

MOVING WITH THE TIMES



IT'S TIME TO MOVE OUT OF THE DARK AGES AND START CONSIDERING THE BENEFITS OF MOVING SOME OF YOUR TREASURY OPERATIONS ONLINE, SAYS NEIL COTTER OF LOGICA.

The cost of acquiring information both real-time and historic is rapidly falling to zero. This factor combined with the ubiquity of the internet and rapidly developing telecoms technology means it may soon be possible to have a fully functional online treasury system with friction-free business processes. E-pundits are advising that the e-revolution will soon arrive enabling treasurers to plug FX deals into a mobile and for his finance director to examine the company's treasury position from an internet cafe in Taiwan – but for now, perhaps it is best to return to reality and look at where we are today and why treasury must change.

BARINGS SCENARIOS – THE CONTINUING RISK. Periodically, Barings-type scenarios arise in treasury departments (and banks, of course) and, for each one in the public domain, no doubt there are another dozen that are quietly brushed under the financial reporting carpet. A number of reasons cause these disasters which include:

- the 'black box' nature of the treasury department, making it difficult to oversee what is happening in detail;
- the small number of staff involved and the resultant difficulty in satisfactory duty segregation (even for a FTSE 100 company it may be only three people) and control environment;
- the relatively low investment in technology spend – some large corporate treasuries still operate mainly from spreadsheets which are prone to error; and
- the ease with which incorrect position reporting can occur – for example, by data input error – resulting in incorrect transactions being executed in the future.

These problems are exacerbated by the fact that corporate treasury transactions are nearly always executed by telephone instruction. No doubt many readers use the internet for executing their own personal share transactions or for paying bills. However, treasury is not quite there yet. Typically a dealer will call two banks for a quote and they will agree a deal verbally, then the bank, and possibly the corporate, will follow up with a written confirmation of

what they believe was agreed. Signed confirmations will then be returned agreeing the transaction. There are many opportunities for error with the plurality of manual processes. But the problem does not end there – transactions need to be settled and payments often go astray requiring staff to chase up and agree with the possibility of incurring large overdraft costs.

Bluntly, it is a mess that can be suitably mitigated if you are as big as BP, say, with the resource to remove much of the manual intervention. But for a FTSE 250 company, the administrative overheads and the recording complexity often precludes them from using the best instruments to manage the company's treasury risk at the most competitive prices.

Audit committees recognise the huge risks of a misguided, neglectful or incompetent treasury department and for those poor committee members the e-revolution may help them sleep easier sooner than they think.

MOVING OUT OF THE DARK AGES. Why are treasury transactions still stuck in the dark ages? The complicating factor is that the treasury transactions are not quoted on an exchange. They are bilateral agreements between the corporate and the bank to deliver, in the case of FX, one currency for another on a specific date at a specific exchange rate for a specific amount. They are too customised to enable them to be exchange traded. So there are no market makers, as such, to ensure the corporate obtains a market rate or any form of system to centralise settlements.

Consequently, the corporate must call two or more banks at the same time and choose the bank that gives him the best rate, then modify the payment instructions based on who is chosen. Herein lies the problem: if the corporate is happy to execute all its transactions with one bank then, yes, it can easily have an electronic interface with that bank and develop straight-through processing (STP) from transaction execution through to settlement.

Nearly all the leading banks have developed such interfaces which are ideal for their captive clients. Unfortunately, FX is like any commoditised product, and if dealers buy from the same place each time they will not get the best rates. It is essential to have a choice of banks to deal with – I deal with six. However, I am not going

'NEARLY ALL THE LEADING BANKS HAVE DEVELOPED SUCH INTERFACES WHICH ARE IDEAL FOR THEIR CAPTIVE CLIENTS'

□ SHOWA SHELL FOREIGN EXCHANGE LOSSES

On 20 February 1993, Showa Shell Sekiyu, a Japanese oil refiner and distributor which was 50%-owned by Royal Dutch/Shell, reported that it had lost ¥125bn (\$1.05bn) in 1992. The firm's losses, equal to 82% of its shareholders' equity, stemmed from \$6.4bn-worth of speculative FX contracts.

