

Shock-Proof Finance

By Margaret Yao

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(CFO Conference Moderator):

Welcome back. We're going to hear a presentation from Margaret Yao. Margaret is the managing director and Asia-Pacific head of liquidity management in investment products for J.P. Morgan. She's based in Hong Kong. She leads a regional team of product and sales specialists, managing J.P. Morgan treasury and security services, deposit liquidity, and investment projects around the region. Margaret, I'd like to invite you up to the stage.

Margaret Yao:

It's an honor to be here today, and the topic that I'd like to share with you today is around a best practice framework for liquidity management and share with you the concept of shock proofing finance.

In normal times, liquidity management is often taken for granted and treated as a routine activity within working capital management. Today, as companies globally are struggling with dealing with business and financial challenges by the weakening economy, credit market dislocation, and limited funding access, liquidity management has gained center stage. In fact, it's the most frequently discussed topic by CFOs and treasurers.

What you will hear today should be relevant in good times, not just difficult times. So for the CFOs and treasurers who are already adopting similar rigor in how you manage your company's liquidity, I hope you will find this presentation a useful validation. For those of you who are assessing how you might want to shock proof your finance function, I hope you will find this presentation a useful framework for the assessment.

Let me briefly run through what I'll be covering in the next 20 to 30 minutes. We will be looking at current trends and market reaction. I'm not going to be focusing on the trends, but I wanted to share with you the myriad of reactions that we've seen from our clients. Some of them are very strategic, but I'd say most of them are very tactical in response to what they have to deal with under the current financial crisis. The importance of liquidity management is just really more as a backdrop.

We'll be looking at areas in terms of how do you ensure the framework that you have is consistent and dynamic. What are the considerations when you're doing forecasting and suggestions on how you may want to segment your cash management needs? Why is it important to tie your investment guidelines appropriately to the nature and time horizon of your cash needs? I'll share with you a case study on how we've been helping companies maximize operating cash efficiency, particularly in this environment where funding sources are sometimes limited. The most ignored area is really generating excess liquidity or cash flows from your own operation.

So let's take a look at what's happening in the market. We've seen stock market volatility, credit market dislocation, limited funding options. This has caused fear and panic in the market on many fronts. What I'm going to share with you are some of the reactions that we've seen taken by corporate clients in today's environment. Companies are trying their best to ensure adequate liquidity to support their working capital cycle and making sure that the liquidity they have is both safe and accessible. Accessible is very important, as a lot of companies have come to find there are systemic risks involved in this cycle.

Cash is king. Cash is a strategic asset. We've seen companies liquidating assets, turn to their reserves, and even tapping into their credit facilities to afford cash. We've seen reaction, amendments of their investment guidelines,

definitely shortening maturity, and restricting their investment options. We have seen some companies even pull away from investing in money market mutual funds and just going strictly into bank deposits. There's definitely an increase in demand for bank deposits and a lot of inquiries about deposit insurance schemes that apply to these deposits.

The focus is on principal protection, definitely safety over yield, particularly in a low interest rate environment. Interest rates are near to zero, so the cost of not having sufficient liquidity far outweighs the negative carrying cost of tapping into the credit facilities. Flight to quality, more focus on counterparty risk, moving liquidity to banking relationships of more well capitalized banks, and banks that have a reputation for good business practice and risk management.

Companies are no longer taking things for granted. They're looking under the covers to try to understand the underlying risk of the investment portfolio that they have. For companies that have used external fund managers, definitely trying to understand the credit discipline of the fund managers managing their funds. A lot of focus is on counter party risks.

Companies are not taking cash liquidity and their access to capital markets for granted. We definitely have seen, particularly in the U.S., companies drawing on their short term facilities to make sure they have adequate liquidity to meet capital requirements. There's a huge focus, huge focus on cash forecasting, because weak forecasting combined with a limited access to a funding source can be detrimental to companies.

During benign times, we've seen many companies and many investors push the risk return spectrum in search of higher yield. As we all know, corporate liquidity should really not be put at risk. Some of the mistakes that we've seen -- many companies that have gotten caught in investing their corporate liquidity in some of the higher risk money market instruments relates to too much reliance on rating agencies, taking things for face value, and not looking deep enough to understand the underlying structures of the investments that they're investing in.

Some of the challenges have to do with poor cash forecasting. They did not take into consideration down cycles, invested too much liquidity cash in instruments that they thought would be very liquid and available on demand. But then when the market turned, what they realized was that there was significant systemic risk sometimes in actually redeeming some of the investments to meet their short term or immediate capital needs. So a lot of the knock on effect of these instruments when you try to liquidate them was not very well understood by these companies.

