ACT

MERCER OLIVER WYMAN

The Role of the Treasurer in Enterprise Risk Management

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Executive Summary

The Association of Corporate Treasurers (ACT) and Mercer Oliver Wyman have conducted a research study focused on the role of the treasurer in the design and implementation of Enterprise Risk Management (ERM) solutions. Our research includes more than thirty in-depth interviews with European treasurers, feedback from the ACT and insights gained from Mercer Oliver Wyman's client work.

ERM has become increasingly popular among European companies in recent years. Risk has moved up the corporate agenda as business volatility has increased, and the recent wave of governance scandals has prompted regulators and shareholders to more closely scrutinise risk and control frameworks. No longer a theoretical nicety, ERM has become a practical necessity.

Managing risk on a comprehensive, firm-wide basis requires a different approach to the traditional, insurance-led focus on minimising losses or box-ticking to meet compliance requirements. This approach must emphasise measuring the full range of risks in ways that can support executive decision-making in setting strategy, budgeting and allocating capital. But where can a company find the skills required by this more rigorous, quantitative approach to risk?

One obvious place to look is the treasury department. Treasurers, after all, are deeply familiar with financial risks and their quantification, and many are already taking on responsibility for a variety of risks outside their traditional remit, such as those associated with insurance, commodities and credit. Over the past few years, treasurers have added significant value in the pensions arena, allowing them to offer valuable input to the ERM programme – or perhaps even manage it directly.

With Chief Financial Officers (CFOs) increasingly hard-pressed to deliver against their own expanding responsibilities and few other qualified candidates available, enterprise risk might be seen as a good fit for treasurers' ambitions – not only does it offer an opportunity for career progression, but it is also the answer to a clear business need. The vast majority of the treasurers we have spoken to confirm that they see ERM as a major and logical opportunity to add value to their companies.

Our research, however, reveals that only a handful of treasurers have truly engaged with ERM. A few treasurers have taken on 'chief risk officer' roles, but equally (and worryingly), we found that others were actually unaware of the ERM initiatives already underway in their own organisations. Some treasurers have taken on wide-ranging responsibility for financial risks yet remain dissociated from enterprise risk. In general, treasurers either have minimal involvement with existing ERM efforts or have made little progress in promoting them as a new and potentially valuable initiative.

Why is this the case? ERM has, in many cases, been defined not by business logic or even genuine prudential requirements, but rather by the raft of new regulation introduced after the governance scandals earlier this decade. Compliance, audit and other control functions have taken the reins, and ERM has devolved into an exercise in 'box-ticking.' Such functions now command the ears of senior management and perhaps also the resources that treasurers need to make real changes, even in the areas where they hold nominal sway.

This is important for reasons that go beyond treasurers' frustrated ambitions. A true ERM programme is a complex initiative that puts the organisation's decisions and activities on a sound quantitative footing. The compliance exercise being disguised as ERM at many companies might offer senior executives and board members comfort when it comes to signing off on accounts and regulatory filings, but does not add value to the running of the business or executive decision-making.

The firms that have fully embraced ERM have demonstrated its potential to create substantial value. It seems, however, that this demonstration has not yet been fully appreciated by the managers and directors of other firms, even though today's incoming board members are far more risk-aware than their predecessors were. In fact, many have been appointed precisely to ensure that the right questions are being asked about the balance of risk and reward in the company's activities, and to ensure that risk is being properly integrated into the decision-making process.

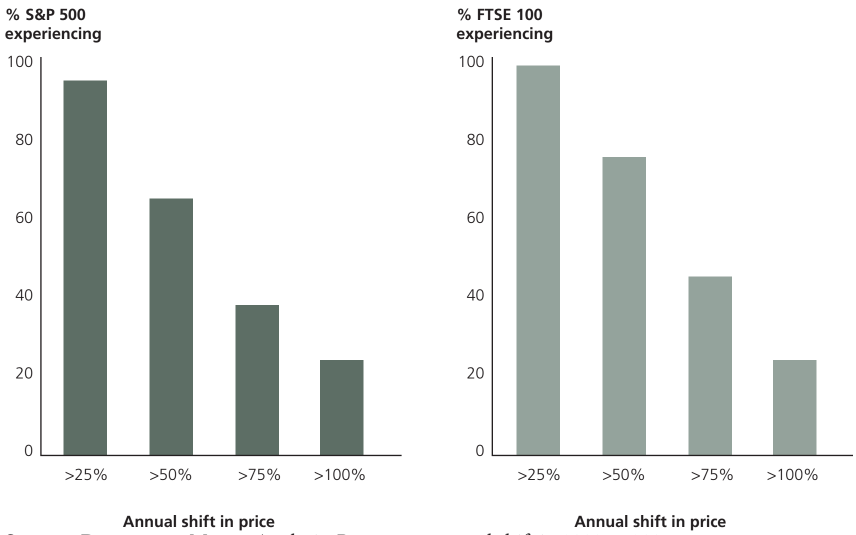
These directors should be a receptive audience for a treasurer's ERM pitch; however, the treasurers we spoke to had little direct contact with the board or with key external stakeholders, such as equity analysts. Without such contact or an increased focus on value-adding ERM activities (e.g. quantification and portfolio modelling), treasurers will be forced to concentrate their efforts on trying to break down organisational resistance to ERM by dismantling the 'silos' in which risk is managed. This dismantling stresses the value implications of better risk management and a facility for applying treasury skills to strategic issues, such as capital management.

