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GTNEWS GUIDE TO

Investing Operating Cash

Strategies for Managing Short-Term Cash Series

Underwritten by STATE STREET GLOBAL ADVISORS | Global Cash

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Welcome to the gtnews Guide to Investing Operating Cash

The world of cash and short-term fixed income investments has become extraordinarily challenging. Managing operating cash efficiently, while continually adapting to changes in global markets, credit risk and the regulatory environment, requires a solid framework for making investment decisions.

As a treasury practitioner or member of a corporate investment committee, the tools and resources you depend on may include the structure of your bank accounts, your investment policy statement and a comprehensive analysis of risk.

Recognising that there is always some risk present in the market, an important question to ask becomes: 'How much risk can reasonably be taken when investing operating cash?'

To help you answer that question, this guide will consider three common investment objectives for operating cash: security of principal, liquidity and yield. It is impossible to maximise all three objectives at once, and we believe there is both an art and a science to managing cash. This guide will help you consider some of the trade-offs, risks and opportunities that may be present when managing cash within a dynamic marketplace.

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In addition, the guide will explore some of the differences between an investment policy statement and a set of daily procedures for operations. We believe it's important to have both – a high-level document outlining your philosophy and goals, as well as a more specific instruction guide that your team can use when making daily investment decisions.

Serving many of the world's largest corporations and institutions, State Street Global Advisors strives to provide you with the resources you need to manage cash well. From educational guides such as this one to timely market insights and a broad range of investments solutions, we are focused on a single goal: your success.

Sincerely,

Barry F.X. Smith
Global Head of Cash Business
State Street Global Advisors

Investing involves risk including the risk of loss of principal.

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Although bonds generally present less short-term risk and volatility risk than stocks, bonds contain interest rate risks; the risk of issuer default; issuer credit risk; liquidity risk; and inflation risk. This effect is usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss.

The views expressed in this introductory letter are the views of Barry F.X. Smith through the period ended 3/01/14 and are subject to change based on market and other conditions. This document contains certain statements that may be deemed forward-looking statements. Please note that any such statements are not guarantees of any future performance and actual results or developments may differ materially from those projected.

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Introduction

This guide is written to support treasury practitioners whose responsibility is to invest or protect short-term surplus cash. While most companies are likely to have varying cash balances over the course of a year, it is appropriate for treasurers to try to consider cash as falling into three separate categories for investment purposes: operating cash, short-term strategic cash and longer-term cash. The focus in this guide is on investing the operating cash used to finance working capital. Decisions on how to treat short-term strategic cash will be considered in a separate guide, to be published later in the year.

Here, we consider a number of key questions to help treasury practitioners to review any existing policy and processes, as well as to design new ones. The guide also includes a document highlighting the key elements to include in a standalone short-term investment policy, and the points to cover when developing investment management procedures.

The Treasury Practitioner's Role and Investing Cash

The treasury practitioner's primary role is to ensure that cash is available to meet the company's obligations to pay suppliers and employees, to make debt repayments and to meet the company's many strategic objectives.

This cash is generally considered as working capital, or the funds that are needed to keep the company operational on a daily basis.

The treasury practitioner's task in this context is therefore twofold: first, to protect and preserve any cash surpluses within the business; and second, to raise any additional cash which may be required from external sources. This guide focuses on the need to protect and preserve this working capital, or operating cash.

What factors affect the volume of cash to invest?

In order to be able to protect and preserve cash via an effective investment process, the treasury practitioner must be aware of the volume of cash, the location of this cash and the currencies in which it is denominated. Obtaining this information efficiently will ensure the optimum amount of cash is actively invested (rather than passively kept in a current account wherever it happens to be) so that, all other things being equal, less cash needs to be raised from external sources.

ACTUAL CASH FLOWS

The complexity of the investment task is driven by the pattern of actual cash flows within the business. Understanding how cash flows, where and when collections are made, and from where and how frequently disbursements are made is the critical element in managing operating cash. Much of this can be achieved by having a streamlined structure of bank accounts, such that most operating cash flows in and out of a small number of accounts per legal entity. Having regular disbursement cycles for non-urgent supplier payments (for example, every other Friday) can also help in managing cash flow. Some companies are able to control collection patterns via the use of direct debits, for example.

ACCESS TO INFORMATION

From the perspective of investing operating cash effectively, it is also important to have accurate information about the flows of cash within the organisation. Having a streamlined structure will help to make the collation of data easier and allow the treasury practitioner to invest cash proactively.

As well as supporting investment, visibility of cash is an important tool in itself. It allows decisions about external and internal funding to be made appropriately. It allows for efficient use of foreign exchange transactions, so that cash is not wasted transacting from one currency to another and back again.

Obtaining clear visibility of cash relies on two elements: cash position forecasts, and the use of technology to capture and organise data.

Cash position forecasts

An accurate cash position forecasting system is a key tool in most treasury departments. It allows the treasury practitioner to anticipate borrowing requirements and to identify whether any cash can be invested for longer than simply overnight. For any borrowers, an accurate cash position forecast is also a vital tool in helping the treasury team to ensure compliance with covenants in any loan mandates. There is more detail in the *AFP Global Liquidity Guide to Cash Position Forecasting.*

Treasury management and other systems

Today's treasury practitioner increasingly bases decisions on an accurate data feed from a wide range of sources. Larger companies have some treasury management system capability, whether this is a dedicated system or a module of an enterprise-wide resource planning system. Banks in most (but not all) markets are able to provide real-time information regarding both transactions and balances to their corporate clients. Ensuring there is an efficient flow of information from group entities as well as banks is another important tool.

If structured effectively, the treasury will capture data from group entities and banks in an accurate and timely fashion. The system will be set up to ensure data is not duplicated and that real data replaces estimates as soon as possible. Such a system should allow the treasury practitioner to spend less time calculating the cash position, and therefore more time investing it carefully.

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ACCESS TO CASH

To be able to invest cash effectively, the treasury practitioner will also need the authority to access and move that cash. In many organisations, particularly those operating internationally, there are a number of factors which determine how much control the group treasury can exercise when investing operating cash.

Corporate culture

A key determinant of central treasury's power to invest operating cash is the level of centralisation of these decisions. Over recent years, there has been a growing tendency for many international companies to concentrate decision-making at the corporate centre. This has been for two broad reasons: first, the evolution of technology has made it possible to manage even global corporations from a central treasury department (or a series of regional treasury departments); and second, some legislation, such as the Sarbanes-Oxley Act, has led to greater emphasis being placed on senior company executives having access to accurate information across the group. Even where decision-making has not been centralised, some central treasuries have been able to get group entities to sign up to group-wide treasury policy, covering a range of activities, including investing.

