A RECENT SURVEY FOUND THAT WHILE 99% OF COMPANIES HAD A TREASURY POLICY IN PLACE, THE PROPORTION WITH PROCEDURE MANUALS COVERING ALL ELEMENTS OF OPERATIONS WAS DOWN SIGNIFICANTLY ON 2003. DOES THIS INDICATE THAT MANY ORGANISATIONS' TREASURY POLICIES ARE NOT UP TO SCRATCH? **PATRICK CLARKE** INVESTIGATES.

What's your policy?

The first thing a treasurer should consider when assessing the quality of his/her policy is why it is there in the first place. As obvious as this seems, too many policies tread lightly over the key risks faced by the treasury and end up resembling procedures manuals on how to deal with foreign exchange (FX) or interest rate derivatives.

The treasury policy is a document, generally and preferably approved at board level, that gives treasury staff written guidelines on what they are responsible for, how they should go about this, what their boundaries are and how their performance will be measured. It may be stating the obvious, but it needs to be said that derivatives are complex instruments that, by their very nature, make them potentially dangerous to the finances of any business that uses them. Properly understood and utilised, they are invaluable for risk management but they have the potential to destroy companies and the careers of those who use them.

It is vital that a treasury policy sets out exactly what instruments will be used and the precise purpose of any transactions that will be made. Whilst there have been countless scandals relating to the fraudulent use of derivatives amongst corporate treasuries, more often it is the failure of a suitable treasury policy and risk management strategy that leads to failure. An example here can be found in the fortunes of a major Australian zinc mining company. Its revenues were in US dollars – the price in which the metal that it mined traded globally – but its costs were mainly in Australian dollars.

When the Australian dollar fell to US$0.65 in the late 1990s, the company sought to lock into this historically low price to protect its expected profits. However, the Australian dollar fell to US$0.50 in 2001 and this created a massive hedging loss that the company's balance sheet could not withstand. At the same time zinc prices fell to historic lows, reducing the US dollar revenues that had been hedged.

Because the US dollars cashflows were less than the amount of US dollars hedged, the company was left with unprofitable currency hedges that were not linked to any cashflows and were out of the money. This was one of the main causes of its insolvency.

Executive summary

- Treasury policies should be approved at board level and give personnel the guidelines on their roles, what their boundaries are and how their performance will be measured.
- Treasury policies should not skim the key risks faced by a company's treasury and should set out exactly what instruments are to be used and the exact purpose of transactions.
- A policy which focuses mainly on financial or accounting risk management could mean that other key risks are being overlooked.
- Treasurers should review their existing policies at least annually and make necessary changes when their companies undergo changes such as acquisition.
- Unless a treasury policy is regularly updated, clear, specific and comprehensive, it is only slightly more useful than no policy at all.

operations TREASURY POLICIES

Treasury Operations survey results

According to a recent treasury operations survey by Ernst & Young (see *Delicate Operations*, page 13, *The Treasurer*, October), 99% of treasuries have a treasury policy. It sounds an impressive number but just how effective are these policies? Policies can vary from comprehensive, detailed and constantly reviewed documents to three page motherhood statements gathering dust in the treasurer's filing cabinet.

A telling statistic is that the proportion of treasuries with procedure manuals covering all elements of their operations has fallen from 69% last year to only 52%. This would seem to indicate that the policies from which these procedures manuals are being derived may not be as complete and relevant as they should be. Unless it is clear, specific, comprehensive and regularly updated, a treasury policy is of only slightly more use than no policy at all.

In this case there was no fraud. All the procedures were followed but the company was eventually taken over by its bankers and its shareholders were wiped out. In effect, the company not only hedged the wrong risk but poorly hedged the risk that it had identified.

The key message is that it is no good if your policy simply states that "FX forwards should be used to manage FX risk" or that "interest rate swaps should be used to protect the business from adverse interest rate movements". Instead, a good treasury policy should outline the key risks and how the specified hedging policy will manage them.

A simple example might be: "Our business imports fabric manufactured in China which is priced in US dollars. Our sales are in pounds sterling. Our principal creditors are paid 30 days after invoice date and we are normally paid within 21 days of shipment. Our prices are fixed each month. Our aim in hedging our currency risk is to ensure that our products can be sold at the profit margin that we forecast when the purchase was made."

The policy would then go on to specify the instruments to be used for hedging, the methods of hedging permitted, the exposure limits, the approval processes and so forth. Each of these elements should be directly linked to the initial justification of the hedging policy.

This is a simplified example, but without this crucial analysis and the explicit statement of the purpose of a hedging policy and the linking of other elements, a policy is of limited value.

