A juggling act

PETER MATZA REFLECTS ON HOW TO GIVE SOME STRUCTURE TO THE PROBLEM OF MANAGING BANK, TECHNOLOGY AND FRAUD RISK.

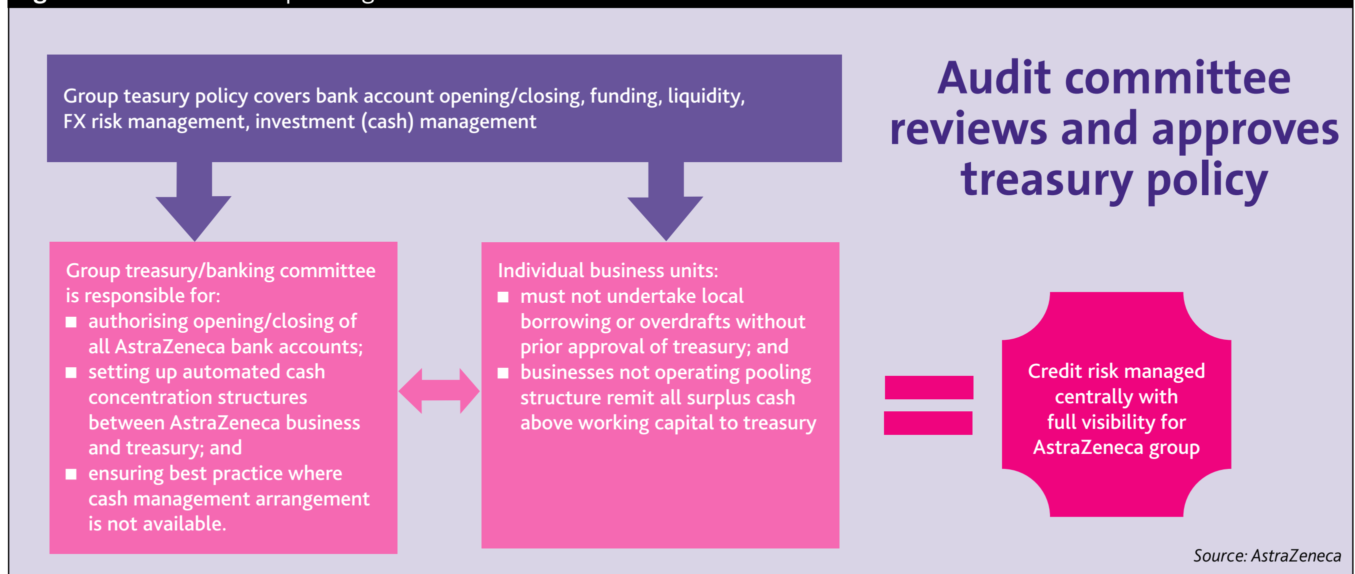
One of the key roles of a treasurer – or whoever is responsible for treasury management in an organisation – is communication. Clearly communicating treasury requirements throughout the business is as important as managing the necessary operations and workflows. This has become critical during the last few years as the financial crisis has reached into all areas of business and commercial life, requiring careful analysis and explanations of events by treasurers for their colleagues. In addition the intrusion of regulatory issues, accounting changes and the dramatic impact of technology changes mean the treasurer has to manage external constraints and communication as never before.

A vital element of this juggling act is the ability to integrate these demands with the risk profile of the organisation. Service providers, for example, will always believe theirs is the most urgent proposal to be dealt with, but what keeps most treasurers up at nights is the underlying business that needs managing.

Gerard Tyler, group treasurer of water and waste water operator Severn Trent, shared with the conference his experience of dealing with these issues, especially in relation to funding and bank relationships. In the UK this is a highly regulated business sector, with various agencies overseeing health, service operations and environmental issues and a financial regulator overseeing pricing, equity returns, the cost of debt and balance sheet structure. Overall, the annual sector turnover (in England and Wales) is £9bn, and capital investment runs at £4.5bn a year. It all makes for huge gross cashflows and intensive use of bank transmission networks across Severn Trent's operating area in the Midlands.

In a regulated industry, the role of the corporate treasurer is to appreciate that information flows are vital to ensure that all stakeholders – including ratings agencies – are fully aware of business performance. In terms of dealing with banks, Tyler has an orthodox approach where the entry point is a lending relationship – a familiar position for most corporate treasurers. Tyler's banking needs are fairly generic to the industry, including core transmission services for payments and income, debt capital markets capability and some depth of industry knowledge. The importance of these activities to corporate performance – especially against regulated targets – means that Tyler knows that relationship management is key to his treasury success. Sometimes doing the simple things well is all that treasurers want from their bankers!

