AFP® GUIDE TO

Global Short-Term Borrowing

Global Liquidity Guide Series

Association for Financial Professionals®

Issue 5

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AFP® GUIDE TO

Global Short-Term Borrowing

Global Liquidity Guide Series

Welcome to AFP's Liquidity Management Guide to Global Short-Term Borrowing.

In today's volatile and dynamic market environment, global treasury operations are consistently being challenged with securing and managing adequate levels of liquidity. Prudent departments have instituted fundamental borrowing policies and strategies to assist in addressing these challenges. For leading multinational treasuries, deploying the right policies, strategies and risk mitigation techniques proves to be the key to ensuring the company has access to sufficient working capital finance to operate effectively.

With new risk areas continuing to surface across the enterprise, treasury practitioners must carefully monitor and mitigate the risk landmines of today's financial environment. When borrowing short-term, danger areas such as liquidity risk, market risk, counterparty risk, operational risk,

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"This guide provides key insights into common treasury objectives on global short-term borrowing and the factors that are leading so many organizations to examine how they manage proper levels of liquidity."

Jason Torgler, Reval

currency risk and covenant risk can rear their ugly heads. Without a sound foundation around policies and strategies, treasury practitioners can leave their organizations exposed to these numerous risks.

Effective foundation building allows treasury practitioners the transparency into liquidity levels and facilitates the proper assessment of their liquidity risk tolerance. Leading treasuries have built proper foundations around four key areas:

1. Global cash positions
2. Global cash flow forecasts
3. Global cash mobilization and pooling
4. Staff decision-making responsibility

This guide provides key insights into common treasury objectives on global short-term borrowing and the factors that are leading so many organizations to examine how they manage proper levels of liquidity and the transformational changes they need to undertake. It also outlines sources of risk, managing those risks, short-term debt vehicles and the role credit agencies play, while detailing case studies and real-life tips and techniques.

Each company has unique elements that require analysis and deployment of strategies and policies that best fit its organization. Additionally, these policies and strategies need to be examined and refined over time. The benefits are well worth the effort:

- to ensure adequate capital to fund operations;
- to be prepared for the unexpected;
- to reduce borrowing costs and fees;
- to mitigate risk;
- to ensure treasury credibility; and
- to provide operational efficiency.

Banks and technology partners serve as strong allies in your analysis and deployment. Lean on them for insight and assistance – the upside is tremendous.

Jason Torgler, Vice President, Corporate Strategy @ Reval

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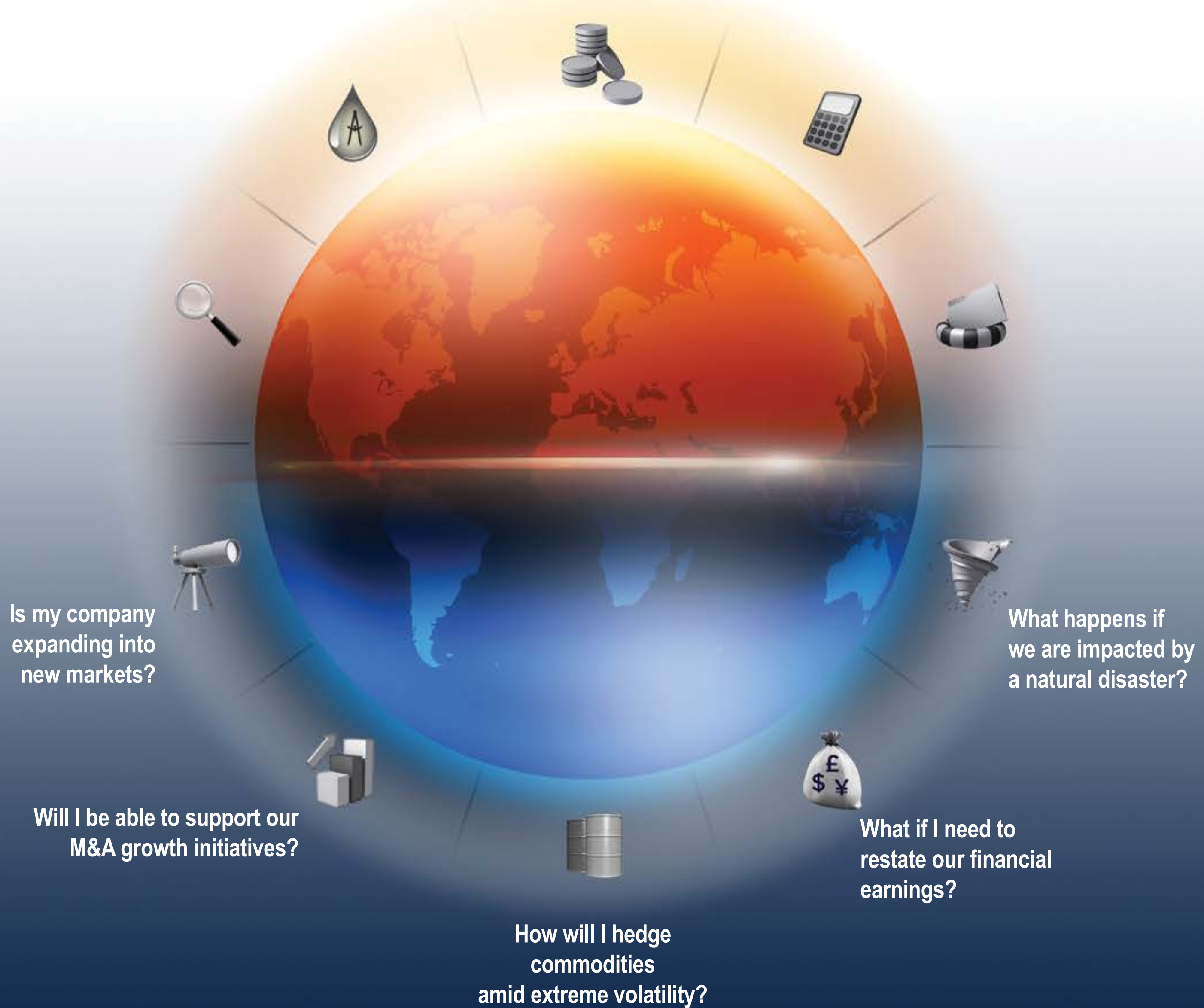
DO YOU SEE TREASURY CHANGE ON THE HORIZON?



IF SO, YOU MAY BE WONDERING HOW FUTURE-PROOF YOUR TREASURY IS.

Staying ahead of challenges known today and those yet to be uncovered requires transparency into all aspects of cash, liquidity and risk. It requires a long-term vision that will enable treasury to work seamlessly across the enterprise regardless of function, location, time zone, now and in the future.

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Introduction

This guide is designed to give the reader the tools to develop a short-term borrowing strategy and manage the associated financial risks. In this paper, short-term is defined as any period up to one year.

Fundamentally, companies seek to raise funds to support their business strategy. Short-term borrowings may be required for working capital to finance general operations, for back stop facilities for commercial paper programs, to support longer-term funding programs, or to fund opportunistic acquisitions.

As with any financial decision, there are a number of risks which need to be managed as part of the wider borrowing strategy. Understanding these risks will help treasury practitioners put in place a robust strategy in which the company is not reliant on a single source of funding, while benefiting from the lowest possible cost of funds.

Creating a Short-Term Debt Policy

Treasury practitioners can work together with the CFO with, in many instances, the board's prior approval, to develop a short-term debt strategy, a short-term debt policy, and a set of operating procedures. Treasury practitioners will be best placed to drive this process, given that the primary focus of any short-term debt strategy should be to ensure the company has access to sufficient working capital finance to operate effectively.

The Strategy-Setting Process

The first stage will be to agree an overarching short-term debt strategy. This will reflect the organization's overall capital strategy and will provide the guidelines for the treasury to develop the short-term debt policy. It is preferable that the strategy and, ideally, the policy are approved at board level.

The short-term debt strategy

The short-term debt strategy and policy are key parts of the organization's approach to both working capital management and corporate finance. In terms of documentation, the short-term debt strategy need be little more than a board minute. It should be consistent with the organization's overall approach to corporate finance. This will be set in the context of whether the organization is a net borrower or a net investor. There are three broad approaches:

- Maturity matching strategy. Organizations using a maturity matching strategy seek to fund fixed and permanent current assets with long-term sources of funding. Short-term funding is used to finance fluctuating current assets and provide general working capital needs.
- Conservative asset-matching strategy. Organizations using a more conservative asset matching strategy will finance some of their fluctuating current assets with long-term sources of funding, resulting in a lower short-term borrowing requirement.
- Aggressive funding strategy. Compared with a maturity matching strategy, organizations using an aggressive funding strategy will seek to finance more of their current assets with short-term sources of funding. This will result in a relatively higher short-term borrowing requirement.

As part of a larger capital structure plan, the strategy may also state which entity is (or entities are) permitted to arrange short-term external financing, and any targeted debt ratios/amounts (level of debt, balance of short to long-term debt, debt/equity ratio).

The real detail will be incorporated into the short-term debt policy and day-to-day operating procedures.

The Policy-Setting Process

Once the company has established and documented its overall debt strategy, treasury practitioners can

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work to develop a short-term debt policy. In terms of process, the best way to do this is for treasury practitioners, together with appropriate other colleagues (who might include the CFO or a treasury committee of the board), to develop a policy. The policy should then be put forward for board level approval. Again, the precise process will depend on the structure and culture of the company. Some companies require treasury policies to be formally approved by the full board; others are happy to devolve decision-making to a board-level committee.

