What does the future hold for risk managers?

David Michell of The Finance and Treasury Association charts the changes in how risk management is carried out, and finds out how it will alter the treasurers' role.

A strong financial risk management culture is a key component of good corporate governance and a valuable element in the creation and protection of shareholder wealth. In late 2000, corporate hedging activity, and the advice provided by banks on hedging, is under the microscope due to the weak Australian dollar and decade high oil prices. This article looks at the state of play in financial risk management and sketches a future path for corporate treasurers and their bank counterparts.

That Australian companies emerged largely unscathed from the Asia financial crisis of 1997 and 1998 was in part due to disciplined currency and commodity hedging. Until 1997, it had appeared that the scope for treasurers to add value in the traditional areas of interest rate and foreign exchange management had been eroded by the reduced volatility in those markets. Asia's financial troubles renewed awareness of the value of treasury management.

But perhaps a greater impact from the crisis was in encouraging demand for risk management professionals in general. The 'contagion' effects of the Asia crisis, and problems such as Y2K, highlighted that big risks can arise from unexpected quarters.

Such developments have accelerated a trend in corporate evolution toward a holistic, business-wide approach to risk management. In a growing number of corporates, treasurers are leading, or active in, multi-disciplinary risk teams.

The technology challenge

Of course, new technology in the form of more accessible databases, faster information flow and networked communications is also a force in breaking down of the 'silo' approach to risk management. Technology is also a threat and opportunity for traditional providers of research advice and transaction services. With the rise of wholesale financial service portals such as CFOweb.com and Fxall.com that provide (or have the ability to provide) transaction services with greater price transparency, research and portfolio management services, the nexus between research and deal execution is breaking down.

Web-enabled services from third-party providers (or even clubs of banks) are a source of disintermediation. A related trend is the potential breaking open of the payments system that will allow diverse groups to offer banking services.

It all means that the bank distributor to corporate clients has to be ever more focussed on providing a value-added service.

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Risk managers

Are corporate financial risk managers becoming more sophisticated? Some evidence that corporate treasurers are spending less time on traditional activities can be found in the 2000 FTA Corporate Treasury Survey in association with Ernst &Young, in which some 60% of respondents said they conducted fewer than 16 risk management transactions for a typical month. (The exception would appear to be an increase in the use of all types of commodity risk management products, but this is not surprising given the general weak US$ commodity prices, in the latter half of the decade.)

Lower turnover of hedging positions need not mean less sophisticated strategies. The Asia crisis experience may have made corporate risk managers more sophisticated users of hedging instruments.

The latest Corporate Treasury Survey shows a decline from 1998 in the use of common interest rate management products, such as FRAs, swaps and exchange traded futures, and an increase in the use of over-the-counter option products, such as buy-only and collar strategies, and knock-in/knock-out and barrier options. Similar trends are exhibited in foreign exchange risk management where fewer treasurers are using the forward foreign exchange contract as a risk management tool.

Foreign currency hedging is currently in focus as a result of the unexpectedly prolonged and deep downturn in the A$/US$ exchange rate. For exporters and others with foreign currency income, hedging is no longer the free lunch it was when Australia had a large interest rate differential with the US. That is, they are no longer able to lock-in a rate substantially better than spot.

In the current environment, it is appropriate that hedging policies are revisited. Where the corporate goal remains cashflow stability, corporate hedging will continue, even if there is a cut in the proportions to be hedged.

For those risk managers that do predominately use traditional products which lock-in a forward rate, there is cause to revisit their approach. Although, a majority of corporate treasurers with foreign exchange risk claim to be active managers, a small minority nominate the ability to close out hedges before maturity as part of their process. This is perhaps an illustration of over-

compensating against the 'risk' of being seen to be engaged in speculation.

In the current financial market environment, the importance of using more flexible hedging tools, notably bought options that do not lock-in a forward rate and provide upside for the cost of a premium payment, is well illustrated. Why are these tools not more heavily used?

