Battling the risk monster

A WELL-ATTENDED ACT BREAKFAST BRIEFING AT THE END OF SEPTEMBER CONSIDERED THE EVOLVING APPROACH TO RISK MANAGEMENT. **PETER WILLIAMS** JOINED THE THRONG AT THE GRAND CONNAUGHT ROOMS IN LONDON.

As the chair of the breakfast meeting, Peter Matza, head of publishing at the ACT, pointed out, The Treasurer has covered many risk-related topics in the past few months, which suggests it remains an important topic for treasurers. The breakfast meeting, sponsored by Lloyds Banking Group, confirmed that risk has become one of the biggest challenges in today's business and financial environment.

RISK, ROLLS-ROYCE-STYLE Iain Foster, assistant treasurer at Rolls-Royce, explained how a hedging operation actually works in practice. Rolls-Royce runs one of the best-respected treasury operations in the UK and Foster focused on the application of treasury thinking to the underlying business. The company makes jet engines. A single engine costs in excess of £10m and there is a long tender period with a long engine life. For treasury this means long-term hedging horizons.

While many treasurers may not have such long-time horizons, many of Rolls-Royce's financial risks will be familiar (see Box 1). Launching an engine programme costs around £500m, which has to be financed either through cashflow from the business or by raising debt. Foster described cash and liquidity management as relatively easy – it is not something that a treasury department should get wrong.

For Rolls-Royce the big issue is often foreign exchange (FX). Its two main, larger competitors are dollar-denominated. To maintain competitive parity, the company keeps a fixed dollar price list, even though the sterling-dollar rate constantly swings up and down.

As a result, Foster cannot pass on the FX risk to the company's customers. Instead, he has to hedge it. In theory, to match the lifetime of an engine programme the company should have a 50-year hedging programme. Sadly, no such programme is available, and treasury looks at a 10-year programme, which is enough, said Foster, to move through a peak-to-trough cycle and should also provide some opportunities to add value.

Foster suggested that an effective hedging policy depended on first understanding and measuring what the exposures were. The Rolls-Royce treasury spends time speaking with the people in the business to help it understand the risk the company faces.

There are options worth exploring (see Box 2). For instance, defence market customers are prepared to take on FX risk in a way the civil market isn't. If none of the risk mitigation routes is open, the final option is to decide whether the profit margin is good enough to make it worth taking on the risk. Foster said that while treasury professionals were most comfortable with the idea

and practice of hedging it was important to engage with the business to explore all the options.

The company's biggest risk is the sterling/dollar exchange rate. The gross exposure is approximately $9bn a year, the net exposure $4bn. A one cent movement in the exchange rate has a £10-£12m impact on the bottom line. Foster stressed that with a 10-year hedging programme it was not necessary to be in the market every day, just when the rate was favourable in terms of the long-run average. He said the benefit of the long-term horizon was that Rolls-Royce could look to the mean reversion, hoping the market would come back.

If it is not possible to get the right hedges, then the business comes under increasing pressure to net down the exposures. Rolls-Royce treasury has created a "dollarisation" programme to help raise awareness within the purchase organisation. The programme seeks to reduce the exposure to the weak US dollar over fears that it hasn't been moving back to traditional levels. Exposure reduction could take two routes: to convert the costs or reduce them.

But the business had to learn to convert the cost at sensible economic levels, because anything else just locks in an inefficient exchange rate. Nor is it right to pass on the risk to another business less well equipped to deal with that risk than Rolls-Royce. All that asking a small supplier to take on the dollar risk would do is hide the problem in the supply chain. In effect, the company is writing its supplier an option if the FX risk can be pushed back at any time.

The Rolls-Royce treasury also spent time working with purchasing, examining the commodity risk using a basic risk/reward model. The price risk evaluation quantifies exposure and estimates volatility. But the commodities market is not the financial market and it is also important for Rolls-Royce to understand the technicalities of the supply chain. A treasurer needs to identify the supply chain risk to be worried about, such as scarcity of commodity, supply pinch points, other purchasers prepared to pay a higher price, new entrants to the market, etc. Answers to worries over supply could be to find a substitute or to hold a strategic stock.

Foster said it was essential to build relationships with people on the front line by being constructive and helpful and taking time to explain the issues – which may be obvious to treasury but not to others – and sharing information so it is not just a one-way street.

RISK MARKET OVERVIEW David Stebbings, director and head of treasury advisory at PwC, gave the meeting an overview of what is happening in the market.

Volatility and uncertainty in the financial risk environment since 2006 has given treasurers an increased opportunity to add value. This changed environment has changed both the priorities of business and of treasurers. However, treasurers still face a challenge to get hold of the resources required to add this value and this represents one of the major challenges facing the treasury function.

Before the credit crunch and the financial crisis, the management of risk was little more than a tickbox exercise, and funding risks were events that treasurers read about in text books. There was a feeling that these risks would never materially affect a business again. As a result few executives took a joined-up view of risk and business investments were driven by a cost-cutting mindset.

Boards are now much more focused on the work of the treasurer, particularly cash and liquidity management and risk. There is a greater focus on visibility and control. Just as Rolls-Royce treasury is talking to the business units about risk, so Stebbings is helping businesses understand the importance of managing cash and improving cashflow forecasting.

According to PwC forecasting/reporting is a big issue, with ineffective reporting of exposure from business units to treasury representing a key inhibitor and perhaps the biggest change management challenge for many treasurers. Stebbings said that while many companies seemed to struggle with this, it was one area where companies owned by private equity appear to excel. If they can do it well, it should be possible for all companies to do it well.

It is not easy for treasurers to achieve good practice in the current environment. Liquidity, bank relationships, counterparty risk, commodity and currency risk are all areas where treasurers need to place resource and expertise. They also need to develop a treasury framework so that they can be a value-adding business partner. But with the constraint on resources, this will not be easy to achieve.

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For more on the results of the recent PwC risk survey, see the June 2010 issue of The Treasurer, pages 30-32.

Box 1: The financial risks for Rolls-Royce

- **Cash and liquidity** – ensuring the availability of short and long-term funding when required
- **Interest rate** – majority from debt issuances
- **Foreign exchange** – long and short positions caused by global customer base and global supply chains
- **Counterparty credit** – customers, suppliers and banks
- **Inflation rate** – short prices, wage escalation
- **Metal price** – short input metals
- **Fuel price** – short jet fuel
- **Energy price** – short electricity and gas inputs.

Box 2: Ways of mitigating risk

In theory, Rolls-Royce has the following ways to mitigate risk:

- **Eliminate the exposure.** By matching the currency of costs and revenue, for example.
- **Pass the risk on.** Let customers and/or suppliers manage it.
- **Hedge.** Use financial instruments to provide certainty by protecting against adverse FX movement.

Box 3: Panel discussion

Lynda Heywood of Kingfisher joined Foster (Rolls-Royce), Stebbings (PwC) and Johann Kruger (IFRS and financial risk management consultant at Lloyds Banking Group) on the panel. The themes of Kruger's presentation are picked up in his article on page 34. The panel discussion focused on the currency and commodity risks, especially as they relate to the supply chain, and how treasurers put the theory of treasury into practice.