Regulatory environment

Even in organisations with highly centralised decision-making powers, it may still not be possible for central treasury to exercise complete control over all group entities around the world. Exchange controls, in particular, can restrict a company's ability to move cash between group entities and the corporate centre.

Liquidity management structures

In many organisations, there will be a debate about how best to structure bank accounts. Some companies try to maintain accounts with as few banks as possible, in order to minimise operational cost. It is now possible to access most bank services that a company needs, even in the absence of an extensive local branch network; however, this can result in an unacceptable loss of diversification of provider.

Others choose to maintain bank accounts with the best provider in each location (whether that is determined by access to branches for operational units, or simply in terms of financial strength or as a source of short-term funding). In many cases, this approach will provide a degree of diversification. The challenge though is to ensure any operating cash flows within the business's bank accounts in such a way that it may be used as effectively as possible to finance working capital. This may mean putting in place domestic cash pools, or combining a series of domestic cash pools into a regional or even a global cash structure.

The benefits of good information

Early warning of likely cash balances gives a treasury practitioner choice. Being able to anticipate future cash mountains and troughs means the treasury practitioner is able to invest cash for periods longer than overnight, selecting from a wider pool of potential investment instruments and reducing operating costs, as these funds will not be being continuously invested and redeemed. On the other hand, counterparty risks increase when funds are invested for longer.

Advance knowledge of likely cash balances allows the treasury practitioner to plan more effectively and ensure that a higher proportion of funds is placed somewhere, rather than simply being left in the organisation's operations accounts. If the company chooses to do so, a greater proportion of cash can be pooled via the group's liquidity management structure. (There may, however, be a requirement to maintain certain minimum balances with local bank accounts, perhaps as a condition of the bank providing the local bank account.)

Understanding these balances means that the treasury practitioner can be more efficient when raising external finance. After the financial crisis of 2008, a number of companies have been raising funds more opportunistically. This means that the focus has changed from using forecasts to avoid simultaneously borrowing and investing cash, to managing more significant cash balances which will be used for operational purposes at some point in the future.

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Recognising Operating Cash

Wherever possible, the treasury practitioner should have access to good quality information about all cash flows into, within and out of the business. This information can be used to identify peak cash requirements to support efficient external borrowing, as well as to identify when group entities are likely to need funding, whether from group funds or from external sources. From an investing perspective, it can also be used to identify when a company is likely to have significant amounts of excess cash.

The next step for the treasury practitioner is to try to stratify the excess cash. Broadly speaking, cash can be used for three main purposes:

1. To support daily operations. The most important cash is operating cash, which is recycled back through the business to fund daily activities via payments to suppliers, employees and governments (tax payments), and through loan and lease payments. Without this cash, a company would be unable to trade. This cash is therefore vital to protect.
2. To fund short-term strategic activities and to provide a backstop for operating cash. Once a treasury practitioner has identified sufficient operating cash, a second level of cash may then be stratified. This can be invested so that it will be available to support short-term strategic activities (such as to make an opportunistic acquisition) or to inject as operating cash should the company experience worse than expected trading conditions. For many companies, this cash needs to be accessible within about three months (the time an opportunistic acquisition may take to make).
3. To provide longer-term funding. Finally, there is excess cash in addition to these first two categories. This cash is much more long term and permanent in nature, so the board will need to decide whether to use it to fund new business or to return it to shareholders.

With cash characterised in this way, the treasury practitioner can determine how much risk to take when investing cash. The treasury practitioner will wish to consider the potential impact on the business if invested cash were lost or became inaccessible. Losing operating cash would make some day-to-day financing difficult, and could require the treasury to try to raise cash at short notice, and therefore expensively. On the other hand, losing longer-term cash might not have much immediate impact, although there would be some loss to shareholder value and a degree of loss of confidence in the treasury team (which could result in more expensive financing costs or tighter restrictions on any borrowing).

The treasury practitioner also has fewer options with regard to the short-term use of operating cash. It is needed within the business within a very short period, at least within a month. Longer-term cash can be used more flexibly, perhaps to support a strategic decision to reduce the company's debt-to-equity ratio, or to reward shareholders.

When investing operating cash, it is therefore important to identify ways in which cash can be kept securely until it is next needed.

Objectives When Investing Operating Cash

Having stratified the group's cash, the treasury practitioner's next challenge is to set appropriate objectives when investing operating cash. It is necessary to ensure that risks to principal and liquidity adequately reflect the nature of the cash being invested.

Setting objectives for operating cash

There are three main objectives for any investor:

- Security of principal. Achieving security means protecting the invested principal amount.
- Liquidity. Achieving liquidity means placing an investment in an instrument which allows the investor access to some or all of the invested amount whenever necessary.
- Yield. Maximising yield means generating the greatest possible return on investment.

These three objectives can apply to all investment decisions, whether investing cash on an overnight basis or managing a pension fund with liabilities falling due in 20 years' time. The investor's challenge is to set appropriate objectives, as all three cannot be maximised at any one time. A pension fund manager, for instance, is more likely to sacrifice liquidity to try to achieve a better return on investment over the longer term.

When investing operating cash, the treasury practitioner needs to ensure that the risk to principal and liquidity adequately reflects the nature of the cash being invested. In other words, when investing operating cash, the treasury practitioner should be prepared to sacrifice yield to safeguard the other two objectives.

It is important to recognise that there is no zero-risk investment option. Even when investing operating cash, the treasury practitioner will need to assume at least some risk, even though such risk may be very low. For example, keeping cash in operating accounts with a cash management bank exposes the company to the risk that the cash management bank may fail overnight.

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Sweeping cash from that bank to another as part of a liquidity management structure exposes the company to operational risk (funds being lost between banks due to incorrect settlement instructions) and to the counterparty risk associated with the second bank.

With this in mind, it is therefore important that the treasury practitioner ensures the company has a clear short-term investment policy. If developed well, this policy should encapsulate the company's objectives in such a way that it helps the treasury practitioner achieve them.

Each company will have a slightly different approach to investing short-term operating cash. This will be determined by companies' basic cash flow patterns (retailers have a different pattern of cash flows to oil companies, for example) and whether or not the company is a net borrower, as well as by the company's fundamental attitude to risk.

There are a number of factors to consider when setting investment objectives. We will consider these in turn.

SECURITY

Fundamentally, operating cash is cash which is likely to be needed by the business within a short period of time. The definition of a short period will be determined by the company's approach to disbursements. Companies with daily cash disbursements will have a shorter-term view than those which have effectively structured outgoing payments on a two-week or monthly cycle.