Rising to the challenge of ERM is not simply a matter of persuading others in the firm, however – it also requires treasurers to educate themselves in new technical skills, best practices, non-financial risks and business strategy. Our research suggests that many treasurers prefer to accept the status quo, but also that the landscape is changing. In the past, treasurers have been seen as the de facto deputy CFO – this might now be at risk as the focus of CFOs has moved to control/accounting and strategic planning. As a consequence, treasurers may not be confident that they will step directly up to the CFO position, and they cannot count on being left alone to manage their piece of the risk jigsaw forever. By taking a more proactive role in ERM, they will add value to the organisation and position themselves better as CFO candidates. The opportunity is there, and treasurers should grasp it.

Introduction

Over the past decade, companies have become increasingly interested in enterprise risk management (ERM). This interest is justified by the increased emphasis placed on risk in corporate governance and regulation and a fundamental upturn in business volatility; earnings, share prices and cash flows are all becoming increasingly variable, as illustrated in Figure 1.

Figure 1: Significant movements in share prices, 2003-2004



Sources: Datastream, Mercer Analysis. Represents annual shift in 2003 or 2004
Note: High UK incidence driven by large 2003 shifts; in 2004 only a third had shifts > 50%

Not only is volatility on the rise, but the shake-up of corporate boardrooms has created an influx of non-executive directors with a detailed understanding of risk and greater motivation to ask insightful questions about its management. This has subsequently put pressure on companies – and, in particular, their finance departments – to reconsider certain basic assumptions and, where necessary, to adjust their structures, processes and objectives. Considerations of value creation and decision-making are rising higher on the agenda, while loss minimisation and insurance cover are now of secondary importance.

The upshot is that the need to implement ERM is now an increasingly urgent fact of business life that requires risks to be evaluated on a more quantitative basis, which permits more precise assessment in strategy formulation, budgeting and capital appraisal. It also requires that all risks relevant to a decision are addressed holistically, rather than managed by independent organisational 'silos.'

Many of these considerations require a strong understanding of risk's connections with value and performance, which subsequently requires a strong quantitative and analytical skill set. The best place to find these qualities is often in the treasury department. As organisations have traditionally looked to the treasurer to manage financial risks, it is logical to suggest that they should apply the same skills to the management of other risks. This is not a new suggestion – it has been mooted since the 1990s – but it is only now that we are seeing practical evidence.

In 2005, Mercer and Russell Reynolds reported that the expanding workloads of CFOs are increasingly requiring them to build strong teams and delegate some of their responsibilities[1]; with ERM rising up the agenda, the treasurer is likely to be asked to shoulder more of the risk management responsibilities. The research of the Association of Corporate Treasurers and Mercer Oliver Wyman suggests that European treasurers embrace the idea that involvement with ERM represents an appropriate and perhaps desirable expansion of their role.

Treasurers have demonstrated an ability to adapt. Many are already being entrusted with the management of additional financial risk classes, most often those associated with pensions and commodities, which signals that organisational barriers are already beginning to erode. One might expect that treasurers would, in time, become involved in the quantitative aspects of hazard and operational risk management; some have, in fact, already been given responsibility for insurance. But how far has this process really gone? How can treasurers accelerate it, and what are the barriers to its fulfilment?

Today's treasurers and risk management

There were relatively few surprises in the areas traditionally managed by treasurers. As one might expect, most treasurers are closely involved with balance sheet structuring and funding. Activities involving equity were the only area where there were significant differences; some treasurers are fully responsible for raising equity, others support the CFO and a small number had no involvement at all in this area. Overall, there has been limited equity issuance recently amongst the companies surveyed; most have focused on share buy-back programmes as a result of reduced gearing levels and strong corporate performance.

We observed that most treasurers play a key role not in formulating the strategy behind these programmes but rather in their execution. In the leading examples, treasurers take a key role in the assessment of appropriate gearing levels for the company and in the initiation of a move to a buy-back programme. However, it is the board (advised by its investment banks) that typically decides how much equity to buy back, over what time period and through which broker(s). The treasurer is responsible only for handling and financing the purchases on a day-to-day basis, and negotiating additional debt facilities for this purpose, if required.

