Future perfect

Executive summary

- Raising funds, risk management, hybrid capital, lightening the administrative load, accounting for financial instruments – the topics may be familiar, but what the future holds for treasurers in dealing with these topics is unlikely to be more of the same.

AT THIS YEAR'S TREASURERS' CONFERENCE, A PANEL GAZED INTO THE CORPORATE CRYSTAL BALL TO ASCERTAIN THE KEY ISSUES FACING COMPANIES OVER THE NEXT 18 MONTHS. PANEL CHAIRMAN **CLARE FRANCIS** REPORTS.

It is no surprise that in an environment of multiple challenges the role of the treasurer is highly stretched, with an ever-widening spread of issues expected to hit agendas in 2006/07. What, then, will be the big issues over then next 12 months?

Changes in derivative trends for foreign exchange and interest rate hedging techniques will always be a fundamental part of a corporate treasurer's strategy. Additional concerns over recent issues such as international financial reporting standards (IFRS), pension funds and commodity prices are being complemented by hybrid capital, inflationary impacts, credit spreads, Basel II and straight-through processing (STP) enabling end-to-end solutions.

So how are treasurers dealing with these issues and what impact will they have in the future?

RAISING FUNDS As bank and investor liquidity options diversify and capital markets instruments multiply, the consensus among the panel debating the Predictions for the Future topic, was that treasurers needed to be on top of their game more than ever and prepared to act quickly. John Fulton, of Cadbury Schweppes, summed up the view of the panellists. "In terms of looking forward," he advised, "look a long way forward. If you like conditions now, seriously think about doing something."

Corporates have enjoyed a period of very benign funding conditions recently. Yet few expect these conditions to continue indefinitely and most recognise they will find it harder to identify more favourable refinancing margins in the future. In addition, the appearance of net pension liabilities on balance sheets under IAS 19 *Employee Benefits* has made the prospect of increasing leverage less attractive.

Although it's hard to picture a meltdown in credit – especially in light of the better risk-diversification techniques that the credit market has developed – such a benign environment is unlikely to continue. The panel was split on the exact future of the credit market, although enough differential between strong and weak credits has re-entered the market for most to expect a change in 2007. Greater credit differentiation will, of course, first affect borrowers with lower ratings or shadow ratings.

Charles van der Welle, of ITV, took the firm view that credit spreads will increase. "I'll be watching the credit markets most carefully next year – namely, the bank and the bond markets," he said. "We're at a stage in the business cycle perhaps where merger and acquisition activity is high, leverage is growing and I'm concerned that credit spreads may rise."

Antony Barnes, of GUS, agreed. "I think that the speed at which credit spreads will move in and out is going to be somewhat shorter in the future than it has been over the last 10-15 years," he said.

For the majority of corporates that still rely on bank funding, Basel II looks like it could be a real issue although the jury was out as to whether the banks would actually enforce margins under revised documentation.

What was once thought of as a back-office issue in banks – to the extent that it was talked about for the most part by internal risk officers – has now migrated via relationship managers onto the radar of corporates themselves. The panellists admitted they had already started looking internally at how this issue would affect them in 2006/07. By altering the risk weightings on different types of corporate debt assets, it is expected to change the pricing over a long-term period.

HYBRID CAPITAL Another source of funds that, like lending, has received a lot of press recently is hybrid capital. The point was made that although the banks keep promising forthcoming issues, it was doubtful whether a UK corporate had yet issued these instruments. Views were expressed by the panellists as to why this could be, with Will Spinney, of Invensys, making a highly relevant conclusion. "Nobody has come and presented to me about hybrid capital," he said. "Yet we have a very large tax loss brought forward and are paying lots of interest out of the UK, so some sort of product that could help this would actually be a very great help."

The audience's attention was drawn to the fact that hybrid capital can be volatile, along with possible interest rate and insurance implications. Although hybrid capital has obvious benefits for credit rating, interest payment volumes and not diluting equity, one treasurer cautioned that hybrid issues were only advisable in the right specific circumstances – such as for a leveraged buy-out or pensions-related situation. And in spite of the banks' current enthusiasm for hybrid capital, the instrument was also described as a "bull market product".

Fulton advised corporates to navigate carefully on these products. "A lot of work needs to be done in this area," he warned. "Any move toward the use of hybrid capital must be done for the right reasons. You really have to understand the key components, and I guess what's going on with the insurance industry and the ratings agencies. This could be quite a volatile product in terms of its usage and application for corporates."

RISK MANAGEMENT FOR THE FUTURE Strategic risk management for corporates is evolving fast. As expected, IFRS has had a significant impact on the use of derivatives. Nonetheless, it was interesting that the panellists expected this to change quickly, with derivatives usage projected to grow faster than traditional instruments. Panellists agreed on the need to do the right thing with a more general acceptance of earnings volatility anticipated.

