The weakest links

AENGUS MURPHY REVIEWS FOUR KEY CORPORATE RISKS IN THE TREASURY AREA AND LOOKS AT MEASURES TO PROTECT AGAINST THEM OR, HOPEFULLY, DETECT ANY INCIDENCES OF IMPROPER ACTIVITY ARISING AS A RESULT.

Treasurers and those responsible for treasury governance need to be concerned with four principal weak spots in the treasury activity. These are the weak spots which, if they fail, will cause significant monetary loss, loss of reputation, or on a personal level, job loss, and sometimes will reach scandal status.

The four weak spots are fraud, significant error, unauthorised position-taking and operational breakdown. Treasury by its nature is susceptible to these weak spots and because values are often very large in treasury activities and transactions, the potential negative impact is also large.

Yet, because of the complexity in the treasury business and the lack of effective understanding of it by those with governance responsibility, the risk posed by these weak spots goes unattended until it is too late. It's a classic case of closing the stable door when the horse has bolted.

Treasury is also an area of the business where internal audit is more often than not ineffective. Again this is because of the complexity and absence of real understanding. So those with governance responsibility cannot safely rely on internal audit to give comfort that all is well.

Neither is it a good solution that the organisation relies solely on the chief financial officer/finance director (CFO/FD), as the person with best knowledge of the business area, to ensure that all is well. This represents over-reliance on one person. In any event, the CFO/FD will have responsibility for executive management of the treasury on a day-to-day basis and good governance will require a corporate-level solution.

In my 25 or so years involved in the treasury business as practitioner, consultant, expert witness, internal audit team member and treasury/finance company board director, I have experienced very many cases where some of these weak spots existed in companies' treasury functions. Those with responsibility for treasury governance – CFO/FD, the corporate executive management team and in particular the board of directors and its relevant sub-committees – should have specific and direct engagement with this aspect of the corporate business.

WEAK SPOTS Before we turn to the suite of effective controls to prevent/detect weak spots, let us examine each weak spot.

Fraud: In treasury terms, the risk is that treasury staff will direct company financial assets or financial value away from the company for personal gain, or with the specific purpose of taking value from the company. In the treasury context, the main ways of doing this are using the payments and transaction settlement systems to direct funds from company accounts or in the company's name to unauthorised third-party accounts or third-party ownership; or collusion with a dealing counterparty to deal at non-market rates

Executive summary

- Four weak spots are fraud, significant error, unauthorised position-taking and operational breakdown.
- Combat weak spots with an effective suite of controls in and around the treasury activity, plus good governance.
- In addition to the main prevention/detection measures, it is advisable to conduct key tests each year.
- Urgent action is needed over bank and counterparty mandates.

with the gain being shared between the treasury dealing staff and the counterparty dealer.

Significant loss: Because of the large value often involved in treasury transactions, significant loss can arise from treasury transactions which have been incorrectly executed and which go undetected for a period of time. For instance $50m bought instead of sold forward for nine months could cost the company $5m. Likewise if $50m is bought instead of $5m.

Unauthorised position-taking: This is the most common weak spot. It happens frequently, but many cases go unpublicised. What happens here is that a treasury staff member believes they can make significant profit for the company by taking positions in the treasury markets, for which there is no underlying business basis, i.e. speculating. This activity takes place 'unofficially' and is not known by management. Inevitably, the position goes wrong and the staff member will try to trade their way out of it, often by doubling up. Again inevitably, the position gets worse, to the extent that it, or more specifically the mounting losses, comes to the attention of management. This activity is rarely if ever for personal gain, just a belief that windfall profit can be generated for the company.

Operational risk: In the main this refers to business continuity issues, such as availability of critical systems and staff, and breakdown of key controls. Indeed, systems dependency and especially dependency on usually one staff member who is well versed in the treasury's systems is an issue. Treasury very often does not provide for adequate cover for systems-competent staffing, due to the small size of treasury teams. Business continuity is now more of an issue, given the extent of systems dependency and the potential for general business disruption.

PREVENTION AND DETECTION So what is the answer? Principally, an effective suite of controls in and around the treasury activity, and good governance (see *Box 1*), should do the trick. What to do to prevent the weak spots arising and causing problems, and importantly to ensure early detection of any potential negative result situations? Starting from the top, these are the key measures.

- A good governance regime, where all elements exist (see *Box 1*), where the culture and management practice demonstrate attention to and effective management of the treasury activity. Again, responsibility rests with the board.

