3.2 TREASURY PROCEDURES

Study Unit:	Study Unit 5 – Treasury Operations and Controls
Section:	Section 3 – Treasury Policy and Objectives
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Summary:	Treasury procedures set out how policies are to be implemented; each policy will indicate the procedures applicable to that policy, but procedures may also be consolidated into a treasury procedures manual.
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1 Introduction

Risk-led policies for treasury, ie treasury policies, approved by the Board, define the overall parameters within which treasury is to operate and the principles to be applied in controlling those aspects of risk assigned to treasury. Treasury procedures set out how policies are to be implemented; each policy will indicate the procedures applicable to that policy, but procedures may also be consolidated into a treasury procedures manual. Treasury procedures may need to be documented at several levels, namely:

- Risk management – how treasury aspects of financial risk management policy will be implemented.
- Controls – how treasury operational risk management policy will be implemented.
- Internal procedures – how the daily tasks will be performed.
- External relationships – how third party relationships are to be managed and controlled.

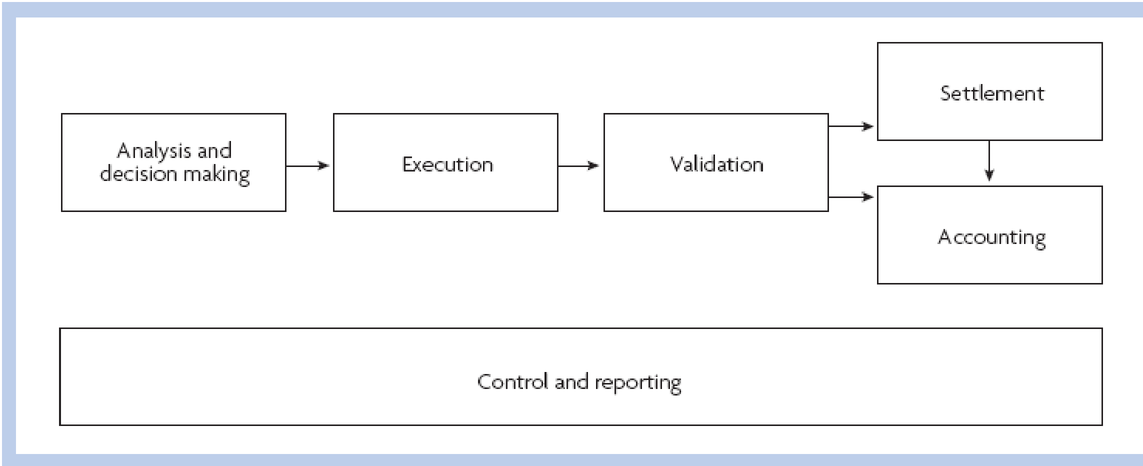
Although the terms "policy" and "procedures" are often used interchangeably, there are subtle, but important differences[1]. A policy states the overall plan and changes infrequently. It is usually expressed in broad terms, addresses the statements of "what" or "why," and answers major operational issues. Contrast this with a procedure, which is a narrow application that is prone to change. Procedures are generally stated in detail and describe a process in terms of "how", "when" and "who".

2 Treasury Processes

Before looking at specific treasury procedures, however, it is helpful to review the treasury process. Most corporate treasury operations can be analysed into the following process elements:

[1] AFP Exchange (2002) *Policies and Procedures: Beyond Simply Documenting what you do*. Available online at http://www.gtnews.com/article/4773.cfm

Exhibit 1: Treasury activities and processes



These elements tend to follow in sequence, except 'Control and Reporting' which is a continuous process throughout the cycle.

The elements of 'Analysis and decision making' are performed by the 'front office'; while the 'Execution' function is also performed by the front office, those responsible for execution are sometimes known as 'the dealers'[2]. The 'Validation' process, in support of the front office, is undertaken by the 'middle office'. This process usually occurs in very close time proximity to the execution stage. 'Back office' functions comprise the remaining administrative steps of 'Settlement', 'Accounting' and 'Control and reporting' functions. These processes often take place at a different time from the front office processes, where settlement (actual movement of funds) can occur days, weeks or months after execution, or the trade date. Not all firms have a 'middle office' in which case all of the administrative support of the front office is referred to as 'back–office'. This segregation of duties is an important part of the control of operational risks and needs to be an integral part of the treasury procedure.