The debt policy should seek to address the risks outlined below. Once the policy has been approved at senior level, it is usually appropriate (depending on the size of the organization) to devolve the approval of detailed operating procedures to the CFO and treasury practitioners.

The short-term debt policy should include the following:

- Any limits and targets for:
  - committed/uncommitted funding
  - short-term/long-term debt
  - debt/equity ratio
  - fixed/floating rate borrowing
  - lender type (bank borrowing, trade credit, money market funding)
  - borrowing by group entity (if group companies are permitted to borrow externally).
- The policy should include details of authorized instruments and permitted borrowing techniques. It should also indicate the process to approve any assignment of group assets as security.
- The policy should include details of individual responsibilities and should state which individuals are authorized to arrange and approve external borrowing (the detail may be included in operating procedures).
- The policy may name approved counterparties or set criteria which lenders must meet. Operating procedures may list limits on funds raised from each lender.
- The policy should stipulate compliance with a number of requirements, including:
  - overall financing strategy
  - covenants
  - Sarbanes-Oxley requirements
  - legal conditions.

  Operating procedures may name individuals responsible for ensuring compliance.
- Oversight. There should be a clear statement regarding the responsibility for overseeing the execution of the short-term debt policy. This may be incorporated into board level signoff of compliance with covenants and other requirements.
- Record-keeping and reporting. A number of key factors will need to be recorded and reported on a regular basis. These will include:
  - accounting requirements
  - tax requirements
  - interest expenses
  - cash flow forecasts.
- Measurement and evaluation. There should be a regular review of performance of the policy and its components against targets.
- Exception management. This should incorporate detail on how any exceptions will be managed.
- Policy review. Finally, the policy should indicate how often it should be reviewed (for example, annually or after any major corporate event), and how changes can be made to the policy outside that review.

The level of detail within the policy will vary between organizations. Many companies prefer to include much of the detail in the treasury operating procedures.

Given the varying circumstances in which short-term borrowing requirements can emerge, it is important that treasury practitioners can identify the appropriate circumstances before a borrowing decision is made.

In practical terms, treasury practitioners will need to know the amount of cash required by the business

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for working capital purposes. This will include the location(s) of any cash requirements and the currency(ies) in which it needs to be denominated. Before borrowing, treasury practitioners will also need to know the period(s) over which the cash will be required. Depending on the nature of the business, treasury practitioners may have a series of requirements: some cash may be needed the next day, whereas other cash may only be required at a known point in the future – at the end of the month, or on a specific date. Treasury practitioners may also have a series of requirements for which the precise timing remains unknown: for example, the business forecast may suggest procurement payments of USD 50 million through the course of the year, but the exact payment date will depend upon the contract agreed by the procurement team.

Having an understanding of how funds will be used by the business will also inform the borrowing decision. For example, if the treasury practitioner expects the business to have regular cash requirements, such as at month end to pay employee salaries and suppliers, then it might be appropriate to arrange funding to cover all of these requirements. On the other hand, if the treasury practitioner anticipates only a small number of borrowing requirements, then it might be more appropriate to fund each one separately.

Having a robust cash position forecasting process and an efficient global cash mobilization structure can give treasury practitioners visibility over any short-term cash requirements.

Cash position forecasting

In the first guide in this series, the *AFP Guide to Strategic Global Cash Position Forecasting,* we discussed the benefits of cash position forecasting and how it can provide the treasury team with information about the nature of borrowing requirements, both locally and at the center. Understanding where the group's cash requirements are, and for how long any cash injections will be needed, will help treasury practitioners to manage short-term borrowing.

In general terms, the earlier treasury practitioners know about a cash requirement, the more flexibility there is to arrange the most appropriate funding source(s) at the best cost. A treasury practitioner will be able to identify different sources of finance and ensure any assets given as security are used as effectively as possible.

Arranging funding at very short notice is likely to be expensive. It also represents a significant liquidity risk: in certain market conditions, a company may not have access to short-term cash, which could result in default on other obligations and the consequent implications.

Global cash mobilization

In the second guide, the *AFP Guide to Mobilizing Global Cash*, we discussed how to develop a global bank account structure which gives visibility to cash balances and has the capability to concentrate cash in a pooling structure. Mobilizing cash on a global basis via the use of notional and physical cash pools can help the group treasury operate more efficiently. These structures allow balances on various bank accounts to be aggregated, typically by currency, so that the group can more easily identify those accounts with cash surpluses and those which require funding.

Pooling cash balances has multiple benefits. From a debt management perspective, it can reduce the amount of external borrowing, as surplus cash from one bank account is used to fund another. This can be structured to take place automatically, and on a cross-border basis. Such structures give a treasury practitioner at the corporate level much greater control over debt strategy and policy. Depending on the organization's circumstances, pooling can also give treasury practitioners the opportunity to access funding in a number of different markets, and to use cash raised in one market to fund activities in other countries.

Decision-making responsibility

In each organization, the responsibility for decision-making and execution across the full range of treasury activities needs to be fully understood and documented in treasury policies. From a short-term debt perspective, organizations range from the highly centralized, where the central treasury is responsible

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for decision-making and execution, to those that are fully decentralized, where operating companies determine and execute their own decisions.

In practical terms, most organizations sit somewhere between these two extremes. In global organizations, there are two key elements to determine:

- The scope of central treasury's authority for setting debt strategy and policy. The organization's culture will have an impact on whether the central treasury can impose policy on operating companies. Broadly speaking, there are three different approaches: central treasury determines all debt policy; central treasury determines debt policy for central treasury and any cash requirements denominated in the organization's main operating currency in all group entities; or operating companies are responsible for setting their own debt strategy and policy. It is more common for companies to centralize their debt and foreign exchange management at the corporate level for control and reporting reasons.
- The extent to which operating companies are responsible for execution. This will be influenced by the cash management structure within the organization. In most cases, practical considerations mean that operating companies will be responsible for executing at least some funding decisions. These may be made after consultation with (and possibly with the approval or authorization of) the central or regional treasury. Execution responsibility should be clearly documented in the treasury procedures.

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Identifying Sources of Risk

There are a number of factors, or risks, which may prevent the organization meeting its declared short-term borrowing objectives. The challenge for treasury practitioners is first to identify and then manage any risks to which the organization is exposed in attempting to achieve these objectives. In other words, treasury practitioners need to identify the factors which might result in a failure to secure sufficient borrowing to meet the organization's short-term needs, or a higher than expected cost of funds. These risks include liquidity risk, market risk (primarily in the form of interest rate and foreign exchange risk) and counterparty risk. This section explains how these risks arise.

Liquidity risk

Liquidity risk is the risk that a borrower cannot access funds when they are needed. This can arise in a number of ways. For example, a bank may change its counterparty lending limits, reducing the amount it is prepared to lend to the organization. Market events can reduce investor appetite for particular instruments, such as corporate-issued commercial paper.

Market risk

Market risk is the risk that changes in market prices affect the real cost of funds. In the case of short-term borrowing, organizations are most likely to be exposed to interest rate and foreign exchange risk.

Counterparty risk

Counterparty risk is the risk that actions by a lender may result in an increase in funding costs for either market-driven or counterparty specific reasons, or even in the complete withdrawal of funding. This can materialize in a number of ways: a bank may exercise a material adverse change (MAC) clause, resulting in significant additional cost of borrowing; a bank may demand the repayment of an overdraft facility at very short notice; or a factoring company may increase the cost of borrowing, after difficulties in making collections from the borrower's customers.

Covenant risk

Where a borrower must comply with covenants, the risk is primarily that the company may breach them. This can result in significant penalties, up to and including the initiation of default proceedings. There is an additional risk that systems which are used to track the required metrics fail to warn of a potential breach.

Other risks

As well as these main risks, there are also operational risks which arise whenever a treasury makes a decision and executes a policy or procedure. These risks include risks of error and fraud within the treasury department, as well as systems risks (failure to execute intended decisions).

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Managing Risk

The key to a successful risk strategy lies in identifying and then managing risk effectively. In most cases, treasury practitioners will want to ensure that funds are available, before seeking to manage the cost of funds.

There are a number of different tools available to manage risk. They include the use of hedging techniques, counterparty diversification, and the selection of appropriate debt instruments. These are explored below.

Managing liquidity risk

The best way to manage liquidity risk is to work to reduce any reliance on external borrowing. Having an efficient global cash mobilization structure will help to ensure that funds flow freely within a group of companies, and will minimize any external borrowing requirement. When using such a structure to fund group entities internally, treasury practitioners will have to be aware of transfer pricing and thin capitalization rules in each location. Any structure should apply arm's-length interest rates, which must be clearly documented and consistently followed to satisfy tax authorities. Legal advice is also important, as some countries restrict the use of intercompany loans.