- The most critical control, which if properly implemented and continually enforced, will make any wrong-doing difficult if not impossible, is the clear division of duties between front, mid and back offices. However, there is a need to go deeper than just the office titles to ensure that the processes, procedures and controls divided between the offices are in effect watertight.

- Nowadays, treasury systems and using them in a straight-through process (STP) can significantly enhance the control framework, taking away the heavy reliance on person-driven controls. Systems should be used to the maximum to enhance controls.

- Treasury dealing, including transaction processing and settlement, is where many of the weak spots reside. There is a need to have in place a best-practice process for dealing and processing/settlement, which should include telephone taping in any situations where there is a significant volume or value of treasury dealing.

- The dealing environment and treasury systems need to be secure, preferably in a dedicated keypad-locked room, with robust access and privilege regimes. All dealing must be done from the office within working hours. Robust IT administration is also an important feature. However, there is a particular need to ensure that the IT administrator does not have a level of access and privilege that could pose a risk, i.e. by being able to set/change every aspect of the system's control features.

- The payment process is also a critical exposure point. At this time, there is a variety of systems used in companies, which makes it difficult to police effectively. From internet-based electronic

Figure 1. The key tests for fraud

TMS	Transaction Capture	Reporting	Segregation of duties	Systems
Captured Conducted Processed	Accuracy Policy Strategy	Complete Timeliness	Execute Confirm Settle Report	Duality Independent SSIs Privileges

banking systems (EB), to in-house server-based EB systems, to written posted instructions, to faxed instructions, to taped telephone instructions, and now SwiftNet for corporates. Often a combination of these systems operates within a company. The process here must be foolproof against fraud and error.

- Documented procedures and controls, at least at a level of detail which sets out a reasonable description of procedures and identifies in detail the controls that are to be exercised and observed, are a must for the treasury activity. Continuous management audit and internal audit of full compliance with these is advised, given the sensitive nature of the activity and the potential for scandal.

- Bank and treasury counterparty mandates are a key control measure. I have a concerned position in relation to this which I highlight and deal with below (see bank and counterparty mandates).

KEY TESTS In addition to these main prevention/detection measures, it is very advisable to conduct key tests each year (*see Figure 1*). Each year because the treasury business and the systems and technology change continually and indeed treasury best practice is only now emerging. These tests must be conducted by a fully competent management and internal audit team, excluding the treasurer and the treasury team. The tests are specifically to establish that fraud, significant error or unauthorised position-taking cannot happen, or at least are most unlikely to happen and go undetected. These key tests are:

1. Establish that all transactions must be captured on the Treasury Management System (TMS) and through this conducted and processed in full under the official control system. It is critical to establish that there is no scope for transactions to be 'done outside the system', as this bypasses the entire control framework. Challenge the treasury to prove this fully.

2. Establish that all transactions on the TMS are accurate, align with the approved strategy and comply with policy. This is difficult to implement. It requires a single robust check by a very competent individual who has knowledge of the business. Often treasury checks are token ones and do not provide the necessary level of protection. In my experience, just one effective check at the correct point in the process by a competent person, supported by STP, is what is needed, rather than several ineffective checks scattered throughout the process, which is the norm.

3. Establish that reporting to corporate management captures all transactions and all positions and that reporting is TMS-generated. Again, challenge the treasury team to prove that transactions and positions cannot exist which are not covered by the standard reporting.

4. Establish that any one person cannot physically execute the deal, confirm it and settle it (make the payment) or manipulate systems to achieve the same effect. As a minimum there has to be segregation of duties between the person who executes the deal and the person who settles it. Walk through the system in detail, again challenging the treasury team to prove it cannot happen.

5. Establish that there is effective dual and independent sign-off on key systems-based controls, especially setting up and changing standing data, with particular attention to standing settlement instructions (SSIs), and EB access and privileges.

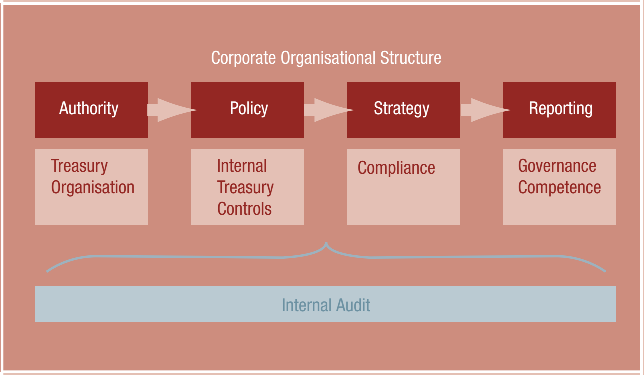
BANK AND COUNTERPARTY MANDATES This is an area where urgent action is needed. At the moment it is somewhat in a shambles. Treasury control can be seriously enhanced if the role of mandates in the overall control framework is rationalised and standardised and then the mandate procedure fully operated by both the treasury and counterparty.

