operations

DEPARTMENTAL IMAGE

Treasuring treasury

Executive summary

- For treasury to be understood and accepted, communication needs to improve.
- Better communication leads to better predictions, and this in turn leads to better management of risk and reward.

Treasury? Who cares? The difficulty for many important central corporate functions is helping people at the company 'coal face' understand why they matter. Treasury is no exception. How do you explain treasury functions to a sales rep, a shop-floor worker, a counter clerk, a repair person, a personnel officer, a brochure writer? If treasury didn't exist, who would miss it?

In my experience, treasury is not alone. Many central departments have similar problems proving that they have value to their fellow workers – investor relations, marketing, procurement, information technology or human resources.

In fact, in some ways, treasury has it easy. Unlike marketing, treasury doesn't squash ideas as they get going. Unlike procurement, it doesn't get in the way of buying paperclips. Unlike IT, it doesn't push systems that could be bought cheaper and better round the corner. And unlike HR, it doesn't take away the key managerial responsibilities of choosing and motivating teams.

Z/Yen's long-standing definition of treasury is this: "Treasury plays a pivotal role in managing risks and rewards both inside and outside the organisation. As the function concerned with the provision and use of finance, treasury typically handles collections, banking, working capital, short-term borrowing, foreign currency management, provision of capital and money market investment. In the past two decades, treasury has become more involved in identifying unmanageable organisational risk and hedging it in open markets. Increasingly, treasury is becoming involved in handling operational risks through insurance mechanisms and, in some leading competitor companies, running internal markets for risk."

So how do we prove to the rest of the organisation that treasury's role is pivotal, and that the department matters a great deal? The first step is to make treasury relevant. Most employees outside the treasury department don't understand how treasury meshes with their day-to-day work. What we've got here is failure to communicate.

BEYOND COMMUNICATION MIGHT LIE UNDERSTANDING

Treasury = rolls No, not toilet rolls. We worked with a large telco on trying to make all of finance relevant, including treasury. The objective wasn't to inflict death by Powerpoint, but to teach with a view to improving performance. To do that, we needed to make finance, in general, matter. As a start, we translated the fundamental, annual, published financial statements into operational terms. For many staff, this was the first time the organisation had ever tried to communicate annual results in terms they could understand. Further, we developed different sets of terms for call centres, regions, districts or engineers. For example, with engineers, profit and loss and the balance sheet were translated into rolls of cable. The cost of capital was translated into days of cable rolls. If a cable roll cost £10,000, then at a weighted average cost of capital of 12% and 220 working days, it cost £5.45 a day just to keep it around.

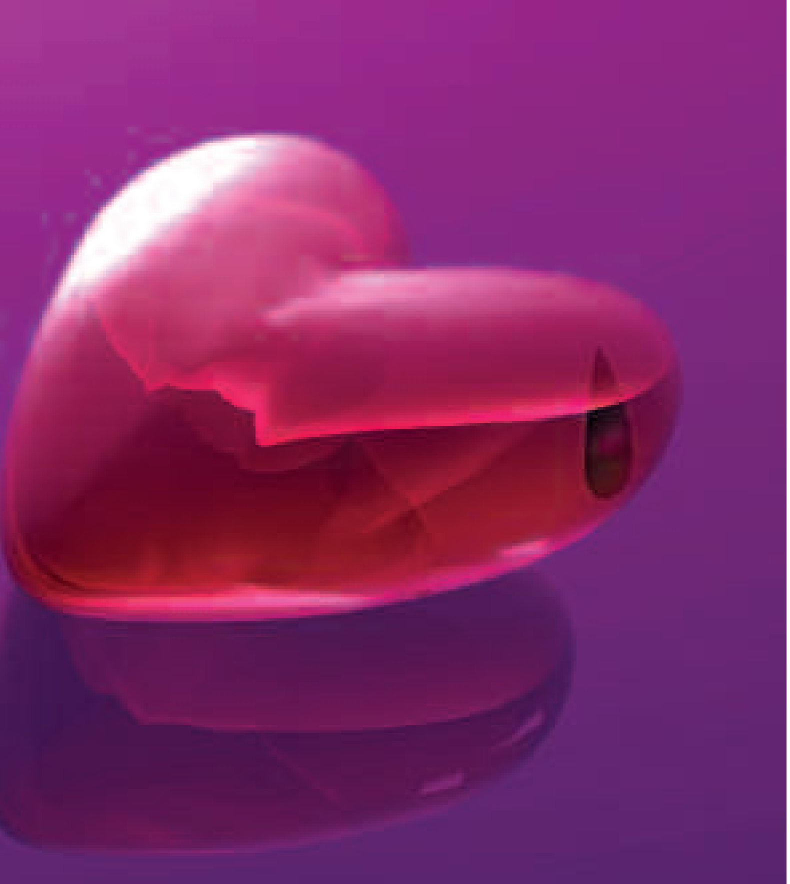
We then went out into the field to run some fun (well, fun for us) short presentations. I particularly remember one team of engineers who were aghast at the poor return for their hard daily work. I also remember them proudly pointing out that they had secreted nearly 60 rolls "against a rainy day". When they realised that they lost some £72,000 for their firm each year on their private stash, they were mortified – and substantial assets were released.

