



## **Funding and liquidity in today's capital markets**

On May 12, 2009, members of the Southeast Audit Committee Network (SEACN) met in Atlanta for the network's 13th meeting. Members discussed the funding and liquidity challenges companies are currently facing. Members were joined for separate discussions by Mark Chancy, Executive Vice President and Chief Financial Officer at SunTrust Banks, and by both Walter Driver, Chairman – Southeast, Goldman Sachs, and Ivan Ross, Co-head of the Corporate Finance Solutions Group within Goldman Sachs's Investment Banking Division.

In a separate, unreported session, members also discussed the future of earnings guidance, audit committee involvement in executive compensation, whether to safeguard internal audit staff during company layoffs, and the impact of those layoffs on internal controls.

Collectively, members of the network participating in the meeting sit on the boards of more than two dozen large-, mid-, and small-cap public companies:

- Eddie Adair, Audit Committee Chair, Tech Data
- Denny Beresford, Audit Committee Chair, Kimberly-Clark and Legg Mason
- John Farrell, Audit Committee Member, Lender Processing Services
- Doug Ivester, Audit Committee Chair, SunTrust Banks
- Warren Jobe, Audit Committee Chair, WellPoint
- Andy McKenna, Audit Committee Chair, AutoZone
- George Minnich, Audit Committee Chair, AGCO
- Tom Presby, Audit Committee Chair, World Fuel Services and INVESCO
- Dave Rickard, Audit Committee Chair, Harris Corporation
- Jim Robbins, Audit Committee Chair, DSW
- Carol Tomé, Audit Committee Chair, UPS
- Erik van der Kaay, Audit Committee Chair, RF Micro Devices
- Bunny Winter, Audit Committee Chair, Wellesley College

Ernst & Young was represented by:

- Karole Lloyd, Vice Chairman of Industry and Knowledge
- Tom Hough, Vice Chairman and Southeast Area Managing Partner
- Chuck Seets, Principal, Ernst & Young



*VantagePoint* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made during the meetings are not attributed to individuals or corporations. However, Msrs. Chancy, Driver, and Ross have given permission for their comments to be attributed. Quotes in italics are drawn directly from comments made by participants during the meeting.

## Executive summary

During their discussions on the financial crisis and funding and liquidity, members and guests focused on the following topics, which are covered in more detail on the following pages:

- **Capital markets: only beginning to thaw** (*Page 2*)

Network members and guests discussed the continuing difficulties in the economy and expressed uncertainty about the future. However, meeting participants noted that both inflation and deflation appear to be low threats and that the markets for commercial paper and corporate bonds are improving, at least for large and well-rated companies – and they attributed some of the improvement to government initiatives.

- **The impact of the financial crisis on bank behavior** (*Page 5*)

Meeting participants discussed how the problems in the financial services industry have affected the behavior of banks. Specifically, members and guests examined the implications of the recent government stress tests for the nation's largest financial institutions. Members report that the increased cost and constraints associated with funding mean that their companies are placing a higher premium on their relationships with banks.

- **The roles of the board and the audit committee** (*Page 7*)

Meeting participants discussed several aspects of the board and audit committee's roles in addressing funding and liquidity risks. The board is more focused now on business partner risks, while the audit committee's responses have included conducting funding and liquidity deep dives, requesting more input from the external auditor, considering additional disclosures, monitoring insurance carrier risk, and reexamining committee composition. Participants also discussed the value of having a separate finance committee.

## Capital markets: only beginning to thaw

When the SEACN met last fall, the challenges facing the financial services sector were growing increasingly evident, and members speculated on whether funding conditions would further deteriorate. At the May meeting, members and guests reviewed companies' sources of funding.

For many, the fear of further deterioration remains: *"We were very concerned six months ago, and I think things are slightly better [than they were], but we're still not in the clear. For now, all we're focusing on is making it through the year. As long as you're generating cash, that's all that matters."* Aggressive actions by the United States and other governments are beginning to thaw the capital markets, but the crisis is far from



over. While SEACN members' companies are experiencing a range of repercussions as a result of the current downturn, all companies are taking the crisis very seriously.

