# Ask the experts:

# Are you prepared to respond?

RISK MANAGEMENT CHALLENGES ARE CHANGING FOR TREASURERS. AND ONE PARTICULAR RE-EMERGING RISK SHOWS HOW THE ROLE OF THE TREASURER AS RISK MANAGER IS EXPANDING.

**Greg Croydon, Group Treasurer, IMI**

There is no doubt that the treasurer's role has developed over the past few years as our risk management skills are being used in a broader business context. In some organisations this has developed in a formal manner with the establishment of enterprise-wide risk management committees and specific new roles for the treasurer, but in many the change has been less obvious, as is the case at IMI.

The fundamental areas of old school treasury remain there for us to manage. Funding, investments, currency, interest rates, balance sheet management are familiar to all of us. We are used to developing tools to quantify and manage the risk in these areas. My role has grown over the years to include commodity hedging, pension fund management and many more strategic issues. The complexity of business risks has increased significantly as the environment we live in has become more global and communications have made our actions (or inactions!) far more visible.

One concern I have is that we are all too focused on easily quantifiable risks. There is nothing wrong with this where the solution is simple and effective, but it worries me that we may be missing the bigger issues. Do some of the qualitative risks run counter to the quantifiable risks we are managing? I see FX come top of the list of major risks in too many polls and I suspect that this is because it is one of the easiest risks to manage – or at least to smooth and delay the effects of volatility. For some businesses, of course, it is the volatility that is more of a risk than the cause of the volatility!

I have been working recently with our businesses to look beyond the mechanical hedging of currency risks to the underlying economic risks, trying to ensure that the right decisions on sourcing, location of manufacture and pricing strategies are taken in the light of competitors' strengths and weaknesses and the underlying economics of the markets. This has been a useful process to draw the big picture, but it is important that operational risks remain the responsibility of the local managers.

Another area that must be considered is the expectation of our shareholders. They are investing in our shares because they believe the risks involved will be worth taking for the returns. An oil company may be able to reduce the volatility of its returns by hedging the future oil price – but is this what the shareholders are expecting?

Communication with shareholders is one of the developing areas in risk management. International accounting standards are putting more emphasis on the disclosure of risks in annual reports, which should help with the issue of shareholder expectation. It comes down to one fundamental question. Shareholders are buying a particular company's shares to participate in a certain risk in the expectation of generating a certain reward. Have they bought into the expected risk?

Treasurers also need to be involved in the allocation of resources in risk management. In FX, for instance, it is straightforward to quantify the cost (both in terms of time and direct expense) and the success of your actions. Sadly, not all other risk areas are so easy to assess. But even in the grey areas treasurers must have some idea of expected costs and benefits, which then provides some basis for discussion of whether it is worthwhile allocating resources to manage particular risks.

In the rest of the business the treasurer needs to be seen as a supportive challenger. While it is fanciful to suggest that treasurers are the natural people to manage all business risks, they can use their skills and experience to become involved in working as part of the team on the broader business risks beyond the traditional treasury controls.

**Yann Umbricht, Partner in the Treasury group, PricewaterhouseCoopers**

Many treasurers consider the processes for managing and monitoring risk to be well-established and embedded within their organisations. However, as a result of the significant volatility in recent periods from market and credit requirements, this belief is likely to be challenged. Are treasurers prepared and ready to respond?

Many senior management teams and boards are seeking much greater assurance – from those responsible for managing financial risk within their organisations – that the risk management mechanisms are truly effective and the monitoring process really is robust.

Risk activities that could be tolerated in a benign market are no longer acceptable in an environment more akin to a rollercoaster than a carousel. The complex vehicles or instruments a company has entered into may, overnight, become unacceptable, particularly to those members of the management team with less understanding of the associated risks and how they can be mitigated.

A change of confidence within the market can also affect the assessment by an individual company of its appetite for financial risk. This may result in the need for a range of possibly unexpected actions – for example, to immediately close long-term positions, sell impaired assets or rebalance assets.

In a fast-changing and uncertain economic environment, the shortcuts often included in many monitoring and reporting processes may not be sufficient to model and monitor activity within an acceptable tolerance or in the right timeframe. In the short term, new analysis may be required to identify issues on a more frequent and accurate basis. In the medium term, investment in additional processes may be required to provide sustainable solutions for identifying and managing risks.

Organisations need to reconsider their appetite for risk, risk management techniques and whether their processes can support such activity.

**Chris Mitchell, Managing Director, Head of Institutional Solutions, Lloyds TSB Corporate Markets**

The wider corporate community tends to ignore inflation as a significant cost/volatility risk to funding, seeing it as an issue for utility companies and housing associations. But almost without exception, every corporate is implicitly exposed to inflation, making it imperative for individual treasurers and their bankers to establish the extent of their exposure and understand how to minimise the cost and volatility (as a measure of risk) impact of that exposure.

The exponential growth in demand for inflation-linked products driven by pension funds and insurance companies has made the inflation market highly liquid. It offers companies the potential to improve the cost-risk profile of their debt portfolio by introducing an inflation-linked component.

Corporates traditionally incorporate a mixture of fixed and floating-rate debt to balance cost and volatility. In a study conducted by our financial markets team using three decades of historical interest rate data, we compared fixed-rate funding with floating debt for various tenors. It showed that floating-rate debt was cheaper than fixed-rate funding on more than 90% of the days of comparison. However, the extra cost of fixed-rate debt paid for a low-volatility exposure compared with floating-rate debt. The mixture of fixed-floating funding therefore needs to balance that cost-risk trade-off – known as the efficient frontier for the corporate.

Markowitz modern portfolio theory – often used by asset managers to optimise their portfolio – states that risk-reward can be improved by constructing a well-diversified portfolio of uncorrelated assets/liabilities. This is where inflation can add value to a debt portfolio. Including retail prices index-linked debt increases the portfolio diversity, making it more efficient whether or not underlying cashflows are explicitly inflation-linked. And from an accounting perspective, embedding inflation derivatives into underlying debt instruments, such as bonds or leases, results in the best accounting treatment under IFRS.

In an analysis carried out by our structurers at Lloyds TSB, we looked historically at the cost/volatility improvements that a portfolio including inflation would bring. It showed that inflation-linked debt in an overall liability profile containing fixed and floating liabilities further reduces volatility and cost. In this sense, inflation-linked funding is something that should be considered by the wider corporate community because linking a portion of debt to inflation could optimise every company's liability profile.

**See Going Places, page 23, Common dilemma page 34.**