We also found a strong trend toward treasurers taking on increasing responsibilities, including insurance, pensions, commodity risks,

1 *How CFOs are Managing Changes in Roles and Expectations*, February 2006; Mercer and Russell Reynolds Associates

commercial credit risks, tax, capital expenditures and corporate finance. In these areas, as well as in the core financial risks, there is considerable divergence in treasurers' roles, responsibilities and practices. The practices in the core areas of foreign exchange and interest rate risk are described in the Appendix. In the remainder of this section, we will examine more closely the practices for commodity, credit, insurance and pension risks.

Commodity price risk

At most firms, commodity risk has traditionally been managed outside treasury, typically by a procurement or supply chain unit that is more concerned with managing cost than risk. There is evidence, however, that this is changing. Oil and energy companies are also an important exception: they usually have well-defined trading functions that use their own risk and pricing models, though this can still lead to sub-optimal activity from the perspective of the firm as a whole.

There are other emerging examples of treasury departments pro-actively using their risk management skills by taking on responsibility for commodity risk management; unsurprisingly, this is most evident at firms that use large volumes of commodity raw materials or consume substantial amounts of energy. The recent rise in commodity prices has encouraged this trend, with firms recognising that their treasurers' greater focus on risk analytics may prove useful in containing or mitigating the effects of price and volume volatility.

Treasurers responsible for commodity risk management usually begin with an approach that parallels the way in which transactional foreign exchange exposures are managed.

However, we have seen leading players adopt approaches more akin to those used by specialist commodity traders with consequent development of more advanced risk management tools. We expect this trend to continue – the increased integration of financial and commodity risk exposures allows companies to take a portfolio view of their financial risks and structure their risk management strategies accordingly.

Credit risk

Two long-running trends, corporate consolidation and the re-engineering of supply chains, have significantly increased credit risk for many companies, particularly in sectors such as chemicals/pharmaceuticals or aerospace/defence. At the same time, banks, partly driven by regulation and partly by business logic, have become more concerned with the active management of credit risk. The result has been a proliferation of tools that can be used to manage credit risks, notably quantitative credit ratings and credit derivatives. In principle, a potential solution has arisen at the same time as a potential problem.

In practice, few of the treasurers interviewed have yet to apply their skills to credit risks other than those arising from their own dealings with bank counterparties. There has been a movement at the leading edge to evaluate credit risk along the entire business supply chain, from component suppliers to end customers. A number of companies have, with support from treasury, started to use credit rating data to evaluate the risk of supplier default, which is then used as input when choosing and managing suppliers. We anticipate that this approach will become more prevalent, and that credit risk will be linked with other relevant risks (such as business interruption) to develop an integrated measure of 'supply chain risk.'

Insurance

Many companies have moved the reporting line for insurance from the company secretary or legal department to their treasurers. This change reflects a widespread sentiment that insurance should be seen to 'pay its own way'; the emphasis is now on cost-benefit and risk-return analysis rather than simply getting the wording right. In practice, this sentiment has rarely translated into a real change of institutional perspective. While treasurers may have gained the reporting responsibility, few have transformed the way that insurance is assessed and purchased, or brought increased quantitative rigour to the analysis of insurance risk or the potential benefits of using insurance capital.

In most cases, the management of insurance risks remains idiosyncratic and poorly integrated with other risks in the business. This often seems to be a result of under-investment – while there is a genuine will to change, resources are lacking. Our research suggests, though, that putting the purchase of insurance onto a more risk-based basis is essential; however, given the resource constraints that treasurers face following their response to the pensions and other challenges, this change is not being given the highest priority in most companies. We expect that the incentive – and, perhaps, resources – to integrate the treasury's financial and business risk activities with insurance will increase over time as the quantitative techniques used (such as value-at-risk, cashflow-at-risk or earnings-at-risk) converge.

Improved management of core responsibilities

The interviewees and other treasuries we have observed have clearly spent much time and effort on cash management structures and appropriate controls in their attempt to rise to the pensions challenge and demystify the hedging implications of IFRS. Yet, only a few have made similar progress in other areas close to their core operations. This is worth fixing in and of itself, but the broader issue of confidence also must be addressed – unless treasurers clearly demonstrate value creation from their management of 'near-core' risks, they face an uphill struggle with other risks.

Capital allocation and budgeting is an area of increased focus for most corporations. In principle, treasurers are well-positioned to adjudicate on the best ways to allocate and manage capital – the leaders are involved in calculating differentiated costs of capital for their businesses based on the inherent risks faced. Undertaken effectively, this enables an improved ability to evaluate which funding alternatives offer the best risk/return potential or the appropriate balance between on- and off-balance sheet funding, including the optimal use of insurance or other sources of contingent capital. In practice, however, many treasurers play little more than a strictly technical role in relation to differentiating between traditional forms of on- or off-balance sheet funding.

