Treasury policy and fraud prevention

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Introduction

In the 'new normal', the treasurer has gained further prominence and visibility in the organisation at board level, with the treasury policies and controls providing the foundation and guidance for how cash and financial risk are managed. Specifically, the policies on liquidity and counterparty risk have often been scrutinised and revised over the last year.

The policy acts as a roadmap for the treasury function and it is crucial that this document is clear, concise and well understood. The treasury policy must also have full board approval and be reviewed and updated at least on an annual basis. Finally, it must be recognised and adhered to for all treasury activities and across all business units.

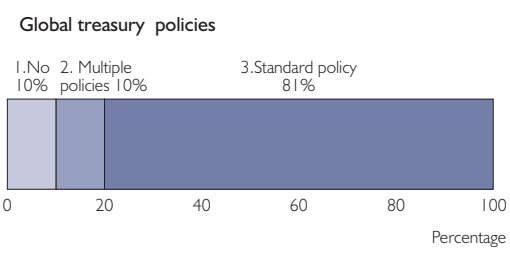
Why do you need a policy?

The treasury policy should follow directly from the group's business strategy and set out the board's appetite for risk and the role of the treasury function. The policy typically covers the roles and responsibilities, sets out how the key financial risks are managed and provides a specific focus on cash management.

Managing financial risk is often a major responsibility for the treasury function and this in itself, needs to be carefully managed internally with a robust policy and set of detailed procedures. The treasury function is different to other functions, for example:

- Treasury transactions can be of significant value.
- The financial markets can be volatile.
- The use of derivatives is not always well understood and their misuse in the past has been well documented.
- The treasury function has limited resources and there are often major time pressures to carry out complex financial transactions by a set deadline.

Figure 1: Treasury policy approval



The role of policy is to set out the control framework so that risks are identified, measured, controlled, reported and explained to senior management.

Recent research shows that over 80% of corporates have one global approved policy documented; 10% have policies in place but not universally approved across the group and another 10% do not have formally approved policies.

What should a policy cover?

The treasury policy should firstly establish how much risk the organisation is willing to accept and how it will actively manage that risk. The policy should also detail the roles and responsibilities of the treasury function and the staff within it. It should be maintained as a key working document that outlines the objectives of the treasury function, the risk appetite and the boundaries within which the function can operate. As such, the policy should be regularly reviewed, updated and not simply filed away until the internal auditor asks to see a copy.

In practice, many organisations split the policy into two or three documents; the first a very high level summary which the board approve on an annual basis and the second a more detailed description of the risks, how they are going to be managed and appendices which detail items such as banking relationships, authorisation limits for individuals and instruments.

The main components of a treasury policy should include:

- Objectives of the treasury function.
- Roles and responsibilities of the treasury function.
- Detail of each risk that is being managed.
- Permitted hedging instruments.
- Authorisation/approval limits by instrument and risk type.
- List of bank relationships.
- Key performance indicators.
- Confirmation procedures.
- Settlement procedures.

Figure 2: Treasury policy framework and excerpt example

Policy content

Section 1: Introduction and Treasury Framework
- Role of Treasury function
- Principal Roles and Responsibilities
- General statement of Principles

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Section 2: Policies
- Definition
- Objectives
- Policy
- Responsibilities
- High Level Reporting

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Appendices to Treasury Policies

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Distribution List

Policy

Definiton
- The nature of the Groups relationships with the banking community ensuring that the Group can access the required banking services within an acceptable timeframe and at a competitive price.

Objectives
- To develop the banking relationship with our core relationship banks.
- To develop relationships with our local banks to ensure the Group receives a high quality transaction based services.
- Maintain a reputation for accuracy and efficiency in the execution of Treasury transactions.

Policy
- The Group Treasurer will manage all bank relationships on behalf of the Group.
- The business units will continue to use established local banking relationships for day to day account management payments, and receipts and off balance sheet financing. The local Finance Directors will manage such relationships.
- Local banking relationships can only be changed with agreement from CFO.
- Local Finance Directors will report on local banking relationship issues to the Group Controller.
- The CFO and Group Treasurer will ensure ongoing communication with the banks on the business results to meet the terms of the Senior Debt Financing.