Figure 1: AstraZeneca corporate governance



Source: AstraZeneca

THE SIMPLE ISN'T EASY

Making something simple isn't easy, however, and that applies to managing risk as much as any area of treasury management. In particular, it applies to counterparty risk, but with a twist: the financial upheavals of the past three years have meant treasurers have needed to worry about their counterparties to investment risk (where service providers are managing cash and assets) as well as transaction risk on financial transactions (foreign exchange or swap deals) with credit considerations. Oh, and those clever regulatory people in Brussels and Washington want to chuck in on-market clearing with margining to boot! So what can we do to help ourselves?

We can, as Martin O'Donovan, ACT assistant director of policy and technical, suggested, give some structure and discipline to the debate. O'Donovan identified four key elements to managing counterparty (for this purpose, bank) risk, or indeed any risk the treasurer is faced with:

- understanding as far as possible what risks the organisation has;
- making an effective calculation of those risks;
- determining the materiality of a risk/exposure to the organisation; and,
- placing risk management in a wider context – are there geographical or legal contexts to identified risks?

In terms of counterparties, there are plenty of sources of information about bank credit positions: ratings, central bank information or credit default swap (CDS) prices (perhaps to be taken with a pinch of salt). It is worth noting here that bank ratings are under some scrutiny by the ratings agencies, so some caution may be advisable when using these measures. Equity markets may also tell a story.

Calculations in themselves give only a partial view. When financial markets are dislocated (as they were for a time after the Lehman collapse), they can be suspect or even unavailable. The formulae used may be unreliable, or even potentially discredited. For example, the use of value at risk (VaR) has been called into question because it is based on historic information and pricing which may have little or nothing in common with any given (or future) market conditions! In the words of one trader, in summer 2007, "We've never seen history like this before!" However, treasurers must make the best of the tools available, even with health warnings. Creating a reporting process that maintains or increases the frequency of exposures can clearly be effective in addressing heightened concerns.

Hopefully, part of a treasurer's armoury will be their company's treasury policy. However, too many policy documents will contain arbitrary limits for counterparty risk without a proper analysis of any impact on a given organisation. Arbitrary limit setting may work for obvious exposures such as deposits or interest rate swaps but not necessarily for the less obvious ones such as daylight exposures for payments and receivables processing. Nor will they necessarily take account of issues such as covenants in documentation or ratings or credit evaluations. Treasurers must therefore try and establish a formal process for determining the materiality of loss – for that is what is at stake – to their organisation. It must be that one of the lessons of a financial crisis is to have a rationale response that will stand up to scrutiny – from the board, from auditors and from stakeholders.

A POSITIVE TONE

Alex Fiott, treasury manager at pharmaceutical group AstraZeneca, offered a very useful foil to O'Donovan's conceptual approach in demonstrating that treasury policy and corporate governance must set a positive tone for management process within the business, using a centralised group treasury structure.

Fiott addressed himself to how AstraZeneca reviews exposures. The underlying principle is that there can always be more information and better analysis.

- Counterparty limits are set with reference to a full range of measurements, including ratings, tenors, types of fund and product (e.g. money market funds or direct investments in securities). Rolling tenor limits are used based on percentage exposures set in the treasury policy.
- Bank counterparties are actively monitored using CDS pricing, equity volatility and market capitalisation.
- AstraZeneca makes considerable use of the risk management model in its treasury management system, which allows for consistency of reporting output and import of market statistics.
- Use of collateral agreements with "weaker" counterparties. Clearly, this is a difficult area for corporates of all sizes because of the resources needed to monitor and manage collateral movements and limits.
- For money market funds, AstraZeneca looks at the level/quality of likely sponsor support, contents of funds, currency mix and so on.
- The use of different products can be effective as hedging tools while at the same time reducing credit line usage from financial service providers (e.g. FX options).

Further warnings about counterparty exposures in non-traditional treasury areas such as insurance management or dealing with complex ownership structures in joint ventures were also given by Fiott and O'Donovan. And on top of all

this, treasurers must learn to contend with fluctuating management focus on these risks – that's no excuse, though, to let the process slip.

FINDING THE LINK

Moving from counterparty limits and reporting to treasury operations and controls might seem an odd step. However, the link lies in understanding that risk management is at least as well served by efficient and effective management of treasury operations as it is by the strategic review of risk and exposures talked about by AstraZeneca. Nick Dadswell, director of finance business services at leading process systems provider Invensys, talked delegates through the principles and mechanics of creating and running a payments factory for a global business.

