Seeing the patterns

GRAHAM BUCK REPORTS ON THE RISE TO FAVOUR OF A HOLISTIC AND MORE EMBRACING MANAGEMENT OF RISK BY CORPORATE TREASURIES.

The renewed emphasis on managing risk follows a boom period so heady that many financial institutions ignored the warning signals flashing from their risk management systems and adopted disastrous strategies that brought down some of the biggest names. The consequence has been that in many organisations, particularly the banks, a formerly awesome risk appetite has been replaced by strict risk aversion.

Corporate interest in enterprise risk management (ERM), a holistic view of managing risk that involves all levels of the organisation, is now greater than ever. But Scott Coffing, chief operating officer for software group SunGard's treasury product AvantGard, suggests that there is little evidence of new or emerging strategies for handling and mitigating risk.

"Everyone is trying to shut down risk completely, even when doing so means bearing higher transaction costs," says Coffing. "People are hedging position by position, which is extremely expensive. However, when an event such as the near-meltdown of September 2008 occurs – an event that is supposedly once in a lifetime – all correlations go out of the window and a flight to safety results and replaces the portfolio effect."

Karen Boxall, head of corporate risk management sales at BBVA, agrees that the corporate approach to risk has become noticeably more cautious in the wake of the financial crisis. In the boom period many organisations were apparently content to rely on league tables when choosing an investment bank for a particular product, she suggests, but with little or no consideration for their underlying risk foundation. They would also place cash with the highest bidder, paying little attention to credit quality.

A "more pragmatic and holistic approach" has since become evident, she says. Treasury's role in selecting the organisation's core banks is based on "those who are able to provide funding and retail banking globally; or for niche areas a safe haven for cash with a core deposit base, diverse treasury products, a strong balance sheet and the comfort of a strong regulatory authority".

Boxall suggests that knowing the actual risks that corporates are exposed to and measuring them once they have been identified is probably a greater challenge than actually mitigating them. "To truly understand the exposures faced, a complete global audit should be undertaken whereby all obligations and expected exposures are put into the melting pot," she says.

A determining factor influencing treasury's attitude to risk is the size of the treasury team. While larger companies with major

resources are generally better at managing risk, even many FTSE 100 treasury teams tend to be lightly staffed, which restricts activity to fairly basic strategies. In other companies it is more sophisticated and extends, for example, to anticipating foreign exchange (FX) exposures or buying corporate bonds. The economic downturn has raised the question of whether these more sophisticated teams have equally sophisticated risk management systems in place. The opportunity exists for misrepresenting positions or manipulating trades – as demonstrated in the sharply rising incidence of company fraud – which can easily escape detection if risk management is not given high priority.

"EVERYONE IS TRYING TO SHUT DOWN RISK COMPLETELY, EVEN WHEN DOING SO MEANS BEARING HIGHER TRANSACTION COSTS."

Another trend noticed by Boxall is a move away from decentralised treasuries, which has affected the management of risk. "The principle of giving autonomy to local entities is fading, and the often diverse and plentiful local banking facilities these entities enjoy are under pressure to be at least reduced, but more often streamlined, to include only banks within the global relationship," she says. "This consequently provides the opportunity to consider risk on a global basis."

The obvious asset classes of exposures managed, such as FX and interest rate risk, have been joined in recent years by centralised treasuries taking responsibility for commodity exposures. "The conventional 'strategy' of leaving commodity price management to the procurement officer – which consisted maybe of a one-year fixed price – is gradually evolving into a more global, professional approach," says Boxall. "Understanding and quantifying the actual exposures is a challenge that corporate treasury professionals are progressively overcoming."

The economic downturn has seen the corporate treasurer's approach to risk become broader and more closely integrated with the organisation's commercial activities, suggests Kevin Grant, chief executive of IT2 Treasury Solutions. "The essential change is that treasuries have become better informed and, perhaps, more prudent," he says, "so that the real level of risk being taken is more clearly understood and is included in management reporting. Funding is, arguably, an equally severe risk for corporates as counterparty risk."

He adds that prudent treasurers regularly review their company's creditworthiness to assess whether their ability to attract low-cost funding has improved or deteriorated. They similarly keep watch on the liquidity and credit status of their traditional financing sources to assess whether these counterparties have become better or worse-placed to provide funding.

Jonty Birrell-Gray, treasurer of the Institute of Operational Risk, believes that organisations need to be clearer on their delineation and understanding of different risks. He says: "It is easy to see what is in the newspapers and it is obvious that reputational risks are heavily linked to market perception and ultimately liquidity. However, it is operational risk issues that underpinned the difficulties that financial and non-financial enterprises and individuals suffered during and post the crisis."

The priority afforded to different types of risk has also changed. Treasurers and their organisations must deal with a range that spans liquidity risk, counterparty risk, market risk and operational risk. Most recently, the temporary suspension of air travel caused by the Icelandic volcano eruption pushed business interruption risk higher up the agenda for many organisations.

However, the onset of the credit crunch has ensured that liquidity risk firmly heads the list. Anya Davis, consultant at Baringa Partners, believes it is a misconception that the downfall of financial institutions such as Northern Rock, Bear Stearns and Lehman Brothers was caused by credit risk; the main culprit, she says, was lack of liquidity. As businesses work at restoring their reputations and the trust of the market, liquidity "has shifted from being a largely invisible risk for many institutions to a serious business issue", she suggests. Any company perceived to have weak liquidity will see public and corporate confidence drain away.