COMMON OMISSIONS. By placing a purely financial or accounting focus on risk management, it is easy to overlook the key risks that businesses face. Most treasury policies cover the basics of currency, interest rate and liquidity risk where appropriate and there is a growing awareness that credit risk is not simply applicable to banks. However, other risks can have a substantial impact on the business and need to be considered.

OPERATION RISK – ARE YOU REALLY PROTECTED FROM ERROR AND FRAUD? Operation risk is primarily concerned with the risk of error and/or fraud within the treasury and also within the finance function as a whole. Financial institutions spend tens of millions of pounds seeking ways to identify, measure and mitigate this risk and there is no reason for even the smallest treasury to ignore this. Segregation of duties, a favourite of audit checklists, is all well and good in a 12-strong treasury team, but what if it consists of you, an assistant and maybe half an accountant when two of you are on leave? Incorporating policies that identify the error and fraud risks in business, having methods to measure the risk, and more importantly, putting in place measures to mitigate them, are just as important and valuable as having a state-of-the-art Value at Risk (VaR) currency risk management framework.

Simply identifying every point of risk, attempting to quantify and document risks and showing them to your CFO is a good way of acquiring the extra resources that you need, or of obtaining more co-operation from the financial controller. It also provides a framework for finding the resources you will need to overcome staffing pressures that make risks worse by leaving you with insufficient time to check for and rectify errors.

CREDIT RISK. When looking at counterparties (see *A credit to your business*, page 26) we generally see a financially healthy, diverse group of banks with AA ratings and above and assume all our deals will always be honoured. According to the rating agencies, that assumption would be right around 99.5% of the time. But banks do fail, as do A-rated corporate entities. The rating agencies are conservative at present but these things go in cycles.

> 'UNLESS A TREASURY POLICY IS REGULARLY UPDATED, CLEAR, SPECIFIC AND COMPREHENSIVE, IT IS ONLY SLIGHTLY MORE USEFUL THAN NO POLICY AT ALL'

Many policies specify the minimum rating of a counterparty, but a good number do not put individual counterparty limits in place, which increases the risk to the business. If keen pricing from one of your banks means you have 80% of your swaps, forwards and overnight deposits with it, you potentially put the entire business in jeopardy. Historically, the institutions that fail generally exhibit below-market pricing in the lead up to their default as their desperation for deposits and premiums to meet their obligations increases.

Methodologies for managing counterparty risk include:

- Definition of how credit risk is measured (ratings are the most common).
- Criteria for selecting, maintaining or dismissing counterparties.
- Objectives – securing credit facilities often requires adding banks to your panel, but geographical matching to assets is another method.
- Limits for each counterparty.
- Weighting of derivative transactions – what percentage of the nominal value should be allocated?
- Monitoring of exposures relative to limits – can the treasury system cope? Many systems can't. Who should check them and when should they be checked?
- Approval process for changing or breaching limits.

PROCESS FOR A BREACH OF LIMITS. More importantly, your benchmarks and performance measurements need to reflect the constraints that an appropriate credit risk policy imposes. Once limits are reached you may be forced to take less than best pricing which reduces your performance against benchmarks. However, this is what risk management is all about – paying a cost to mitigate risk. It is vital that this is considered, acknowledged and incorporated into the treasury policy. This will remove the incentive for treasurers to breach limits to meet targets or to penalise unfairly those who comply with their limits.

ARBITRARY BENCHMARKS. A policy may often state that a certain percentage of the next three months' forecast foreign currency exposures will be hedged but give no reasons for the percentage other than that it just seemed an appropriate figure. The test of any hedging benchmark is its impact on cashflows and profits. Many models and systems exist to enable benchmark levels to be back-tested on previous or forecast financial outcomes and market movements to provide guidance on how a certain benchmark might impact company performance. Their use is invaluable in ensuring the benchmarks and targets that are included in the treasury policy are appropriate and achievable.

LACK OF CONTROLS/WRONG CONTROLS. Many policies focus on risk management but overlook a number of basic controls. A review of the treasury-related scandals over the last 30 years reveals it is the basic controls that are often inadequate and/or breached.

As a guide, every treasury policy must address:

- Each member of staff's detailed responsibilities;
- specific and complete delegations of authority for all treasury actions;
- dealing limits by transaction and dealer;
- authorisation limits;
- payment mandates; and
- counterparty limits.

REGULAR UPDATES. Finally, every new treasurer should comprehensively review the existing treasury policy to ensure it measures up to his/her own standards. Everyone brings their own views, expertise and style to a treasury and it is important the treasury policy supports the treasurer's approach to achieving an effective and well-controlled operation. Reviews should take place every time the business undergoes a change in ownership, acquisition, divestment, geographical growth and so forth as the policy must always be customised to the business it supports. At the very least, an annual review that takes into account new technology, improved techniques and changing business and market environments, should be considered essential.

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