Following a crisis in Invensys in the early 2000s – brought about by takeover-induced leverage – the company has rebuilt itself. Part of that process has been a revamping of treasury operations for a global business with three relatively independent business areas trading in more than 60 countries worldwide. The treasury is run on a centralised basis covering all transmission banking, trade finance and financial risk management. This includes a central cash pool for all foreign currency bank accounts (at least in transferable currencies).

As the name suggests, a payments factory is designed to consolidate flows of third-party vendor payments. Although there are clearly technology-driven benefits from each business having a single interface from their own enterprise resource planning (ERP) system and payment instructions being made via SWIFT, there are more elemental treasury values at stake. In particular, there are cost reductions across a whole range of bank transactions, notably payments (of course!), but from a risk perspective there are two other less obvious but highly important "wins": a reduction in the need for local business units to access credit for payments and, more subtly, a reduction in potential error or even fraud from local accounts becoming solely receivables vehicles. Internal ERP systems now process all invoice management, remittance advisory and payment files to various banks.

Transaction cost reductions are material as almost all payments are now made and charged at domestic tariffs with the additional and process savings from the use of SWIFT. Within the euro area, the Single Euro Payments Area (SEPA) enhances this benefit, although Dadswell warned that some local banks in certain territories were not playing the SEPA game (e.g. by deducting local charges).

In an aside on managing this process for the US, Dadswell pointed out that acceptance of electronic payments via the automated clearing house (ACH) system remained slow because vendors were reluctant to offer their banking details – at least partly from a view that this could increase fraud on the vendor! Overall in the US, ACH usage has overtaken US cheque usage but it's a slow process. More broadly, there are other issues in some emerging markets about funds flows from central locations but they are surmountable with patience and education.

OFFERING GLOBAL TOOLS

Stuart Clarke, group treasurer of Fujitsu Services Holdings, brought together the diverse elements of treasury operations in a presentation that focused on the impact of technology and the opportunities created in shared services. As a treasury, Fujitsu is not totally centralised but offers "global tools" to its business units. This is partly because of the group's development by acquisition but also because its management principles are based on a more traditional Japanese model. From a treasury viewpoint, the key issues for technology companies are substantial working capital finance and customer financing needs, which equal a demand for cash – with associated (and familiar) problems of credit, cost and systems management. In the traditional Fujitsu model, shared services and treasury worked independently, but working capital performance is a treasury responsibility. So the question that Clarke posed to the conference audience was: what can technology change do for treasury management?

Many opportunities deriving from implementing various technology solutions are dependent on the size and scale of commercial activity in the organisation. Clarke emphasised, however, that the "thinking" work in looking at processes and solutions can benefit even small businesses, whatever their access to technology investment. Whether these are in payment factories, improving transmission banking, counterparty credit management (in a commercial or treasury sense) or using non-bank suppliers of transmission products, Clarke urged the audience to apply their treasury skills in risk management via the use of technology to the wider business and commercial environment.

The downside of treasury process management – from error to fraud – was amply illustrated by a presentation on trends and developments in security and controls, by Brian Welch, treasurer EMEAI of Valspar Corporation, a global paints and can coatings manufacturer. Welch is a recognised expert in this field and has presented at numerous ACT and other conferences. At the heart of the issue lies, as always, risk management. In this context Welch defined the problem as "a policy failure to recognise or quantify risk and then failure to analyse and understand exposures and use procedural safeguards correctly".

Treasury has huge potential for fraud, which can put an organisation at risk of distress or even failure. Reported

private sector fraud runs at around £2bn in the UK, about 90% of which takes place in large businesses. The potential risk areas include not just simple theft of cash but accounting manipulation, tax-driven fraud (especially VAT), intellectual property theft, bribery and criminal activity such as money laundering. Unwitting error (e.g. failure to meet payment due dates on, say, interest or capital repayments) can also cause loss and the salve that it is error may not soothe those whose jobs and careers are put at risk.

While many of these activities can easily occur without the use of electronic systems, there are clearly risks in using them. The problems are similar for internal and external systems, whether accounting, information or e-banking. They range from the generation and protection of payment files and their transmission to the effectiveness of encryption and security measures. Sadly, in most cases it is not the failure of the system but of its users and their procedures that causes error and loss or allows fraud. Treasury security must be fit for purpose, which entails promoting good practice, ensuring that all monitoring and audit is disciplined, and creating an environment where everyone has responsibilities to safeguard the organisation's security and funds.