"It is certainly one of my predictions that interest rate risk management will be used much more throughout the Invensys group," said Spinney.

However, Spinney said he sometimes found it hard to gain approval for more sophisticated instruments. "I find it hard enough to explain to operating management in some of our companies how forwards work," he said, "let alone how to explain how options work."

Stephen East, of Woolworths, went on to explain the use of foreign exchange derivatives at Woolworths and how they were used to do the "right thing". The complexities associated with sporadic supplier payments also made the model less clear, particularly in terms of timing differences.

"We have a model whereby we source a lot of product from the Far East and therefore most of that is paid for in dollars," he said. "Therefore you've got to tailor your foreign exchange exposure and the way you hedge to take account of when your actual commitments arise and when they fall due.

"One of the things we may use as a part of the cocktail, as well as forwards, is to take more dollars from the bank in exchange for actually having a rate above the current market."

Movements in both traditional and emerging markets across a growing number of asset classes continue to be volatile, with consensus that volatility would only increase. This was evidenced in the audience's responses to the traditional markets question on the direction of both the sterling/dollar exchange rate and UK interest rates. The predictions for one-year future rates were split fairly evenly across the five rate ranges offered, making the selection of an overall consensus impossible, as you could expect (see *Figures 1* and *2*).

Questions on global risk management identified more focus on Eastern European, Asian and Latin American currency flows, with treasurers concentrating increasingly on risk management techniques in emerging market currencies. As you would expect, this was a particular issue for global corporates such as Tesco and BAT. Nick Mourant, of Tesco, predicted that: "I see the main engine of our growth being China and Turkey probably in years 10-15."

Barnes offered an interesting insight into his experiences at GUS with Asian suppliers looking to source in local currencies. "We've been surprised that people haven't been pressurising to supply us in other currencies except the US dollar," he said. "So far the renminbi has not become a currency of international trade. If you are a Chinese factory you want payment in US dollars. We've asked our suppliers and the answer is no."

Looking at the more strategic view, David Swann, of BAT, was particularly keen to manage and optimise the treasury impact of entering these markets. "A key issue we continue to work on is leveraging our global scale both as an organisation and as a treasury function," he said. "So the way we deal with treasury issues and with banks and other financial counterparties around the world is as a

Figure 1. Where do you see the sterling/US dollar exchange rate in one year's time?

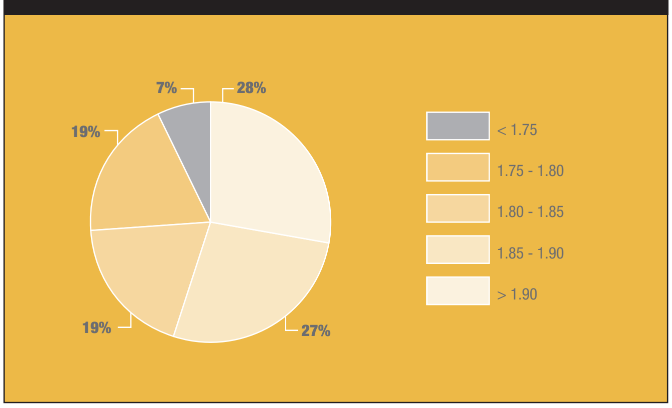
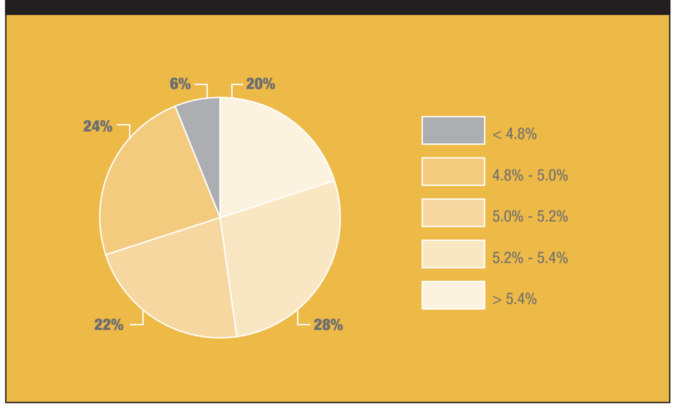


Figure 2. Where do you see the five-year sterling swap rate in one year's time?



single global organisation, as opposed to a group of 180 separate countries."

The use of credit derivatives to reduce credit risk was particularly topical. Growth in this market since 2003 has been impressive although actual take-up by corporates is limited. This was reflected in the panel's responses – none used them specifically at this time. Spinney admitted that in the past he had found catastrophe insurance a simpler solution to the same risk, not least because premiums were stable and predictable in contrast with the often volatile financial profile of credit derivatives.