As a result, the treasury practitioner will want to invest to protect the principal. The treasury practitioner will not want to risk any consequential loss, whether that is as a result of a failure to pay a supplier or to meet a loan repayment. In addition, any loss of operating cash will be expensive to replace from external borrowers.

The requirement to protect principal is more complex for multinational companies, especially if they operate regional or global cash pools on a cross-border basis. As well as understanding the group's overall cash position at any one time, the treasury practitioner needs to know each participating group entity's cash position (which typically will involve more than one currency), so that each entity is able to meet its obligations. Treasury practitioners will also need to determine how decisions will be implemented, especially if the pool covers multiple time zones, whether and when to make foreign exchange transactions, and to understand the potential impact of tax, accounting and regulatory requirements so that principal is not lost or withheld.

LIQUIDITY

The next step is to try to ensure sufficient liquidity. There are two elements. First, the treasury practitioner will plan redemptions such that cash is available when required, according to the cash position forecast. Second, the portfolio should be invested with flexibility, such that additional cash is available should the cash forecast prove inaccurate for whatever reason. For example, the company may hold investment instruments which can be sold in the secondary market. A problem may arise in times of market displacement, when it can be difficult to redeem instruments without some loss of principal.

The treasury practitioner must also understand the implications of any exchange controls. These can make repatriating cash difficult or even impossible, especially at short notice. At the very least, the need to comply with documentation requirements can add time and cost to the process of repatriation. In extreme cases, it can be impossible to repatriate cash without an underlying transaction.

YIELD

When investing operating cash, the first two factors are paramount. As a consequence, the third factor, yield, or return on investment, is unlikely to be a priority when investing operating cash. If yield becomes important, it is more likely that the cash being invested is not operating cash and should be considered as strategic cash. Over recent years, some treasury practitioners considered relatively high returns on investment to indicate high-risk instruments for operating cash. However, as interest rates start to increase, treasury practitioners will become more interested in generating a return from operating cash, if only to be able to record it as a cost of holding cash.

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Identifying Risk When Investing

Having identified the objectives for operating cash investment, the treasury practitioner's next task is to identify the risks which might prevent the company achieving those objectives. As discussed, even when investing operating cash, there is no completely risk-free solution. The purpose of identifying risk in this circumstance is twofold: first, to eliminate any unnecessary exposure to risk; second, to establish a policy which mitigates any remaining risk.

The impact of time

For any investment, the associated risks increase with time. As an investment period extends, there is an increased chance that the market environment will change and, potentially, affect the value of the invested principal.

When investing operating cash, time also affects the accuracy of the bases on which any investment is made. For example, the next day's cash position is always more likely to be accurate than next week's cash position, simply because the data on which the position is calculated is more certain. This is an important reminder when stratifying cash: the underlying assumptions of the cash forecasts should be evaluated as part of this process.

Sources of investment risk

Given this general point, risks to operating cash arise in four main ways: counterparty risk, market risk (in the form of foreign exchange, interest rate and spread duration risk), liquidity risk and operational risk (this arises out of managing investments and their redemptions). We consider each in turn.

COUNTERPARTY RISK

Understanding counterparty risk

Counterparty risk is the risk that actions by, or the failure of, an investment counterparty results in the investor suffering a loss of principal, being denied access to funds (a loss of liquidity) or being denied a promised level of return.

The biggest threat to an investor of operating cash is that the counterparty fails. In the worst cases, this will result in the investor losing all principal: an insolvent commercial paper issuer may be unable to repay any holders of its paper. In some cases, however, the investor can mitigate the risk of a counterparty failure, perhaps by taking additional security as part of the investment: a common example is the use of securities in repurchase agreements. Some investments may be covered by insurance: some countries cover institutional investors in their bank deposit insurance schemes. In these circumstances, the investor may recover some or all of the invested principal, although recovery may take time to resolve, resulting in a loss of liquidity.

As well as the risk of loss of principal, there is also a risk that actions by a counterparty could result in a loss of liquidity, such that a redemption cannot be made. This might arise, for example, if a money market fund places a temporary ban on all redemptions as part of a wider attempt to end a run on the fund. Alternatively, a commercial paper issuer may release a set of unfavourable quarterly results, which may make it difficult for an investor to sell any held commercial paper in the secondary market (even though the issuer is able to repay the investor on maturity).

An investor may also experience a simultaneous loss of principal, loss of liquidity and loss of potential yield. If a bank fails, and the company is not covered by a deposit insurance scheme, the investor may not receive any invested principal until a wind-up plan is agreed and implemented. Ultimately, the investor may receive only part of the invested principal, having lost access to the funds and received no interest payments in the meantime.

How to assess counterparty risk

The first step in managing counterparty risk is to try to understand the company's actual and potential exposure to each counterparty. This can be a complex task for multinational companies in which different group entities invest operating cash. Even in highly centralised groups, group companies may still maintain operating accounts in their particular locations, especially if group entities are authorised to open and maintain their own operating accounts. Taking steps to reduce the scope for group entities to operate accounts without the knowledge and oversight of central treasury is a key step in improving the understanding of where surplus cash is held.

Having identified the company's exposure, the next step is to try to evaluate the risk of failure associated with each counterparty. Although there is a great deal of information available, the challenge for most treasury practitioners is to know how best to use it. There are three main problems. First, it is difficult for a treasury practitioner to evaluate the relevance of much of this information. The much-publicised problems with credit rating agencies in recent years have led many to question the validity of any third-party information or analysis. Second, as with all other parts of companies, treasury departments have been under increasing pressure to do more with less. The result is that very few treasury departments have the in-house capability to do anything more than access a small amount of data. Third, when investing operating cash, decisions are typically made on a daily basis, meaning there is limited time available to assess even approved counterparties on an ongoing basis.

That said, there are certain steps most treasury practitioners can, and should, take to try to assess the relative strength of different counterparties.

1. Access sources of credit information

In the past, published credit ratings were considered by many to provide a sufficient assessment of counterparty risk, especially for the purposes of short-term operating cash investment. However, well-publicised examples

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of some very rapid or late downgrades from investment grade to junk have refocused treasury practitioners' minds on the utility of published credit ratings.

Nevertheless, for very short-term investments, credit ratings still represent a good first indication of the relative strength of different institutions. They are still used in investment policies such that operating cash may only be placed with counterparties with a particular credit rating. Policies may then allow the company to become more exposed to institutions with higher credit ratings. For example, a short-term investment policy may only permit a company to place operating cash with banks with a minimum credit rating of BBB. However, the counterparty limit for BBB-rated institutions may be USD 25 million, rising to USD 250 million for AAA-rated institutions. Note that, with many different rated entities, especially within financial institutions, care should always be taken to ensure the correct rating is used.