Responsibilities and High Level Processes (See Appendix 1)

Board of Directors	• Will approve overall Bank Relationship Policy and significant changes to policy • Review internal and external audit reports relating to banking issues • Will approve amendments to Bank Relationship Group
Chief Financial Officer	• Will ensure ongoing communication with the banks on business results • Will report "positive undertakings" commitment to syndicate banks and other banks
Treasury Committee	• Determination of the strategy in relation to bank relationships for subsequent execution by Group Treasury and relevant holding companies • Will review positive undertakings reporting
Group Controller supported by treasury officer	• Will manage the Group's banking relationships • Will be the principle contact with core relationship banks • Will recommend to the CFO/Treasury Committee on all bank relationship issues within the Group • Will be ultimately responsible for all bank related documentation • Will compile positive undertakings statements for CFO/Treasury Committee
Reporting Manager	• N/a
Tax Manager	• N/a
Internal Audit	• Will annually verify compliance with policy
Local Finance Directors	• Will manage day to day local banking relationships • Will provide information to the Group Treasury on bank relationship issues

Liquidity management

Since autumn 2008, liquidity risk has been one of the foremost concerns for the treasurer both externally through renewing or securing new sources of finance and internally by attempting to optimise working capital and through more regular and detailed reporting requirements. Techniques such as cashflow modelling, scenario analysis and stress testing used by banks under guidance from Basel and the FSA are likely to be adopted by the corporate world in future years. However, this analysis relies on accurate and timely data and high cash visibility which, in reality, only a limited number of companies have achieved so far. Policies are being revised in the area of cash management and specifically on short term liquidity with KPIs such as achieving high daily cash visibility (e.g. 90% level coverage targets).

Counterparties

Counterparty risk has historically been of lower importance relative to other treasury risks but that has all changed in the new environment with this rising up the priority list and often now ranked second after liquidity. Many corporates have based their limits on credit ratings with some taking into account a company's balance sheet and profitability measures. Other measures such as the credit default swap rates are now actively observed as indicators and the stability and ownership of counterparties are closely watched. Monitoring concentration risk with an institution across all operations globally and also country risk are now essential requirements for a robust policy.

The challenge is how to monitor this at a global consolidated level as businesses become more diversified with increasing geographic spread. Some policies still fail to include the market value of their derivative position in the overall exposure to a given bank. The lack of system capability and also the challenge of explaining more sophisticated risk management techniques to senior management may be barriers. However, the emphasis is on answering the key question: 'Where is my cash and how secure is it?" which has lead to significant improvements in reporting and management of these exposures.

Risk management

Most treasury policies address the traditional financial risks faced by the organisation such as liquidity, funding, foreign exchange, interest rates and counterparty risk. Commodity price risk and pension risk are increasingly featured as a key responsibility of the Treasurer. Operational risk however, is gaining more awareness, yet it remains a major challenge with few corporates specifically addressing or successfully mitigating this risk. The supposed holy grail of risk management is a holistic approach for all financial and non-financial risks and this is an area that Enterprise Risk Management (ERM) attempts to address. Certainly, the correlations and interactions of the risk types should be understood, as there may be natural hedging opportunities. The treasurer should be best placed to take on the role of the 'risk expert' for the group as they will generally have a strong grounding in risk techniques and have strong relationships within the banking sector.

Commodities

Commodity and energy price risks still remain (for many organisations) largely outside of the treasurer's remit and hence the treasury policy. While resource and energy

companies have a dedicated team to manage these types of risk and this naturally sits outside of treasury for these specific companies, the treasurer is likely to be best adviser for companies in the other sectors. It boils down to materiality and volatility of the risks and perhaps more critically how much ownership the treasurer can claim for this risk category. Ideally, it should be covered in the treasury policy and at the very least, the exposures and hedging instruments should be reported to treasury.

Operational risk

Operational risk is the risk of direct or indirect loss resulting from inadequate internal processes, people and systems or external events (Basel) or put simply 'screw up' risk. This risk is seldom directly identified in the treasury policy but is managed indirectly through segregation of duties, more robust controls and more accurate and timely reporting. Treasury should identify and agree their performance metrics and indicators and then report on both the operational and key performance indicators on a monthly basis. These should then provide early warnings of any potential issues.

