasurers had been under pressure to maximise returns to balance their budgets, leading to some treasurers wrongly prioritising yield and running excessive investment risks.

Treasurers need the commercial acumen and behavioural skills to resist this kind of pressure.

Ultraconservative

The proper appetite for risk is not driven by chasing yield, but by the nature of the organisation's business and its economic environment. Simon Kilonback, group treasurer for Transport for London (TfL), emphasises the prime importance of security for his organisation as follows:

> TfL has £4bn in cash reserves… As you would expect of a body that spends public money, it takes an ultraconservative approach to cash management and investment, prioritising security and liquidity over yield.
>
> "I worry enormously about counterparty risk. It's probably the one thing that keeps me awake at night. This is public money. We have to find a safe home for it."[2]

Diversify

Another important dimension of security and liquidity risk management is to avoid putting all of the organisation's eggs into one basket, or even one type of basket.

Matthew Norris, assistant group treasurer at oilfield services company Petrofac, observes:

> "I see more companies concerned about the banks, resulting in a preference to diversify into money market funds, liquidity funds and commercial paper. They are more worried about security and liquidity than yield."[3]

Excellent learning returns

Turning to your learning, naturally you want an excellent return from your investment of money and study time. To achieve your goals, your time investment needs to be substantial and sustained. Your future treasury career will benefit immensely from the increased depth and breadth of your practical understanding.

If you are in the first cohort of Treasury Fundamentals candidates taking your assessment in September 2015, I wish you the very best of luck. Though when you are well prepared, as you will be, luck will have very little to do with your undoubted success. Your substantial safety margin will be unbeatable.

1 Based on extracts from *Risk and return. English local authorities and the Icelandic banks*, UK Audit Commission, March 2009. archive.audit-commission.gov.uk/auditcommission/subwebs/publications/studies/studyPDF/3514.pdf
2 *The Treasurer*, July 2013, page 27.
3 *The Treasurer*, December 2014/January 2015, page 33.

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