5.5.2 Treasury Policy Critique Exercise

Unit: Unit 1 – Treasury strategy

Module: Module 5 – Treasury structure

Date: 1 March 2012

Summary: An exercise based on a real situation, requiring characterisation of the business environment, identification of the major treasury functions and determination of what the policy with respect to risk management should be. This is followed by a requirement to critically evaluate the policy bequeathed to you by your immediate predecessor and to formulate proposed amendments, focusing on policies for investment of surplus funds, funding, interest rate and FX management and share repurchases.

Keywords: treasury policy, procedure

Part 1: Setting the Scene

Although this is a policy exercise, first we need to make sure we understand the business. So without spending too much time on them, consider the following basic questions.

Question 1

Characterise the domestic environment and the business environment of NTC. What implications do these have for NTC?

Question 2

Identify the major tasks for treasury now and going forward.

Question 3

Summarise (at a very high level) what you think should be the company's policy for treasury with regard to risk management.

Part 2: Policy critique

Your predecessor, who had been recruited from the treasury function of a foreign bank a year ago, has decided to return to banking. Before leaving she has drafted a policy statement for treasury, from which key extracts are set out below. You have been asked to review this statement and amend it if necessary before it goes to the Board for approval.

Question 4

Briefly comment on the overall policy statement.

Student Notes:

You need to consider:

- Types of exposures and risks defined
- Risk limits based on quantifiable data lead to hedging actions to reduce risk to acceptable limits

- Approved hedging instruments, counterparties
- Procedures for reporting limit breaches
- Segregation of duties
- Risk management terms defined and policy builds expectations of what the risk management programme will and will not achieve

Using normal governance criteria, you need to consider:

- processes for directing and controlling
- procedures for making corporate decisions
- the framework for monitoring management performance

Question 5

Critically evaluate and, as appropriate, amend **one** of the proposed policy statements 1-5. (Evaluations are given of all policies and one full policy worked out. You can work through these as well as your choice.)

Background information NTC

Part 1

You have taken advantage of career opportunities available in the Gulf region, and have been appointed treasurer of NTC, the national telephone company of a small but rapidly developing oil-rich kingdom in the Middle East which is a member of a regional political grouping of seven countries (the Gulf Cooperation Council, or GCC). The company, which to-date has had a monopoly of local telecommunications, is locally regulated and the Government has retained 10% of the equity since privatisation a decade ago. Three local institutions (two commercial banks and an insurance company) own another 30% of the equity. The remaining 60% is held by the general public. The government, which has a strong balance of payments surplus, does not currently levy corporation tax on locally incorporated entities. The board has no committees.

The three local institutions are represented on the Board and a close relative of the ruling family is Chairman.

The company receives payment in US$ for international incoming calls and pays US$ for international outgoing calls. Terms in both cases average 30 days. In recent years, annual capital investment in equipment has run at around US$35mn, of which 80% is in foreign currency. Lead time on these capital projects is typically fifteen months from placing the order to commissioning, with interim stage payments. The local currency tracks the US$.

There is free access to foreign currency, foreign money markets and related derivatives. However, up to now there has been no use made of any hedging instruments for currency or interest rate risk because the relevant skills do not exist within the treasury function which concentrates mainly on payments, reconciliations and the investment of surplus cash. For instance, budgeted future foreign currency payments for capex are held in bank deposit accounts denominated in the particular currency of payment.

Financial statements for the company, which has no debt and strong cash flow, are summarised below in US$ equivalent amounts:

BALANCE SHEET (US$ EQUIVALENT)	**LATEST $ million**	
Property, Plant & equipment	246	246
Current Assets		
inventories	1	
accounts receivable & prepayments	28	
bank balances & cash	75	
	104	
Current Liabilities		
accounts payable & accruals	(40)	
proposed dividend	(35)	
Net Current Assets	29	29
		275
Shareholders funds		
share capital		140
statutory reserve		65
retained earnings		70
		275