Where external borrowing is required, a treasury practitioner can manage liquidity risk in a number of different ways. These include:

- Accessing funding from different sources. The simplest way of managing liquidity risk is to seek funds from more than one source. This allows risk to be spread (in the event that banks merge and the company sees the combined bank cutting its overall exposure to the company), and also for the company to benchmark the cost of funds across similar lenders.
- Using different entities to access funding. Even in highly centralized organizations, it can be more effective to use a number of different entities to access funding, rather than relying on the central treasury to do so. Each entity can determine the best use of their assets as security to access funding which best reflects their needs. However, this approach can result in a reduced ability for central treasury to raise funds (as receivables and other assets across the business are not available for security).
- Accessing funding in different countries. Organizations with operations in more than one country are able to access funding more easily through their local subsidiaries in each of these markets. Some multinational companies also issue commercial paper and other instruments in more than one market, to access as many potential investors as possible.
- Accessing different types of lender. Another way to diversify is to access different types of lender. For example, a company could issue commercial paper and/or short-term bonds, seek a range of bank finance (an overdraft, a term loan and revolving credit facilities), and raise funds by selling trade receivables via a factoring agreement or securitization.
- Committed lines. To ensure liquidity, one option is to arrange committed facilities from a bank or other lender. Committed facilities are made available to the borrower in exchange for a commitment fee which guarantees funds are available, subject to the borrower continuing to meet any terms and conditions, and complying with any covenants.
- Using long-term finance to fund working capital. As previously indicated, using long-term sources of finance to fund working capital will also ensure liquidity is available as necessary. Such a strategy will usually result in the company simultaneously borrowing and investing for at least some of the time. Treasury practitioners will need to highlight this when seeking board-level approval for the short-term debt strategy and policy. A conservative board may well consider this to be an appropriate price to pay to ensure sufficient liquidity, especially as it is not significantly different to paying commitment fees for the same reason.

Managing market risk

For short-term funding, market risk arises primarily in the forms of interest rate risk and foreign exchange risk.

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In some circumstances, a company can face 'negative carry', where the cost of short-term funding is higher than the any benefits generated by the company from the use of those funds. This is most likely to arise when there is a difference in the company's forecast cash position and determining cash needs, funding an acquisition ahead of closing it, or issuing short-term funding ahead of deploying the funds more permanently.

Interest rate risk

Borrowers face interest rate risk in two ways. First, an increase in interest rates will increase the cost of borrowing for any funding arranged on a floating rate basis. Second, if an organization has fixed the cost of its borrowing, it will not benefit from any fall in interest rates. At a time of very low interest rates, this may not represent a significant risk, but as interest rates start to rise (and borrowers become more inclined to seek to fix their cost of borrowing), this will become a bigger potential issue.

Borrowers can choose a number of different ways to manage their interest rate risk, depending on their risk appetite.

- Seek preferred funding terms. The best way to manage interest rate risk is to obtain funding on the desired terms. Many organizations choose to target a ratio of fixed to floating rate debt, which can be adjusted as views of future interest rate movements change.
- Identify natural hedges within the organization. This may be easier if borrowing is arranged to fund a particular project in which the resultant cash flows can be forecast. This may also apply when simultaneously borrowing and investing: if borrowing is at a fixed rate, investing should be made at a fixed rate too.
- Hedge positions via derivative agreements. Finally, treasury practitioners can choose to hedge positions via one or more derivative agreements. These instruments are often specifically listed in debt policies and will require specific board approval and limits.
    - Swap. A swap allows a borrower to exchange one set of payments for another. This allows a borrower to fix an interest rate by exchanging a series of repayments determined by a floating interest rate with a series of repayments set by a fixed exchange rate. A borrower can also swap a series of fixed rate repayments for payments determined by a floating rate.
    - Forward. A forward rate agreement effectively fixes the cost of borrowing at a particular point in the future. This is based on a notional principal amount with a physical transfer of funds on the settlement date. If the interest rate is above the agreed forward rate on settlement day, the counterparty (usually a bank) will pay the borrower cash to compensate for the increased cost of borrowing. If the interest rate is below the agreed rate, the borrower will have to pay the counterparty the settlement figure.

      Borrowers can also use interest rate futures to hedge interest rates, although, because they are exchange traded, corporate treasury practitioners tend to prefer forward agreements.
    - Option. An option allows a borrower to protect against an increase in interest rates and still take advantage of any fall in interest rates. Borrowers would purchase an interest rate cap, which is only exercised if interest rates rise above the cap. The borrower will pay the counterparty a premium which is based on the likelihood of the option being exercised.

Foreign exchange risk

Borrowers face foreign exchange risk when they borrow in one currency and generate the cash to repay those borrowings in another currency. An appreciation of the currency in which the debt is denominated relative to the company's operating currency will result in an effective increase in the cost of borrowing.

Borrowers can choose a number of different ways to manage their foreign exchange risk, depending on their risk appetite.

- Borrow in the appropriate currency. The best way to manage foreign exchange risk is to borrow funds in each currency which can be repaid in that currency. This can be done by asking local

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entities to arrange local funding in their operating currencies to finance their own working capital.

- Hedge positions via derivative agreements. Alternatively, treasury practitioners can choose to hedge positions via one or more derivative agreements. These instruments are often specifically listed in debt policies, and require specific board approval and limits.
  - Swap. A currency swap allows a borrower to exchange one set of payments for another. This allows a borrower to raise funds cheaply in one currency and then to repay the funding in its operating currency. In most currency swaps, the notional principal is exchanged at the beginning and end of the transaction. As with an interest rate swap, a currency swap allows a borrower to exchange fixed rate payments in one currency for floating rate payments in another.
  - Forward. A currency forward effectively fixes the exchange rate at a particular point in the future. This is based on the current exchange rate between the two currencies, the term of the contract and the current interest rates in the two currencies. These can be used to fix an exchange rate when a borrower has a known commitment such as a balloon payment at a particular point in the future.

    Borrowers can also use currency futures to hedge exchange rates, although, because they are exchange traded, corporate treasury practitioners tend to prefer forward contracts.
  - Option. An option allows a borrower to protect against an appreciation in the exchange rate in which repayments must be made and still take advantage of any depreciation (which would reduce the effective cost of borrowing). The borrower will pay the counterparty a premium which is based on the likelihood of the option being exercised.

The use of derivatives to 'structure' financing is common where organizations have a funding requirement in a currency which does not have a very liquid market. In these circumstances, the funding might be packaged with a swap transaction allowing the organization to raise funds in USD and then transact its repayment obligations into its operating currency.

Managing counterparty risk

Counterparty risk arises primarily in two ways: a counterparty can change its approach to lending, or can cease operating (whether through bankruptcy or as a result of a merger).

The best way for borrowers to manage counterparty risk is to minimize their reliance on a small number of lenders. This can be difficult for smaller and rapidly growing companies (including subsidiaries of larger organizations), as they may be required to pledge certain assets as security to individual lenders.

If more than one lender is used, the treasury practitioner should try, as far as possible, to agree the same terms and conditions for all lenders. Otherwise it may be difficult and time-consuming to ensure compliance with different terms (which may include a variety of performance ratios), especially if more than one of the conditions are tight and maintaining compliance requires contradictory actions.

Managing lending relationships

Relying on a core group of funders will also require more time spent managing relationships with those lenders, especially any banking partners. Understanding the nature of the relationship with each lender is an important part of the treasury practitioner's role. This will include ensuring that banks do not overcharge for services, but also understanding that the bank's relationship with the borrower must be sufficiently rewarding for the bank. This can be difficult if the treasury practitioner is trying to award ancillary business to each lender.

Maintaining a good dialogue through regular relationship meetings is a good way for both parties to share information. Privately held companies often share more information than similar publicly held companies, as a result of a higher reliance on bank debt for funding purposes. This will also help the borrower get advance notice of any possible changes in approach to lending decisions. As banks are placed under more pressure by Basel III and other regulatory

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changes, they will be reassessing the nature of their balance sheets. This will include changes in their view of some corporate lending, both in terms of target business sectors and geographies. Even if a borrower has access to committed facilities, treasury practitioners may still need to identify new sources of funding at the end of a particular financing agreement. Just because an arrangement has been renewed in the past does not mean that it will be renewed in the future. It is also best to maintain good working relationships with the bank credit analysts. Some corporate practitioners hold an annual bank credit meeting, as well as credit rating meetings with their banks.

Ongoing dialogue will help treasury practitioners to fully understand the application of all terms and conditions. In particular, the borrower should fully understand when a bank can impose changes to conditions, such as increased borrowing rates or the withdrawal of facilities. This can be important if a borrower suddenly experiences difficulties in meeting repayment obligations. If advised in advance, a bank may be prepared to help the borrower manage cash flow by rescheduling repayments. If advice is not given, a bank may take a much tougher line and initiate default proceedings.

Borrowers should also work hard to manage relationships with money market borrowers. Any commercial paper program should be accompanied by roadshows or other techniques to build and maintain relationships with institutional investors. Maintaining these relationships, either directly or via dealers, will also help to understand changing appetites. If a borrower issues privately, it should always be prepared to consider issuing paper or bonds on a reverse inquiry as part of the process of managing investor relationships.

Lessen the impact of mergers

Another reason for having a wider pool of lenders is to lessen the impact of mergers between such lenders. These can result in a borrower borrowing funds from one bank, rather than two. If the two banks had each lent the borrower USD 50 million (and this represented the maximum permitted by each of their credit limits), the newly merged entity might be reasonably expected to impose the same credit limits, leaving the borrower short of USD 50 million. This will not be a problem until the end of any term loan, but money market advances or overdraft facilities may not be made available or could be withdrawn at very short notice. This risk can be mitigated by appropriate drafting of the loan agreement, to ensure the acquiring bank honors the pre-existing commitment.