### **Neither inflation nor deflation is seen as a serious risk**

One meeting participant noted, *"There seems to be a lot of debate around whether we are going to have deflation or inflation."* In an April policy statement, Federal Reserve officials said they anticipate inflation "will remain subdued" and that they see "some risk that inflation could persist for a time below rates that best foster economic growth and price stability in the longer term."<sup>1</sup> Mr. Driver remarked, *"The risk of deflation is there, but it's declining ... some say modest and stable inflation has historically been good for capital markets."*

### **Commercial paper markets show tentative improvement**

One of the more stunning developments in the wake of Lehman Brothers' bankruptcy was the dramatic collapse of the market for commercial paper. The money market funds that had been major purchasers of commercial paper became very risk averse, making it difficult to issue paper that wasn't extremely short term and didn't carry high interest rates. This threat to the ability of companies to fund their day-to-day operations prompted a quick response by the federal government in the form of lower interest rates and several programs designed to support short-term debt markets, such as the Federal Reserve's Commercial Paper Funding Facility and Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility.

The situation has improved, at least for highly rated companies. Mr. Chancy commented, *"One thing the government did well was institute programs that enhanced the liquidity in a variety of corporate debt-rated markets, including the commercial paper market. These kinds of programs have significantly increased the level of liquidity in certain key markets. You don't hear about 'breaking the buck' as much as we did six to twelve months ago."* Members agreed with one audit chair who said, *"There has certainly been some stabilization in these markets recently."*

However, as the *Wall Street Journal* reports, there is still a significant need for the government programs: "The AMLF had seen very little action, a sign that the market could function on its own. But when the Fed announced two weeks ago that it wouldn't accept commercial paper that had been placed on 'negative watch' by credit-rating agencies, funds borrowed heavily against AMLF ... This suggested money funds were worried about getting stuck with paper they couldn't sell, a sign that the market still needed the government backstop to function normally."<sup>2</sup> Indeed, as economist Kenneth Kim told *Reuters*, "Without a better sense of guaranteed recovery, businesses will still be cautious, as the commercial paper data reflect. Companies don't want to be the first out there spending money."<sup>3</sup>

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<sup>1</sup> Brian Blackstone, "Prices Drop but Threat of Deflation Is Remote," *Wall Street Journal*, May 16, 2009. Available at <http://online.wsj.com/article/SB124239045456723735.htm>.

<sup>2</sup> Mark Gongloff, "Government Holds Strings to Markets," *Wall Street Journal*, May 11, 2009. Available at <http://online.wsj.com/article/SB124200067135005117.html>.

<sup>3</sup> "US commercial paper outstanding least since 2004," *Reuters*, May 7, 2009. Available at <http://www.reuters.com/article/bondsNews/idUSN0736373620090507>.

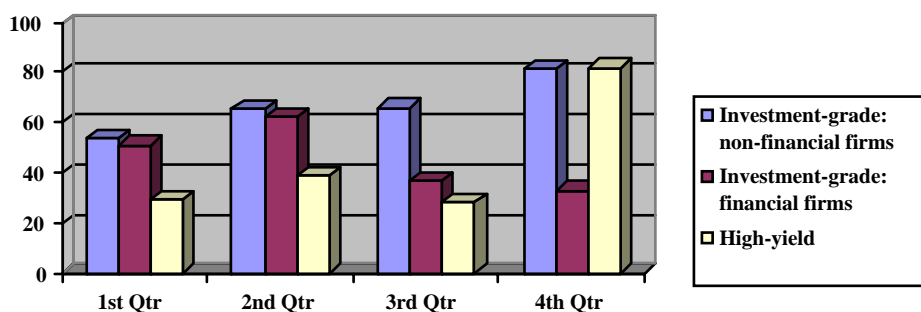


**Long-term debt markets improve**

The market for long-term debt has been very challenging as the financial crisis has escalated. While stronger companies have been able to continue to issue bonds, the average spreads on investment-grade bonds, as well as riskier bonds, reached record levels in October 2008, nudging up to 500 or 600 basis points over Treasuries for high-grade bonds, and as high as 14 percentage points for junk bonds.<sup>4</sup>