Treasury practitioners should also consider other data from credit rating agencies. Sovereign ratings provide an indication of the relative strength of the wider economy in which a particular institution operates. In the case of banks, an investor may be able to form a view as to whether a government would be likely to permit a bank in its jurisdiction to fail – and if so, how any winding-up action would be likely to impact on institutional investors. Some rating agencies provide their own assessment of a government's approach to bank failure. Sovereign ratings can also be used to set lower counterparty limits for banks in particular jurisdictions. For example, even if a counterparty limit of USD 100 million applies for A-rated institutions, this may be capped at USD 50 million if the institution is located in a BB-rated country.

2. Other data

Having identified credit ratings as a base tool to use when assessing counterparty risk, there are other sources of information which treasury practitioners can use to provide a more reactive and predictive assessment of counterparty strength. These tools include a range of publicly available information such as (for publicly listed institutions) share prices, credit default swap spreads and more general news information, including official stock exchange announcements and published annual results.

However, keeping abreast of all relevant information is difficult, especially if an institution is trying to maintain maximum single-party exposures of, say, 5%. This realistically means the company needs to be analysing a wider pool of potential counterparties, which could extend to 30 or 40 names at a minimum.

For all but the largest corporate treasury departments, this is unlikely to be a realistic objective, especially considering that the returns generated are only likely to be slightly more than positive.

It is also possible to access data developed by third-party providers which have their own systems for measuring and modelling counterparty risk. The AFP Corporate Treasurers Council's *CTC Guide to Counterparty Risk Management* looks in more detail at some of the propositions available in the market place. These solutions can be a more cost-effective way of assessing counterparty risk for organisations which lack the resources available to the largest corporate treasury departments.

3. Outsourcing credit risk analysis

It is possible to outsource credit risk analysis, either as a discrete transaction or as part of a wider outsourcing of investment management.

First, it is possible to outsource the credit analysis activity to a specialist consultancy. These consultancies employ their own analysts and can provide information on a range of potential counterparties. Because they are specialists, they can provide information across the counterparties.

However, because they are only providing opinions, these consultancies are not accountable for their decisions in the way that either an asset manager or the treasury department itself is. In addition, their work tends to be generalised for broad distribution, rather than specific for the treasury practitioner's requirements. As a consequence, the treasury practitioner has to determine the quality of such research and, therefore, how much weight to give to a consultancy's opinion.

Second, it is possible to outsource credit analysis to a specialist asset manager as part of a wider outsourcing of investment management. In the case of operating cash, this is most commonly to a money market fund. Money market funds, and other asset managers focused on the shorter end of the market, have a specialist expertise in assessing the class of instruments an investor of operating cash will wish to be exposed to. As well as outsourcing daily credit analysis, the investor will also be outsourcing operational tasks, including custody and reporting to the fund manager.

When selecting a money market fund, an investor has to scrutinise the approach and policy of the fund manager, to try to identify whether it reflects the company's approach to risk. In some markets, there are strict rules covering the activities of money market funds: these apply to 2a-7 funds in the United States and UCITS/ESMA Short Term Money Market Funds in the EU. These parameters determine the characteristics of the individual asset classes the fund is permitted to invest in, the maximum term for any investment, and set series of rigorous rules with respect to diversification and redemption.

> Barry F.X. Smith, Global Head of Cash Business, SSgA: 'When outsourcing to an asset manager, it is important to understand their risk management philosophy. The key is to try to understand how a portfolio manager will react in six months' or a year's time. Will the manager continue to reflect the investor's risk appetite?'

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(Note that some funds outside the United States or the EU may be called money market funds but have significantly different regulations. This will normally reflect the nature of the local market where, for example, there may be a shortage of short-term issuance appropriate for operating cash.)

Third, the company could outsource investment management to an asset manager via a mandate. In effect, the company would agree the investment policy with the asset manager, which would then be responsible for implementation. Depending on the agreement, the mandate can transfer much of the operational investment activity, including some credit risk analysis, to the asset manager.

Diversification as a protection against counterparty risk

However, managing counterparty risk through the use of credit analysis is only part of the solution. Credit analysis can at best be only an informed assessment of the likely failure of a particular counterparty within a specified period of time. No credit analysis will be able to predict with 100% accuracy whether or not a particular counterparty will fail over time and, more especially, what form a failure might take and, therefore, how that failure might affect the investor.

The challenge then is to use the credit analysis to inform an appropriate diversification strategy such that a company is never over-exposed to any single credit, groups of credits or geographic location of credits. Having an appropriate diversification policy means that even if one counterparty fails, the resultant loss will not have a disastrous impact on the investor's operating cash.

It is increasingly easy for treasury practitioners to track their exposure to particular counterparties. Treasury management systems (and standalone investment management platforms) allow investors to track, often in real time, portfolio holdings, including those held via asset managers.

Note, too, that investors are exposed to counterparty risk from an operational perspective, most notably through settlement risk, which is the risk that one party to an agreement does not perform as expected under a contract. The increased use of electronic tools to match transactions and to tie delivery to payment has meant that this is more easily managed today. Treasury practitioners must always understand both parties' responsibilities under any agreement. Ensuring settlement instructions are up to date is an important part of this process.

MARKET RISK

Market performance also has the potential to have a significant impact on the treasury practitioner's objectives when investing operating cash. Three factors – a change in interest rates, a change in exchange rates and a change in an asset's value – have the most potential to have an effect in this context.

Interest rate risk

As with counterparty risk, the risk posed by a change in interest rates will increase, the longer the investment term. As an illustration, if interest rates were to increase overnight by 1%, this would result in a fixed-term investor facing an opportunity loss of USD 28 per USD 1 million per day. On an overnight investment, even a change in interest rates of this magnitude would have little impact. However, if cash had been invested for a year, the loss would be USD 10,000 for the same invested principal.

For the last few years, interest rates have been at historic lows, so treasury practitioners have been less concerned with interest rate risk. However, as speculation increases about the timing of future interest rate rises, investors have become more aware of interest rate risk. Longer-term investors have started to reduce the duration of their portfolios, to avoid the risk that they are tied into low interest rates when rates do start to rise. Investors of operating cash will also want to consider interest rate risk, especially when placing cash for longer than a week or so.

Changes in interest rates have a greater potential to affect the price of instruments issued at a discount, such as commercial paper, which are then sold in the secondary market. The risk to the investor of operating cash is that a fluctuation in market price may result in a loss of principal, but only if the investor seeks to sell the instrument before maturity. Holding an instrument to maturity allows the investor to avoid this risk, although this may not always be possible.

