BUSINESS AS USUAL

HAVE THE EVENTS OF THE PAST TWO YEARS CHANGED THE WAY BUSINESSES AND TREASURERS THINK ABOUT RISK? *THE TREASURER* ASKS **DAVID SWANN**, GROUP TREASURER OF BAT.

▪ In the last couple of years, the importance of effective risk management has hit home with shocks such as the corporate collapse of Enron, September 11 and the build-up to the current conflict in Iraq. Has this period of uncertainty affected attitudes to risk within BAT Treasury?

I think we have always been aware that the world is a very risky place and that things can go down as well as up. I wouldn't say there have been any fundamental changes in the ways we are looking at risks in treasury. BAT has had no 'fall-out' from any of the crises which we have witnessed over the last two years, which is a validation of what we have in place in terms of the way we manage risk. BAT is fundamentally a risk-averse company: we spend a lot of time trying to analyse risk – to identify it and decide how best to manage it.

▪ Is this risk-averse approach confined to treasury or is there a risk management framework in place across the business?

Within the BAT business, risk is not an area which is regarded as a separate function or a separate responsibility. Risk management is a fundamental part of the remit of commercial and business managers. In essence our most active and most effective risk managers are the people who run our businesses.

BAT Treasury may be leading the way in looking at financial risk but that's not to say that risk management is not undertaken round the Group. It is – and it's done very well. But it's not done explicitly; it's not done by people with 'risk' in their job title.

▪ What are the greatest challenges for a treasury in supporting risk management by commercial business units?

Managing inherent business risks is still considered a bit of a 'black art'. However, in our Treasury, we are always looking at ways of reinforcing the message about effective risk management. It's not that the treasurer should be responsible for business risks, it's just that any treasurer worth his salt gets happier being closer to the business. In my experience, some organisations encourage their treasuries to do that more than others, and it shows in the quality and effectiveness of treasury management. At BAT we're a very decentralised group but, increasingly, we're managing financial risks at a group level, in particular foreign exchange and interest rate risk. But it does take a lot of effort: just trying to get your arms around this very large and decentralised group is quite difficult.

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There are also issues with 'the language of risk'. It's often problematic finding common ground where you can start to compare risk and the magnitude of risk from one area of the business to another. In financial risk management, you have a range of quantitative tools such as value at risk and cashflow at risk. In a corporate context, these have not yet spilled over into managing risk in its broadest sense. In our business, we are talking to people who are very good risk managers – they just don't know it. The last thing that a treasurer wants to do is come across as a 'geek' or be over-theoretical, yet often a treasury can provide the language to discuss risk and ensure that risks are being managed consistently throughout the group – for me that's the big issue.

It's just the same within the Treasury itself – it's all about focusing resources on what we consider to be the major risks. That's where there is real value added. As a treasurer, it is pointless spending all your time looking at the obvious, easily managed risks on cable while ignoring the Latin American currency which is undergoing extensive devaluation.

▪ As factors such as low and relatively stable interest rates arguably reduce companies' exposures from a financial standpoint, do you think that, from the treasurer's perspective, these 'major risks' will soon be regarded as the non-financial ones?

No, hopefully nobody will be lulled into a false sense of security. Even though we are in a low-rate environment right now, you can't lower your guard. It can go horribly wrong very quickly. I suppose it all depends how long in the tooth you are – we've been here before in a sense. Let's put it this way, we're still hedging.

▪ In terms of striking the balance between financial and business risk management, does BAT Treasury have any responsibility for the Group's insurance provision? Have you seen any innovative insurance-led risk management products?

For us here in the centre in Group Treasury, we don't have responsibility for insurance. However, in some parts of the world, treasury does look after it.

As for insurance-based risk products, I do believe there is scope for insurers to get more involved in supporting corporate risk management from an advisory perspective. I'm surprised that this side of the market hasn't grown more with insurance companies coming in and getting more involved in the capital markets or derivatives side. Some insurers do seem to have invested in this in terms of thinking, manpower and resources but I haven't yet seen a big drive to get the insurance companies involved. I think it makes a lot of sense to do so.

We do see benefits from the insurance companies providing guarantees versus banks providing them, for example. As cost of capital becomes much more of a focus on the banking side, the alternative market with the insurance companies can seem quite attractive but we're not seeing the insurers really making the most of those opportunities. You could expect them to get more involved in the broader risk management advisory front, in the crossover between financial risk and business risk, and yet they just don't seem to be doing it.

▪ Has BAT looked at the possibility of using credit derivatives?

We don't use credit derivatives at present; we haven't persuaded ourselves that it's a market worth getting involved in right now. But we do pay a lot of attention to the market because, of course, it's another way of assessing how your credit's being traded and understanding its cost dynamics.

In general, BAT is a simple, straightforward business which therefore requires simple, straightforward hedging. We tend to shy away from those complex derivatives which do not appear to have any relevance to the underlying financial risks within the business.

▪ And what techniques have you explored in terms of commodity risk?

On the commodities risk side, we're increasingly looking at the possibility of using the commodity markets to manage some of our underlying exposures – on paper and cardboard, for example. However, a simple analysis of the relative magnitude of risks tells us we should be looking at foreign exchange and interest rate risk as our key concerns right now.

Our buyers are very aware of the risks on the commodities side and they do use fixed price contracts and over-buying on certain products to stock up when prices start to rise. This is not necessarily the best way of managing price risk as you may end up with a significant counterparty risk both in terms of the credit quality of the counterparty and in the counterparty's ability to identify and hedge its own risks. Often the approach we take is that we'd much rather take on the risk from a counter-party or supplier in the knowledge that we have the greater ability and resources to understand and hedge the risk. We're not risk averse in the sense that we won't take the risk. We just want to ensure that the risk is in the best possible place to be managed. In commercial contracts, there can be a trade-off between risk and price and it's often better to take the risk in-house. There's greater transparency and visibility in adopting this approach.

'ON THE COMMODITIES RISK SIDE, WE'RE INCREASINGLY LOOKING AT THE POSSIBILITY OF USING THE COMMODITY MARKETS TO MANAGE SOME OF OUR UNDERLYING EXPOSURES – ON PAPER AND CARDBOARD, FOR EXAMPLE'

At the end of the day, it's all about global leverage – an approach that can cut across the group's strongly held philosophy of decentralisation. Bringing these types of risks to the centre will happen only if it's right from both from a risk and a business perspective.

▪ And, finally, where do you see corporate gearing levels settling in this more risk-conscious environment?

Obviously, debt looks quite cheap at the moment. It is a perfect opportunity to issue fixed-rate debt at these sorts of levels but the question is what to do with the cash. It is the reinvestment spread that costs the money and running a grossed-up balance sheet for any length of time can generate significant costs – far more than, for example, the commitment fee on the equivalent bank facility.

However, going beyond borrowing costs, I think there has been a reaction against high levels of gearing because of the control issues and just the general uncertainty in the business environment. There are two opposing forces at play – low rates coupled with uncertainty. This has really led people to be more cautious. We have seen a number of share buy-backs with organisations saying, "We've accumulated a lot of cash, we're not necessarily going to gear up but we've got to return the cash as it's looking pretty inefficient on the balance sheet", which is risk management of a sort.

Overall, corporates do seem to be more conservative in the gearing of the balance sheet at present. I don't really see this conservatism coming too much from reluctance on the lenders' side. You might say that the rating agencies are being more aggressive in their credit assessments of business, but they would argue that they are just applying the same old rules and that the goalposts haven't changed in terms of interest cover, debt to cash flow and so on. I suppose, in the end, treasurers are just showing their true colours. We're actually a fairly cautious bunch.

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