However, recent reports show that things are starting to improve: “While other financial markets have languished in the global economic downturn, the U.S. corporate bond primary market has been the venue of choice for investors since the beginning of the year.”<sup>5</sup> Indeed, according to research done by MarketAxess, “New investment-grade corporate bond issuance could top \$100 billion by month’s end ... The market has not seen a monthly volume that large since May 2008, when \$143 billion was sold.”<sup>6</sup>

Meanwhile, a large amount of investment-grade debt is set to mature over the course of 2009. According to a report by Standard & Poor’s Global Fixed Income Research group, approximately \$450 billion will come due over the course of the year in the United States. For non-financial companies, the amount of investment-grade debt due in the fourth quarter is predicted to be 50% greater than in the first quarter. High-yield debt has lower amounts coming due over the first three quarters, but again, Standard & Poor’s expects a spike in the fourth quarter.<sup>7</sup>



**Table 1. Debt maturities in 2009 in billions of dollars, by quarter<sup>8</sup>**

A good chunk of the maturing debt – about \$180 billion – is from financial services firms, whose ability and willingness to lend are critical to resolving the crisis. As part of the federal government’s efforts to shore up banking and get credit flowing again, the Federal Deposit Insurance Corporation (FDIC) announced the so-called Temporary Liquidity Guarantee Program, which guarantees bank debt with a maturity of 30 days or more. According to President Barack Obama’s fiscal 2010 budget proposal, financial institutions’

<sup>4</sup> Liz Rappaport, “Corporate Bonds Slide Along With Stocks,” *Wall Street Journal*, October 11, 2008. Available to subscribers at <http://online.wsj.com/article/SB122368129669524867.html>.

<sup>5</sup> Tom Ryan, “New U.S. corp debt sales show no sign of slowing,” *Reuters*, May 11, 2009. Available at <http://www.reuters.com/article/companyNews/idUKN1152763620090511>.

<sup>6</sup> *Ibid.*

<sup>7</sup> Stephen Taub, “Refinancing Debt Percolates as Big Worry,” *CFO.com*, October 15, 2008. Available at <http://www.cfo.com/article.cfm/12415055?f=search>.

<sup>8</sup> *Ibid.*



government-guaranteed debt issuance, which has reached about \$300 billion since the program started in November, will rise to about \$600 billion by October.<sup>9</sup> *Reuters* reports that “in March, the FDIC extended the program by four months and approved surcharges targeted at institutions that take advantage of the extension.”<sup>10</sup> However, FDIC chairman Sheila Bair told Congress on May 6 that the agency still plans to end the debt guarantee program for new issuances on October 31. It will monitor the markets in the third quarter and then decide how to phase out the program.<sup>11</sup>

In the meantime, Mr. Ross raised the idea of “*de-risking by going long term.*” Specifically, Mr. Ross advised companies to gain access to the long-term debt market and use the money to pay down short-term debt. He also alerted members to additional changes on the horizon, such as the decline of five-year revolver loans: “*It’s mostly one year now, so you need sources other than banks. Now it’s five-year bonds, five-year convertibles, and equity.*”

### **The impact of the financial crisis on bank behavior**

Drawing upon Mr. Chancy’s recent experience with the government stress tests, members discussed the longer-term implications of the tests for financial institutions. They also discussed the evolving relationship between banks and their corporate customers.