Similarly, leading players have been able to leverage the advances in market risk tools and techniques made by financial institutions – where tools have been developed and widely applied to understand the significance of exposures – to set limits on their exposures, establish mitigation strategies and measure performance. Their techniques have been tailored to address the exposures that underlie commercial transactions, and their experience suggests that such efforts reap rewards.

Most treasuries have been unable or unwilling to make such progress. Different risks continue to be managed in isolation and via established practices such as fixed/variable mix or static hedging, even when more advanced and analytically rigorous practices are readily available. In some cases, this can be justified on expense grounds: companies with largely domestic operations and low gearing may not think it worthwhile to invest in better market risk management. In a great many cases, though, it simply cannot be justified.

It is difficult to explain this state of affairs. It is possible that treasurers have neither the mandate nor the scope to undertake the initiatives necessary for change; at the very least, treasurers perceive this to be the case. While we have witnessed the emergence of a 'new breed' of treasurers who are well-educated in the latest tools and techniques, the supporting evidence is discouragingly low. There is also strong evidence, though, that treasurers are flexible and that they can, when called upon, rise to the occasion as they have done very effectively across the board in responding to the pensions challenge.

Case Study: How treasurers stepped up to the pensions challenge

Can treasurers successfully expand their roles to include new risk classes? The example of pensions suggests that they can, provided there is real demand for their services.

The early part of this decade provided something of a 'perfect storm' for defined-benefit pension schemes. Bond yields had declined, increasing the present value of pension liabilities and pushing funds into deficits. The decline in equities had also contributed to deficits and made it difficult for them to simply invest their way back into the black; changes in accounting standards meant that those deficits were more readily apparent than they had been previously. Even basic actuarial assumptions about longevity were changing.

In many cases there was a need for urgent action, but at most companies, no one was specifically tasked with resolving difficulties with the pension fund. Finance Directors were facing awkward questions but lacked answers or any way to get them. A few very large companies might have had pension managers, but these individuals typically reported to the HR department and lacked financial or risk expertise. Other advisers, such as scheme actuaries, also typically had conflicting responsibilities. Scheme trustees were becoming concerned as well, but increasingly realised that their concerns did not always coincide perfectly with those of the company.

The treasurer was often the obvious person to fill this gap, as he or she already had the technical skills to understand funding, investment and risk. The form of this involvement varies – they may act as a company representative, a trustee or an investment advisor – but has proven to be very successful. Our research suggests that treasurers now routinely take responsibility for pension risk, and it is likely to form part of most newly appointed treasurers' mandates. In fact, treasurers may become victims of their own success – in some cases, their extensive involvement with the fund may leave them exposed to conflicts of interest.

Why has this success not been replicated in other areas, notably insurance? One reason is that there was a clear and present need for the treasurer to be involved in pensions. In the absence of such demand (manifest as regulatory or stakeholder pressure), the arguments for changing the methodology tend to lose out to the status quo. The treasurers have yet to reframe the argument in ways that highlight value, rather than loss mitigation. As noted above, they could discuss insurance in terms of 'contingent capital.'

ERM is a similar proposition. While treasurers can make important contributions in the financial risk arena, they are less likely to know how to address operational and hazard risks. Is a dollar better spent on a sprinkler system or on directors' and officers' liability insurance? As long as board members and senior executives remain fixated on the box-ticking required by revamped governance codes, there may be little incentive to find out. The pay-off for better management of risk tends to be less obvious than the threat of regulators' and investors' displeasure. That may change, however, as the challenges of business volatility become more appreciated and ERM becomes more widely accepted.

Moving towards ERM

Treasurers have become more involved in managing a range of financial risks (e.g. pensions, insurance and commodities) besides their conventional roles in foreign exchange, interest rate and cash management. There are a number of reasons for this. One is that treasurers, like others among CFOs' direct reports[2], are being assigned responsibility for areas that hard-pressed CFOs cannot address personally. As previously discussed, treasurers' skills make them well-suited to broader risk management issues, an area that is also in the spotlight due to greater scrutiny from boards, regulators and rating agencies.

While many treasurers have been expanding their roles into new areas, there is as yet little evidence that treasurers have taken on comprehensive responsibility for risk management, including responsibility for ERM, which has for the past few years been driven by compliance, internal audit and other control functions. This lack of involvement could hinder career progression for treasurers who might otherwise have aspired to the CFO role. Many find this state of affairs frustrating because they sincerely believe that their organisations would benefit from the application of treasury skills and tools to a broader set of risks than simply financial and hazard risks. By extending their remit into ERM, treasurers should be able to demonstrate increased value contribution to their firms and increase their opportunities for moving into the CFO slot.