So what's happening now? Today investors have largely retrenched from many of the higher risk money market instruments to move into more traditional risk free types, to seek safe harbor. What's interesting about this dramatic shift is the shift away from higher risk instruments, such as auction rate securities and commercial paper, has actually left the borrowers scrambling to find other funding sources. There have been a lot of companies that in the last couple of years relied on commercial paper and those instruments to fund themselves.

At the height of the crisis in September last year, I was in New York. And what had happened was the investors had panicked, and there was about \$500 billion pulled out from money market funds. Money market funds are a big industry in the U.S., \$4 trillion, and they don't have capital. However, they provide daily liquidity when investors want to redeem the money. You can imagine the impact when all of a sudden retail small investors were panicking and pulling money out of these money market funds. They had no option but to try to sell and liquidate their portfolio in order to meet the demands, so that also creates the dynamic of companies relying too much on commercial paper for financing found themselves in a very awkward situation.

These days a fortress balance sheet is a strategic asset. When the balance sheet weakens, liquidity becomes more important. Lack of liquidity is often the reason for financial insolvencies. This may sound very basic, but having cash at the right place at the right time is very important. There really isn't anything worse than discovering that the liquidity your company relies on is really not there to meet your payment obligations.

An optimal liquidity management framework in our mind needs to cover a few things. First of all, your cash forecasting has to cover your actual and potential cash needs. Safety diversification and accessibility of your liquidity is of paramount importance, and you need to consistently test and expand your alternative funding sources. We will discuss a case in terms of how I see this as a tipping point. The adversity actually creates an opportunity for companies to start looking at how well they're optimizing their cash position. Global companies, are you leveraging internal cash flows and tapping into the most affordable source of funding that you have to reduce your working capital requirements?

Listed on this slide are the tenets of liquidity management. We will be looking at a couple of best practices. The first is how do you ensure you adopt a dynamic framework? It needs to be consistent and dynamic, and I'll explain why as I go through that section. Your cash forecasting and segmenting really needs to be realistic, realistic about the liquidity you need over time.

We at J.P. Morgan recommend that clients look at the nature and liquidity requirements by segmenting your cash into four broad categories. Look at operating cash, reserve cash, strategic cash, and what I call restricted cash that may be trapped in certain jurisdictions or certain legal entities where it's not that easy to tap into. So we'll be looking at that.

When looking at investment guidelines, I've worked with a lot of companies. Some of them have very good investment guidelines, but then they do not segment their cash. So what we're recommending is you have to look at the nature of your cash, segmented, and perhaps apply different criteria and guidelines, depending on the nature of the cash. So we'll go through a couple of examples in terms of what I mean.

Don't rely on a single source for your funding. Never take cash, liquidity and capital market access for granted. But it's also important to test your funding source. Test your funding sources for resiliency to make sure they're there when you need them. The most affordable funding source may be your own internally generated cash flows, so we will be looking at an example in terms of how you could maximize cash efficiencies through that.

For companies who are global with operating entities all over the world, it's important to have control visibility over the cash held by your different legal entities. And in that regard, it's important to simplify your banking structure and partner with the right bank, so that you can optimize efficiency not just from a liquidity management perspective, but from an operating perspective and from a cost perspective, as well.

It is important to adapt a very dynamic framework, and the framework needs to work in normal business cycles, as well as market downturns. Companies that rely too much on "business as usual" models tend to underestimate the risk of the extreme, but probable scenarios. When you're doing your downside planning, it is useful to actually assume what you need if your business funding sources were to be shut down for a sustained period. Do you have enough liquidity put aside to make sure you could manage through your business cycle or your working capital cycle? Because of this, it is very important to look at the nature and the horizon of your cash flows.

It is important to understand why you're holding cash. Are you holding cash for working capital requirements, for potential capital expenditure, for debt repayment, for repurchases, or dividends, or for acquisitions? Understand the nature of your cash requirements. And then for every requirement, make an assessment on whether it's short-term, medium-term, what's predictable, what's discretionary and not discretionary. Put all these elements in mind when you're thinking about striking an optimal level of liquidity. Again, a liquidity shortfall in this environment is pretty detrimental. Sometimes it's better to keep more than you normally would just to make sure that you don't get caught.

In order to ensure that you have the right amount of cash in the right place at the right time, it actually requires accurate and conservative cash forecasting. We need to adjust our cash forecasting frequently to reflect the business environment and the market changes. Develop a range of forecasts, not just daily to medium term. You may even want to push it out a little longer, 18 months plus. This will allow you to identify a suitable cash position to maintain, and then appropriately invest the cash positions that you have based on your cash forecasting, ranging from overnight to medium or long term. We believe cash should be segmented into four different segments — operating cash, reserve cash, strategic cash, and restricted cash.