PROFIT & LOSS (US$ EQUIVALENT)	**LATEST $ million**	
Revenue		
domestic services	69	
international calls	90	
	159	
Interest & Investment Income	3	162
Operating Costs		
international calls	(38)	
domestic payments	(50)	
depreciation	(32)	(120)
Profit		42
Statutory Reserve	1	
Proposed dividend	35	
Retained Earnings	6	42

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Part 2
POLICY STATEMENT (EXTRACTS)

1 INVESTMENT OF SURPLUS FUNDS

1.1 *Policy*
Optimise the yield on surplus funds consistent with full capital preservation, maximum liquidity and minimum risk

1.2 *Permissible Investment Instruments*
Following instruments are permitted;

Money Market Instruments
- Term deposit with bank
- Certificate of Deposit
- Bank Acceptances
- Capital Guaranteed Instruments

Corporate
- Commercial paper
- Corporate Bonds
- Corporate Floating Rate Notes
- Asset backed securities

Government
- Government and Government Agency Treasury Bills
- Government and Government Agency Bonds

1.3 *Country Exposure*
- Investment restricted to OECD and following regional Banks:
  - Bank X
  - Bank Y
  - Bank Z
- Investment in any one country not to exceed 25% of NTC's net worth

Note: There are 30 countries involved: AAA = 9; AA = 10; A = 4; BBB = 5; BB = 2

1.4 *Credit Quality*

(a) Subject to (b) below, all investments must have a credit rating as follows:
- Short term (from one day to one year) = A1/P1 or better
- Medium term (over one year up to 5 years) = A
- Long term (over 5 years) = AA

(b) The company is permitted to invest in instruments issued by an unrated Local Bank or Institution provided that its capital adequacy ratio as per the published accounts has been greater than 10% over the last 3 years

1.5 *Counterparty Limits*

Investment with any one Local Bank or Financial Institution, or subsidiary of an overseas bank must not account for more than 10% of the published net worth of the legal entity with whom funds are placed as at its latest balance sheet date, or 10% of NTC's paid up capital whichever is lower

Parent company net worth may only be taken into account where there is an unconditional guarantee for the branch/subsidiary

1.6 *Liquidity*

All instruments must have a recognised and liquid secondary market, sufficient to enable an orderly realisation within 3 months

1.7 *Currency*

Investment of surplus funds is restricted to Local Currency, US dollars or if in any other currency is 100% hedged back to US dollars

1.8 *Placing Process*

Investment of surplus funds should be done on a competitive tender basis, with the highest accepted subject to credit and counterparty limits

2 FUNDING

2.1 *Policy*

The company's total debt should not exceed 30% of its debt plus equity

2.2 *Permitted Sources of Finance*

- Overdrafts and short-term borrowings (ie up to twelve months)
- Medium-term bank borrowings (ie in excess of one year and up to five years)
- Operating and Finance Leases
- Hire Purchase
- Export Credit Guaranteed financing

3 INTEREST RATE RISK MANAGEMENT

3.1 *Policy*

To protect the investment of the company from adverse interest rate movements, and in the case of Finance/Borrowing to hedge against rising interest rates

3.2 *Permitted Instruments*

- Forward rate agreements (FRA)
- Interest rate swaps (IRS)
- Caps/Floors/Collars

4 SHARE REPURCHASE

4.1 The Treasurer will evaluate on a six month basis the appropriateness of a share repurchase

5 FOREIGN EXCHANGE RISK MANAGEMENT

5.1 *Policy*

A - To protect operating profits and cash/flows by hedging all firm and highly probable currency transactions as soon as they arise

B - To facilitate the availability of upside gains while protecting the downside

5.2 *Permitted Instruments*

- Spot foreign exchange transactions
- Currency deposits
- Outright forward contracts
- Forward contract / option-dated delivery
- Purchasing currency options

5.3 *Limitations on the Use of Options*

Currency options are to be used only to hedge commercial transactions. In no case should an option be written. The strike price of the option should not be in excess of 5% of the forward rate at which forward cover can be effected.