In this section, we will review the current 'state of play' in corporate ERM, the perceptions of key stakeholders as regards its implementation and the consequences for treasurers.

Current practice

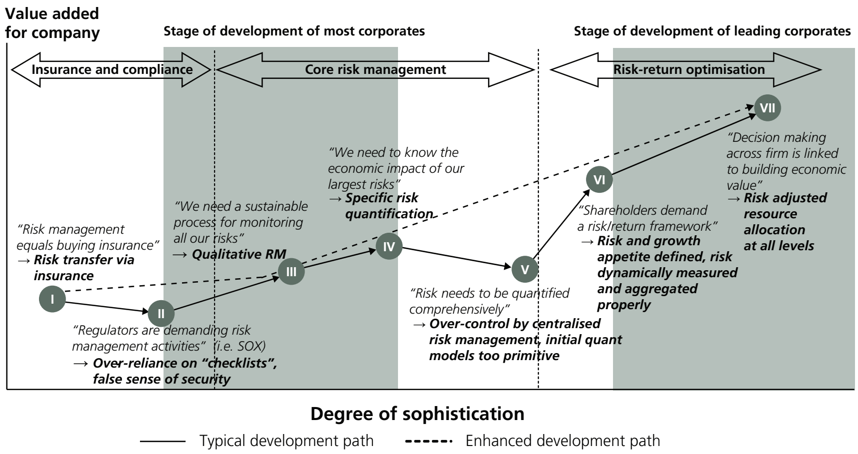
Most of the companies interviewed had some version of an ERM programme in place, but we discovered that many such programmes are in fact strongly compliance-led exercises driven by incoming regulations and governance codes. Such programmes are strongly led by (and often synonymous with) compliance functions such as internal audit or company secretary and tend to be refreshed infrequently. They also involve only qualitative assessments of probability and impact ('high, medium or low impact?'), address risks individually, fail to incorporate risk into decision-making and deal in one-off 'point' estimates rather than dynamic ranges of outcomes. However, leading players are

2 For more on the CFO's workload and delegation of responsibilities, see the report *How CFOs are Managing Changes in Roles and Expectations*, February 2006; Mercer and Russell Reynolds Associates

increasingly focusing on incorporating a risk-return perspective in all aspects of decision-making.

In Figure 2, we describe the evolution of ERM from a compliance optimisation perspective to risk-return optimisation perspective. The stages of development indicate a wide range of organisations – the left shaded area demonstrates where many organisations currently stand, and the right shaded area indicates the target many are trying to reach.

Figure 2: Evolution of enterprise risk management



Source: Mercer Oliver Wyman

Practices, however, are strongly polarised; a few firms' efforts far outstrip those of the pack. At these leading practitioners, the objective of the ERM programme is typically to enhance corporate decision-making with tools being developed to support actions ranging from optimisation of the insurance programme to analysis of overseas expansion plans, business mix or capital allocation. Such programmes systematically identify and quantify volatility in earnings, cash flow or other defined metrics, taking care to produce results that can be used as meaningful inputs to decision-making.

Such paragons do exist: we have chronicled ERM structures that genuinely add value to their organisations and help managers appreciate the potential risks and returns of their business decisions. Although there are examples of leading practices in the UK, the research suggests that 'UK plc' is at risk of being left behind by its continental European peers in this respect.

Companies that have fully implemented an ERM framework and have integrated this with their strategic decision-making processes generally exhibit a number of key characteristics.

Key Characteristics of an ERM Framework

Risk measurement: these companies know what their risk profile is, in quantified terms, over the entire spectrum of risks, ranging from financial risks through operational to strategic risks. They can isolate the impact of individual risks and can also aggregate across all risks to produce an integrated view of risk taking at any meaningful level of the organisational hierarchy. In addition, they are able to assess the effect of risk mitigation (insurance, hedging, etc.) in economic and accounting terms on their risk profile.

Risk appetite: the firm has thought through how much risk of each particular type it wants to take. Its risk appetite is expressed in measurable terms and is communicated throughout the organisation. It has defined the difference between 'off-strategy' risks, which are strictly managed through a formal limit structure and 'on-strategy' risks, which are entered into as a conscious part of the firm's business strategy and are aligned with the firm's return targets.

Balance sheet management: the firm's gearing ratio is set consistently with its risk appetite and with the capacity of its assets to generate cash-flow. The firm takes a portfolio view of its assets and allocates its own capital in order to optimise the group level risk-return positioning.

Performance measurement: the firm has defined its performance targets using risk-adjusted metrics that reduce the impact of risk-taking on business unit results. These metrics are then linked to individual performance assessment.

Culture: those organisations that are most effective at risk management are characterised by an awareness of risk taking that starts at the very highest levels in the organisation and permeates down to the lowest levels. Everyone is aware of risk and seeks to minimise risk where possible and to ensure that the organisation always earns a suitable level of return for bearing risk. These organisations usually have a high tolerance for losses resulting from known risk taking and a low tolerance of surprises.