What are some of the shortcomings of treasury policies?

The biggest concern is that the treasury policy is not kept up to date, unapproved and does not have global buy-in across all the company's operations.

Another key issue is that businesses are constantly evolving through mergers and acquisitions and if the policies are not updated to reflect changes to the strategy or the revised organisation, there can be a serious disconnect resulting in non compliance with the existing policies and potential risk management issues.

One common shortcoming is to have just one complex and lengthy all encompassing document on treasury policies. It is expected that the treasury policies are read, understood and approved by the board and as such, a comprehensive, yet summarising policy document of only a few pages long should be produced to accompany the main document.

Another common fault is that the policies are too restrictive and prescriptive. For example, the policy on transactional foreign exchange exposure may give very clear guidelines on the timeframe, the required hedging ratio and that the exposure can only be hedged once it is committed. This fails to take into account the likelihood of the uncommitted exposure being crystallised and during the ensuing period a significant exchange rate move taking place, which may adversely affect the underlying value of the exposure/asset.

Finally, many policies address the risks individually rather than from an integrated viewpoint. For example, a company that has exposure to oil prices may set detailed guidelines on the timeframe, percentage coverage and what instrument types are allowed for the oil price risk. However, if the organisation adopts a different hedging policy for foreign exchange, there could potentially be timing mismatches and inconsistencies in approach. However, some exposures are less obviously correlated such as the impact of interest rates on credit and business risk.

The treasurer should also be conscious of the impact the hedging policy has on the overall business performance rather than just purely focusing on the financial risks.

For more information on performance management see the following article.

Why are controls so important?

With many examples of historic control failures and the drive towards stronger governance and regulation resulting form Sarbanes Oxley, the treasurer is only too aware of the importance of controls. They are a necessary evil to safeguard the organisation's assets and prevent the risk of a major catastrophe such as fraud, human error or significant market movements. The emphasis in recent years has been on controlling the process risks but this is only one aspect.

The control framework should naturally follow from a clear and comprehensive policy.

What are the types of control?

Controls are often categorised into preventative; stopping an error before the process begins or detective, identifying when a procedure has failed. Obviously there should be a balance between the two and ideally, it is better to prevent than merely report an error or loss.

The control types include:

- organisational;
- physical;
- system;
- process;
- reporting; and
- independent review.

Organisational controls

One of the critical reasons for many of the financial scandals has been due to a lack of senior management oversight (e.g. Barings, Diawa, Orange County). This has been addressed over the past 10 years, partly due to regulation such as Sarbanes Oxley making senior management directly accountable with the threat of fines or even a jail sentence. Many treasury functions now have an improved governance structure with formal risk reporting to a risk committee on a monthly or quarterly basis.

The recruitment of staff into the treasury function should include background checks on all potential employees. There should be a training programme so that all members of staff are familiar with the control framework and the systems. Everyone should be encouraged to take their annual leave entitlement as it can not only improve

productivity and prevent over reliance on individual members of staff but also reduce the opportunity for fraudulent activity. Team members who do not take holidays may have something to hide.

Ideally the treasury function should segregate dealing, authorising, releasing payments and accounting activities so that the treasury staff are only responsible for one activity of the treasury transaction lifecycle. However, for most treasuries this is not always practical so one way to overcome all the checks and balances is to automate the process and move towards straight through processing (STP).

Physical controls

In the first instance, there should be controlled access to the building and prevention of 'tailgating'. Within the treasury function it is quite common for the dealing room to be physically separated and it is generally good practice for all telephone lines to be recorded for unauthorised use.

System controls

Where physical controls act as the first line of defence, system controls should form the next set. These include passwords for the network and separate passwords for specific applications such as the treasury and payment systems.

User profiles are normally configurable within the treasury and payment systems restricting user access to only the front, middle or back office activities. Enforced system segregation is recommended and is an area where internal audit should verify that it has been set up and is being used as designed.