Managing covenant risk

Managing compliance with covenants is an important task. Any breaches will result in the lender taking action to protect their investment. This may include increasing pricing or withdrawing a credit facility. For this reason, a company should have a clear set of written procedures detailing how it manages compliance with covenants. This should include a number of features:

- A comprehensive list of covenants. This should include details of any payment obligations under the terms of all agreements.
- Financial models of covenant ratios. For each covenant condition, there should be a technique for reviewing compliance, which should be subject to stress-testing.
- Details of the compliance team. This will include treasury, financial control/internal audit, accounting, legal, tax, and financial planning. Individual subject matter experts should be identified and assigned to particular covenants. This is particularly important for non-financial covenants. A training program should be put in place to avoid overreliance on particular individuals.
- Review of covenants, forecasts and models. All covenants should be reviewed on a regular basis and after any market event. Forecasts and models should be reviewed for accuracy and should be relevant to the covenants.
- Exception reports. There should be a clear procedure for escalating any emerging and potential issues to the compliance team as soon as possible. It is always better to discuss possible covenant issues

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with lenders before any breach, rather than after the event. The procedures should indicate who is responsible for discussing these issues with lenders.

For those companies which have to comply with Sarbanes-Oxley requirements, it may be appropriate to incorporate covenant compliance. This can be used to demonstrate management signoff of compliance with covenants.

More advice on compliance can be found at www.afponline.org/mbr/reg/res/reg_news/10_Practitioner-Tested_Debt_Compliance_Tips.html.

Managing other risks

Preventing fraud and error is best achieved by means of a series of robust controls to support clear limits of authority. Only specified individuals should have the authority to arrange funding on behalf of the company. This should be documented at board level (perhaps in a finance committee meeting). Banks will have to perform their own 'know your customer' checks to establish identities and will usually want a copy of a board minute to ensure the individuals are authorized to arrange borrowings on behalf of the company. Certificates of incumbency, board resolutions, and other corporate documents are often required by the bank as validation.

If funding is arranged which allows the organization to draw down funds as needed, again, clear authorizations should be in place to ensure only specified individuals can sanction the drawdown. Clear and documented processes to authorize and change settlement instructions should also be in place. This will help to prevent fraud and also help central treasury manage information about the level of funds arranged.

Treasury management systems can usually accommodate robust and auditable authorization trails. They should also be robust enough to be able to track any metrics so to warn of any potential breach of covenants, most especially by facilitating an effective cash forecasting system.

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Short-Term Borrowing Vehicles

There are a number of different borrowing vehicles available to corporate treasury practitioners. Not all types of funding are suitable for all borrowers. Some borrowers rely on one type, whereas others use a combination of techniques as part of a robust funding strategy designed to ensure liquidity at minimum cost. Borrowing can be arranged in three main ways: from the money and capital markets, from commercial sources, and from banks. We investigate these in turn.

Money and capital market funding

Short-term funding is primarily available via the issue of commercial paper. It is also possible to issue short-term bonds, either on a standalone basis or as part of a wider medium-term note (MTN) program.

Commercial paper (CP)

Commercial paper is issued by companies and other issuers, usually in the form of unregistered promissory notes. Regulations in the jurisdiction in which the paper is issued usually determine its maximum maturity. These regulations usually cover the security registration requirements of the local regulator. For example, in the USA, securities with a maturity over 270 days have to be registered with the Securities and Exchange Commission (under the terms of the 1940 Investment Company Act). Regulations also usually prevent commercial paper being marketed to retail investors. This is generally done by setting a relatively high minimum denomination for issued paper (often USD 100,000, or the foreign currency equivalent), or by explicitly limiting issuance to institutional investors. This also has the effect of pricing small and medium-sized enterprises out of the commercial paper market.

Borrowers can issue commercial paper for any maturity up to the maximum permitted in the relevant jurisdiction. Paper is usually issued at a discount to the face value, with the paper being a commitment by the issuer to pay the holder the face value on maturity. Although many investors choose to hold commercial paper to maturity, it can be sold in the secondary market, meaning that the identity of the holder may change during the paper's issuance. Many companies that use commercial paper as a source of working capital will seek to repay holders by rolling over the paper (using the proceeds of a new issue to repay investors in a previous issue). The practice of rolling over commercial paper allows borrowers to view it as a permanent source of working capital finance, while circumventing the security registration requirements of longer-term instruments.

CHART: SIZE OF US AND EURO CP MARKET

Rating	Total CP Issuance in 2012 (USD million)	
	ECP	USCP
A1+/P1, A1/ P1, A1 or P1	2,561,033	5,567,933
A2/P2	183,976	1,315,491
Total	**2,835,249**	**18,023,055**

Sources: Dealogic, Federal Reserve Board.

Most commercial paper is issued as domestic commercial paper. The largest market is the US commercial paper market. This is a ratings-driven market, such that issued commercial paper has a published credit rating from one or more registered credit rating agencies. A number of other countries also have large and established domestic commercial paper markets. In these markets, most commercial paper is issued in the applicable domestic currency.

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JOHN TUS, VICE PRESIDENT AND TREASURER, HONEYWELL

Honeywell has operated a successful US commercial paper program for a number of years. After any free cash flow and surplus cash balances, the CP program is the primary source of short-term funding for the organization. Volumes vary over time with cash flow, but, at the end of the first quarter 2013, Honeywell had USD 1.2 billion CP outstanding. The program is supported by a credit facility providing back stop funding with a USD 3 billion capacity.

As well as the CP program, Honeywell also has a trade accounts receivable program. This enables investors to purchase interests in designated pools of trade accounts receivable, although nothing is outstanding at present. Honeywell also occasionally issues short-term notes if it wants some variable rate funding.

How do you use your commercial paper program?

JT: We use our USCP program in two ways:

First, it provides short-term liquidity. Our cash flow cycles through each quarter so we use CP proceeds to fund operations or to make payments for acquisitions. These are short-term payments which we can then term out or pay down over time.

Second, our CP program is part of our permanent capital structure. We generally have about USD 1 billion of CP outstanding. This is valued by the market place and gives us very low funding rates. We also ladder our funding with a range of maturities, so we are never faced with the need to repay all the outstanding paper at once.

How do you issue CP?

JT: We have six dealers, all major banks which participate in the back stop credit facility.

We use our cash flow forecast to identify our liquidity needs. We then tend to issue CP once or twice every two week period. Having been in the market for a long time, we have built up a strong investor base which has demonstrated good demand for our paper. To support our issuance, we have an open dialogue with the rating agencies. I tend to talk with them once a month and we have formal annual meetings with each agency. I will also call them in advance of any market events, such as an acquisition.

What advice would you give to a potential new CP issuer?

JT: For highly rated companies, a commercial paper program can be a very successful tool to access inexpensive funding. The most important point is to understand whether there will be a market for your paper.

Ask yourself some key questions to work out what you want to accomplish from the program. Do you see it as a permanent source of funding, a source of short-term liquidity, or both? How big do you want the program to be? Credit ratings and company size will both play a part in this. Understand the rating agencies' requirements when putting a back stop facility in place.

Finally, meet with a few different banks to get their opinion on your paper's marketability, as they will be the ones trying to sell it in the market place.

Commercial paper is usually issued on a regular basis as a source of working capital finance for the issuer. In some cases, the issuer will use banks to 'privately place' paper, meaning the paper is sold directly to the investor (rather than being available on the open market).

Some issuers also respond to reverse enquiry, such that they issue paper to investors to meet particular requirements. This allows investors to match the investment with their liquidity requirements.

In addition, there is the Euro commercial paper (Euro CP) market, which is effectively an international commercial market allowing international companies to raise funds across different markets in a cost-effective manner.

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The most strongly rated credits have additional credit enhancement facilities. These are usually in the form of back stop credit lines from banks, designed to ensure the repayment of principal on maturity (in the event that an issuer cannot 'roll over' the paper to a new issuance). An issuer will need to incorporate the cost of arranging these lines or other facilities into the overall cost of funding. Arranging back stop facilities will reduce the ability of the issuer to arrange other sources of bank funding.

One of the key variants of commercial paper is asset-backed commercial paper (ABCP). This is issued in the same form as standard commercial paper, but the issuer tends to be a standalone entity which is established to be bankruptcy-remote. In these circumstances, a borrower (or a set of borrowers) will sell assets (often receivables, such as mortgage payments or car loan payments) to the bankruptcy-remote issuer (which pays the borrower using the proceeds from the ABCP issuance). For an ABCP structure to work effectively, the borrower needs to be generating a reasonably diverse portfolio of assignable assets, on which detailed records can be kept.

Going direct or indirect and issuing Euro CP

Borrowers need to decide how and where to issue commercial paper.

How to issue commercial paper

Borrowers have two choices when issuing commercial paper:

- Direct issuance. A borrower may choose to issue commercial paper directly to investors. Without dealers, any issuer choosing to issue commercial paper directly will have to identify how to access those investors. This will be time-consuming, so will only be worthwhile if the organization wants to issue high volumes of commercial paper on a regular and frequent basis.

  There are two main benefits of direct issuance. First, for large issuers, it can represent a major cost saving, although the issuer will have to employ its own team to manage issuance and investors. To be cost-effective, these costs will have to be lower than any fees charged by dealers. Second, direct issuance allows the borrower to maintain relationships with their investors. This avoids any potential conflict of

Tips on picking a CP dealer

One of the challenges for any new commercial paper issuer is to appoint dealers to act on its behalf. Most issuers have a panel of dealer banks which issue and distribute commercial paper to institutional investors. The dealer banks will usually manage relationships with those investors. The issuer may need to communicate directly with potential investors initially, perhaps via a series of roadshows, although once a program is operational, dealers may not disclose the names of investors to the issuer.