BENEFITS OF SWIFT ACCESS

Harcus Copper of Barclays Corporate came to talk all things SWIFT and started with a short history lesson. SWIFT was established primarily as a standards and communications body for the banking industry, and not specifically for funds transfer. But in recent years corporates globally (of all sizes) have been able to take advantage of increasingly simplified access to SWIFT, which offers treasurers an opportunity at least to talk in a standardised language and to look for consistent levels of (electronic) service from their banks.

The benefits to corporates include improved operational flexibility, better security from standardised technology and processes, concentration of access to multiple banks in multiple geographic regions, a reduction in the cost of liquidity across group operations, and the scalability of the processes as a business grows in volume and location. Depending on the access method, corporates need to take care that if, for example, they use a bureau to access SWIFT, the documentation is clear about who shoulders the various responsibilities and potential liabilities for service provision. This applies particularly when considering the key issue of how, where and by whom financial movements are authorised and released (think Valspar's Welch looking over your shoulder!). Costs and service level agreements are subject to negotiation – the corporate doesn't have to accept the first offer and if using a bank-sponsored bureau should make keen use of the relationship!

Figure 2: Business case and supplier evaluation

What did we want the technology to deliver?

- Automatic consolidated global data from:
  - business bank accounts
  - ERP environment
  - market data fees
  - automated accounting
- Transparency
- Low technical maintenance
- Low total cost of ownership
- Global mobility/accessibility

SWIFT is not the solution to every treasury cash management problem but, bearing in mind Clarke's comments on exploiting technology, treasurers may use SWIFT to access developing corporate banking solutions such as digital signatures, automating paper-based business flows and electronic bank account management (eBAM), which can only enhance this tool for treasurers.

Simon Crown, a partner at law firm Clifford Chance, was given what some might consider the short straw – an update on SEPA and the Payment Services Directive (PSD).

The purpose of SEPA is to harmonise rules and standards to enable cashless payments in the euro area from a single account, using a single set of payment instruments, to be made as easily, efficiently and safely as current domestic payments. SEPA was intended to be fully implemented by the end of 2010 but has had a slow take-up and a small (if slowly rising) market share of payments. Why? Well, there are number of reasons:

- providers complain about the maintenance and sunk cost of legacy systems;
- some countries are accused of protecting inefficient domestic banking sectors; and
- the lack of public authority commitment and low

corporate acceptance – basically, customers aren't yet sufficiently convinced to implement SEPA solutions.

So? Well, the European Commission has said it will legislate an end date for migration... but, er, what is the date? The likely dates are the end of 2012 for credit transfers and the end of 2013 for direct debits. However, Crown's advice was that nobody should hold their breath.

The PSD was designed to create a harmonised framework for the regulation of payment services within Europe and thereby to enhance consumer protection, a framework with the force of law. The PSD includes elements of consumer protection, a licensing and passporting regime and miscellaneous other provisions such as governance rules, ownership and money laundering controls.

Like SEPA, the PSD has had its teething troubles but is gradually becoming an accepted part of the financial services regulatory framework. Also, as with SEPA, opt-outs of various elements, imprecise language (e.g. definition of payment account or refund obligations) and domestic industry protection have hampered its implementation. Unsurprisingly, the UK under the Financial Services Authority has been at the forefront of implementation. Crown's conclusion was that SEPA perhaps needs a rethink on take-up. By contrast PSD implementation is almost complete but its effectiveness remains uncertain.

The final corporate presentation of the conference was made by Olivier Brissaud, the managing director of Volkswagen Group Services. The sheer scale of the organisation, with its €120bn turnover, multi-brand approach (Volkswagen, Audi, SEAT, Skoda, Bentley…) and sales in just about every country of the world, left even this conference audience impressed. However, part of the story that was told by Brissaud was a salutary one and encapsulated the issues of risk management in managing the cashflows of any organisation.

In 1987 Volkswagen suffered a near-catastrophic foreign exchange scandal which cost it almost an entire year's net profit. Unsurprisingly, corporate treasury was rebuilt from scratch, with the first and most long-lasting step being to stop intercompany invoicing by using internal factoring via a financial centre in Belgium. Today this centre finances around €57bn of corporate receivables, usually at 100% of value, and manages Volkswagen's cash pools in euro. This factoring involves 33,000 invoices annually and €230m a day in 14 currencies.

Until 2005 no other treasury activity was centralised at Volkswagen. But that year saw the advent of payment factory processes for supplier payments and the subsequent centralisation of much more group treasury activity. Today, the Volkswagen treasury management function – located in the company's home base of Wolfsburg, Germany – is large-company standard. The company has set up regional treasury centres for Latin America, China, South Africa, Germany, the rest of Europe (based in Brussels), North America and India. Volkswagen also has corporate treasury centres for some brands because of regional/emerging markets or physical locations.