Transparency: risk management functions best when there is a clear flow of information up and down the management hierarchy. In the upwards direction, senior management needs to receive timely and accurate risk reports; in the downwards direction, there needs to be clear communication of both the authority to take risk, delineated by product area, geography and customer segmentation and of the limits on risk taking.

The experience of those organisations that have implemented value-creating ERM suggests a need for a senior executive who sits on decision-making bodies and ensures that an improved understanding of risk is leveraged effectively. This individual should also be responsible for risk management strategy, processes, infrastructure, people and culture. Such individuals – whether they bear the title of 'chief risk officer,' 'director of treasury and risk' or another moniker – face a number of challenges:

- Understanding the business drivers (it is not unusual for ERM specialists to be initially sourced from outside the business)
- Finding tools and techniques that can be used to quantify the risks
- Capturing all sources of earnings or cash flow volatility in the ERM process

As discussed, the treasurer would seem well-positioned to move up into this broader risk management role and lead efforts to address these challenges. We did find some examples in which ERM development was being sponsored and fostered by individuals with treasury backgrounds. Additionally, a small number of treasurers have extended their activities and influence to the point that they are chief risk officers (CRO) in all but their title. (Conversely, there are a few CROs who have the title but not the role.)

Most of our respondents strongly agreed that treasurers should be playing active roles in ERM as a stepping-stone to a CRO role, but acknowledged that this is not currently happening.

The current role of the treasurer

Our research found a great disparity between treasurers' aspirations with respect to ERM and their achievements to date. While the vast majority of our contacts expressed clear interest in driving the ERM process, only a small fraction (representing very few companies) are actually doing so. There are some treasurers who have taken extremely broad roles and have line management responsibilities for many financial risk functions yet do not have responsibility for enterprise risk. That there were a number of treasurers interviewed who were unaware of ERM initiatives underway in their own organisations should be a source of concern.

This reflects, in part, the fact that many so-called ERM programmes are, in effect, extensions of governance/compliance processes, but the failure of treasurers to redirect the agenda is nonetheless puzzling. It is not entirely clear why the treasurers have been unsuccessful in becoming involved in ERM, particularly because they are often considered to be doing a good job with the financial risks traditionally assigned to the treasury and have responded positively to the extension of their role into areas such as pensions. Such risks may be well-managed along with certain operational risks even in the absence of an effective ERM process, but treasurers have not yet been able to extend their reputation for competence in these areas to broader strategic risks. Some potential reasons for this include:

- Other organisational units with stakes in risk management are resistant to treasury's increased involvement
- Senior executives and board members fail to appreciate the value that treasury can bring to ERM, and the value that ERM can bring to the business

We will examine these possibilities in more detail.

Organisational resistance

ERM is now an inescapable fact: there are good examples of well-developed ERM programmes under which risks have been quantified in a way that enhances both strategic and tactical decision-making. Instances do exist in which individuals from a treasury background have been allowed to take on the ERM role and have put in place ERM structures using a range of quantitative techniques, many of which have been adapted from the treasury risk management field (i.e. value-at-risk). More examples will emerge as time passes.

However, most corporate ERM initiatives are still not fully quantitative, do not focus on exposure management and do not offer decision support. Rather, they are exercises in compliance or internal audit rather than a fundamental business process that contributes to shareholder value creation. This minimises the potential role of the treasurer to the detriment of the ERM programme, which is unlikely to be truly effective without at least incorporating the treasurers' financial risk expertise and quantitative skills. Many of our interviewees noted that their board, audit committee and senior management were quite happy with the current, compliance-focused ERM approach, but the effect has been to entrench compliance or audit departments as the 'owners' of the ERM process.

In response to the willingness of some boards to allow the compliance-focused approach to continue, treasurers must re-assert the value of their contributions to the ERM process; not only is this a positive move in its own right, but treasurers are otherwise liable to find themselves in a dangerous position if and when the current focus on governance wanes and the management of harder risks moves back up the agenda. For the moment, though, we found that many treasurers felt unable to achieve this.

The treasury often finds itself stymied when risk management responsibilities are ceded to business line managers. Even in the core responsibilities of the treasurer, there can be clear organisational resistance. Many companies, for example, give commercial managers a substantial amount of discretion about hedging currency exposures; when exposures are recognised, they decide whether to take out cover and how much to hedge. Commodity-intensive companies often give dedicated teams similar flexibility. It is front-line traders who decide if, when and how much to hedge. That implies a need for a significant change in attitude if the treasurer is to make significant progress on the ERM agenda.