These were accumulated by the firm's treasury department, apparently without authorisation. The contracts, taken out in 1989 and subsequently rolled over, bought the dollar forward at an average exchange rate of ¥145, to which level the yen had briefly weakened that year. At the end of 1992, the yen was trading at ¥125 per dollar.

In Showa Shell's case, because the losses were 'unrealised' – that is, not closed out – they did not have to be reported in the company accounts. Banks in Japan routinely allowed their counterparties to defer settlement of loss-making contracts by rolling them over until they were advised by the Ministry of Finance to desist.

spend time wading through six different software systems and STP solutions – I do not have the time or resource. And, anyway, it is difficult to replicate the efficiency of the telephone by using different systems at the same time – trust me it does not work. For the banks it is not much better – they require large back offices to chase up confirmations, agree settlement instructions, follow up on errors and the like.

They often have expensive dealers tied up on small transactions from corporate clients. There has to be a better way for all, but banks have been happy with the current set up since, in a level playing field, it is the client who pays for the inefficiencies.

A SINGLE WINDOW TO THE FINANCIAL MARKETS. The obvious way forward is for the banks to develop a collaborative system for offering and auctioning their financial instruments through a single window to the client. Effectively, each bank will have a shop window in the electronic high street to advertise its wares, together with the current prices. The challenge for these windows, known as multi-bank portals, will be to replicate the cut and thrust of the current voice-driven market.

Banks have started to recognise that this will become the primary client interface and a number have invested in joint ventures to develop the technology. Two of these, FXall and Atriax, have recently gone live, although it is early days as to what volumes they will attract. Both of them are sponsored and financed by separate groups of banks, although there are many non-founding banks which operate from both platforms. A third product, Currenex, is independently financed by venture capital and a minority share holding from a big FX client, Shell.

At present, these platforms are focusing on a narrow range of instruments (FX) and none of them provide a capability to execute money market transactions – which many single bank systems can do. Additionally, they are heavily focused on the execution element of the transaction, but they are starting to recognise the value of providing features such as a comprehensive reporting capability to the client. If the client chooses to execute all their transactions through the one platform then the platform has a complete record of all their transactions. If there is then an automatic link to the treasury system then re-keying errors are removed. Many treasuries require only basic treasury reporting, so once these platforms include money market instruments they can act as an on-line treasury system without outlay on internal systems. In other words it becomes an application service provider (ASP) for free.

Since the transaction is being executed through the platform it can also act as a real-time policeman. It has visibility of the overall position and volume of transactions and can therefore prevent dealers from breaching limits accidentally or deliberately – such a structure may have avoided the Barings or Showa Shell fiasco (see *Box left*). It can also provide up-to-date values on the transactions – again, another indicator of when things may be going wrong.

Treasury systems are often unable to record unusual transactions, which then have to be recorded separately on a spreadsheet. This is highly unsatisfactory. As the platforms develop they should be able to record such complex transactions (as they are the conduit for executing the deal there should be little room for error).

For companies which have treasury operations in different offices it is possible to use these platforms to make the treasury centre the bank to the regional treasury operation and for all internal treasury transactions to be aggregated and netted at the centre for external execution. This generates real cost savings since spreads costs can be saved on netting, and the skill and time required of external execution can be concentrated at the centre. Effectively, treasuries now have a sophisticated inter-company FX trading system at little or no cost. A side-benefit is its use in supporting transfer pricing on internal FX.

Another option to the above solution is to use a product by Chief Dealer – FX Benchmark from Citibank. This allows a number of clients to have their deals aggregated and netted. Citibank transacts in the market at predetermined times in the day and the price of the transaction is independently benchmarked against the mid-market rate. For many who do not need to execute FX to particular rates or immediately this can be a useful means of obtaining a competitive rate with minimum fuss. Since it is directly linked to the Citibank systems it can provide more functionality than the current multibank systems.