However, there was one important element to this presentation which perhaps is really worth emphasising as a matter of good practice for all treasurers. VW's treasury and finance teams operate with a mission statement, something that specifically says internally and externally what they intend to deliver and what can be expected of them.

In terms of finance, this means providing financing and money flows at the best available price, using best-in-class technology and the highest possible level of integration to minimise risks and to maximise efficiency.

In terms of service, this means meeting a customer's need for specialised support and consultancy services to their utmost satisfaction, and, critically, ensuring that staff are committed and competent to ensure customers receive a truly reliable, top-quality service.

As a set of marching orders for treasurers, these are about as good as it gets!

The conference closed with an excellent economic overview from Lai Wah Co, head of economic analysis at the CBI. The CBI expects global growth of 5%+ in 2011 and into 2012, roughly similar to pre-2008. There remains a marked contrast between traditional OECD economies and developing markets such as China, India, etc. The outlook suggests at least a two or three-speed EU economy, with Germany at the front, then France, the UK, Italy, Austria (unless Central and Eastern Europe has a real blow-up) and Holland followed by Spain, and with the smaller more vulnerable economies such as Greece, Ireland and Portugal trailing behind. The CBI expects the sovereign debt crisis in

southern European economies to continue, as do the financial markets, judged on those governments' German bund spreads. Commodity prices have reacted after 2008 although they are not at their peaks. Undoubtedly this will impact on OECD inflation although whether via inflation or stagflation is uncertain.

The CBI growth forecast for the UK is 2%, which is more or less the UK trend level but with a slower recovery than from previous recessionary periods in the 1980s or 1990s. However, UK consumer price index inflation should decline back to a 2% level in 2011/12 once the recent VAT increase has been factored out. UK growth will have to be driven by investment and trade because consumers are hurt, the government isn't spending and inventories are being held down. Average earnings are stable despite the inflation outlook, so household purchasing power is being eroded. Unemployment may rise further to 2.75 million, with limited employment growth until 2012/13, although there will be some growth in the private sector to offset public sector job losses. On interest rates, the CBI expects base rate to be 3% by the end of 2012. Treasurers will need to watch yield curves closely to see whether this means a flattening of the curve or a complete upwards shift.

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Buffer building

DAVID MANSON EXPLORES THE ARRIVAL OF THE LIQUIDITY BUFFER AND LOOKS AT POSSIBLE SOLUTIONS FOR TREASURERS FACING A CHANGED WORLD OF LIQUIDITY.

The annual ACT Cash Management Conference highlighted the importance of effective management of cash and liquidity for treasurers, especially when managing multiple sites. This was certainly confirmed through the voting session at the start of day one – 60% of delegates rated cash management as their main priority. The common view is that the financial crisis is easing for a number of business sectors; however, some are still feeling the effects. Against this backdrop of a changing economic landscape, the treasury function and the role of the treasurer has increased in profile.

A treasurer's ability to manage a company's working capital and liquidity is key to achieving business growth and meeting the company's objectives. In addition, more stringent regulations, such as Basel III, will drive companies to review existing polices and processes as well as achieve a thorough understanding of counterparty risk and how best to mitigate that risk. For those corporates at the conference, over 50% have changed their counterparty risk profile over the course of the past 12 months.

Another theme at the conference was the stability of the banks' balance sheets. This continues to be a primary focus for the UK's Financial Services Authority (FSA), and remains a key concern for 80% of treasurers surveyed. A number of new regulations and guidelines have already been introduced or are on the horizon. These regulations are designed ultimately to strengthen banks against future banking collapse but they also bring with them a number of operating implications for both corporates and banks to consider.

LIQUIDITY BUFFER

Prior to the financial crisis some financial institutions were deemed to have held inadequate liquidity reserves. The FSA's requirements are designed to allow an institution to survive a severe liquidity stress as a going concern. This should improve the resilience of the UK financial system, but this comes at a cost as the assets held in liquidity buffers are low-risk and low-yield.

Then there are the liquidity provisions of Basel III, which principally cover a mandatory liquidity stress test and a long-term funding ratio. The former is similar to the FSA's approach, but has a one-month time horizon, not three months. The latter creates a requirement for long-term assets to be funded with longer-term liabilities. These regulatory initiatives are intended to improve the resilience of the banking system by reducing reliance on short-term funding. This is likely to be reflected in the price that banks are prepared to pay for short-term deposits.

Banks now have to satisfy new capital requirements and hold a capital liquidity buffer, which in today's environment is a regulatory requirement that all banks and building societies operating in the UK must comply with. All banks