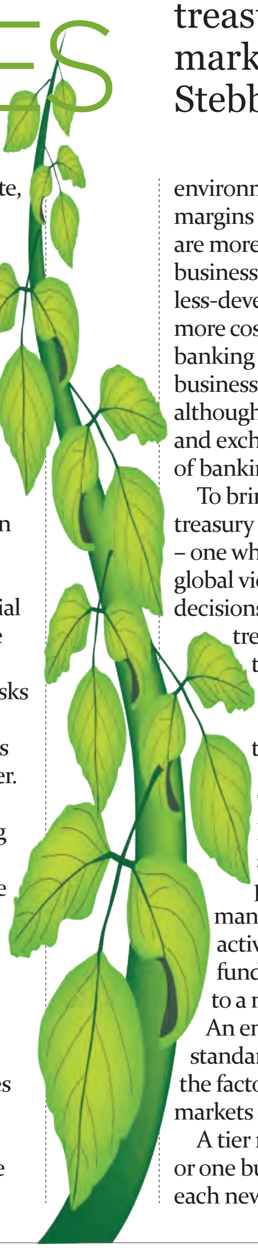
A WORLD OF OPPORTUNITIES

How should global businesses approach treasury in emerging markets? David Stebbings explains



The current economic climate is presenting the treasury community with many varied and conflicting challenges and opportunities. Increasing regulation, FX and commodity price volatility, instability in the eurozone, the creditworthiness of banks and their appetite to lend, the effect of high-profile failures and the availability of improved risk management tools, to name but a few, have added to the treasurer's remit. But while such issues would suggest increased resourcing requirements, there is often a desire from senior management for the treasurer to do more with the same or less.

One of the most profound new challenges is the increasing business focus on emerging markets. The world has changed and business growth for many is now often outside the traditional markets of Europe and North America. Such markets have technical, operational and cultural challenges that treasurers have tended to approach in an ad hoc manner that focuses on the technical challenge at hand and often reinvents the wheel when it doesn't need to.

Given resourcing constraints and the range and complexity of the issues, the treasurer needs to act smarter and put in place an explicit operating model framework for emerging markets. This will free up time to grapple with the technical challenges while enabling him or her to more easily manage the ongoing treasury risks. It will also provide a template as to how treasury activities in an emerging-markets business should operate, which can be revisited time and again.

The scope of treasury

Before exploring what this framework might be, it is useful to reflect on the scope of treasury activities. The definition of treasury varies between organisations, although many define it by what is within the remit of the treasurer (see table below).

This approach misses value outside of group treasury, however, and treasury can better be defined by a series of activities and associated exposures and flows that involve a bank and/or the use of a financial instrument that can take place anywhere in the organisation. Such activities range from the management of key financial risks using complex derivatives and funding structures at one end to how the business makes a commercial payment at the other. Each activity, risk or flow is important, not least because of the cost of managing them, and all need to be considered in the emerging-markets context even if the treasurer is not ultimately responsible for their day-to-day fulfilment.

What does this mean for the treasurer?

Firstly, it's important for the treasurer to adopt an operating model that recognises the differences between traditional and emerging markets. Traditional markets, Europe, North America, etc, tend to have well-developed treasury and banking environments and a pressure on business margins and costs. Emerging markets are more likely to have higher-growth businesses, with higher business risk, less-developed treasury environments, more costly financial instruments, higher banking charges, more complexity in business structures (JVs, etc), significant although reducing regulation, banking and exchange controls, and a lower level of banking structure development.

To bring these together, a strategic treasury approach could be considered – one where the treasurer has a holistic global view, is involved in all treasury decisions (not just those related to the treasury function) and develops tiered global standards based on global policies detailing how to 'do treasury' throughout the organisation.

Tiered global standards

Most businesses have treasury standards based on key policy principles, detailing how they manage and control key risks and activities – cash, FX, commodities, funding, banking, credit, etc – down to a required level of granularity.

An emerging trend is to see those standards tiered to take account of the factors that make non-traditional markets different.

A tier may include a series of businesses or one business. As the organisation grows, each new business would be assigned a tier

TREASURY FUNCTION ◄► OPERATIONAL FINANCE/SHARED SERVICE CENTRE

CORPORATE ACTIVITIES	DAY-TO-DAY TREASURY ACTIVITIES	CASH MANAGEMENT	OPERATIONAL ACTIVITIES
M&A Bonds, long-term debt Bank relationships Complex derivatives Banking facilities Interest rate Policy/strategy/controls Funding structures Cash investments	FX external Short-term cash management and visibility Short-term borrowing and investment In-house bank Management of loans, FX Commodity risk management Risk analytics Credit risk management Management of intercompany loans	Short-term cash forecasting Cash position and visibility FX/commodity forecasting Local banking arrangements, technology, mandates, etc Cash concentration/pooling Netting Payment factory Intercompany In-house bank Letters of credit, guarantees, etc	Commercial payments and collections Bank reconciliations Cash allocation Management of bank accounts Management of electronic banking/SWIFT, including interface to enterprise resource planning, etc