Operating cash is what is required to fund your daily operation. It's not entirely predictable, and it may be subject to unforeseen volatility. For this portion of cash, safety and liquidity is of paramount importance, and the decisions around investing this cash typically is daily.

Reserve cash, in our mind, is really your liquidity cushion. It is more predictable, and it's maintained to meet short-term requirements. In conditions of market volatility, there may be days or periods where you have to dip into your reserve cash.. So it is important to further layer your reserve cash to make sure you have the right amount available on demand to meet unforeseen volatility in the market.

Strategic cash is your war chest -- Most stable, held longer term. With many companies I've actually seen them hire external managers to manage that in separately managed accounts. I've also seen companies that actually have a whole treasury area that do direct purchases of money market instruments to manage to this cash. And unfortunately some of them did get caught by searching for more yield, and trying to do the analysis themselves, and relying too much on credit rating agencies.

The restricted cash pool is separate from the three that I just described. It's cash that's trapped in certain legal entities that you might have within the group or within foreign jurisdictions. You cannot tap into that cash that easily. And when you're looking at these cash pools, it's important to apply the same rigor in terms of how you segment these cash pools in restricted entities or jurisdictions. Look at them in terms of operating, reserve, and strategic cash, and the time horizon in terms of the deployment of the cash when you're considering investing it.

Operating cash, as I mentioned, needs to be in the most secured investment option. Since daily availability is important and it's tied very closely to your working capital and cash management requirements, these are typically left in operating accounts. Left with cash management banks, the banks that you conduct your cash management business with, and if it's in the U.S., there's no interest paid in the current account, so we have seen clients actually tie it to an end of day investment sweep in order to get a little bit more yield. Outside of the U.S. in a lot of countries, banks are allowed to pay interest on this operating cash. So that's the typical, most likely area where most companies keep their cash..

The reserve cash is a liquidity cushion. It's like an insurance policy in case you need to tap into it. The areas that we see companies investing reserve cash tends to be in time deposits. They may stagger the maturity of the time deposit to ensure that they always constantly have a very liquid portion maturing every day, in case they need to tap into it. Some have invested in money market mutual funds as I have mentioned, because these have daily liquidity so some of the systemic risks around when you all of a sudden want to tap into it was really not quite well understood back in the fourth quarter of last year.

Higher yielding savings accounts in the U.S. — this would be money market deposit accounts. Outside of the U.S., in a lot of countries there are deposit types where it's not really meant for operating cash, but the banks do pay a slightly higher return. So that's where we are seeing most companies keep their reserve cash.

Strategic cash — again, longer time horizon. You may use external fund managers, or you may have a treasury department that actually actively invests that directly in the market. Restricted cash — again, you can think of markets like China or India where cash is not that easily taken out of the country, and it needs to be managed as a separate pool. The investment options available are driven by the jurisdiction or the banking environment in that particular country.

Setting investment guidelines are really about setting the appropriate investment guidelines. The investment guidelines that you set should be reviewed periodically to ensure that it meets current objectives, not historical practices. I'm pleased to share with you that a lot of companies have looked at their investment policies recently and started tightening and revamping it a lot. Your investment guidelines should address what are authorized investments. Are there any maturity restrictions around these authorized investments? And to the extent that you're segmenting your cash and applying guidelines to different types of cash, this is where the maturity restriction definitely comes to play. Credit quality, what's acceptable credit quality to you? Approved counter party and concentration limits.

Having an investment policy in place and filing it away is not good enough. What we need to ensure is the policies are actually monitored and reviewed periodically to ensure that the investments are in compliance with what the Board or the investment committee has approved, and also making sure that there's sufficient accounting controls in place in case you need to mark to market or assess the investments that you have.

It's important to diversify your contingent funding sources, verify their availability. When you're negotiating terms, avoid terms that will restrict your accessibility. It's going to be a trade-off. Prior to the crisis last year, what we've seen is very aggressive management of liquidity. I've been in situations where treasurers are trying to fund a very big payment or a transaction, close on transaction, and they have funds invested in various money market mutual funds or with other banks. And what they come to us and say, I need to close on this transaction today, and you will be receiving ten different payments from ten different sources to come into my operating account. And then I want to send a payment out. It was very aggressive management. They didn't even want to lose a day of interest by pre-funding the accounts to make sure the transaction goes through without any hiccup.