[2] The 'front office' is often referred to as 'the dealers'. However analysis and decision making may be done by persons other than the dealers themselves, depending on the size of treasury and complexity of the organisation.

3 Financial Risk Management Procedures

Each risk management policy should contain a reference to the procedures to be followed in implementing the policy. These procedures detail how risk management policy is put into action and at the departmental level such as treasury, the procedures set out in the policy document may have to be expanded so that they are clear to treasury personnel. Procedures may be consolidated, and if so they should be cross-referenced to the relevant policies and should define the key responsibilities of staff members. For treasury, these procedures need to ensure that all policy outputs and objectives are achieved in accordance with policies such as:

- Liquidity risk management, including:
    - Market risk.
    - Funding risk.
- Financial Market risk management, including
    - Foreign exchange exposure.
    - Interest rate risk.
    - Commodity risk.
    - Price risk.
- Operational risk management, including:
    - Criminal Activity.
    - Legal risk.
    - External event risk.
    - Processing and system failure risk (including business continuity).
- Credit risk management, including:
    - Counterparty risk
    - Sovereign risk
    - Pre-settlement risk.

4 Control Procedures and Operational Risk

In implementing financial risk management policies, treasury opens itself up to a range of operational risks, which are largely unrewarded and which investors expect the firm to take action to reduce their impact. Because treasury departments commonly handle large sums of money, and enter into large transactions in relation to the size of the business, controlling operational risk is of paramount importance.

Treasury procedures should provide for certain controls such as:

- Organisational controls, such as appropriate segregation of duties within the function.
- People controls, ensuring the correct staff are recruited and trained
- Procedural controls on dealing, such as mandates, confirmation and settlement.
- System controls for:
    - electronic banking systems
    - treasury management systems
    - maintenance of static data such as standard settlement instructions
    - reconciliation of bank accounts and supplier / customer accounts.
- Physical controls, including access to premises, for larger treasuries.
- Audit and review, including management reporting and internal and external audits.

5 Internal Procedures

Internal procedures must be documented, to ensure that:

- Financial risk management policy is implemented successfully.
- Operational risk within treasury is minimised.

Treasury procedures should be more detailed than the outline procedures set out in the relevant policy. Procedures should provide a sufficient level of detail to introduce new staff to their work and allow temporary staff to move into roles as required.

Specifically, the procedures should define:

- Daily, weekly and monthly processes to be carried out by treasury.
- Other periodic processes such as those to support preparation of financial statements.
- Details of the staff responsible.
- Counterparties, instruments and limits to be applied.
- Systems to be used.
- Controls to be applied.
- Reports to be generated.

The procedures should mirror the workflow and at each point ensure that they tie back to the relevant treasury policy. The following examples adopt the workflow diagram in Exhibit 1, to illustrate which procedures need to be documented. It follows the operational perspective, showing how treasury operations call on a variety of policies at each stage. The phases of:

> Execution, validation, settlement, accounting, reporting and control

require the most detailed procedures as they are generally repetitive in their nature.

5.1 Analysis

Cash and liquidity management

The first step is to determine the cash position of the business. The analysis generates an opening position for the treasury of being in cash surplus or deficit, by currency. For example, the European arm of a US oil company may have a surplus of euros, generated from petrol sales, while being short of US dollars due to the need to pay for its supplies of crude oil. The underlying business position is modified by treasury transactions with cash implications, for instance foreign exchange transactions, or maturing loans or deposits.

This opening cash position is then projected forward by the creation of a cashflow forecast, which again may include multiple currencies. The result of the analysis phase is to generate the corporate treasury view of its cash position today, and for a specified period into the future.

Financial risk management

The analysis required to support financial risk management policy derives in part from the underlying business operations, and in part from corporate finance and treasury activities. Conceptually at least, the analysis phase for corporate finance and treasury operations activities is easier than for business operations, as more data about the underlying position is immediately available to the treasury team. However in large complex corporations, there may be activities at many levels which are not fully communicated to the treasury team at a regional or group level. For example, a major multinational corporation (MNC) with many subsidiaries with local borrowings typically has difficulty establishing a complete view of its interest rate risk.