Foreign exchange risk

The impact of a sudden change in a foreign exchange rate is potentially more serious than a change in interest rates, when investing operating cash for a short period of time. An overnight devaluation of a currency could have a significant impact on principal. The potential impact will depend on how any operating cash is invested and how the cash is expected to be used by the business in the future.

Consider this scenario. A multinational company has USD 10 million of surplus operating cash on deposit. The company intends to use this surplus to pay its European suppliers EUR 8 million in one month's time. The treasury practitioner has a choice when to transact the USD into EUR in order to make the payment. Many treasury practitioners would choose to transact some USD into EUR immediately and then to manage the surplus USD and the EUR 8 million separately. In this way, the treasury practitioner will have eliminated the risk of the value of the USD declining with respect to EUR such that additional borrowing would be required to meet the EUR 8 million payment. There is of course still a risk that the USD appreciates against the EUR over this time period, resulting in a potential loss of surplus USD. This solution highlights a decision that it is

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more important to ensure security of principal (in EUR) than a return on the investing operating cash.

As an alternative, the treasury practitioner may keep all the cash in USD and use a separate derivative transaction to fix the future USD-EUR exchange rate, to ensure sufficient EUR are available on the due date. Again, the treasury practitioner has chosen to ensure the company has access to sufficient EUR on the date the obligation falls due. The company's use of derivatives should be documented either in the treasury policy or similar document. (Note that the use of derivatives expands the company's exposure to counterparty risk.)

This illustration highlights how foreign exchange risk can arise when a company plans to use receivables denominated in one currency to meet a future disbursement obligation in another currency.

Companies may also be exposed to a translation risk. This can arise if investments are held in one currency and the company's accounts are prepared in another. Any change in the exchange rate can result in a change in the reporting currency value of the investment. This may need to be monitored if, for example, the company has to comply with tight loan covenants.

Keeping cash in the home market is normal for operating cash. It allows cash to be invested locally in the local currency without any need for foreign exchange transactions. The main risk is that some local markets may not provide the range of alternative counterparties or instruments to satisfy the demands of diversification indicated above. In these circumstances, it is possible to transact some of the cash into another currency to allow for more diversification, but the downside is that the company will lose some principal on both legs of the foreign exchange transaction and the company becomes exposed to foreign exchange risk. As a result, this solution is unlikely to be worthwhile for all but the largest sums. Some banks do offer cross-border cross-currency pooling solutions, primarily in Europe (specifically the Nordic region).

Spread duration risk

Spread duration risk is the risk that an instrument changes in value while the investor holds it. For most instruments, this only represents a problem if the investor wants to sell the instrument in the secondary market before it matures. In these circumstances, the investor could lose some of the invested principal, if the value of the instrument has fallen since purchase or issue. This is most likely to occur for instruments with a longer maturity and which are issued at a discount, such as commercial paper. Money market funds may also be affected if they are floating net asset value funds, such that a change in value of assets in the portfolio may result in a reduction in the value of a company's invested sum. It is possible to avoid spread duration risk by only selecting instruments which will not be affected, although there will then be a reduced ability to diversify.

LIQUIDITY RISK

This is the risk that funds held in the name of an investor cannot be accessed when needed. The use of accurate cash position forecasting can help to avoid this situation, by identifying when cash will next be needed by the business. To compensate for any inaccuracy, treasury practitioners will want to build in extra flexibility on redemptions so that a certain proportion of investments are either invested overnight or mature within a week or less.

However, the treasury practitioner will also want to avoid all instruments maturing at the same, especially if these funds are expected to be reinvested. This could result in additional counterparty risk if there is a shortage of instruments available for reinvestment at that time. This is sometimes referred to as 'roll risk'.

OPERATIONAL RISK

The final risk to manage is operational risk. There are two main sources of risk: human and systems.

All transactions are at risk from both human error and deliberate fraud. Error can manifest itself at plenty of points along the investment process: for example, incorrect data entry, poor investment instrument selection and execution, and inadequate record-keeping. In addition, activities can be performed fraudulently through, for example, the use of inaccurate settlement instructions. To protect against these risks, all investing procedures should ensure there is an appropriate segregation of duties, such that a single individual cannot play multiple roles on the same transaction. Each individual should be authorised to act within his or her own competency, and individual limits should apply. All actions should be subject to audit, both on a regular basis and as part of a spot check of treasury performance. Any automated processes, including the cash flow forecast and any automated sweeping of cash balances, should also be subject to regular checks.

Treasury management systems and other systems used within the treasury department should also be reviewed more generally to ensure that information flows effectively between them where necessary. It is also important to have back-up procedures in place in the event of a communication problem between the treasury department and the counterparty. Such procedures can include the acceptance of telephone and faxed instructions, subject to clear limits and additional checks.

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Drafting an investment policy to achieve those objectives

Having identified the potential exposure to risk, a short-term investment policy should be designed to help the company achieve the objectives listed above. The best policies set parameters reflecting the company's appetite for risk when investing operating cash. The treasury practitioner is then able to construct an investment portfolio within those parameters, and help the company to achieve its objectives.

> Matthew J. Steinaway, Global Head of Cash Management, SSgA: 'Identifying and preventing inappropriate risks from entering the cash portfolio is the key to protecting capital in the long run. However, investors cannot completely eliminate risk and our approach is more about being risk aware than risk averse.'

When managing operating cash, it is usually appropriate to target the maintenance of principal and the assurance of sufficient liquidity as the primary objectives. Obtaining a return on investment is the least important objective.

The investment policy must also be clear about its scope. Some companies have a single investment policy covering the full range of investment activity from operating cash through to pension fund assets. Others maintain a separate short-term investment policy, which is one of a number of different policies covering treasury activities. If a company does have a separate short-term investment policy, its scope (for example, whether it covers operating cash or all cash required under a year) must be specified.

The policy must also be clear with respect to the entities it applies to. It may apply to all group entities, or just those managed from the corporate centre. This may depend on the level of control the centre exercises over group entities. For example, central treasury require group entities to seek approval before they open local bank accounts, and then direct how group entities invest surplus cash. Alternatively, central treasury may only have direct control over the group liquidity management structure, only covering surplus cash in one or more international currencies (for example, USD).

These questions also illustrate that the investment policy (in whichever form it takes) cannot exist in isolation. It needs to be consistent with the wider treasury policy and any other standalone policies which exist within the company as a whole or the treasury.

Having established the scope of the policy, the next step is to put in place a series of parameters, each designed to help the company achieve its investment objectives.

PRESERVING PRINCIPAL

To preserve principal, the investment policy should be designed to limit exposure to a single counterparty and to try to ensure appropriate investment instruments are selected. This will not eliminate the chance that principal will be lost, but it should act to minimise the impact of any such loss. The following factors should all be incorporated into the investment policy.