Having a good dealer group is an important component of a successful commercial paper program. The issuer needs to decide how many dealers to appoint. Broadly speaking, the dealer group needs to be large enough to cover a sufficient number of investors in the market place and the investor distribution channels they represent. In most cases, three or four dealers will be sufficient, although it may be necessary to appoint more for large programs or, in the case of Euro CP, if the program issues paper in a number of currencies. If an issuer is issuing both US CP and Euro CP, it may be possible to use the same banks to deal in both. In the case of Euro CP, it is often appropriate to select dealers with strength in one or more particular markets, depending on the size of the program and likely investor demand for the paper. The dealer group also needs to be manageable: having too many dealers will mean too much time is spent communicating with them. Margins are low for commercial paper dealers, so issuers need to incentivize them by ensuring they almost always receive paper when it is issued.

As well as appointing dealers, an issuer may want to select one as a lead arranger. One or more will also act as an issuing and paying agent to manage payments from the issuer to investors.

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interest when, for example, a dealer is acting for a number of clients, including on its own account.

- Indirect issuance. Most borrowers choose to issue commercial indirectly, via one or more dealers. Dealers charge a small fee to issue paper (usually a proportion of the face value of the paper, typically three to 15 basis points). The fee is determined by a range of factors including creditworthiness, the size of the program and the nature of the market at the time. Dealers issue paper on behalf of a number of clients, and so have regular access to many of the core commercial paper investors.

STEVE HOWARD, CAPITAL MARKETS AND LIQUIDITY MANAGEMENT, TOYOTA FINANCIAL SERVICES

At the heart of Toyota Financial Services' short-term financial strategy is a USD 25 billion US commercial paper program. The program is executed via direct sales channels, with six associates managing relationships with over 600 institutional investors across the USA.

Each day, before the New York market opens, the treasury team identifies the company's cash position and establishes pricing for its short-term debt issuance. The Sales & Trading team posts levels for its commercial paper, strategically raising capital to meet the business's funding requirements and to improve the company's liquidity profile, all the while satisfying the diverse needs of its investors.

Toyota Financial Services does not have a formal investor relations team. Instead, Sales & Trading serves as the primary link to the group's commercial paper investors. The treasury front office produces all the relevant investor relations materials for its investors. The team also conducts multiple one-on-one and group meetings, both with institutional investors directly and with their banking partners who are the link with TFS's longer-term investor base. The size of the commercial paper program means the direct sales channel provides incredible cost savings for Toyota. It also allows Toyota to control the process. Steve Howard points to the recent financial crisis as an example of how dealers might not act in Toyota's best interests at a time of market instability. "All through 2008 and 2009, we were able to focus on our requirements. We were able to place commercial paper into the market every day. With banks struggling to sell their own paper, would they have been making their best efforts to sell ours?"

Toyota's A-1+/P-1 credit rating is central to the success of its commercial paper program. "Without our credit rating, it would be very difficult for us to achieve our objectives," says Howard. "Investors attach an enormous value to those credit ratings and they need to be confident about their purchase."

This credit rating reflects Toyota's strong financial position. The majority of the group's funding stream matures within two years, matching the group's two and a half year asset cycle. It has USD 17 billion total committed and undrawn credit facilities among over two dozen global banks. It maintains a cash buffer of between USD 4 and 10 billion at any one time. It also has the capability to securitize over USD 50 billion retail consumer receivables. At present, the securitization program provides about 10% of the group's core funding. It also represents important contingent funding for the group, as the treasury is able to ramp up the funding very quickly if necessary. For example, in 1998, the securitization program funded the group for over six months while the debt markets were effectively closed due to the Russian debt crisis and the Asian meltdown.

"Toyota's approach is to strive to be best in class. This applies in treasury too," says Howard. "Investors hate unpredictability. Our plans are transparent and unambiguous and we work hard to be consistent and to act rationally in the market. Communicating this approach rigorously to our stakeholders has helped to develop trust in our name and our brand. Ultimately this has been rewarded by the long-term support of our sponsors."

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Where to issue commercial paper

A second decision for borrowers is where to issue commercial paper. There are essentially two types of market.

- Domestic commercial paper. There are domestic commercial paper markets in many countries around the world. The US CP market is the largest in the world with all issuance denominated in USD. Issuers rely on credit ratings from at least one of the main credit rating agencies and the market is open to US corporations, including financial institutions, and also US subsidiaries of large multinational corporations. Other domestic markets cater primarily for domestic corporations, and can be ratings driven or name driven.
- Euro commercial paper. The other type of commercial paper market is the Euro CP market. This is not to be confused with the eurozone. It is more appropriate to describe it as the international commercial paper market. Issuance is primarily denominated in USD and EUR, reflecting the profile of Euro CP investors, although most major international currencies can be accommodated in a Euro CP program.

The key consideration is how to identify the most appropriate potential investors. Issuing domestic commercial paper will, primarily, tap domestic investors. For US-based organizations, US investors may be able to provide sufficient financing. However, in other locations, the domestic commercial paper market might not be deep enough to offer a borrower the ability to raise the required levels of funding. Euro CP gives access to a much wider pool of potential investors, as it can be marketed to investors based in many different locations. Bear in mind, though, that Euro CP cannot be marketed to US investors, so any international company wanting to access US commercial paper investors will need to establish its own US CP program.

Understanding CP investors

As with any sale, it is vital that commercial paper issuers understand the requirements of potential investors, if they are to have a successful commercial paper program. Issuers will also need to be flexible and respond to investors' requirements. This will maximize the chances of selling all issued paper and so being able to manage working capital effectively.

Some investors like commercial paper because they can use the short-term nature of the instrument to manage the duration of their own portfolios. Increased regulation of money market funds has required them to focus more directly on the weighted maturity and life of their portfolio, to maintain their 2a-7 (or IMMFA-equivalent) classification.

Borrowers will also need to meet any market rating expectations. In those markets which are ratings-driven, borrowers will find it difficult and expensive to issue commercial paper if the rating falls below the expected level. In name-driven markets, this may be less of a problem, although then the borrower will need to spend time talking with potential and current investors.

Investors may also need committed standby facilities or guarantees in place as a credit enhancement. This will be reflected in the credit rating (if there is one), but is part of the wider cost of issuing commercial paper. Bear in mind that it will reduce the borrower's ability to access other sources of funding, especially from banks, because the bank providing the credit enhancement will consider that to be part of any credit exposure to the borrower.

Finally, investors will want to know that there is a clear repayment plan in place. They will look to the issuer's ability to roll over commercial paper issues, and the extent to which commercial paper is the primary source of working capital finance.

Issuing short-term bonds in the capital markets

Either as an alternative or as a complement to commercial paper, it is also possible to issue short-term bonds in the capital markets. This will give access to different potential investors, who will have different investment requirements. Other than the nature of the issuer and the price of the instrument, the most important characteristic of a bond is the relative seniority of the instrument versus other bonds and equity. Bond investors will want to earn a return which reflects their appreciation of the risk they are exposed to via the investment.

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Factors when issuing a bond

There are a number of factors to consider when issuing a bond.

- Size and purpose. Understanding how the proceeds of a short-term bond issuance is to be used is important. In some cases, a single, short-term bond may provide sufficient short-term liquidity without the need for further issuance, for example, if it is to provide seed funding for a particular project. In other cases, the company may anticipate issuing a number of bonds over a short period of time. In these circumstances, it may be appropriate to establish a medium-term note program. This will be more expensive than a single short-term bond issue, but it will allow the borrower to revolve the bond or to fund the business opportunistically over a number of years.
- Currency of issue. Issuers will need to select the appropriate currency (or currencies) in which to denominate the bond. This could be the group operating currency, another currency in which the company has a borrowing requirement, or a currency that will attract investors. In the last case, there will be a foreign exchange risk, which can be managed by the issue of a structured bond. Structuring a bond by incorporating a derivative will be more expensive, and should be included in the overall cost of borrowing. If the bond is to be issued into different markets there will be additional costs to cover legal fees, roadshows, ratings and, possibly, additional dealers.
- Repayment policy. Many short-term bonds are zero coupon bonds, which are issued at a discount and paid in full at maturity. Some bonds pay an interim coupon. When planning the bond issue, the treasury practitioner should identify how the repayments are going to be made. Some bonds may need back stop facilities to be put in place.
- Tax requirements. Treasury practitioners should try to ensure any interest payments can be offset against tax. If structuring a bond, it is also important to recognize potential investors' own tax requirements.
- Impact on credit rating. Any short-term bond will affect the issuer's debt/equity ratio and will impose additional repayment obligations. Together, these may negatively affect the issuer's credit rating, increasing the group's overall cost of borrowing.

Arranging an MTN program

As with a bond issue, an MTN program will require agreements to be negotiated with all dealers and an initial offering circular, known as the shelf registration, outlining the terms and conditions of the program as a whole. For each issue under the program, a pricing supplement giving details (of size, currency, term, etc.) of that issue will be prepared.

An MTN program is often cheaper than arranging a series of bonds. It can be used for a variety of short-term and long-term funding in a range of currencies, and allows assets to be matched with liabilities.