"Without proper visibility on liquidity within your organisation, short-termism can creep in to scupper your long-term goals," she adds. "Many banks were so tied up with day-to-day fire-fighting that they missed the bigger picture and failed to make liquidity risk management a core part of their strategy."

Birrell-Gray suggests that the regulatory view is that a more holistic enterprise risk framework is necessary, He says: "I certainly agree with that and I am drawn more to the comments and requirements for 'living wills' or perhaps more 'funeral direction' to be in place for financial institutions."

These requirements will highlight that many organisations believe they have good controls but such controls may not identify the real risks that the business and its processes have and so may not be used to manage the business correctly. In the past risk management was too compartmentalised, with too much credence given to modelling based on past events rather than identifying possible future scenarios. Birrell-Gray says that business processes are increasingly compartmentalised too, with reliance placed on computerised matching where exception reporting is accepted. However, the product knowledge is not fully understood by those who are required to react to the exception reporting, or they are unable to comprehend the real exposures that the business faces.

"At the end of the day, the credit crisis was caused by people who did not realise the full risks of their business in terms of the sensitivity of other risk disciplines on theirs," says Birrell-Gray, "and did not recognise that the controls and processes on which their businesses were built were incapable of managing the risk appetite that boards were happy to sanction."

The move by the Financial Services Authority to more principles-based regulation means that financial institutions will in future require a better grasp of liquidity risk management. The FSA's new liquidity regime, introduced last December, aims to protect "customers, counterparties and other participants in financial services" from the "potentially serious consequences of imprudent liquidity risk management practices".

The regulator plans to assess the business models of banks instead of specifying reporting requirements, obliging them to move from basic reporting to standard formats and to begin modelling scenario analysis instead.

Birrell-Gray suggests that while the regulators, led by the FSA,

have addressed the issue of liquidity, it should be recognised that the FSA is also in the process of raising the bar on the operational risk frameworks that exist within the financial services industry. "It is through this that I would expect firms may derive more benefit in the long term," he says, "as it will identify the true operational weaknesses in their organisations."

In the short term there are three areas of risk management that banks will specifically need to review, suggests George Ravich, executive vice president and chief marketing officer of Fundtech. The first of the three is how much risk management needs building into the payment infrastructure. "Banks now recognise that they need to go further in assessing payment risk and counterparty risk," he says. "They need to re-examine their risk models and approach, following the alarm bells rung by the crisis."

The second area is the handling of liquidity contingencies. "Risk and liquidity are at the top of everyone's agenda and will result in investments in automation for the future," Ravich says.

Third is what provisions are in place for financial institutions that are not direct clearing members and risk finding themselves short of liquidity because the clearing member they use is in a situation. "Although the relation between the direct and indirect clearing member is bilateral, it can have a substantial impact on the market," Ravich adds.

Graham Buck is a reporter on The Treasurer.
editor@treasurers.org

Case study: ABB

ABB, one of the world's major engineering companies, is a major force in power and automation technologies. Created more than 20 years ago by the merger of Switzerland's Brown Boveri and Sweden's Asea, it operates in around 100 countries and has 117,000 employees, including 2,300 in the UK. While ABB has proved resilient in the economic downturn, it suffered a liquidity crisis in 2001-02, which it tackled by divesting its non-core businesses.

Treasury has evolved over the years since ABB was formed, says John Krum, the Zurich-based head of group treasury operations. Over a period of more than a decade that spanned the merger and the retrenchment that took ABB back to its two core businesses, the treasury department was decentralised and oriented towards being a profits centre, he explains.

From mid-2002 onwards, the treasury began to transform into more of a centralised service centre. The group's financial fortunes began a recovery the following year and profitable growth resumed. The treasury department today acts as ABB's "in-house bank", providing a range of services and managing its financial risk.

Going forward, Krum says that the treasury team aims to further streamline the processes and solutions for managing risk and will focus particularly on growth in emerging markets, where ABB will need to be innovative while also keeping its costs under control.

The team is supported by two regional treasurers, one for the Americas and the other for Asia, with a third to be added to cover the Middle East. There is also a treasurer for each of 24 countries where ABB has major operations. In others, the treasurer's role is combined with that of the country CFO.

The treasury department is subdivided into a range of functions that include corporate finance (encompassing equity injections and dividend collections), capital markets and debt issuance, pension asset management, export and trade finance, insurance (which extends to the group's captive insurance operations) and group treasury operations (encompassing group internal payments, liquidity management, foreign exchange hedging, commodity risk and interest rate risk).

"As risk management extends across all of these areas, treasury reports to the executive committee, endeavours to look for solutions that will support the group's profitable growth, manages its financial infrastructure and manages its internal payments," says Krum. Treasury manages both credit risk and market risk in real-time and also hedges currencies, with the team pricing up everything and using risk warehousing in FX, with small, conservative risk limits applying, which it seeks to lay off to the markets.

ABB group treasury operations has a team of four risk managers who monitor the group's risks online and, since the advent of the financial crisis, have worked to refine the process of monitoring credit risk on a daily basis. "We experienced our own liquidity crisis eight years ago," says Krum, "and we know from experience that the market soon picks on a company when it is in trouble. So we have policies in place and the supervisory bodies monitor what we do."

The group is a major purchaser of aluminium and copper, and treasury has a close working relationship with the business as well as with supply chain management. "Commodity prices have been very volatile, but that hasn't prevented us from hedging," says Krum. "Over the years, our hedging programme has proved good for the company."