Counterparty limits

The policy should define the concept of approved counterparty. If the company chooses to have an approved counterparty list, there should also be a process for reviewing the list, to ensure it stays relevant. Alternatively, the company may have a set (or a series) of criteria for appropriate counterparties, in which case there should be a separate process to ensure a proposed counterparty qualifies as part of the investment operating procedures (see below). The policy should require that the appropriate dealing mandate is in place before any investment is made with a counterparty.

The policy should then set clear counterparty limits. These can be broken down into sub-categories, so that there may be limits by country or by counterparty type (for example, bank, non-bank financial institution, other). The policy may also set participation limits, such that the company may not hold more than a specified proportion of a particular instrument or fund.

It is common for counterparty limits to vary according to a counterparty's credit rating. The danger with formalising credit ratings is that it can require the company to take action very quickly (and at potential loss) in the event that a credit is downgraded, especially if different counterparty limits apply for instruments with a separate counterparty. To overcome this problem, the policy may permit the company to hold investments with downgraded counterparties, subject to maturity limits. Current regulatory proposals also suggest that formal money market fund ratings may not be available in the future, in which case existing investment policies will need to be reviewed.

Use of appropriate instruments

The policy should list those instruments permitted for short-term investment of operating cash. It may also list instruments not permitted for investment. Some policies also set out the circumstances in which derivatives can be used to protect principal, such as in some of the foreign exchange scenarios outlined above.

The use of instruments can also be subject to limits. For example, the policy may stipulate the maximum proportion of operating cash to be held in bank deposits. For practical reasons, these limits may need to be subject to a minimum threshold balance. If the company only has a small positive cash balance at a particular point, it would be difficult to insist upon diversification, for two reasons: the necessary investment of time to achieve it would not be justified, and minimum investment requirements may make it impractical anyway.

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If a company decides to use money market funds, it is now possible to use information published by the money market fund to ensure the holdings within the fund are also considered as part of the wider portfolio held by the company.

Some instruments offer additional security. For example, if a company uses repurchase agreements, it will hold a security in exchange for any deposited cash. In the event of counterparty failure, the investor can sell the security to redeem the principal. In this circumstance, the company is also exposed to the counterparty risk of the issuer of the security.

The policy should state whether foreign currency investment is permitted and, if so, whether positions should be hedged using derivative instruments.

PRESERVING LIQUIDITY

The simplest way of preserving liquidity is to retain all cash in overnight instruments, such as bank deposits, repos or money market funds. However, this imposes significant operational requirements on the treasury practitioner, who has to redeem and then reinvest cash on a daily basis. Where large sums are involved, this can be at the expense of diversification requirements.

Instead, the investment policy can incorporate a range of measures to ensure the company has access to maturity at any time. First, the policy can set a maximum maturity for any single investment instrument. This will then reduce the impact of any inability to sell an instrument in the secondary market. Second, the policy may then set a maximum duration, or weighted average life, for the portfolio as a whole. Third, the policy may require that a certain proportion of cash is redeemable at specific periods: this may be 15% redeemable overnight, 35% within a week and 70% within a month, for example. Finally, the company must also understand the implications of any exchange controls on the free movement of cash throughout the group. It may be preferable for entities operating in countries with complex exchange controls to remain outside a highly centralised liquidity management structure, and manage that cash separately. (The same policy with respect to counterparty limits etc. can apply, but at the local level.)

GENERATING YIELD

In most cases, the investment policy will not set objectives for generating yield. Setting a benchmark to measure performance against may be counterproductive when investing operating cash, simply because if an inappropriate benchmark is selected, it may conflict with the objectives of maintaining principal and preserving liquidity. The policy may set a target for the proportion of cash held in fixed versus floating rate instruments as a protection against the impact of a change in interest rates, although this is not as relevant for operating cash as for other investments.

Tax rules have the capacity to reduce yield significantly, so it is vital that independent tax advice is sought while an investment policy is being developed. The key tax treatments to consider are transfer pricing, thin capitalisation and any withholding tax on interest payments. These factors should have been considered when any cross-border liquidity management structure was established, especially if it was being run by an in-house bank. However, if liquidity management is being reviewed at the same time as the investment policy, it is important to establish that any potential improved returns are not eliminated by an increased tax bill.

CHANGING CIRCUMSTANCES

The policy should also provide guidance for how to approach changing circumstances. First, it should set out how counterparty limits, the approved counterparty list and approved instrument list can be changed. Doing so may require formal approval of the board, for example. Second, the policy should provide clear guidance about the approach when limits are neared or breached. Third, it should also state how frequently the policy should be reviewed. Most policies are reviewed on a regular basis, and then subject to special review after a corporate event (such as a major acquisition).

With an investment policy in place, the treasury practitioner then needs to draft and follow a set of compliant operating procedures to oversee the implementation of the policy and to structure appropriate investment decisions, which are covered in the next section.

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Making Appropriate Investment Decisions

Where the investment policy sets the parameters within which the treasury practitioner must invest, the operating procedures set the precise actions which must be followed.

A set of operating procedures

The operating procedures should essentially describe how a decision should be made. It should start at the point at which the cash forecasts are produced and assessed, to help to stratify cash into separate categories, one of which will be operating cash. There should then be the process of identifying the appropriate investment instruments and counterparties to use. It should conclude with the process of investment execution and record-keeping.

It is important to recognise that the company may have a series of equally appropriate investment instruments and counterparties. In many cases, the company will not be constrained by the limits set in the investment policy: very few companies have sufficient cash to be at the limit across all instruments with all counterparties. This means that the treasury team will need to select from a range of options and should, whenever possible, assess the impact of each alternative on the portfolio as a whole.

The complexity of the selection of the appropriate instrument and counterparty combination will vary significantly between companies. Companies using one or money market funds for the majority of their operating cash investment may simply have to choose between funds, often on the basis of the outstanding assets invested with each one. Companies placing funds in bank deposits may take a similar approach. When a company has a more complex operating cash portfolio, the impact of each investment on the maturity profile of the portfolio, the redemption patterns and the wider counterparty exposure will all need to be modelled before an investment is made.

The operating procedures should then describe the process of making the investment, once the preferred instrument and counterparty has been identified. This may include processes for obtaining quotes, although for some instruments this can be done via an investment portal. The treasury practitioner may simply have to seek three alternative quotes from different counterparties or a panel of dealers. However, because obtaining a quote to invest a large sum, especially in some less commonly traded currencies, can have an impact on the market, the procedures may only require competitive quotes for regular operating cash investment.