However, MTN programs are expensive to set up as a result of legal fees as well as sometimes significant internal management time. One of the risks of an MTN program's flexibility is that the low marginal cost of additional issuance may encourage the treasury to overuse the facility.

Private Placements

As well as arranging bonds and commercial paper issuance to institutional investors, it also possible to borrow funds by making private placements to institutional investors. Essentially, the underlying transaction is the same as commercial paper or a bond, but the transaction is not publicly listed. A private placement allows a borrower to arrange funds from an investor quickly and without the costs associated with an intermediate dealer. Private placements are also used to allow borrowers to respond to 'reverse enquiries' from investors wishing to extend their exposure to the borrower. Private placements in the USA are exempt from registration requirements under the terms of section 4(2) of the Securities Act, and comply with rule 506 of Regulation D. This includes restrictions on the marketing of the paper and limits the issue to 35 non-accredited investors. Rules on private placements vary according to jurisdiction, and specialist legal advice should always be sought.

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Using short-term swaps opportunistically

As indicated above, interest rate swaps can be used to manage a borrower's exposure to interest rate risk. They can also be used on a more opportunistic level to allow the borrower to manage the balance between fixed and floating rate borrowings. This may apply in the short term when a company wants to match its assets and liabilities more closely.

Repo agreements

It may be possible to use repurchase agreements to raise cash overnight or for very short periods. In this scenario, a borrower would be able to sell a security in its investment portfolio, with a promise to repurchase it on a named date in the future. This has the benefit of achieving liquidity from a company's investment portfolio, although it does require the borrower to hold appropriate security for this to be an effective source of funding.

Third party repurchase agreements are becoming more attractive to investors, because of the enhanced security they offer. However, there are some additional setup and administration costs associated with third party repos. These costs include legal fees, even though most agreements are covered by standard terms (the Global Master Repurchase Agreement is a standard master agreement covering repos), and also the cost of appointing a third party agent (TPA) which acts as intermediary between the parties. The TPA costs are borne by the borrower.

Trade credit

There are a number of ways of borrowing from trade partners. These include:

- Financing via deferred payment. Any delay in paying suppliers is effectively a form of short-term finance. This is a risky strategy, as a pattern of late payments can be taken as a sign that the company has wider financial problems.
- Supply chain finance. There are a number of different techniques which allow participants in a supply chain to use the financial strength of the strongest entity in the chain to finance the remainder. This technique is most commonly used by larger companies to finance its suppliers, although it can also be used to finance end customers.
- Trade bills of exchange. These are negotiable promissory notes written by a customer to its supplier. A supplier can transfer ownership to a third party at a discount to accelerate cash flow. If the instrument is accepted by a bank, it is called a banker's acceptance.

Bank loan products

Banks provide a variety of forms of funding to corporate borrowers, some of which are also provided by non-bank financial institutions. Availability varies in different locations for both regulatory reasons and due to local custom.

Overdrafts

Where overdrafts are available, they are usually repayable on demand. Some banks may also require an overdraft facility to be fully repaid once a year, or to be subject to an annual (or more frequent) review.

As a result, overdrafts are generally more expensive than formal loan agreements. Interest is usually calculated daily at a margin above the appropriate market interest rate. The margin will be significantly higher for any overdraft which is not prearranged. In addition, banks may apply overdraft fees.

In some cases, security may be required. Treasury practitioners should consider other short-term sources of finance before committing assets as security for an overdraft facility. This is because these assets could be used to arrange much cheaper short-term finance.

Asset-based finance

There are a number of techniques which allow companies to arrange finance via the sale of particular assets. The application of different techniques varies considerably between locations, so it is vital to understand the practice in the particular market. Invoice-based finance is usually best in two situations: if the borrower generates a small number of large invoices or a large number of small invoices.

Factoring

In a factoring arrangement, the borrower will sell invoices to the lender (the factor). The factor may be

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a subsidiary of a bank, or a specialist lender. In return, the factor will advance a pre-agreed percentage of the total invoice value to the borrower. If the factor collects a higher percentage of the total invoices, the borrower may receive an additional payment.

Factoring is common among fast-growing small companies, as they are effectively outsourcing sales ledger management to the factor. However, the effective cost of borrowing is often high. Borrowers will usually be required to sell all their invoices to the factor. This is because the best invoices are effectively a guarantee of payment, and subsidize the risk of non-payment associated with weaker credits. Agreements are made with or without recourse to the borrower. If the factor has recourse to the borrower, it can reclaim some advanced funds if it fails to collect on sufficient invoices. The issue of recourse varies according to market practice, with non-recourse factoring more expensive.

Because of the limited opportunities to generate free cash flow while in a factoring relationship, it can be difficult for a company to wean itself off the relationship. Factoring is usually disclosed to the borrower's customers and, in some countries, factoring is seen as a sign of financial difficulty.

Invoice discounting

Under invoice discounting, a borrower sells its invoices to the lender at a discount. The borrower continues to manage its sales ledger and so the arrangement is not usually disclosed to its customers. The borrower will repay the discounter on collection of payment from its customers, and will have to meet any costs of non-payment. The cost of funding will be determined by the discounter's view of the creditworthiness of the borrower's customers.

As with factoring, it can be difficult for a company to wean itself off invoice discounting. This means the company's best assets (in terms of security) are not available to provide support for any longer-term bank or money market finance.

An invoice discounting program can, however, be seen as a precursor to a securitization program, especially in the case of the borrower generating larger numbers of similar invoices.

Leasing

Where a company wants to raise funds to use particular assets, it may be more appropriate to lease the assets. This has the advantage of matching the assets and the liabilities. Some companies have also obtained liquidity from real estate portfolios by entering into sale and leaseback transactions.

There are a number of reasons companies choose to lease assets, rather than purchase them. These include:

- Cash flow. Leases can provide a number of cash flow advantages, especially for growing companies, because they require little or no upfront financing. Sale and leaseback transactions allow companies to release cash from fixed assets. This is most common when companies sell property (such as office blocks) and then immediately lease back use of some or all of the same building.
- Tax reasons. There can be significant tax advantages, especially with the use of operating leases. Tax treatment varies significantly between jurisdictions, so treasury practitioners in global organizations should always ensure appropriate advice has been sought.
- Balance sheet management. Leases can often be structured as off-balance sheet financing. This can be a significant advantage, especially when seeking to manage any debt/equity ratios.
- Nature of leased assets. The nature of the assets themselves will also play an important part in this decision. Leases are common for the use of assets which have a clearly identifiable life-span and where a residual value can be calculated before the lease agreement starts. Such assets are often financed via the use of operating leases for periods of up to five years for equipment leases (shorter for computers or mobile phones), and for ten or more years for real estate.

Before entering into a lease agreement, a company should consider the following factors:

- residual value and ownership of the assets at the end of the lease
- responsibility for maintenance of the assets during lease period

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- lease period
- accounting and tax treatment, which will be determined by the first two factors according to the accounting standards and tax code applicable in the relevant jurisdiction.

Bridge loans

A number of lenders offer short-term bridge loans. These are most commonly used to provide very short-term funding until longer-term financing is in place. Such loans may be used to provide financing until a divestment is made, or a new tranche of private equity financing becomes available. Lenders may provide bridge loans on an interest-only basis. The precise terms and conditions will be determined by the nature of collateral available, the borrowing term, and the nature of the borrower's repayment strategy.

Bank credit facilities

There are many different ways for a company to arrange formal credit facilities from a bank or group of banks. Understanding how the funds are to be used will help the treasury practitioner develop the most appropriate credit facility (or set of facilities) for that purpose. As with other funding strategies, the borrower may have to give security to the lender to either access funding or reduce the cost of borrowing. Many credit facilities incorporate terms and conditions, including covenants, which, if breached, permit the lender to call in the loan. Finally, the treasury practitioner must always establish how any credit facilities will be repaid.

Bank relationship management

Managing bank relationships well is critical to any successful credit facility. Fundamentally, this means that the treasury practitioner has to communicate why the company is borrowing, to a bank, or group of banks, which is prepared to offer the company credit. The fundamental objectives of the borrowing will change as the company and the market environment change, so it is important to maintain communication with lenders over time. This allows lenders to reassess their credit decisions and to advise whether they will continue to offer facilities into the future. Each lender has its own credit limits, so some will be prepared to extend more credit to a particular company over time, while others will not. As part of this process, treasury practitioners will also work to manage the share of their bank fee spending with each of their credit providers. This requires the practitioner to identify different roles played by each bank with respect to credit facilities and syndicates.

Features of credit facilities

There are a number of differences in the type of credit available from banks. Treasury practitioners will want to arrange a facility which best meets their purposes. Borrowers arrange credit facilities for a variety of reasons, often in combination. It may be to provide core, longer-term working capital finance, to provide liquidity at relatively short notice to finance a program of merger and acquisitions, or to provide back stop facilities for other funding programs, such as commercial paper issuance.

- The credit facility structure. The purpose of the facility will help the treasury practitioner determine the most appropriate structure. There are two main choices for any borrower:
  - Term loan. A term loan is, usually, fully drawn at the beginning of the term and then repaid according to the pre-agreed repayment schedule. Some term loans permit more than one draw-down. The repayment schedule should reflect the company's business plan, to include the most appropriate combination of interim payments and a final balloon payment.
  - Line of credit. A revolving line of credit allows a borrower to draw up to an established limit for the period of the agreement. Funds can be drawn, repaid and redrawn over the period of the agreement. Some agreements require a line of credit to be fully repaid once a year and to remain unused for 30 days or longer (this is sometimes known as a clean-up period). These agreements can be secured against particular assets, which will affect the company's ability to access other forms of finance. A material adverse change clause allows a lender to end the agreement if the borrower's creditworthiness weakens. Lines of credit can be committed (on payment of a commitment fee) or uncommitted.

