Strategic treasury

MARTIN O'DONOVAN REPORTS FROM A RECENT ACT SEMINAR ON STRATEGIC TREASURY AND NON-EXECUTIVE DIRECTORS.

The financial crisis and the latest drying up of interbank liquidity, the sovereign debt crisis and the wave of impending financial regulation, not to forget the changed perceptions of risks, have all contributed to a greater awareness of treasury at board level. And that clearly extends to non-executive directors (NEDs) too, given the enthusiastic turn-out for an ACT seminar on strategic treasury given to the Next Generation NED network, part of an ACT programme to extend the awareness of treasury.

The foundation for a sound approach to strategic treasury, according to John Grout, the ACT's policy and technical director, is to go back to the three key questions in financial strategy: first, how do we decide what to invest in?; second, how do we raise the money?; and third, how do we control the risk posed by the first two questions?

To deal with these requires a consideration of sources of debt, credit rating targets, debt maturity profile, liquidity finance, financial price risks and – absolutely paramount – leverage targets. The standard weighted average cost of capital (WACC) graphs show that as gearing and risk increases, so does WACC, but beyond some critical gearing, refusal at any cost is reached. The crucial point for directors is that in a financial crisis the point of refusal shifts to lower gearing levels. A business may find that, despite no change in its own business, outside conditions prevent it being able to finance itself.

The current environment is plagued by uncertainty on all sides affecting the business itself and the financing and financial risks to that business. We are seeing growth evaporating, unemployment rising, bank shares weak, increased correlations and contagion risks, banks not trading with each other, the flight to gold and the like. To be safe and able to withstand shocks to its own business, or arising from a more cautious attitude in financial markets, a company needs to be operating well below its optimal gearing. It needs to work towards a cautious capital structure and greater liquidity to hand rather than relying on access to capital or loan markets when needed.

Looking forward to the macro conditions, impending regulation will impact the availability of funding and the capacity of markets to deliver new capital. Bank capital will be constrained, which will mean generally higher margins across the board. Availability of revolving credit facilities will be reduced and even undrawn facilities will be expensive, so better cash forecasts will be needed on both counts. Trade finance commitments will be particularly heavily hit, disrupting normal business patterns of business.

On derivatives even if companies are exempt from the full rigours of central clearing, there will be a trend towards collateral demands generally, which could create unmanageable demands for additional liquidity or end up creating constraints by having to secure assets.

All these difficulties and uncertainties will conspire to drive companies more and more towards greater reliance on equity.

To counterbalance the theoretical view of the future drivers of treasury strategy, the group of non-executives were then able to hear from Michael Pavia, an NED at Thames Water and an experienced executive director. The importance of a rigorous approach to treasury was reinforced as was the need to have some treasury expertise in the executive team, but the board should not abrogate its responsibilities. Key pillars of any treasury strategy, as outlined by Pavia, include: maintenance of target credit ratings; maintaining a strong liquidity position; management of counterparty credit risk; diversification of funding sources; defining clear risk management parameters; and establishing the appropriate governance structure.

The latter point was picked up in the questions to explore just how much information NEDs needed, and how frequently. While treasury policy should not change from one board meeting to the next, NEDs needed to be confident that suitable delegated powers exist and day-to-day controls are operating continuously – for example, over counterparty credit risk, where exposures and risks can change quite rapidly. By comparison, funding maturity profile monitoring will not change much from one board meeting to the next and so needs less active board monitoring.

The issue of assisting the operation of the treasury subcommittee should the committee include an external expert or adviser came up in questions, and was considered generally helpful by the panel of speakers. However, it did not remove the directors' responsibilities to understand and set treasury strategy and policy. And a final tip from one NED to the group was: arrange an occasional meeting with the company treasurer and hear informally just what the issues are and how they are being dealt with – it's all part of an NED's education and information gathering. Grout has blogged on a similar theme at **www.treasurers.org/node/6911**.

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