5.2 Decision Making

Funding management

If the overall position is a deficit in a particular currency, the treasury team reviews their borrowing options as defined by their policy documents and external facilities. In the medium to long term this involves arranging debt finance, which may come from banks or public markets. The treasury team also deals with the documentation and day-to-day management of relationships with lenders.

Investment management

If the firm has a cash surplus, investment options are reviewed, defined again by policy and internal authorisation, together with a view of the investments available in the market at the time they need to be executed. It is the duty of treasury to ensure that surpluses are securely invested in appropriate instruments. In deciding where to invest and for how long, it is a fundamental tenet of corporate treasury management that security of principal ranks ahead of liquidity; and both have a higher priority than yield. This is often referred to as the 'SLY' principle on investing.

Currency management

This concerns implementing foreign exchange aspects of the firm's financial risk management policies. Most firms which are large enough to justify a treasury function for liquidity management are also likely to have significant currency flows. Currency management includes managing exposures that arise from treasury activities themselves, business operations and corporate finance activities. For example:

a) Treasury activity risk management: Many activities undertaken within treasury result in financial risks that require management. An example would be: A firm with a short term surplus USD position determines that its highest investment yield comes from buying euro-denominated commercial paper, after allowing for hedging. Unless it takes currency risk management action, the firm will be exposed to the USD/EUR exchange rate until the maturity of the commercial paper.

b) Business operations risk management: Although a corporation may not technically be a multinational corporation, if, for example, it has its operations in just one country; it may nonetheless have financial risks arising from its business operations. An Italian retailer sourcing products from Asian countries, and paying in USD, for instance, is exposed to movements in the USD/EUR exchange rate. True MNCs typically have a complex set of exposures, requiring detailed analysis to determine the overall net exposure which needs to be managed.

c) Corporate finance risk management: The treasurer is involved in arranging funding and in the detailed implementation of mergers and acquisitions, investment project appraisal and subsidiary evaluation - in all of which the cost of capital plays a key part.

Example 1: Currency Management

A French company has fixed rate EUR debt maturing. The treasurer may establish that the optimum instrument, market and currency with which to refinance the EUR debt is to use medium term notes (MTNs) in US dollars with a floating interest rate. Such a refinancing generates exposures to the USD/EUR exchange rate on the amount being refinanced and to the differences between fixed rate EUR interest and floating rate USD interest.

Intercompany settlement

Larger firms also have options for efficient intercompany settlement using bilateral and multilateral netting. The system is structured to produce the information needed by treasury to perform the risk and liquidity management activities arising from intercompany settlement.

5.3 Execution

When the analysis is complete and decisions have been made about what to do, action is required. In general, actions taken will be of a predefined nature (drawing a loan, issuing commercial paper, selling currency) thus requiring well documented procedures. The execution process is generally referred to as ‘dealing’ regardless of the market or instrument. The requirement to deal, the amount, maturity, acceptable counterparties and so on, is defined by policy and authorisation documents; dealing, therefore, becomes a procedural activity unless circumstances are for some reason atypical, such as illiquid or turbulent markets or specialist instruments. The deal is entered into a treasury management system (TMS) as soon as it is executed.

5.4 Validation

Following the execution of a deal by the dealers, certain checks need to be made by the administrative function. These include checking for internal authorisation (against limits etc.) and external validation (‘confirmation’). Confirmation consists of verifying with a counterparty that all the material details of the deal (instrument, amount, currency etc.) are agreed by the counterparty exactly. Validation checks are typically undertaken within a very short period of time after the deal is executed. When a deal has been successfully confirmed it is recognised as valid and can be settled. Mismatches at this stage require urgent inquiry and resolution.

5.5 Settlement

Settlement of deals (i.e. the cashflows that arise from the deal) may occur much later than the deal date; for example a forward foreign exchange contract, or an interest rate swap on a bond may settle weeks or months after the deal date. One of the vital functions of the TMS is to record settlement dates and to prompt those responsible for settlement to take the necessary action at the appropriate time. Payments to counterparties must be initiated before agreed cut-off times and incoming settlements must be monitored for timeliness and accuracy.

