Treasury policies

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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. Our most recent treasury operations survey, produced in conjunction with the ACT, indicates that 100% of treasuries now have a treasury policy in place and that a growing majority formally document and update them regularly. But what does having a treasury policy really mean?

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. Most treasuries deal with derivatives and so to must their policies. It may be stating the obvious, but it needs to be said that derivatives are complex instruments that, by their complex 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. The key to using them well is a high quality treasury policy

Our survey indicated that the main responsibilities managed by treasury and hence covered by treasury policies were:

- cash and liquidity management;
- foreign exchange exposure management;
- funding;
- interest rate risk management; and
- commodity risk management.

However, there has been a growing awareness of the need to manage, and hence have a policy for:

- operational risk management; and
- credit risk management.

It is vital that a treasury policy sets out exactly what instruments will be used by the treasury and the precise purpose of any transactions that will be made. While 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 USD 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 USD 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 dollar 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. In this case there was no fraud. All policies and procedures were followed but the company was eventually taken over by its bankers and its shareholders lost their entire investment. In effect, the company not only hedged the wrong risk but also poorly hedged the risk that it had identified.

The key message is that it is not good enough 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 coupled with the explicit statement of the purpose of a hedging policy and the linking of other elements, a policy is of limited value. Other elements that should be contained within a treasury policy include specifying the relevant benchmarks and other means by which treasury performance is to be measured, which risks are to be managed and who is responsible for them.

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.

Operational risk – are you really protected?

Operational 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 easily applied 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 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. 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;
- having a mark to market capability to identify 'soft' breaches caused by the revaluation of relevant instruments;
- *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; and
- 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. It remains crucial that all breaches are investigated or have pre-approval by senior management.

Arbitrary benchmarks

A policy may often state that a certain percentage of the next three, six or twelve months' forecasted foreign currency exposures will be hedged but give no reasons for the stated 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 backtested on previous or forecast financial outcomes and market movements. These models would 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, truly reflect the firm's risk appetite and that they are 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;
- counterparty limits; and
- monitoring of all of the above.

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 that 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. The recent trend to source products from the Far East or Eastern Europe introduces a new set of counterparty and foreign exchange risks and represents a classic example of a time to review the existing treasury policy. 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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For further reading around this subject see:

www.treasurers.org/technical/resources.cfm

and select Managing the Treasury Function: Treasury policy and objectives