The company should have a policy for using dealers, especially if the dealers see transactions as part of a wider banking relationship. Some companies may have a panel of three banks, with each bank given business in turn. Others may have a similar panel, but deal with each bank on a best-price basis. The approach should be communicated to all dealer banks, so that it does not cause problems for the wider relationship.

Again, once the selection has been made, the treasury practitioner must follow specific procedures. These will be designed to protect against many of the operational risks, including error and fraud. This will therefore include the use of an approval and authorisation process for deals, whether executed manually or automatically via the treasury management system (or similar platform). In addition, issues such as settlement, the use of security, after-purchase monitoring and audit should all be covered in the operating procedures.

Available Investment Instruments

The range of alternative investment instruments available when investing operating cash will depend on the precise characteristics of the market in which the cash surplus is generated. Broadly speaking, an investor will have two choices when investing operating cash. The first option is to place cash within the market in which the cash is generated. This is a common policy where a company has both sales and production activities in the same location. A company will use sales proceeds to finance future production via, for example, the payment of wages to local employees. This option is also common where it is difficult or expensive to repatriate cash to a group treasury somewhere else. Finally, it is popular when the local market has a good range of alternative investment instruments, allowing the investor access to a diversified set of potential counterparties.

The alternative is to establish a liquidity management structure which allows cash surpluses to be pooled (notionally or physically) to a location away from the initial location. This may be done on a global basis (for cash in global currencies, in some cases) or on a regional basis (by time zone or continent, often reflecting a company's wider organisational structure). The ability to do this depends on permissive local regulation and legislation. In addition, local banks must have the functionality in place to facilitate pooling without any loss of visibility over cash balances.

Key differences between investment markets

It is important to understand fully the nature and characteristics of investment instruments before placing funds. There are some significant differences between instruments in different markets, including:

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- Terminology. Terms are used differently in different markets. For example, the term 'money market fund' is clearly defined in both the United States and the EU. When investing in a different market, investors should not assume that a local money market fund has the same restrictions as those in the United States.
- Impact of regulation. Bank capital adequacy regulation varies significantly around the world. This results in significant differences between jurisdictions. Until recently, for example, banks in France and the United States were not permitted to pay interest on any investment with a maturity of less than a month. As a result, both countries have sophisticated domestic money market fund industries.

  As banks around the world start to comply with the Basel III capital accord, bank appetite for corporate deposits is also changing. Operating cash is viewed differently from other short-term cash, as regulators consider it more likely to be kept with a cash management bank. Therefore banks have to set aside less capital against operating cash deposits. At the same time, banks are more likely to offer higher rates against deposits for maturities over 30 days, again for capital adequacy reasons. However, local regulators also apply their own rules, which can affect investors. For example, UK banks have an additional liquidity threshold of 93 days, which will have a similar effect on short-term interest rates.

  Finally, securities regulation also affects some short-term investment instruments. Commercial paper maturities are driven by the requirement to register paper with the local regulator. This means that US commercial paper has a maximum maturity of 270 days, whereas UK commercial paper has a maximum maturity of 364 days.
- Size of local market. Just as investors will want to diversify their pool of counterparties, so borrowers want to draw on the maximum number of potential investors, to ensure access to the funding levels they need. In addition, some territories have a more established secondary market for some instruments, such as commercial paper, than others.

Characteristics of investment instruments

Given these key differences between different markets, the investor then has to assess the characteristics of each instrument under consideration before making a decision where to invest. These factors may not need to be considered in detail for each decision. For example, where a company is investing short-term operating cash overnight with a bank, its policy (perhaps to invest with one of a dealer panel in turn) may be sufficient. However, it is important that the different characteristics are understood in the context of the company's objectives for managing operating cash.

- Counterparty. The most important feature of any investment instrument is the counterparty. Note that for some issuers of instruments, notably banks, there can be a number of different issuers of instruments within the same group. In these circumstances, it is important to establish which entity is the precise issuer, whether other group entities provide any guarantees in the event of default, and what level of public information is available on the issuer (for example, credit default swaps).

  Most governments will have the option of repaying, simply by printing more money. This may mean that the principal may not be lost, although its underlying value may decline if the exchange rate also depreciates. Some governments which share currencies, including eurozone governments, do not have this option.
- Term of investment instrument. There are essentially three types of instruments suitable for operating cash.
  - *Open-ended investment instruments.* These instruments allow the investor access to cash on demand (subject to operational constraints) and so are highly liquid. These are the most common investment instruments, as they include any cash held in operating accounts at cash management banks. Money market funds are also open-ended, allowing investor to invest and redeem cash on an intra-day (or next-day) basis.
  - *Notice instruments.* These require investors to provide advance notice (perhaps one week or longer) to redeem funds. The funds may be accessible sooner, but on payment of a fee (and with loss of any interest earned). Some bank deposits are structured in this way, with the notice periods likely to be driven by capital adequacy requirements.
  - *Time-limited instruments.* Finally, most formal investment instruments have a maturity date. These may be in the form of a stated maturity date (on which the borrower has to pay the face value of the instrument to the bearer). Government-issued treasury bills and corporate commercial paper are generally both issued in this way. Longer-term bonds will also have a fixed maturity date, albeit with interim interest rate fixing dates. Banks also offer term deposits, or certificates of deposit, for fixed terms.

    Some instruments have a fixed maturity which is agreed between the issuer and the investor. Commercial paper issuers often respond to a reverse enquiry, where an investor may ask to buy, say, USD 2 million of the company's commercial paper for a period of four months. This allows the investor to structure the cash portfolio to reflect anticipated cash surpluses. Repurchase agreements are typically agreed between investor and issuer to meet a similar requirement.

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An investor may also commit to depositing cash with a bank for a pre-agreed term (usually anything up from one week, with one month or greater more common). These are not usually redeemable until the end of the term, unless agreement can be reached with the bank.

- How funds are held. Investment instruments differ in how funds are held and, consequently, the level of security and access to liquidity they offer to the investor.
  - *No certificate.* Many short-term investment instruments, including demand deposit accounts and money market funds, are held in a co-mingled fashion. This means the investor has an amount of invested funds set aside and recorded in the investment manager's book – whether this be as an account entry in a bank's ledger or as an investment in a money market fund. This information is generally available to access in real time in more sophisticated markets, although in emerging markets banks may not have the functionality to provide access to information in real time.
  - *Certificate of investment.* Other short-term investment instruments allow the investor to hold specific instruments (usually now in dematerialised form) which provide a clear record of the investment held. In most cases, this instrument can be sold in the secondary market, giving an investor the opportunity to access cash before maturity. This difference will also matter if the counterparty or issuer of the investment instrument fails and the investor wants to demonstrate title.