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- Number of participating lenders. Depending on the type and size of the required credit facility, it may be preferable or necessary to involve more than one lender.
  - Bilateral lending. Bilateral loans can be kept confidential and will be easier to negotiate because only two parties are involved. Managing a bilateral loan relationship will typically be less time-consuming, although the company will be exposed to greater counterparty risk.
  - Syndicated lending. A syndicated loan will usually be flexible (revolving credit facilities and term loans are both commonly available) and the use of standard loan documentation will reduce the time needed to negotiate terms. Using a syndicate will allow larger facilities to be arranged and a more complex loan structure can be agreed, with different tranches and maturities incorporated into the same facility. A syndication can also be opened to non-relationship banks.

Arranging a syndicated loan

Managing bank relationships is an important part of arranging a syndicated loan. There are a number of issues to evaluate when selecting banks to play particular roles within the syndication.

Picking your leads, administrators, and underwriters

Selecting the leads and administrators in any syndication will depend on the size of the facility and the spread of the participants. For smaller loans with a tight geographic spread, it may only be necessary to appoint a single lead in the syndication. There are two main reasons why appointing more than one lead is appropriate:

- Geographic spread. If the borrower wants participants in a number of countries, it may not be possible to find a lead with appropriate relationships across all locations.
- Bank relationships. For larger loans, it may be possible to divide the role of lead arranger simply as a tool to provide additional members of the company's core banking relationship with their required fee income. However, it is important that all arrangers can work together.

The company will have to appoint at least one administrator (or administration agent) to be responsible for distributing any interim payments to the syndicate and for arranging any interim drawdowns. Again, the same factors might indicate that more than one administrator should be appointed.

Finally, the borrower will need to agree early on in the negotiation process whether the loan will be underwritten, or whether the arranger will seek to raise the required facility on a best efforts basis.

Picking your participants

Borrowers will usually have a core group of relationship banks to which it will offer the first option to participate in the syndicate. If the loan is large, or if one or more of the relationship banks declines to participate, it may be necessary to extend the offer to participate to other banks and financial institutions. If a relationship bank declines to participate, it is prudent to try to establish their rationale, as this may indicate a change in that bank's policy. (It may simply be confirmation of an existing, and known, credit limit.) If new banks join the syndicate, they may be doing so to try to win ancillary business, and this will need to be managed.

Most syndicated loan agreements permit participants to sell loans in the secondary market, often on an undisclosed basis. This can pose problems for the borrower in two main ways. First, the borrower may continue to award ancillary business to that bank even though the bank is no longer extending the same level of credit to the company. Second, this can be a problem when the borrower seeks to renew a facility, if the borrower can no longer rely on some participants. It is good bank relationship practice to know which banks are selling their exposure and which ones are interested in buying it. Often times, new bank relationships start with purchasing loan commitments on the secondary market.

Covenants and compliance

Formal loan agreements, whether for term loans or revolving lines of credit, will usually incorporate covenants which place restrictions on how the borrower can operate. Ideally, any covenants will

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allow the borrower to continue to operate normally. Any covenant clauses should be examined to ensure that they do not represent conditions that are too onerous or require the borrower to change policy to its detriment.

Some covenants can place conditions on the borrower. These may simply pose an additional discipline on internal procedures, such as requirements to maintain accurate financial statements, to provide periodic reports to the lender, or to permit a lender to inspect some of the borrower's activities.

However, covenants may also place restrictions on a borrower which have a negative impact. Common restrictions or requirements include:

- A covenant may prevent the company borrowing additional funds.
- Even if security is not required for the loan, the covenant may not permit assets to be offered as security elsewhere.
- Covenants often require borrowers to operate within set financial ratios. This might involve meeting set current or debt ratios. These may be appropriate if they reflect the borrower's policy, but not if they place too much stress on operational activities.

Before agreeing to any covenants, the treasury practitioner will need to decide whether they will adversely affect the company's ability to operate normally. Covenants may, for example, reduce the company's ability to fund itself opportunistically, or impose additional management costs on treasury.

Once any covenant has been agreed, it is vital that the company complies with the terms, otherwise the lender will be able to initiate default proceedings. Where financial ratios are tight, it is often necessary to review and strengthen the company's cash flow forecasts to provide as much warning as possible of a potential breach.

Comfort letters and guarantees

Comfort letters and guarantees are most commonly issued by parent organizations to support group entities borrowing funds on their own account. There are a number of different ways a parent organization can provide support for subsidiaries. These include:

- Comfort letters. These are written by parent organizations, indicating the actions it may be prepared to take (or is explicitly not prepared to take) in support of its subsidiary. This is a way of improving the creditworthiness of the subsidiary without the tax, accounting and other implications that a more formal guarantee would impose. Legal advice is vital before a comfort letter is drafted, to avoid those complications, even though a comfort letter is not legally enforceable.
- Guarantees. These can come in a variety of forms. A parent can guarantee a subsidiary organization, either fully or partially. This may be to guarantee payment on specific loans (for example, on a loan to purchase particular plant), or only if the subsidiary is found to be formally in default.
- Performance guarantee. This is a guarantee that the assets being financed are of a certain quality.

A parent company should always consider the impact of a guarantee on both its own ability to raise funds and its credit rating.

Features of credit facilities

There are a number of standard features which affect the overall cost of bank borrowing. These include the lender's view of the borrower's creditworthiness, the structure of the facility, including the use of security, and the term. These are reflected in the rates charged by the borrower for the particular facility.

- Credit evaluation of borrower. The most important factor which affects the cost of borrowing is the creditworthiness of the borrower. For international groups, this may vary significantly, depending on which legal entity (and its location) is the formal borrower. Group entities can mitigate this by offering guarantees.
- Bank-imposed conditions. The lender may impose conditions which may apply both before funds are advanced and during the course of the agreement.
- Reason for borrowing. Funding to purchase particular assets may be seen as less risky than general working capital funding by some lenders.

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- Use of security. Secured finance is cheaper than unsecured finance, with the reduction in cost determined by the quality of the assets.
- Committed facilities. Committed facilities are more expensive than uncommitted facilities, as a commitment fee is payable on any undrawn funds.
- Syndication. A syndicated loan will have higher fees than a bilateral loan agreement, because broker and agency fees will be payable.

Fees and charges

As part of the negotiation process, fees and charges will be agreed. Before documentation is signed, the following should be clearly listed (often in the term sheet or financing arrangement agreement):

- The amount of principal.
- The interest base (to what figure is any margin applied?).
- The agreed margin. This should be clearly defined.
- The interest period.
- Any penalty clauses and fees.
- Any additional margins that the lender may apply, such as reserve asset costs, along with the circumstances in which they can be exercised.
- Commitment fees (if applicable).
- Arrangement, broker, agency and commission fees and charges.
- Any prepayment, cancellation and repayment fees.

Legal advice should always be taken when negotiating and before signing any loan documentation.

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Credit Rating Agencies

Obtaining and maintaining a credit rating is vital in order to access money market and capital market funding in many locations. For example, a commercial paper issuance program in the USA is impossible without at least one published credit rating or, ideally, two. However, bank finance will not require a credit rating, as all banks have their own internal credit assessment departments.

Working with rating agencies

Each rating agency publishes its own rating process and criteria on its website, available to both rated entities and potential investors. Even though issuers pay to be rated, all rating agencies are under pressure from regulators to demonstrate their independence. In effect, this means that the agencies will be reluctant to revise any published rating after any discussion with an issuer.

This means that potential borrowers should take time to understand rating criteria and prepare as much information as possible for agency analysts before seeking an initial rating. The rating will be prepared using both quantitative (such as publicly available financial reports and cash flow forecasts) and qualitative (such as discussions with senior management) information. Being open about future plans and being able to defend cash flow and business forecasts will help analysts view the rated entity positively.

For short-term commercial paper and bond issuance, an issuer will need a top, investment-grade rating to sell instruments publicly in most instances (see Jim Gilligan's case study). In ratings-driven markets, such as the US CP and Euro CP markets, the precise rating (A1/P1, A2, etc.) will affect the pricing, especially in the case of commercial paper, as long as the paper has a sufficient rating. Without such a rating, an issuer will need to make a private placement to raise funds.

JIM GILLIGAN, ASSISTANT TREASURER, GREAT PLAINS ENERGY

Great Plains Energy is a holding company for two electric utility companies, based in Kansas City, MO. The company operates two USCP programs, one for each utility company. They have slightly different ratings: one has an A2/P2 rating, with the other holding a split A2/P3 rating.

Each morning corporate treasury sets the cash position for the day. If this shows excess cash, the company will pay down outstanding commercial paper. The company has paper maturing most days, but tries to keep the maximum daily maturity at USD 60 million, to minimize repayment risk.

As a net borrower, the cash position is more likely to show the group to be cash short. In this case, the treasury will call up a dealer (or multiple dealers, depending on the size of the shortfall) and ask them for a rate run from overnight to one month or longer. Treasury will then select a dealer and ask them to place the required amount with a maturity which matches the forecast.

