Ask the experts:

A balance between certainty and cost

Treasurers have a key role in understanding how managing financial volatility can contribute to meeting business objectives across a broad spectrum of risk categories. What are the key financial risks facing treasurers today?

Charles Coase, Treasurer, Diageo Plc

The treasurer's overall objective is to ensure that the financial risks to which the business is exposed are managed at an acceptable cost.

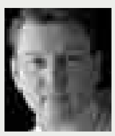
Providing a level of certainty for an organisation through risk management entails costs (resource to identify and monitor exposures, risk premiums, transaction costs, compliance etc). Typically the higher the degree of certainty required, the greater that cost. Each organisation will have its preference for positioning on the risk/cost spectrum. The treasurer must first identify this preference in respect of the financial risks for his/her own organisation, and then ensure that the execution is in line with this policy during the financial year. For Diageo, successfully achieving this aim allows the corporate treasury to provide financial stability to the operating businesses whilst helping to maximise shareholder value by doing so cost-effectively.

This can be illustrated with two recent examples of risk management in practice, namely interest rate and transactional foreign exchange (FX) hedging.

The requirements of IAS 39 *Financial Instruments: Recognition and Measurement* have forced companies to consider the nature of their financial instruments, both in principle and in practice. Diageo conducted a detailed review of current hedging activities to assess the degree of compliance with the new legislation. This provided a high degree of transparency of current exposures and also facilitated discussions on developing practices that would both meet regulatory requirements and further improve effectiveness.

Companies have a choice on whether or not to risk manage transactional FX risk. Mechanistic hedging will not consistently out-perform the market. However effective hedging processes allow intra-year predictability that can be valuable for both internal planning and external reporting purposes. Companies' currency exposures, financial policies and risk appetites will therefore be influencing factors on the extent to which they wish to hedge transactional FX risk.

It can be seen therefore that, for the treasurer, agreeing and then striking that balance between certainty and cost is key in managing risk.

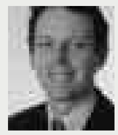


Karl Fenlon, Head of Tax and Treasury, Hanson Plc

Each industry will face its own issues and prioritise accordingly. At Hanson, formal risk identification is based on Turnbull, a bottom-up process whereby our Risk Committee collates and ranks submissions from both business units and central functions. Risk tolerance is a matter of board policy.

As a producer of heavy building materials with the majority of sales outside the UK, Hanson faces a number of business cycles. Treasury's involvement in project appraisal and raising and allocating capital is aimed at mitigating exposures such as FX and interest rate risk as well as considering factors such as business diversification to support ratings stability, key to maintaining access to long-term funding. In the shorter term liquidity is subject to daily analysis.

Reliable data on financial risks is essential, but not always available within treasury. For energy and commodities we rely on our procurement teams to collate data from over 1,000 plants. In pensions, an understanding of assumptions made in the often opaque world of actuaries is an ongoing challenge and in both energy and pensions effective risk mitigation often lies outside treasury's direct control.



Ken MacDonald, Chief Operating Officer, Aon Captive Service Group (ACSG)

Finance directors are increasingly looking to treasurers to take on a more holistic view of financial risk and act as their 'risk champions'. This is evidenced by many insurance functions now reporting to treasurers. It is now more widely accepted that insurance is a hedge and the strategy, techniques and tools used by treasurers to manage financial risk can benefit non-financial risk areas, and vice versa. With such an approach, the risk finance debate becomes elevated to a strategic level together with the potential to create value for the organisation by developing more integrated approaches to financing risk and breaking down internal risk silos. Examples of this value creation include awareness of previously unrecognised natural internal hedges. This occurs frequently for example in such areas as supply chain risk and business interruption insurance coverage.

Treasurers are well placed to influence the definition of the organisation's capability for retaining and managing risk. Risk retention optimisation tools employed by Aon IRMG such as Capital Based Risk Modelling (CBRM) are useful aids in helping to refine these parameters.

Sophisticated organisations are considering vehicles such as Alternative Risk Financing and captive insurance companies to manage an ever expanding 'risk bank' of non-correlating risks on an aggregated basis. This allows companies to place less reliance on the volatile insurance and capital markets for risks considered within the organisation's capability to manage, and can contribute to good corporate governance.

Ultimately this might lead to treasurers becoming key champions in the development of risk management approaches that span the enterprise as a whole.