A HIDDEN BENEFIT. A recent estimate suggested the total cost of a London dealer (such as office space, IT systems, back office and salary) is close to a \$1m, yet many dealers are often tied up doing small FX deals for clients that they cannot refuse as they have to be seen to provide a complete service. Many of the banks now have

TABLE 1
THE BENEFITS OF CROSSING OVER TO AN ELECTRONIC PLATFORM

METRIC	COMPETITIVE ADVANTAGES OF ONLINE TREASURY VERSUS TRANSACTIONS BY TELEPHONE
PRICE DISCOVERY	Corporates will have access to extensive live pricing from all its key central relationship banks.
AUCTION	Bids can be solicited and managed from many counterparties without additional staff overheads or transaction complexity.
EXECUTION	Counterparties will be forced to quote against strict timelines ensuring transparency of best price. Corporate dealer time will be reduced through price engines. Activity will become almost clerical.
VALIDATION	Platform can identify and prevent real-time breach of deal limits by counterparty and in aggregate.
NETTING/SETTLING	Platform can act as 'clearing agent' for all parties with all funds flowing through web host. No requirement to make payments direct to counterparties.
CONFIRMATION	Confirmations instantly sent by web host electronically to both parties in a standard format.
RECORD	Simultaneous recording of transaction on online treasury system avoiding risk of re-keying error or data manipulation. Particularly helpful for complex products.
ACCOUNT	High volume of clients will enable investment in significant accounting/reporting capability.
MONITOR/VALUE	Platform will have real-time data feeds to value mark-to-market positions with no risk of re-keying errors. No bespoke datafeeds required. Price targets can be set up to initiate action.
RISK MANAGEMENT	Real-time VAR datafeeds will be available. Real-time sensitivity analysis likely to be built-in.
ACCESSIBILITY	Full system access from mobile telephones, palm-held devices, television and the like.

pricing engines whereby a request for quote via the platform can be automatically calculated by computer and returned back to the client.

Again, this efficiency should pass through to the client over time with finer pricing due to reduced headcount. If the pricing engine feeds through to the multi-bank portal (as can be done by FXall) then this should provide better service quality to the client as the bank can continually update and 'stream' quotes to the client as there is no manual intervention at the bank end. Arguably, it also fits better with the realities of the FX market since it allows continuous price updating and removes re-keying errors when banks return quotes to clients.

FUTURE IMPACT ON CASH MANAGEMENT. Eventually these systems should have a significant impact on day-to-day cash management. But this is some way off as it will be necessary for the platform to act as a conduit for settling transactions with the bank. To do this it will need to operate through a clearing mechanism since, ideally, corporates will want to pay to one place and have the platform deal with the transmission of the payment to the relevant bank.

Possibly the main corporate currency accounts could be maintained by the platform, making it unnecessary for physical cash transfers to take place. There seems no reason, given time and sufficient imagination, that the platform could not become the treasurer's clearing bank.

This will be a real step forward for medium-sized companies as it

could enable competitive dealing but without the usual increased administrative headaches of multi-bank dealing.

THE DOWNSIDES. If these platforms are used as treasury systems they do have drawbacks. First, transacting electronically can make the treasurer more distant from the market as he will have reduced contacts with dealers on market conditions. Second, if the platform fails it has catastrophic implications. As well as being unable to trade it may prevent the treasurer from accessing the system for basic treasury reports. It will be a brave treasurer who switches fully online until there are well established market-leading platforms

DON'T KNOCK IT. The rapid approach of multi-bank dealing platforms should generate another level of efficiency for procuring FX and other financial instruments for both suppliers and clients. There are compelling reasons for companies to embrace this technology. Apart from the eventual finer pricing, which I believe it will generate, it dramatically improves all aspects of the transaction (see *Table 1*) versus transactions undertaken over the telephone. Many B2B exchanges in other industries have ignominiously closed down over the last year. However, the volatile pricing and people intensive nature of transacting financial instruments makes them ideal for a centralised exchange.

Neil Cotter is Group Treasurer of Logica plc.
cottern@logica.com
www.logica.com