There is often internal IT support for maintaining the treasury system in-house but the same cannot always be said for the EFT system. First, segregation of activities is often more limited and as the system is often set up with the banking partner; internal knowledge of the system configuration may be limited. With the advent of SWIFT and the move towards straight through processing, these risks will become less of an issue as companies integrate their payment systems with their Treasury Management System (TMS) or their Enterprise Resource Planning (ERP) systems thereby reducing the need for manual intervention in the payment process. Automation also means errors are more likely to be spotted much earlier in the process thus preventing further loss.

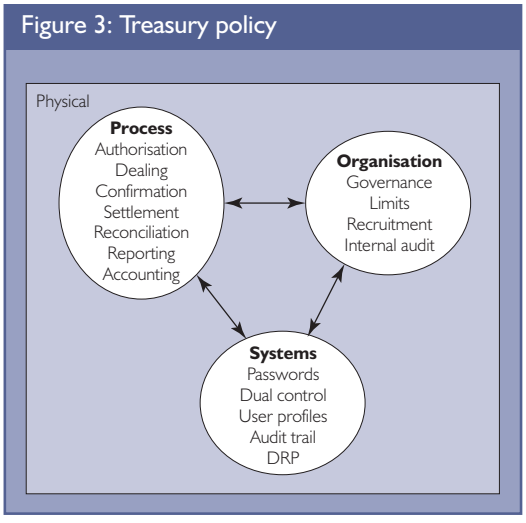
Having a fully documented disaster recovery plan that has been regularly tested each year is strongly recommended for potential disaster scenarios such as power failures, terrorist action and even transport problems. Technology and web access have meant that getting access to systems is easier and virtual working is gradually becoming a possibility.

Process controls

Bank and dealing mandates: set out the rules of engagement with the bank and this includes who is authorised to approve, what products are allowed and specifies the bank accounts where funds can be credited/debited (SSI).

- *Dealing*: the advent of sophisticated TMS systems has lead to much stronger controls around dealing records, audit trail and the authorisation and approval stages. Due to regulation; processes, controls and risks tend to be well documented and better understood. This is a big improvement but it does not necessarily prevent operational errors happening or stop an individual who is intent on evading the controls
- *Confirmation:* matching that is carried out daily, where holiday cover exists and the process is automated by dedicated matching software, should form a strong control foundation. One challenge in the past has been that the confirmation process works well for basic trades such as FX and MM but it is less effective for the more complex trade types, but improved automation and developments in financial messaging should mean this issue will be covered for most trade types used by corporates.
- *Settlement:* the standard recommendation is that this should be segregated into three stages (input, approve and release) with separate people carrying out each stage. However, not all counterparties and payments have the same level of risk so a 'one size fits all' approach may not be the best approach. What is of critical importance are the controls around the addition of new counterparties or one off payments. There should also be sufficient documentation supporting all existing counterparties, no matter how old the relationship.
- *Reconciliations:* this should be done independently of the front office and normally by back office or accounting. It should be carried out every day, without exception and an explanation of un-reconciled items should be sought and obtained each day. The source of the bank statements must be independent of the front office.
- *Reporting* and accounting: are vital steps in ensuring that senior management have a good understanding of how well the treasury function has performed against its key metrics of managing the group's financial risks. Reporting is often monthly or quarterly and includes detail on risk

Figure 3: Treasury policy



positions such as liquidity, FX, interest rates, funding and counterparty exposure. It should also include details of any breaches, control failures and performance against key performance indicators (KPI) e.g. dealing error percentage or the outstanding confirmations percentage.

- *Independent review:* Finally, internal audit should be carried out, at least annually and should provide management with assurance that the controls exist, are effective and highlight areas for improvement. Management will then need to challenge and/or implement changes so that a strong control framework is maintained.

Summary

The treasury policy sets out the ground rules for the treasury function and its importance is as relevant now as it was in the 'old world'. Thus, policy and controls are vitally important to the treasurer, but perhaps too much emphasis has been placed on the controls to the detriment of the policy and what ultimately the treasury function is trying to achieve. Make sure your policy is clear, well understood, has board approval, is aligned to the corporate objectives of the business and most importantly is an operational document.