### **Impact of government stress tests**

On February 10, 2009, Treasury Secretary Tim Geithner announced that bank regulators would be subjecting the nation’s largest financial institutions to stress tests to estimate the impact that a severe recession would have on bank balance sheets and to determine which banks would need more capital.<sup>12</sup> On May 7, it was reported that of the 19 largest banks that were tested to see how they would handle a worsening economy, 10 were found to need more capital,<sup>13</sup> including SunTrust Banks.

Mr. Chancy observed that the Federal Reserve and Treasury were rigorous in their assessment, but he highlighted an overarching challenge the government faced: “*[The government] had some talented people involved. But, the thing that is very challenging to do is to take the complexity of the industry’s models and data and then plug it into a standardized model in a relatively short period of time to draw conclusions.* Mr. Chancy also noted that the stress test results have been widely misunderstood: “*The most important thing to remember is that the results were about how banks would perform in a more adverse economic environment rather than in today’s economic environment ... Not all people understand that the results were only what would occur in a severe downturn ... You really need to envision yourself in a very different world to make*

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<sup>9</sup> John Parry, “U.S. banks issue bonds, but government backing is key,” *Reuters*, May 12, 2009. Available at <http://www.reuters.com/article/newsOne/idUSTRE54B4DS20090512?sp=true>.

<sup>10</sup> “FDIC projected to back \$600 bln in debt program,” *Reuters*, May 7, 2009. Available at <http://www.reuters.com/article/rbssFinancialServicesAndRealEstateNews/idUSN0736764020090507>.

<sup>11</sup> *Ibid.*

<sup>12</sup> US Department of the Treasury, “Secretary Geithner Introduces Financial Stability Plan,” press release, February 10, 2009. Available at <http://www.financialstability.gov/latest/tg18.html>.

<sup>13</sup> Mark Felsenthal, “Improving markets helped banks pass stress test,” *Reuters*, May 9, 2009. Available at <http://uk.reuters.com/article/usTopNews/idUKTRE5481PW20090509>.

*sense of the test results. The banking system is being asked to hold a capital buffer today against that more adverse, and currently unexpected, scenario.”*

Despite the range of opinions on the value of the stress tests, recent reports suggest that they have had a positive effect on confidence: Gallop reported that the level of confidence in US banks increased after the stress tests were released.<sup>14</sup>

### **Importance of good banking relationships**

Many predict that one likely consequence of the stress tests is that banks will be issuing fewer loans, at a higher cost. This may be problematic for companies having trouble with funding and liquidity issues, who naturally turn to their banks. In fact, many companies, whether struggling or not, have been trying to tap their lines of credit to cover actual or potential cash shortfalls, a strategy that may be straining the already limited supply of credit. Some companies have been dismayed to find their lines of credit either terminated, capped, or priced out of consideration despite their strong positions overall.

Some members expressed frustration with how the financial stresses have affected their relationship with their bank: *“We’ve had different dealings with our bankers across the board because you can’t tell if they’re being totally straight. From an audit committee standpoint, things are coming to focus that didn’t before, and the question is, ‘Is Bank X really going to deliver?’ We’re certainly paying more attention to our banking relationships, and in many cases we don’t like what we see. It is very unnerving that we don’t know if they can deliver.”* However, some members feel differently: *“A lot of people have been complaining about banks, but it strikes me that they are behaving very rationally and perhaps are finally doing what they should have been doing all along. They let things get too loose ... I think there have been some definite improvements.”*

Mr. Ross pointed out, *“[In the current environment,] there is less money available, and the cost of money is higher. That certainly stresses relationships because any time there’s a new deal that’s not as good as the old deal, that is going to cause stress.”* In some cases, companies are forced to find and forge new relationships. One member said, *“Our primary banker [went out of business], and all these relationships automatically went away as a result. We’re out trying to establish new relationships now.”*

Members were interested in whether government intervention in bankers’ compensation might impact the banks’ ability to retain talent. Mr. Ross commented, “For banks that look like survivors, we aren’t really seeing a material talent drain. That said, there has been a bit of a renaissance at boutique firms.”