    These instruments can provide investors with improved security when placing cash as part of a repurchase agreement. Again, it is important to consider the creditworthiness of all participants when assessing counterparty risk in such transactions.
- How investments are recorded and how returns are made. For operating cash, one important objective is usually to ensure security of principal. A key distinction then for investors is whether the investment is made at face value, with a return generated on top, or whether the investor purchases an instrument which might fluctuate in value.

  This is a topical issue, with regulators on both sides of the Atlantic considering whether constant net asset value money market funds should continue to be available to institutional investors. At present, CNAV funds are considered, from an accounting perspective, to have a constant value and can be recorded as such. Any return is accounted for in the same way as bank interest. However, because investors hold a proportion of a fund, some argue this represents an artificial view of the nature of the instrument. Although money market funds grew as institutional investors wanted to generate a return on short-term cash, it may not be appropriate to treat them for accounting purposes in the same way as, say, investing in short-term bank deposits, because the protection of the invested principal is different. If regulators do decide to restrict the availability of CNAV money market funds to institutional investors, including corporations, there will be a change in the accounting treatment, although this should not be a complex challenge.
- Support for investments. Finally, the investor should try to identify whether, and at what level, a counterparty is supported by third parties, should the original counterparty fail. Broadly speaking, potential support falls into two categories:
  - *External support.* Some investments, primarily bank deposits in certain jurisdictions, are covered by external guarantees up to a maximum investment amount. As discussed, the availability and coverage of such schemes vary significantly between jurisdictions. It may be that funds placed with a member of a banking group in one location are covered by deposit insurance, whereas funds placed with another are not. Companies may be covered by deposit insurance in one location, but considered to be institutional investors in another, and therefore outside the scheme.
  - *No support.* At the other extreme, some institutions may sponsor and cross-sell investment instruments under the same name, but provide no guarantees in the event of failure. This is most likely in the case of bank-sponsored money market funds, which are usually not formally supported by the bank.
    Some institutions may enjoy implied support from other group entities, but in the absence of a formal guarantee, investors should not rely on any support.

Finally, investors should understand how instruments will be treated in the event of the issuer's failure. Each instrument has a different status with respect to the seniority of the debt. In addition, banks increasingly are required to provide clearer indications of how they would react in the event of failure or bankruptcy, which should allow an investor to identify how a particular investment instrument would be treated in those circumstances.

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Conclusion

To manage operating cash successfully, a treasury practitioner needs to set clear objectives, establish an investment policy which reflects their organisation's risk appetite, and then implement the policy through a set of robust operating procedures. The key element is to measure and manage risk effectively. In the context of investing operating cash, a daily activity, this means narrowing the pool of potential counterparties by the use of credit ratings or some other easily accessible tool, and the list of approved investment instruments by reference to their underlying characteristics. It is not possible to eliminate counterparty or other investment risks completely; effective management should focus on establishing as diverse a portfolio of investments as possible. Once diversification has been achieved, and if more resources are available, then it is appropriate to devote time to assessing counterparty risk in more detail.

The following three sections are designed to help treasury practitioners when reviewing or developing new investment policy and procedures. The first is a set of questions to help treasury practitioners better understand the nature of the environment in which they are operating. The second is a set of features to include in a short-term investment policy (or in that part of a broader investment policy which addresses operating cash). The third includes features to be covered in treasury investment procedures. These are provided as a guideline, as companies have different approaches to the level of detail required in their treasury policies. In some organisations, the treasury policy is very detailed, so some of the material covered in the procedures section could be incorporated in the policy; in others, the policy is a high-level document, with much of the detail included in the operating procedures.

Treasury review

1. Is it possible to consolidate any bank accounts, at group or operating company level?
2. Is it possible to streamline disbursement patterns? Can the timing of collections be made more certain?
3. Has the cash position forecasting system been reviewed for effectiveness?
4. Does the company use the cash position forecasting modules of any existing treasury management or ERP system?
5. Does the treasury receive timely data feeds from banks and group entities?
6. Is there a group-wide investment policy in place?
7. How do exchange controls limit the ability of the group to move cash freely between entities and the corporate centre?
8. Is a global or regional liquidity management structure in place? If so, has it been reviewed for effectiveness and efficiency?
9. How does the company define operating cash?
10. What are the company's objectives when investing operating cash?

Short-term investment policy

The following is a list of all the features to be covered in an investment policy:

- Scope of policy: which entities and currencies are covered; whether the policy just covers operating cash or all-short term cash.
- Objectives when investing operating cash.
- An approved counterparty list or set of guidelines for acceptable counterparties.
- Dealing mandates in place with counterparties.
- Counterparty limits and possibly participation limits.
- Policy if a counterparty is subject to a downgrade, resulting in a breach of limits.
- A permitted instruments list. There may be a prohibited instruments list.
- Investment limits by asset class.
- In which circumstances additional security may/should be taken.
- In which circumstances derivative instruments may be used.
- In which circumstances foreign currency investment is permitted, and how any positions should be hedged.
- Maximum maturity limits by instrument.
- Maximum duration or weighted average life for portfolio as a whole.
- Redeemable investments overnight/within one week/within one month (for example).
- Investment instruments subject to tax review prior to use.
- Investment instruments subject to regulatory review prior to use.
- If a market benchmark is used, whether it is appropriate.
- Frequency of investment policy review.
- Authority to amend investment policy (add/remove counterparties and investment instruments).
- How frequently transactions are recorded and audited.

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Short-term investment procedures

The organisation's investment procedures should cover the following points:

- How to use cash position forecasts to stratify cash:
  - How much operating cash must be invested?
  - Where is it located and in which currency (or currencies) is it denominated?
  - When is the cash next needed by the business?
- How to select an appropriate investment instrument:
  - Term.
  - Instrument.
  - Impact on portfolio.
- How to select an appropriate counterparty:
  - Check counterparty limits against existing positions.
  - Is there a default counterparty? (This might be a money market fund or the next bank from a dealer panel by rotation.)
  - If not, is it appropriate to seek quotes from approved counterparties? This may be via enquiry or by reviewing a dealing platform.
  - Select counterparty and check settlement instructions are in place.
- How to complete a transaction:
  - Get any necessary internal authorisation for the precise transaction: this should include details of instrument and counterparty.
  - Initiate the transaction.
  - Confirm the transaction via manual process or automated deal-matching system.
  - Settle the transaction.
  - Record and reconcile the transaction.
- How to monitor a transaction:
  - Ensure appropriate reports are generated:
    - daily transaction report
    - regular portfolio reports, including schedule of redemptions, counterparty positions, portfolio by asset class/instrument.
  - Update the cash position forecast.
  - Assess the quality of the investment.

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