However, when questioned, Spinney recognised that purchasing a credit derivative could be cheaper. "I think there is potential for us to use credit default swaps," he said, "but again it's going to need an awful lot of education to get people to understand it."

PENSION FUNDS High on the agenda for 2006/07 is the continuation in managing pension fund risk. Most of the audience (75%) concurred with general expectations that in one way or another it would be an important part of their plans for this year (see *Figure 3*).

Fulton expressed no surprise at this result. "Any treasurer doing his/her job in terms of risk coming through the company needs to really understand the deficit," he said. "It's something we are doing."

For those focusing on pensions, reviewing the asset mix and considering the best ways to hedge the deficit efficiently seemed to be the two central concerns. As a result, usage of inflation-linked derivatives and 'de-risking' structures are becoming increasingly popular.

IAS 39 Financial risk management cannot be discussed today without reference to IFRS, especially IAS 39 *Financial Instruments: Recognition and Measurement* and increasingly IAS 21 *The Effects of Changes in Foreign Exchange Rates*. The practical approach translates into ensuring that relevant parties are adequately educated on what to expect and why, with a key distinction being made between expected and unexpected volatility. A well-briefed investor-base need not be spooked by fluctuations that are clearly accounting-based and do not represent a genuine increase in underlying risk. There is no reason to expect that dedicated analysts are unable, or indeed unwilling, to strip out the effect of IAS 39.

East summed up this point. "Volatility in itself is not necessarily the thing that will spook the market," he said. "It is unexpected volatility that will do that."

The panellists had nonetheless come up with – and come across – some novel ways to address the impact. One panellist said he had created a separate line in the income statement for accounting gains and losses to remove them from operating profit. Another said he had created a dedicated budget to absorb accounting volatility. And one company present, which did not engage in hedge accounting at all, had nonetheless yet to experience serious volatility within the income statement.

All confirmed that they had not allowed IAS 39 to drive a change in the underlying business, but agreed that internal education about the impact of derivatives usage – for instance among operating companies and subsidiaries – was a necessity. The panel also concurred with the results of the audience vote in which the biggest vote (40%) was for accepting up to 5% volatility in the income statement if hedging made good economic sense (See *Figure 4*).

The implementation of IAS 39 has also perhaps overshadowed the lesser-profiled IAS 21. For companies with foreign subsidiaries, this standard brings translation complexities to the income statement, the extent of which is yet to be truly felt or explored. Particularly critical are the issues of determining each subsidiary's functional currency and the practicalities of recycling foreign exchange translation differences for each to the income statement upon disposal (including the effect of any hedging).

COMMODITIES Judging from the downturn at the end of May, the commodities price boom of the past year seems to have given way to a period of increased volatility and sparked new demand for commodity risk management instruments. Although the new accounting environment is regarded by some as a barrier to hedging, it seems likely that a structured approach to commodity hedging will become an increasing priority. For many, this will become a new focus as the remit largely falls under the control of treasurers.

This view was widely supported by the audience. When asked if a review of commodity exposures was expected to be a priority, almost half responded that they were looking at exposures for the first time. Revealingly, only 6% said they had made an active decision not to hedge (see *Figure 5*).

Ian Fleming, of Debenhams, supported this consensus for reprioritisation. "Debenhams has more than 100 stores, primarily in

Figure 3. Is the company pension fund expected to be on your agenda in the next year? If so, what is your main priority?

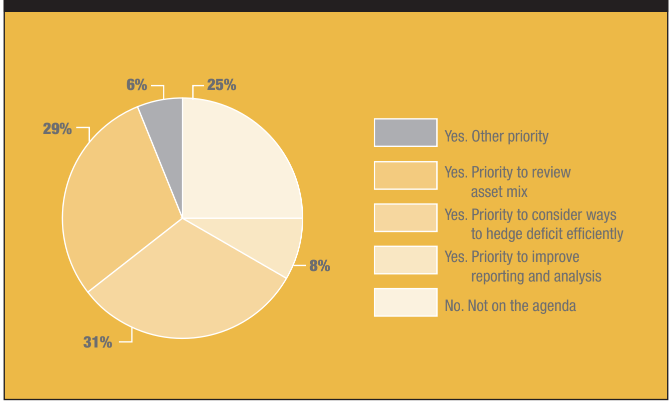
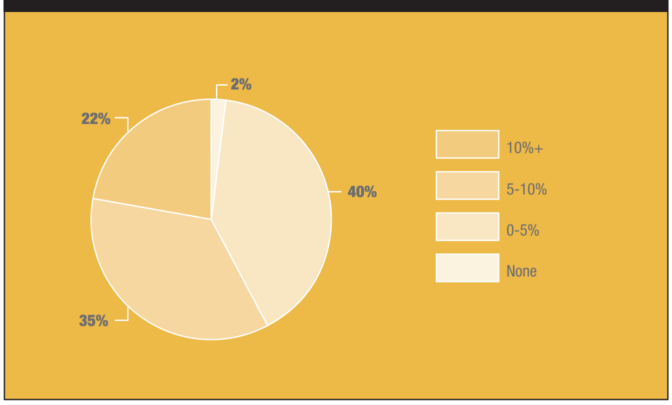


Figure 4. If hedging makes good economic sense, in the future, how much volatility in the P&L would you be prepared to accept?