Managing the company's dealers is an important part of Jim Gilligan's role. "We have three dealers on one program and are adding a third to the second. We try to be even with our dealers, such that they have similar levels of outstandings at any one time. We also avoid pitting dealers against one another. We consider our dealers to be there to help to make the market, rather than to compete with each other. We would expect them to take a position with us, rather than to return any unsold paper."

Commercial paper dealers are selected from the banks which participate in the company's revolving credit facility. Gilligan tries to ensure the dealers he selects have different investor bases in order to access as wide a spread of investors as possible. He also attempts to choose dealers located in different cities to ensure business continuity in the event of a geographical interruption.

Although the company has two revolving credit facilities and two accounts receivable securitization

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programs (one for each utility), Gilligan prefers to use the commercial paper programs for daily liquidity needs. “Our CP programs are cheaper and more immediate than the revolving credit facility. We can borrow a minimum of USD 100,000 overnight via CP. Under the terms of the revolving credit facility, we have to give three days’ notice to draw a minimum of USD 5 million for a minimum of 30 days at a rate linked to LIBOR.”

Gilligan is a firm believer in the importance of communication with dealers and banks. Asked if he has any advice for people thinking about issuing CP, he says: “I would advise people to talk with banks and take time to understand how the market works. There are nuances which affect each issuer differently. Finally, see the dealer relationship as a partnership. Our cooperative philosophy has served us well over the years.”

It can be both time-consuming and expensive (in terms of fees paid and internal management time) to obtain and then maintain a credit rating. Companies should always seek to maintain good communication with rating agencies. Treasury practitioners usually make a formal presentation to rating agency analysts once a year, as well as having informal conversations quarterly (or more frequently). It is prudent to advise agencies of market events (such as mergers or sales warnings) as soon as possible.

How many ratings to obtain, and from which agencies, should be determined by the expectations of investors for the instrument in the particular market. The best way to determine that is to identify who rates similar issuers. In the US CP market, most issuers have two ratings (from Moody’s and Standard & Poor’s). Some have a rating from another agency, either as a substitute or as a third rating. A third rating is only likely to have a beneficial effect on pricing if it complements a higher rating if two agencies provide a split rating.

Conclusion

This guide has focused on establishing a borrowing strategy and policy. It has identified the risks to be managed when borrowing and has provided an overview of the vehicles available to provide short-term finance. This is an ongoing process, in which treasury practitioners must focus on ensuring that liquidity is always available as needed, by managing those risks to which their companies are always exposed.

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Country/Region-Specific Differences

Market practice and local regulation mean that there are significant differences in the availability of funding vehicles in what are otherwise very similar markets. From a short-term borrowing perspective, one major difference between markets is whether overdrafts are permitted and, if so, for how long. From a money market perspective, there are significant differences in the availability of commercial paper and the liquidity of the short-term bond markets. Finally, some countries have developed their own funding vehicles, which are not available in many other locations.

This can mean an international treasury practitioner is faced either with more funding opportunities than at home or, in some cases, with far fewer choices. Understanding those differences is an important part of designing an efficient borrowing strategy. International organizations will have the opportunity to raise funds centrally or via local subsidiaries. Establishing an efficient and cost-effective strategy can be complex, as it may involve understanding exchange controls, transfer pricing and thin capitalization rules, as well as cross-border pooling regulations. Treasury practitioners should always take specialist legal and tax advice before establishing a group-wide liquidity management structure, especially if it would require changes to any existing borrowing policies, at either group or subsidiary level.

In this section, there is a brief description of the most commonly used borrowing instruments in a number of key markets around the world. Further information on short-term borrowing is available in the AFP Country Profiles, which can be accessed at www.afponline.org/countryprofiles/.

Highlights from Country Profiles

Bank lines of credit/loans

Banks in all countries provide lines of credit or short-term loans, although some countries place restrictions on loans to foreign-owned entities. In many ways, creditworthiness of the borrower is a more significant factor than country of operation when it comes to determining terms, conditions and cost of borrowing. More detail of both short-term and long-term bank credit facilities are available in the AFP Country Profiles.

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Trade bills

The practice of discounting trade bills to accelerate cash collection varies from market to market. This table indicates whether the practice is available and, in some cases, the most common discounting periods.

Country	Trade Bill
Argentina	Available, for seven to 180 days.
Australia	Available, usually for 3-6 months.
Belgium	Available, but not commonly used.
Brazil	Available. BRL denominated bills for 30-60 days; foreign currency average of 180 days.
Canada	Not usually available.
Chile	Available.
China	Available.
Czech Republic	Not often used.
France	Mainly used by SMEs for 90 or 120 days.
Germany	Commonly used.
Hong Kong	Available, but most trade bills are sold rather than discounted.
India	Available, most commonly for 90 days.
Ireland	Available.
Israel	Not available.
Italy	Available.
Japan	Available, but requires complex supporting documentation.
Luxembourg	Available.
Mexico	Available, primarily used by small exporters for periods up to 90 days.
Netherlands	Mainly used for export financing.
Poland	Available.
Puerto Rico	Not commonly available.
Russia	Not commonly available.
Singapore	Available.
South Korea	Available, for periods up to 60 days.
Switzerland	Very rare.
Sweden	Available, usually for between 90 and 180 days.
Taiwan	Very rare.
Turkey	Export bills may be discounted, but cannot be used to finance domestic activities.
UAE	Not commonly available.
UK	Available, usually for between three and six months.
USA	Not commonly available.
Venezuela	Available.

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Commercial paper

As indicated in the main text, most commercial paper markets, including the massive US CP market, are domestic in nature. This means issuers are primarily domestic entities seeking to place paper in that country's local currency. Historically, many of these markets have been name-driven, meaning domestic issuers have not needed any published credit rating to sell paper to domestic investors. Some markets, notably the US CP market, have become ratings driven, typically because of the size of the market and the number of issuers. Domestic commercial paper markets have developed differently in many countries and a number of different practices have emerged. This table indicates whether there is a significant domestic market and, if so, whether credit ratings are required. Euro CP issuance does require a rating.

Country	Commercial Paper
Argentina	Issuance has been low since 2001.
Australia	Large domestic CP market. Requires rating.
Belgium	Domestic CP market does not require rating. Euro CP does require rating.
Brazil	Domestic CP must be registered with Brazilian Securities Commission and placed via a bank or broker.
Canada	Large domestic CP market. Requires rating and paper is issued in CAD and USD.
Chile	Domestic CP requires a rating.
China	Foreign-invested entities are not yet permitted to issue CP in China.
Czech Republic	Small domestic CP market. Paper does not require rating but must be placed through a broker.
France	Domestic CP market does not require rating. Euro CP does require rating.
Germany	Domestic CP market does not require rating. Euro CP does require rating.
Hong Kong	Domestic CP market is shrinking.
India	Domestic CP market requires rating.
Ireland	Larger companies use Euro CP programs.
Israel	Rare.
Italy	There is a small domestic CP market.
Japan	Domestic CP market requires rating.
Luxembourg	Larger companies use Euro CP programs.
Mexico	Domestic CP market requires rating.
Netherlands	Larger companies use Euro CP programs.
Poland	A variety of debt instruments are issued in Poland.
Puerto Rico	Not widely used.
Russia	Borrowers prefer to use bonds rather than local promissory notes (veksels).
Singapore	Domestic CP market requires rating.
South Korea	Domestic CP market requires rating.
Sweden	Domestic CP market does not require a rating.
Switzerland	Larger companies use Euro CP programs to issue CHF-denominated CP.
Taiwan	Domestic CP requires back stop facilities to be in place.
Turkey	Domestic market was closed until 2009. A small number of stronger credits issue domestic CP.
UAE	Not widely used.
UK	Most domestic CP issuers have ratings. Larger companies use Euro CP programs.
USA	Domestic CP market very large and ratings are required.
Venezuela	Issuers have to be authorized by the National Security Superintendency.

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Overdrafts

Overdrafts are a common source of very short-term funding in a majority of countries around the world. Because they are often repayable on demand, they are not usually suitable as the sole source of working capital finance. This table indicates whether overdraft facilities are available, as well as some country-specific differences.

Country	Overdraft
Argentina	Scarce, but available.
Australia	Available.
Belgium	Available, usually for an unlimited period.
Brazil	Available only for very short periods (24 to 48 hours).
Canada	Available, but repayable on demand or at short notice.
Chile	Available for up to one year, but repayable on demand within 30 days.
China	Available.
Czech Republic	Available.
France	Available, for periods up to one year. Treasury credits are available for 10-30 days for stronger credits.
Germany	Available, but repayable on demand or at short notice.
Hong Kong	Available.
India	Available but security is usually required. Facilities are reviewed annually.
Ireland	Available for up to a year, but repayable on demand.
Israel	Available, usually subject to a fixed annual charge.
Italy	Available. Very short term borrowing (24–48 hours) is also available.
Japan	Available.
Luxembourg	Available, usually for up to one year.
Mexico	Available, but relatively expensive.
Netherlands	Available.
Poland	Available, but banks link to see borrowings cleared for a period each year.
Puerto Rico	Available.
Russia	Rare, but available to higher quality credits.
Singapore	Available but security is usually required. Facilities are reviewed annually.
South Korea	Available, usually for periods of between six months and a year.
Sweden	Available.
Switzerland	Available.
Taiwan	Available.
Turkey	Available.
UAE	Available.
UK	Available, but repayable on demand or at very short notice.
USA	Not available.
Venezuela	Technically illegal.

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About the Author

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