More and more these days, what we are seeing is rather than risk not being able to fund a huge transaction that needs to close on a particular day, companies are more willing to call their investment banks two or three days earlier than the actual day they need to make the payment on, just to make sure that they don't run into any hiccups or systemic risks or any delay in the incoming funds that would affect them. So again companies are beginning to be more aware, more conscious, and not really risking their liquidity and their reputation by not being able to execute a payment when it needs to. Again I will move into what I think is the most neglected before this time of a source of funds, which is really internal cash flows — cash flows that companies have within themselves to maximize self-funding opportunities before you even tap into bank lines.

Best practices, with a lot of U.S. and European headquartered companies, concentration is not a new concept. Early adopters have been companies in the U.S. and very large companies in Europe setting up centralized treasury, regional treasury, around improving control visibility over their global cash flows. In Asia, I think we've seen some companies going very global, and they've built their banking business over time. They're beginning to take a look at what's the best

way to increase control and visibility over the cash flows generated by the different subsidiaries all over the world. We work with them a lot, and it really starts with the willingness to simplify your banking structure.

The more banks you have, the more disaggregated cash positions you're going to have, and the more challenging it's going to be to try to pull this information together for you to make informed decisions, or even to leverage these segmented positions to self-fund yourself. So there's definitely a growing trend, at least in discussions with a lot of Asian companies around, you know, this is my dilemma. This is my goal. What are the things that I should be thinking about and doing? From an organizational perspective, it's working with clients to try to see what is the best structure to help them optimize that. I'll go through a case study as an illustration of how a company actually, by putting in a more centralized approach to managing their liquidity, was able to reduce their working capital requirements.

What we have here is a large Japanese manufacturer, a car manufacturer, with manufacturing bases in Europe, Africa, North America, Latin America. What they wanted to have was greater visibility over their global cash positions, and hence the cash and operating efficiency. They already had three regional treasury centers, and they did not want to disrupt their current banking structure. So what they put in place was an overlay structure through establishing a finance and treasury center in Singapore. Using the overlay structure with JPMorgan, rather than replacing their existing banking relationship, was really to be able to upstream the liquidity from their three regional cash pools into one single, global cash management system. Through the Singapore finance and treasury center, they also created a payment factory.

The payment factory was designed to take the FX risk out of being embedded in some of their operating subsidiaries. So the payment factory was established to purchase receivables from their manufacturing subsidiaries in their own local currency. And then they re-invoiced their purchasing subsidiaries through the local currency as well.

This effectively pulled the FX risk management into one central location, so that the company could more effectively manage that exposure, and also so that their operating subsidiaries can focus on the core activities. As a result of implementing this structure, they were able to improve their foreign exchange risk management and also reduce their working capital requirements by as much as seven percent of the annual turnover, and also the net debt that the company had.

This is a good example of a neglected source of efficiency and funding source that some companies have. And with the challenge that we're facing, it's actually a good tipping point for companies to start looking at, how could they optimize the cash flows that they have within their own group as an affordable and cheaper source of funding when they're thinking about funding sources.

A Quick Recap: What I've touched on is really the importance of adopting a very dynamic framework. Be very conservative. Think about potentially segmenting your cash requirements — nature of the cash, time horizon of your cash requirements. It's not a bad idea to keep a little bit more liquid than you normally would to make sure if you get shut out of the market, you still have sufficient liquidity to meet your obligations. Investment guidelines should be appropriate, should be reviewed periodically. You may want to think about that in terms of the appropriateness for the different types of cash if you decide to segment your cash. Again think about ways of maximizing internally generated cash flows. That's very often the most neglected, but your most affordable and cheapest source of funding these days.

What I'd like to leave you with is a couple of questions to provoke thoughts around whether you've shock proofed your finance function. Think about what's the right amount of liquidity you need to meet expected and unexpected funding needs. How accurate is your cash forecasting today? Is it sufficiently conservative? How frequent are you stress testing your cash requirements? If you don't segment your cash the way I've described, that's not a problem. But you may want to think about it conceptually, whether you are actually investing your liquidity so that if you have a need to dip into your reserves, they are there for you, and you are not subject to any systemic risks. Do you have an investment strategy? How often do you review your investment guidelines and policies? Should you amend it to tighten the maturities, counterparty risk, exposure, et cetera, et cetera? And how frequently do you review your banking relationships? As we see more companies really pulling cash into their banks and keeping it with bank deposits, you should also be taking a look at the banking partners that you're dealing with. Is there room to simplify your banking structure so that you could actually help improve your cash efficiency?

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