The 2000 Corporate Treasury Survey indicates that treasurers rank cost and risk/reward profile as the first and second most important factors in their choice of derivative instruments. The third most significant factor (with other factors such as liquidity and tax treatment well behind) was policy restrictions.

The banks have been trying for many years to sell option-based strategies to corporate treasurers and, although there has been some success, they need to continue the effort of showing the value of options relative to plain vanilla alternatives. Greater success on that front should be followed by more flexible treasury policy guidelines.

Accounting impact on corporate risk management choices

Although accounting treatment was seen in the survey as a factor of low importance in determining the choice of derivatives, treasury product distributors should be aware that US and Australian accounting standards setters now require that treasurers track each hedge position against an underlying financial exposure. This is a disincentive to using a portfolio approach to risk management and may also come into conflict with popular products such as basket options.

The US derivatives accounting standard FAS 133 has made it harder for a derivative position to qualify for hedge accounting. For Australian companies reporting in the US, those hedges that fail an 'effectiveness test', or are not properly designated as hedges at inception, must be regularly marked to market with changing valuations going directly to the profit and loss account, rather than the balance sheet.

The degree to which the change in value of the derivative substantially offsets the change in value of the underlying transaction is measured by statistical correlation tests. The time value of an option correlates poorly for typical cashflow hedging and so this would have to be written directly to profit and loss. In this way, sensible hedging strategies can be penalised, because CFOs and company boards will not want to see volatility in the accounts. Although investors may eventually see through bottom line volatility caused by risk management activities, that volatility will be another factor dissuading corporate risk managers from using more structured products and strategies, and another factor with which value-adding bank product distributors must contend.

New risk management products

An increasing number of products and services have become commoditised and hence tradable in recent years. Using self-funded or externally provided insurance may still be more appropriate protection against some risks, but the general trend has been for more active management of risks. As businesses seek to cut costs and put more upside leverage into their businesses they are likely to participate in the new markets.

It follows that derivative products will be developed to help the new market participants manage their exposures. For instance, if trading in telco bandwidth takes off, one would expect over time a derivatives market to be created; already basic forward contracts have been traded.

In other instances, derivatives have been developed to permit parties to transfer risk from a 'product' for which there is no specific underlying exposure, for example, weather derivatives.

Given the financial impact of being exposed to changeable markets, and because financial risk management skills will be required, it makes sense – but is by no means assured – that corporate treasuries will manage, or co-manage with the internal product specialists, these new exposures. It follows that an important potential growth area for banks will be a non-financial, wholesale risk management product. Moreover, as banks' traditional product lines become commoditised there will be an internal imperative for them to use their balance sheet, research and distribution strength to play the market-making and intermediary roles in these new areas.

The National Electricity Market, and exchange-traded and OTC electricity derivatives, demonstrate the evolution of a new market. While these physical and derivative markets are long enough established, there are few corporate users active in either market. Part of the reason for this is that, with a few exceptions, banks have been reticent to enter the derivative market to provide risk transfer, liquidity and advice.

While the banks can do little about the difficult 'product' characteristics of electricity, they can play a part in the redesign of the under-utilised derivative market.

Conclusion

This article explored the evolving role of the corporate treasury function, and corporate risk management in general. Although a key role of the corporate treasurer remains financial and price risk management, structural change in markets and tighter accounting controls are causing changes in practice.

Due to a number of influences, the treasurers' role is being broadened into new areas of risk management.

The streamlining of traditional corporate cash and risk management functions and the potential separation of research and execution caused by the internet means that banks will have to look to new services and products. Given their balance sheet, research and distribution strength, banks are well positioned to play the market-making and intermediary roles in new markets and risk management products.

In the future, financial risk management will be but one component of a multi-disciplinary approach to risk management across an enterprise. The challenge for corporate treasurers is to ensure that new financial risks are identified and managed. The challenge for their bank counterparts is to find ways to help them. ■

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