THE DEVELOPMENT OF TIERED STANDARDS

	EXAMPLES OF BUSINESS CHARACTERISTICS AND TREASURY IMPLICATIONS	EXAMPLE KEY GROUP POLICIES	EXAMPLE KEY TIER STANDARDS (TO BE DOCUMENTED IN DETAIL ELSEWHERE)
TIER 1	◆ Full ownership and control ◆ Located in open economies ◆ Liquid markets to use derivatives and borrow cash ◆ Group treasury has opportunity to centrally manage risk and treasury activities ◆ More likely to use global enterprise resource planning ◆ Use of global shared service centre for finance activities	• Protection of credit rating • Transaction FX risk hedged • Hedge accounting applied • No commodity price risk hedging • Centralise cash as much as possible • Funding via public debt • Focus on key banks that lend money plus key local banks	◆ Maximisation of straight-through processing in payment, cash and accounting activities ◆ Payments via shared service centre ◆ Use treasury system for all risks and instruments ◆ Full cash concentration structures ◆ Centralised bank account management ◆ Group treasury provides analysis and full management of risks
TIER 2	◆ Maybe control restrictions ◆ Maybe located in economies with some government monitoring and FX restrictions although reducing ◆ Varied systems environment ◆ Group treasury has opportunity to centrally manage certain treasury activities although local execution and analysis may be required		◆ Partial cash concentration perhaps within region – as much as possible ◆ Treasury transactions undertaken centrally, but maybe on behalf of local businesses ◆ Group treasury has a controlling role with some management activities ◆ Use of global banks for funding, although may be local
TIER 3	◆ May have local minority partners ◆ Likely to be located in countries with FX restrictions ◆ Cash repatriation key issue ◆ Agreement of other shareholders required to extract cash, so limited cash concentration possible ◆ Central treasury more likely to have a more advisory role; favours local execution and analysis ◆ Banking environment less developed		◆ Group treasury oversight and overall control role and receives reporting ◆ Treasury and cash transactions undertaken locally ◆ Limited use of treasury systems controls ◆ Centralisation of cash to key in-country accounts at key banks as much as possible ◆ FX conversion via central bank processes with key banking partners ◆ Funding from development/ local banks ◆ Some central visibility of cash

and the standards set accordingly. There is no right answer as to how tiers are set. But, whatever the determining factors, there are generally a number of key attributes:

1. Tier 1 would generally be activities in traditional markets and the standards would tend to be the tightest, focusing on activity standardisation and efficiency to minimise time spent and cost. Hence, in this tier, risk management and cash are more likely to be centralised, hedging would tend to be more mechanical and activities more automated.

2. Below tier 1, there may be a number of tiers down to the bottom tier, which would be those emerging markets where treasury activities are least standard and require the most diversity to achieve business objectives. It may not be possible to hedge risks or move cash easily in this tier. But control standards, particularly around cash and financial instruments, are likely to be just as tight, if not tighter, than tier 1. Interestingly, this tier may be the most important for overall business performance, so a key treasury goal will be to support this.

3. Business or locations will move up through the tiers when key attributes change – for example, when ownership changes or exchange controls are relaxed. Hence, the tiers need to be reviewed on an annual basis at least.

An example is shown above, which focuses on high-level standards for a business where the tiers are determined by business characteristics, location, level of ownership and the ability to pool business cash.

Some organisations have taken the tiering concept beyond the business to influence their view of looking at banking partners or funding providers – what the business is able to do with them and how they are viewed for credit risk purposes, for example.

A strategic treasury approach

Tiered standards in themselves will not meet the challenge; a strategic treasury approach is also required. Key elements to support this are:

◆ That 'treasury' encompasses all activities in the table on page 24 wherever they occur in the organisation, and there is a business focus to such activities;

◆ That the treasurer sets the standards for all treasury-related activities wherever they occur in the organisation, and remembering that the day-to-day fulfilment of certain activities may lie outside of his or her remit, often in a shared service centre;

◆ A global treasury organisation and governance model and a global approach to managing risk, at least on an overlay basis; and

◆ One source of the truth for all treasury information and analytics in the business via an appropriate treasury management system and a solution (either SWIFT- or bank-led) for visibility of cash worldwide.

Of course, the organisational model needs to fit in with the culture of the business, but even if risks and positions are not managed centrally, they should be visible centrally. In addition, treasury management, regional or local, should conform to the tiered standards and fall within the group-wide governance model.

Emerging markets present interesting technical challenges for the treasurer and an opportunity to show how they add value to the organisation. But many treasurers often fail to maximise their effectiveness, because they have not put in place the appropriate approach or framework that considers the challenges of the emerging markets and allows them to focus on solving the key technical issues. Tiered standards and a strategic treasury approach will help the treasurer to achieve this.

David Stebbings is head of treasury advisory at PwC. Contact him at david.stebbings@uk.pwc.com