First, though, let it be clear that the primary responsibility for a company's treasury control framework and the effectiveness of this framework rests fully with treasury. It is a nonsense to rely fully on the counterparty's operation of mandate requirements as the main plank of the company's control framework. In any event this does not stand up legally.

However, the bank/counterparty mandate is a key independent component of the corporate treasury control framework. The main elements of it, which provide the essential controls, cover what business can be conducted, who can conduct the business, the confirmation arrangements, including the critical need for the bank/counterparty to send confirmations to the designated officer and address, and the settlement arrangements. Proper adherence to

Box 1. Good Governance

What represents good governance in the treasury function? The key elements are:



- **Corporate Organisation:** The structures from the treasurer-level to the board with clear roles and responsibilities for the activity – roles and responsibilities appropriate to each level, and importantly an effective role for the board and its sub-committees. Treasury must receive adequate attention from each level of corporate management, including meaningful coverage at least quarterly by the board.
- **Authority and decision-making:** Formal authority allocation and a process for decision-making in a manner suitable for the environment in which the treasury activity is conducted are required.
- **Treasury policy:** Well-developed formal policy for treasury which sets out clear objectives, practical guidelines for treasury activities and risk management, and performance expectations.
- **Treasury strategy:** Treasury activities and risks should be covered by formal and regular comprehensive strategy presentations to all levels of corporate management, setting out the underlying exposure, the extent of hedging in place, the residual risk and what is proposed in relation to it, and the performance of the strategy against policy.
- **Reporting:** Presentation of positions and reporting on the activity in a manner which enables informed decision-making and facilitates effective oversight by all corporate management levels. Too often poor reporting combined with management information and treasury jargon make proper understanding for sound decision-making difficult if not impossible.
- **Compliance:** The system in operation under which the board and corporate management can be assured that the treasury activity is actually being conducted in line with approved policy and strategy, and in accordance with approved procedures and controls.
- **Governance competence:** Specific training for all levels of corporate management to enable each level to fulfil an effective role in treasury governance is a wise investment.
- **Treasury organisation:** An absolute must is effective front, mid and back office division of duties, where there can be no compromise, together with adequate resource for the business in terms of skilled staff and systems and IT.
- **Internal treasury controls:** There are a dozen or so key internal treasury controls which those responsible for governance should ensure are in place and fully observed within the treasury.
- **Internal audit:** A comprehensive effective internal audit is needed annually, with occasional beef-up of the internal audit team through engagement of external treasury specialist experience and expertise.

These 10 components of good treasury governance will ensure that management is focused on the potential risks and has measures in place to protect the company as far as possible against weak spot failures. It is the responsibility of the board of directors to ensure that this robust regime prevails in their companies.

the procedures contained in the mandate by both the company and the counterparty is the single best way of ensuring that nothing improper is going on in the company's treasury activity. No treasury or counterparty should conduct any business without a proper mandate being in place.

Yet there is continuing difficulty in relation to mandates. Companies want their own mandates to operate; banks are insisting on their mandates; mandates tend to be unbalanced and one-sided depending on whose version is in place; sometimes there are several mandates – a main one, one for EB systems and one for fax situations. Overall, something of a mess, and as a result they do not operate well and do not provide the essential control that they are intended for.

The seriousness of the risks for corporates due to the absence of a robust mandate solution is being underestimated and downplayed, and it is time to bring the problem forward on the agenda. It is about time that an industry standard is developed and agreed for corporate banking and dealing between the company and the counterparty, one which is balanced and can be practically implemented. Treasurers in particular should call for this and ACT has a key role to play.

There is also a need for banks and counterparties to invest in technology that would automate the operation of the mandate requirements. Relying on manual processes for such high-volume processing is not workable. Perhaps an opportunity for a specialist systems provider to develop a purpose-built system for this, which is only possible if an industry-standard mandate is adopted.

Food for thought, perhaps even action, on these subject matters. I would urge board directors, who have ultimate responsibility for treasury governance, to review their companies' treasury governance and to get behind a call for a solution to the mandate issue.

For further reading on this topic, see The Guide to Treasury Best Practice & Terminology, *which has recently been distributed free of charge to all ACT members and subscribers to* The Treasurer, *courtesy of* The Treasurer *and Lloyds TSB. If you've not had your copy, please contact Malcolm Rosier or Pauline Simpson on 0845 300 6330.*

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