One member reported, *“We are seeking to both deepen and spread our relationships, trying to sort out winners and losers and adjust depending on capacity if we need to. We’re looking at banks that are potentially going to go out of business and using that analysis.”* Another member pointed out, *“No question, it’s more difficult to deal with banks in general [in this economic environment]. They’re making some choices they wouldn’t have been making two years ago, and [as a result] we’re spending more time*

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<sup>14</sup> Dennis Jacobe, “Post-Stress Tests, Confidence in U.S. Banks Improves Slightly.” *Gallop*, May 13, 2009. Available at <http://www.gallup.com/poll/118384/Post-Stress-Tests-Confidence-Banks-Improves-Slightly.aspx>.



*talking with bankers and sorting out our relationships. However, the good news is that the banks that stick with you want to stick with you. It just takes more time.”*

## **The roles of the board and the audit committee**

The challenges of the current economic environment are placing new demands on boards and audit committees: boards are finding themselves much more involved in assessing business partner risk, and audit committees are asking themselves in what other ways they can assist their companies in monitoring and mitigating the heightened financial risks that have emerged in this economic downturn. Some boards are thinking about establishing a separate finance committee to ease the audit committee’s workload.

### **The board is focusing on business partner risks**

Even companies that are weathering funding and liquidity challenges well have to worry about the effects of the liquidity crisis on their largest customers, supply chain (including subcontractors), insurers, and joint venture partners. One member commented, *“[Business partner risk] is a big risk for us because in some industries you’re limited to only one or two main suppliers ... Subcontractor risks are also a critical, critical item for us. This issue is very much on the audit committee agenda.”*

Members agreed that most senior executives recognize the importance of monitoring business partner risks: *“[The supply chain] is the lifeblood of the company, so it’s usually not hard to get people’s attention around this.”* Meeting participants shared several ways in which they have been addressing these risks:

- **Extend additional funding to suppliers.** *“We had one supplier who was at such risk [that] we had to give them [a significant amount] in working capital. We couldn’t take the risk of having them go under.”*
- **Encourage management to focus on the supply chain.** One member remarked prior to the meeting, *“What we’re doing is pushing on management. We’ve asked them to follow up with our suppliers and asked to see their financial statements, credit ratings, and proof that these people are going to be able to pay their bills ... It has been a very fruitful area of questioning because it’s resulted in constructive changes.”*
- **Change terms of sale.** *“In one case, we changed the terms of sale to extend the ownership. It had the effect of deferring revenue, but we didn’t want to get caught up in anyone else’s bankruptcy.”*
- **Apply a risk rating to customers for credit and collections.** *“We give all of our customers a risk rating. It has been very helpful.”*

### **What should audit committees be doing?**

Given market conditions and the heightened focus on funding and liquidity, audit committee members are naturally intensifying their analyses of financial risks and in some cases expanding their oversight to ensure other key risks are addressed.



Members and guests suggested several additional ways audit chairs can address financial risks brought on by the crisis:

- **Conduct deep dives on funding and liquidity issues.** *“One thing we’ve done on our audit committee is we take a deep dive on a specific financial issue. We have our regular committee meeting, recess, come back, and do a deep dive on a given subject. Testing goodwill impairment, for example.”* Another member reported, *“We’ve done that as well, and it’s a very useful exercise.”*
- **Encourage more input from the external auditor.** *“We’re trying to press [our auditor] for more peer comparisons. We’re asking them, ‘What are other audit committees asking you?’ We’re trying to get a better idea of where we stand relative to our peers.”*
- **Consider additional disclosures.** Some members report that the increasing number of risk factors has led them to issue more disclosures: *“In the past, we used to talk about [risk] once a year, but now that we talk about it [more often], we’ve considerably expanded disclosures. Management hasn’t once resisted the idea of additional disclosures.”*
- **Reexamine committee composition.** Some members are questioning whether their boards have the right committees, with the right members focused on the right issues. One member noted, *“We find it very useful to have overlapping members on both the audit and compensation committees.”* Another member said, *“We are fortunate to have an experienced banker on the board, and we formed a finance committee around this one banker. It is very valuable to have people like that on your board.”* Others are looking for former bankers to add to their audit committees.
- **Monitor insurance carrier risk.** *“We do an annual risk management review, and we’ve expanded that review to include a rating for insurance agencies.”*