We had similar success with a delivery company of 800 vans where the drivers were responsible for cash collection. The drivers were permitted to give customers a few days credit, but the practice was starting to make the company's overall performance deteriorate. Credit was tightened, but very few customers were lost.

Treasury = big bets you don't want to make Working with one electricity company we once built a small simulation of a month in treasury. Everyone understood how the electricity pool purchasing worked, but they didn't understand how the pool affected finance. More than 50 managers had a go with our simulation. In our, admittedly fairly simple, simulation we showed the effect of the commitments and purchases on treasury. The managers were astonished to see that all the fun they had playing the electricity pool could be lost by not communicating with treasury. Then we added their first overseas acquisition and the foreign exchange – few were left feeling that they could handle it all themselves!

We are currently exploring the idea of using 'political cards' as a means of helping managers understand the role that treasury can play in maximising their performance.

Treasury = real people In other organisations, just making treasury people seem human goes a long way. Have you thought about a 'day in the life of' article about someone who works at managing cashflow? Have you thought about putting a small quiz, perhaps a



MICHAEL MAINELLI EXPLAINS HOW TREASURERS CAN BE BETTER UNDERSTOOD BY THE REST OF THE ORGANISATION – AND BETTER LIKED!

reasonable question copied from the ACT website, in the staff newsletter? We put a short quiz with a small prize for a few months in one client's staff newsletter and it was surprising how many people realised that notifying treasury of likely foreign exchange commitments could make a real difference.

Treasury, what a bunch of comedians! If a picture is worth a thousand words, a good laugh is worth a thousand pictures. A good laugh is remembered. Have you thought about having a comic strip centred on treasury? As treasury is in many ways at the heart of the organisation and sees the effects of all major decisions, perhaps TreasuryMan could combine a bit of laughter with a lot of relevance. If you think treasury has it hard, just take a look at how the lawyers at AttorneyMan (www.attorneyman.org) do it – and nobody likes lawyers.

Our treasury, I don't understand it but I like it! Working with 26 banks and large corporate treasuries, Z/Yen conducted one of the largest ever benchmarking studies on the cost of funds for business units and transactions. We went on to model in detail the cashflows and potential performance improvements of 10 of the large payment-handling organisations.

What surprised us was that the organisations which scored well in the benchmarking were proud of their treasury functions even when they hardly understood them. So if you have the chance to benchmark, and can bury your results if you're in the bottom 50%, have a go!

BEYOND COMMUNICATION LIES PREDICTION To focus too much on cashflow management or foreign exchange is to misrepresent a modern treasury function. However, one treasury skill that most parts of the organisation do not fully appreciate is the skill, and responsibility, of prediction. We have worked with numerous clients on using multi-variate statistics to help many elements of finance, treasury or risk management develop predictive models. But predictive models are more powerful when they are shared.

For example, one European investment bank used three years' worth of data to predict losses and incidents from data such as deal problems, IT downtime and staff turnover over a six-month period. It achieved reasonable predictive success – 90% at times, although more frequently 60%. Of course, each loss or incident affects funds, cash, foreign exposures, working capital, capital allocations and taxation. Data on some items – for example, new recruits/leavers or IT disruption at the system level – can in practice be very hard to obtain. It is also noteworthy that, as a data-driven approach, predictions are only as good as the data put into them – garbage in, garbage out.

In some areas, the data may not be at all predictive. And data quality can vary over time in hard-to-spot ways, and interact with wider systems, particularly the people in the systems. Many data sources underscore Goodhart's Law: "When a measure becomes a target, it ceases to be a good measure." For instance, the IT department at our European investment bank client was upset at IT downtime being considered a key risk indicator and unilaterally changed from "downtime" to "unplanned IT downtime", skewing the predicted losses.

Many of our clients are now sharing predictive models around the organisation with the aim of reducing operational risk or pricing operational risk or economic capital. By showing how predicted outcomes relate to patterns of instrumental variables, treasury shows how the organisation's activities affect reserves, funds or cash. This moves treasury into a position as an adviser to operations – how do your activities affect organisational risk?

BEYOND PREDICTION LIES INDEMNITY Treasury functions often need to lead their organisations in understanding and managing risk and reward. Personally, in the future I see treasury contracting directly with managers, rather than taking a group view. Some of our clients are contracting directly with central treasury: "We, central treasury, can guarantee this cost of capital or that exchange rate. Yes, it is slightly above today's available rate, but it's guaranteed for x years."

I also think that treasury needs to spend a lot more time specifying how it should be evaluated. I realise that this is a perennial problem, but in an age of increased focus on shareholder value, with a competitive financial industry and demanding corporate governance, treasurers should be their own devil's advocate and work much harder at specifying how they should be measured. Part of that measure must be a level of indemnification against benchmarks – for instance, no more than x% against the average cost of funds, no more than x% of cashflow.

With measures in mind, I think that treasury can be better cast for operational managers as both insurance and banking: insurance that they can pay against untoward events, and banking that gives them a return on the funds they accumulate. Treasury needs to be directly charged, and rewarded, against profit centres. Therein lies true communication and will lead savvy operational managers to truly treasure treasury.

Michael Mainelli is Director of Z/Yen, a risk/reward management firm.
Michael_Mainelli@zyen.com
www.zyen.com