When treasurers are able to align themselves more closely with the business in managing commercial exposures, such co-operation tends to enhance the perception of the treasurer as a valued member of the organisation. This allows treasurers to press for risk management initiatives based on 'the greater good' of the organisation without falling foul of suspicion that such initiatives will undermine bottom-line business concerns. This is still not an easy case to make, particularly if there is little support from senior managers at the top of the organisation.

Stakeholder disinterest

One of the most important business developments of the past five years has been the emergence of increasing risk sensitivity among corporate board members. The new generation of non-executive directors, backed by new regulations and codes of conduct, are pressing managers for detail on risks to corporate stability and performance. The most enlightened are demanding that management demonstrate an understanding of risk that goes beyond governance standards to inform operational and strategic decision-making, and thus enhance shareholder value. These non-executives want performance measures that take proper account of the risk-return relationship inherent in the decisions and trade-offs that they need to make.

Some companies have made great progress in developing and implementing this kind of value-based approach to enterprise-wide risk management, but most have yet to reach that point; while their boards may be more interested in risk than they were previously, they are not yet pushing for risk analysis that goes beyond the tick-box approach to compliance. Treasurers are typically provided with little involvement with the board beyond ensuring that the risks for which they are directly responsible (FX, interest rate, liquidity, etc.) are appropriately represented.

Many of our interviewees expressed concern that boards may be taking false comfort from governance processes and confusing them with true ERM. At least half of those interviewed felt that senior management and the board overestimate the value and security offered by their organisation's current 'ERM' practices. In many cases, the CEO and other senior executives have not made value-based ERM an immediate priority.

Treasurers are also not necessarily building bridges to stakeholders outside the firm. Equity analysts offer much more challenge to the risk agenda in some industries than others; as a result, there was a wide spectrum of involvement level among treasurers dealing with that group. As expected, the treasurers interviewed had a very high involvement with the rating agencies who are increasingly demanding more transparency and information on the ERM approach as part of the ratings process. More risk detail could clearly be provided through this channel if treasurers were in a position to provide it, which is not currently the case.

In such an environment, a pro-active treasurer can feel that he or she is pushing a solution that no-one actually wants, even though it might be in the best interests of both the treasurers and the firm. How can they set about changing 'hearts and minds?' We believe the answer lies in the treasury role itself, in demonstrating the current and potential value to be unlocked by value-based risk management.

Conclusion

Treasurers clearly realise that the time has come for action on enterprise risk management. The rise in business volatility makes it imperative that risk be managed on an integrated, firm-wide basis, rather than the piecemeal approach that currently prevails. They also understand that they have an important role to play in making ERM work; their quantitative skills and familiarity with risk make them obvious contributors to an ERM programme – and potentially its leaders.

Yet the evidence suggests that this has yet to be translated into real progress at most companies. While treasurers have stepped up to the mark and taken on some responsibility for risks beyond their traditional remit, this has not yet prompted the majority of companies to achieve greater integration and alignment of risk management with the goals of the organisation. While there have been notable successes in some areas (pensions), there has been less action in others (insurance) and stagnation in some (market risk). For the most part, treasurers remain disengaged from ERM and have made little progress toward it.

Why? At this time, boards and senior executives remain preoccupied with the need to comply with revised corporate governance codes. This has resulted in 'ERM' being reduced to an exercise in 'box-ticking,' and its leadership delegated to compliance, audit, legal and other non-financial functions. The true utility of ERM in assessing and creating value, and supporting decision-making, is being overlooked or downplayed by many boards and senior executives. There is a lack of clear mandate for change, and consequently of the resources to bring it about.

What should treasurers do? The answer depends on the circumstances, as the urgency of enhanced risk management will vary from firm to firm. Some organisations have made significant progress and the changes that they have made have fundamentally enhanced their core decision-making processes. Treasurers can help to share the value in these leading practices within their organisations and can help sponsor the developments.

All treasurers should be prepared. Circumstances may make quantitative ERM a priority with boards and senior executives in preference to the currently predominant compliance-led approaches. There is evidence of a growing trend toward the integrated, quantitative approach that supports decision-making. When this crystallises more widely, treasurers will be called upon to step up to the challenge. They can begin by trying to break down organisational resistance to ERM – dismantling the 'silos' in which risk is managed and stressing the value implications of better risk management.

Rising to the challenge of ERM is not simply a matter of persuading others in the firm, however – it also requires treasurers to educate themselves in new technical skills, best practices, non-financial risks and business strategy. Our research suggests that many treasurers prefer to accept the status quo, but also that things are changing. Treasurers have in the past been seen as the de facto deputy CFO – this might now be at risk as the focus of CFOs have moved to control/accounting and strategic planning. As a consequence, treasurers may not feel confident that they will step directly up to the CFO position, and they cannot count on being left alone to manage their piece of the risk jigsaw forever. By taking a more proactive role in ERM they will add value to the organisation and position themselves better as CFO candidates. The opportunity is there, and treasurers should grasp it.