### Should boards establish a separate finance committee?

Although only a handful of the companies on whose boards members of the SEACN sit have a separate finance committee, members discussed the value that a finance committee offers. In companies that do have a separate finance committee, that committee tends to take the lead when the board addresses liquidity issues, but the reporting implications of some of the issues emerging from the crisis may require the audit committee to take a leading role.

One member reported, *“We recently created a separate finance committee at [my company] because we found finance issues have been coming into focus more than ever before. [Creating the separate finance committee] has been an excellent decision, and I am encouraging it at all the companies I’m involved with now.”*

Still, some members believe the audit committee is capable of handling the work that would be delegated to a finance committee. One member said, *“The audit committee often becomes a de facto finance committee ... We don’t have a separate committee, but the audit committee is spending an increasing amount of time on finance issues.”* Another added, *“We are the audit committee, but we are in essence the finance committee. I would say about half the time our meetings are devoted to finance as much as to audit. We’re*



*focused on liquidity, refinancing issues, looking at our investment portfolio, talking about dividends versus share buyback – all of those issues [that a finance committee would be addressing].”*

Another member pointed out the importance of keeping the broader corporate governance picture in mind: *“At different times the audit committee moves in different directions, depending on what the issues are. Clearly the audit committee doesn’t stay within certain boundaries. This [idea of a separate finance committee] is an issue for today. In a few years, we’ll be focusing on something else, so I have a hard time thinking we need to split committees when it’s likely we’ll be on to other issues in a few years.”*

## **Conclusion**

SEACN members and their guests see some signs of improvement in the economic situation, but they remain acutely aware of the ongoing impact of the financial crisis, especially as it has affected companies’ relationships with banks, perceptions of partner risks, and approaches to managing financial risk, more broadly. One member summed up a prevailing attitude when he said, *“The number one issue from my standpoint right now is survival. I want to make sure each of my companies makes it to 2010 untouched. [We are] not as concerned about earnings; [we are] more concerned about finding adequate resources to fund a year of lousy business.”*

## **About this document**

The Southeast Audit Committee Network is a select group of audit committee chairs from leading North American companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit committee environment.

*VantagePoint* is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *VantagePoint* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *VantagePoint* may share it with those in their own network. The more board members, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

*The views expressed in this document represent those of the Southeast Audit Committee Leadership Network. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young, or Tapestry Networks. Please consult your counselors for specific advice. Ernst & Young refers to all members of the global Ernst & Young organization, including the US member firm of Ernst & Young LLP.*

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### **Appendix: Questions on funding and liquidity for audit committees to consider**

- ?** Are you satisfied with your company's liquidity management and funding efforts? What funding challenges is your company facing? How do you see the situation evolving over the next year?
- ?** How are your company's banking relationships? What changes do you expect in 2009?
- ?** Is the current board committee structure and process adequate for dealing with the funding challenges posed by the credit crisis? What is the division of labor between the audit committee and other committees, in particular the finance committee? What changes might be helpful?
- ?** Which extra initiatives to assist and oversee management with funding issues have proven useful? Which have been less useful? What sources of expertise are available to support the audit committee?
- ?** What new measures for monitoring partners and planning for disruptions has the recession triggered for your companies? How have the thresholds for board or audit committee monitoring of customers or suppliers changed? What business partner risks are dealt with at board level?
- ?** How can the audit committee ensure that management has adequately addressed business partner risks? What kinds of questions should the committee be asking?
- ?** What additional disclosures have been required? What may be required in the future?