"VOLATILITY IN ITSELF IS NOT NECESSARILY THE THING THAT WILL SPOOK THE MARKET. IT IS UNEXPECTED VOLATILITY THAT WILL DO THAT."

the UK but also in Northern Ireland and Eire," he said, "and the energy cost position over the last 12-18 months or so, as well as the rise in energy costs, is something that will focus our attention and introduce the possibility of energy hedging."

There is a clear distinction, however, between large regular users of specific commodities – which will have dedicated internal resources for controlling this risk – and more ad hoc users, which will look more towards their banks and advisers.

There is nonetheless one area where most companies, even large service companies, will have an exposure that is probably not managed in a structured way – namely, fuel and energy costs. This is another area where the relationship between financing and operations is essential, given that reducing distribution costs clearly comes before hedging those costs.

Spinney spoke of his particular desire to expand the treasury remit to cover distribution cost risks. "I'm also interested in this fuel hedging," he said. "I've no idea how much we spend on diesel and fuel as a group, so I'll definitely be looking into that this year."

At the other end of the commodity spectrum are the niche materials required by some companies for very specific purposes, such as manufacturing or engineering. Managing price risk in a small and concentrated market may require a different set of skills and instruments, but in its own way may be equally important to the overall health of the business. Even for a very specific business or procurement unit, education by the treasury department as to the potential availability of hedging structures may therefore be a priority – a point wholeheartedly supported by all panellists.

LIGHTENING THE ADMINISTRATIVE LOAD The panel was also asked to comment on a variety of other risk-mitigating operational issues and opportunities. Almost two-thirds of the audience expected to invest time and money in upgrading e-trading solutions and treasury systems – testament to the widespread benefits of technology (see *Figure 6*).

E-platforms clearly have a big role to play. The expanding capabilities of single and multi-bank trading platforms make both transactional and more structured trades less time-consuming.

On the subject of STP, the panel was extremely positive. Unsurprisingly, increased STP was viewed as a means of freeing up treasury resources to focus on more innovative risk management strategies. The general consensus was that outsourcing back-office and treasury functions was less desirable than fostering development internally. However, Spinney was keen to look at the outsourcing of the day-to-day cash management of moving money from where it is generated to where it is required, including the payments that flow from this. "I have decided to look at it again as it's the factory piece of the department," he said. "So for me, there may be a better way of doing it."

Interestingly, with the number of counterparties on continuous linked settlement upwards of 750 and settlement volume standing at an average of \$2.7 trillion, the smallest number of respondents cited continuous linked settlement as their main focus. That said, only 12% of continuous linked settlement-enabled companies are currently corporates, although many will be looking to see if this percentage increases in the next 18 months.

In summary, the impact of all these issues is uncertain, the tools used to manage them are diverse, and the market challenges ahead are unpredictable. But what is clear is that treasurers can expect an extremely busy and challenging time over the next 12-18 months. Only time will tell whether what was seen in this year's crystal ball will ever become reality.

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The graphics show the opinions of the 300-strong TTC audience, who were equipped with voting buttons so their views could be captured.

Figure 5. Is the review of commodity exposures in your company expected to be an increasing part of your role?

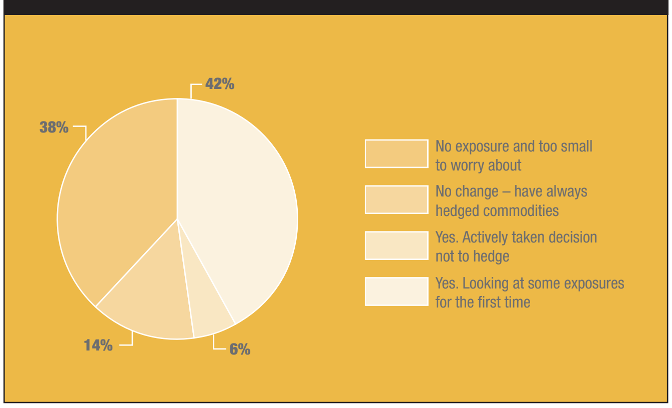

Figure 6. What is your main focus for freeing up time in 2006/07?