Potential action plan for corporate treasurers and their involvement in ERM

- Engage CFO to ensure that they are supporting the CFO agenda
  - External demands for improved risk management
  - Articulation of risk appetite
  - Enhance strategic planning – incorporate risk-return perspective
  - Capital budgeting and approval (e.g. capex, M&A)
- Re-evaluate analytic tools for core treasury risks and potential extension to other risks
- Making pensions achievements more visible internally
- Propagate leading practices from other organisations
- Re-articulate mission statement of treasury
  - Volatility management vs. hedging
  - Value focus vs. risk reduction

Appendix

Foreign exchange

Transaction exposures are generally considered to fall squarely within the treasurer's remit, but treasurers take a very wide range of approaches when evaluating them. Sophistication varies somewhat according to exposure size and industry sector, but many firms are sticking to the practice of simply hedging a fixed percentage of known exposures and making little subsequent adjustment for changes in the size, significance or volatility of a position. While for most firms it is clear that their policies were established using an initial risk-based assessment, there is little evidence that there is a dynamic approach to monitoring the risk in ongoing positions.

Nonetheless, some progressive treasuries do use market risk tools adapted from the financial sector to evaluate and reposition hedges as circumstances change. These treasurers' activities also reflect the fact that their foreign currency sales and purchases constitute a continual flow, rather than the transaction-by-transaction approach employed by their counterparts. Most indicated that the move to international financial reporting standards (IFRS) has made them more careful when constructing and booking hedge transactions. They also claimed that the techniques and instruments used were still determined by economic, rather than regulatory, factors. Only one interviewee focused exclusively on reported earnings as the measure of its effectiveness in this area. The evidence suggests that the move to IFRS has contributed to a reduction in the extent to which treasurers are willing to use dynamic, risk-based hedging approaches for transactional foreign exchange hedging.

Translation exposures were also universally accepted as part of the treasury role. There was again little evidence of increased sophistication in hedging practice: the bulk of activity consisted of denominating debt in currencies that offset net asset positions (subject to interest rate differentials). While this approach may fall short of in-depth risk analysis, it is effective and cost efficient for most firms, with the exceptions being those that tend to issue little debt as a matter of course. Many of the companies interviewed raised the issue of the translation hedging of earnings, but noted that they felt unable to take much action except using the servicing costs of appropriately denominated debt serving as a 'natural hedge.' While this approach works to some extent, it leaves the company exposed to unexpected or unusual moves and can also have a significant impact on its value and financial covenants, depending on the scale of the exposure.

Our research also uncovered a number of FX-related issues that treasurers thought were important but on which they have yet to take significant action. The reasons for this inaction vary. For example, certain respondents raised the potential significance of economic exposures, and noted that this was an area where they felt further investment was needed. However, the process of hedging such exposures is complex and, tending to involve fundamental changes in the underlying strategy and business model (such as moving production sites), does not fall entirely within the treasurers' remit. While some treasurers interviewed felt that it was of major potential impact, they felt unable to initiate the necessary change in their company.

Interest rate risk

Interest rate risk was also seen as central to the treasurer's role, but the benevolent interest and inflation rates of recent years have decreased the perceived urgency of making improvements in this area, as has a general reduction of leverage. Despite this, there are a few leaders, particularly among more highly-leveraged companies, who have embraced sophisticated tools and demonstrated their business value. We also see these practices in industries where prices are set in relation to an inflation index or those where investment programmes account for a significant proportion of cashflow. We have seen examples of corporate treasuries using tools, techniques and processes that match in sophistication what might be used for a bank's interest-rate management activities.

These organisations are clearly obtaining significant value from their investments in such sophisticated interest-rate risk management. Illustrating how interest rate risk affects the company is useful particularly for the firms that understand and model effectively the interplay of interest, inflation and profitability. Such firms are also better at using more sophisticated re-pricing horizons, duration-matching the underlying assets to the interest rate profile and tailoring risk management to the firm's risk appetite.

Despite this, many of our interviewees continue essentially to 'manage' their exposures by maintaining a fixed/floating mix in which the ratio used has been set by reference to the organisation's ability to afford increased servicing costs. While there is evidence that some of these approaches are based on an up-front risk-based analysis, in other cases the parameters used may be updated only rarely and have become more arbitrary. Some treasurers have stated that they stick to a 50/50 ratio simply because board members find it comforting. It is striking that in general, this is not explicitly and consistently linked to the risk appetite of the organisation.

This approach does, however, have significant drawbacks: the ways in which such policies are applied may increase rather than reduce the company's exposure to changes in interest rates. Such policies often consider a fixed-rate bond with a large face value to be 'fixed' even as it approaches maturity. When that bond matures and must be refinanced, the single-period impact on interest costs can be very significant.

ACT

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