5.6 Accounting

Accounting entries are derived from the above activities in accordance with corporate accounting policy and its accounting manual, which define the correct accounting treatment for each instrument used. Under normal circumstances, the TMS feeds the firm’s accounting system directly with periodic accounting entries. The accounting system, in turn, provides the basis for financial, fiscal and statutory reporting.

5.7 Reporting and Control

Throughout the above processes, reports are generated that allow staff to monitor progress and identify positions and status. Reports are also generated to allow management to see the overall position, and to ensure that the processes are properly controlled. Reconciliations of internal company records and external reports (particularly bank accounts) are a significant element of the control process and many treasuries perform them on a daily basis.

6 External Relationships

In addition to internal procedures, treasury also needs to document procedures controlling external relationships. Again, these procedures will be in accordance with financial and operational risk management policies, and two important aspects are bank account and dealing mandates, and standard settlement instructions.

6.1 Bank Account and Dealing Mandates

A bank account and / or dealing mandate should be established with each bank with which the corporate does business, whether as banker (holding and operating bank accounts) or as dealing counterparty (party to a financial contract). The purpose of such mandates is:

- To define the authority of banks to accept the firm’s instructions.
- To establish the authorities and segregations required in the execution of bank transactions.
- To notify the banks of the accounts to which funds should be credited (dealing mandates).

At a minimum, the mandate should specify:

- The type of transactions permitted.
- Individuals' authorities for issuing instructions (bank account mandates), dealing, confirmation and settlement (dealing mandates).
- Confirmation requirements.
- Standard settlement instructions (SSIs) (dealing mandates).
- Authority required to change the mandate and SSIs.
- Firm specific requirements, if any.

Additional mandates will be required to control other products and services such as electronic banking systems, dealing portals, credit card agreements, leasing arrangements and so on. Controlling and coordinating the issue of mandates is a major task for treasury. Note that the move in recent years to almost total electronic instruction of all types of transaction requires a different approach to traditional paper mandates, based round passwords and levels of authorisation. For example, the concept of a "reader" of bank data, without payment authority, is new, as well as the concept of an "inputter" of payments, without authorising ability. Nevertheless, paper mandates are usually still required for almost all firms.

Some bank systems, in communications received from their customers, do not recognise individuals, banks are merely looking to confirm that an instruction has originated from its customer before carrying out their instruction. In those cases security is purely the responsibility of the firm. This applies equally to payment instructions as to dealing mandates where it has been noted that there is a tendency among banks, reflecting the impact of Sarbanes-Oxley, to refuse to take responsibility for such mandates, insisting that such controls must be the responsibility of the customer.

This approach is supported by the regulators; corporate treasuries cannot rely on banks to carry out their customers' internal control responsibilities (although that does not relieve banks of a duty of care). Treasurers should, therefore, ensure their internal controls are robust, and that they cannot be held to be delegating responsibilities for control via dealing mandates.

6.2 Standard Settlement Instructions

The use of standard settlement instructions attempts to minimise the risk of funds going astray by standardising the details of the bank accounts to and from which funds are transferred. In the corporate context, SSIs are used for the following purposes:

- With account holding banks, to control accounts to which funds can be paid.
- With dealing counterparties, to inform them where to pay amounts owed.
- Internally, within electronic banking systems, to define levels of payment authority.

7 Procedures Documentation

In principle, every step in the treasury operations process should be fully documented. In practice, many of the 'documents' involved are no longer printed, but exist as records on an IT system. Important exceptions, where documentation is likely to be in hard copy format include:

- Treasury policy and procedures documents.
- Delegated authorities, board minutes, risk management committee decisions and other specific management approvals for activities not covered by delegated authorities.
- Bank mandates and counterparty agreements.
- "Long form" deal confirmations, eg for swaps where references to underlying documentation such as a master agreement may be required.

Whether printed matter or electronic media, documentation supports the essential processes of:

- Validation.
- Compliance checking.
- Management review.
- Audit.

In particular, it should always be possible to see a complete audit trail from the inception of a transaction through to completion, together with the proper application of the controls appropriate to that transaction.

