IN SHARP FOCUS

RISK IS FIRMLY UNDER THE LENS OF GLOBAL BOARDS. SO HOW CAN TREASURERS PREPARE FOR THE NEW THREATS THAT CONTINUALLY APPEAR ON THE HORIZON? FRANCYN STUCKEY SHARES HER THOUGHTS

Over the past five years, we have seen significant uncertainty and market change. Among the most unsettling events have been the global financial crisis, political unrest in the Middle East, EU regulatory changes, such as the Single Euro Payments Area (SEPA), and the European debt crisis.

The ongoing crises have uncovered vulnerabilities in the financial system, which were clearly already present, but not commonly focused on. The prevalence and diversity of risk is one such vulnerability that is now firmly under the lens of corporate treasurers and boards of directors the world over.

This hasn't always been the case, however. Risk featured little in pre-2008 financial crisis dialogues and risk management was rarely something against which treasury teams were measured. Indeed, until quite recently, very few chief risk officer roles existed.

Today, risk management is a mandatory agenda point. Extensive questions around risk are now standard in requests for proposals, and it's rare that our conversations with clients don't touch upon their key risk indicators and how we can help them manage risk.

When we talk about risk, what is interesting is how quickly the risk lens is moving and evolving. Just five years ago, businesses were primarily focused on liquidity risk as sources of financing became scarce and markets became more volatile.

Liquidity risk remains important, but recently the lens has shifted towards counterparty and operational risk. In fact, a recent industry survey showed that over the past three years, treasurers' fears over liquidity have dropped by 20%. This compares with a 50% increase in concern around both counterparty and operational risk. Investment risk hardly registered in the survey, which emphasises the extent to which the focus remains on security and capital preservation rather than yield.

This shift is partly explained by how quickly institutions are learning to adapt and survive in the 'new normal'. So while the availability of funding continues to contract, many firms have worked to improve their capital profiles since the start of the crisis and today, feel better prepared to face any future 'shocks'.

Efficiency and risk

But addressing risk is not straightforward. Treasurers can find themselves faced with a very real conflict between achieving efficiency and managing risk. Especially as some of the solutions that were designed to automate and standardise treasury – and cash management set-ups in particular – may no longer be fit for purpose or address today's risks. There is a careful balance to be struck between efficiency and risk management, and a need for a fresh perspective on what serves the business most effectively right now.

No single treasurer or treasury can fully prepare for every risk they might face, but there are practical steps that can be taken. Top of the agenda is to identify the most significant or material risk to the business and to ascertain what level of exposure is tolerable on an ongoing basis. Next is to put a process in place to mitigate the risk and to communicate the impact of that approach to the wider business.

For example, if liquidity risk is key, then the business must have visibility and be able to move cash to where it is needed in a timely manner and in the right currency. Companies have boosted their capital positions and cash reserves in the past three to five years to improve their resilience.

Building up cash levels can also come at the expense of expansion, however. Growing your operations and moving into new markets or regions is in itself a risk mitigation tool because it improves diversification and expands revenue streams. There is also a danger that in stockpiling balances, you are simply swapping one risk for another and pushing liquidity risk towards counterparty risk.

There is an inherent tension in these solutions since mitigating one risk does not automatically mitigate others. It is therefore vital to take a fresh look at any legacy structures to ensure they are friendly to 'new normal' conditions.

> Operational risk is the granddaddy of all risks; it permeates everything

Counterparty risk

The definition of counterparty risk has changed and expanded over the past few years. For instance, the eurozone crisis and the downgrading of several developed nations have prompted many corporates to now consider sovereign risk.

Treasurers need to take a complete and holistic view of every entity with whom they work – banks, suppliers, customers and vendors – to identify all dealings with these counterparties. It is possible, for example, to have highly efficient systems in place that re-route liquidity in the event of a country exiting the eurozone, but to overlook whether existing contracts allow you to make

collections or to pay employees and suppliers in other currencies.

Counterparty risk isn't just about the number of companies you work with either. Consolidating relationships can improve efficiency and enable better straight-through processing, but reducing the number of companies also increases your organisation's exposure to individual partners – paradoxically increasing risk if those partners are not carefully selected.

The questions we ask ourselves are changing. For instance, which is more risky: working with 50 banks or with just one? A single bank relationship is great for efficiency, but not for the diversity of counterparty exposure, but having many relationships creates a pay-off against efficiency. It's a case of knowing your counterparties well rather than concentrating on numbers.

The granddaddy of all risks

In my view, operational risk is the granddaddy of all risks; it permeates everything. It is not only the risk in your operations today; it is also the meta-risk in deploying solutions to manage your currency, credit and other risks. Whatever you are planning for, and however you are addressing other risks, you will have to operationalise those mitigants within the treasury set-up or routines, and this can introduce new risk.

There are many operational solutions that have proved valuable for businesses in helping them to manage their risk. For example, SWIFT's messaging platform is a stable and secure system, which reduces certain operational risk. But while solutions such as SWIFT and the XML ISO 20022 data format are often sold as 'bank agnostic', the underlying data they run on is still dependent on bank accounts, clearing and financial systems. And while they do improve operational risks around standardisation and interoperability, other risks remain. So in achieving efficiency, it should not be assumed that risk management has also been achieved.

The very best operational risk solutions provide a balance between efficiency, resilience and sustainability. They are practical, extending beyond standardisation to address the risk areas that the board wishes to concentrate on and want reported, while also being agile and 'anti-fragile'. It is about operating effectively today while implementing solutions to address known and material risks in order to best future-proof the business – with the ability to absorb unexpected shocks.

> At the same time, the risk lens is continually shifting and new challenges constantly appear on the horizon

Don't get caught up in 'cliff diving'

Treasurers need to be able to look both deeply and broadly to identify their immediate key risks, and pursue a pragmatic, but proactive approach to managing them. This is particularly important given the evolved and evolving role of the treasurer. Today, we recognise that cash is a board-level issue and that there are increased opportunities for treasurers to provide strategic input and support their company's over-arching business objectives ever more closely.

What is clear is that in all scenarios there are conflicts in managing risk – between one risk and another, in efficiency versus risk management, and in the cost and effort of planning versus resources needed for business-as-usual activities. So informed trade-offs may be needed to get the balance right.

At the same time, the risk lens is continually shifting and new challenges constantly appear on the horizon. Therefore you cannot assume that legacy processes and technology are, or remain, fit for purpose. It is vital, however, not to get caught up in the latest sport of 'cliff diving' with a knee-jerk reaction to the latest crisis. It's time to take a fresh look at risk management, and with support available from your banking partners, to ensure your business is prepared for the new risk era.

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