1.4.1 Where Does Treasury Fit In?

Unit: Unit 1 – Treasury Strategy

Module: Module 1 – Corporate strategy

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Summary: A look at the history of treasury and to see where treasury fits inside a modern corporation. The definition of treasury by a competency framework.

Keywords: treasury, financial control, corporate finance, stewardship, cash and liquidity management, capital markets and funding, corporate financial management, risk management, operations and controls, shareholder value, financial strategy, treasury strategy

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Learning outcomes:

1. To understand the history of treasury in corporations.
2. To understand the three functions of finance: treasury, financial control and corporate finance.
3. To understand the role of a modern treasury.
4. To understand the ACT competency framework.
5. To understand the importance of shareholder value.
6. To understand that treasury strategy follows from financial strategy.

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1 Introduction

1.1 The history and evolution of treasury management

At its broadest, Treasury describes the activities which take place at the interface between the business and the financial markets. The treasury function exists to support the business activities of the firm and, therefore, its policies, procedures, structure and culture are very much dictated by the nature of the business (economic environment, product-market profile, geographic spread, capital intensity, financing, growth rate) and the strategy, structure and culture of the company.

The activities and risks encompassed by treasury management exist within every business, from the corner shop to Microsoft, but treasury as a discrete corporate function within management has only emerged since the late 1960s / early 1970s, and then only in larger companies and developed economies.

As with any growing, vigorous body, the process of evolution continues, overtaking attempts to define the function too literally. Nonetheless, understanding why the process occurred provides us with a rationale for what treasurers do today and a framework for speculating about what they may have to do tomorrow. The following review of developments provides a good illustration.

Accounting phase: Before 1970 anyone with the title “treasurer” was likely to be managing cash and deposits passively, for example reconciling bank statements. The relationship between corporate and banker was weighted in favour of the latter as banks were principal source of corporate financial products, non-equity finance and financial expertise. The early running in treasury management was made in the USA via the Cash Managers’ Association.

Risk management phase 1: The abandonment of fixed exchange rate regimes in favour of floating rates for most major currencies in the early seventies transformed a traditionally one-way bet (occasional changes, timing uncertain, but direction known) into a two-way bet. Transactional FX risk became important overnight because of its potential to seriously damage profits. Because European corporates (prior to European Monetary Union) were more likely to be involved with multiple currencies compared to US companies, European companies, particularly in the UK, took up the running in treasury development.

Cash management phase: The major rise in oil prices in 1973 led to widespread economic recession and resulted in a profits fall for corporates and unprecedented volatility in interest rates. The combination of these two factors drew attention to the possibility for substantial savings from planned liquidity management.

Basic treasury management: The abolition of exchange controls in the UK in 1979 and other major economies in the following years presented currency managers and cash managers with more discretion, allowing them to borrow freely and hold any currency. Consequently treasury management became more complex.

Cheap funding phase: Recycling surplus petro-dollars led to dramatic growth in euro-currency lending in the 1970s, primarily to developing countries. As the sovereign debt

market nose-dived in 1981 following another oil price spike, competition grew among banks to lend to good quality borrowers. However, the impact of banks' sovereign debt provisioning (realised in 1986-89) contributed to a decline in bank ratings. Higher quality corporates found that they could attract funds directly from the money and capital markets more cheaply than doing so via banks – thus "disintermediating" banks from the debt funding process. So, investment banks, which were traditionally "transaction-based", began competing directly with commercial "relationship" banks for longer term funding business, initiating the continuing debate about the merits of each type of banking relationship. A number of banks bought or merged with competitors, forming so-called 'universal' banks combining investment banking with commercial banking.

The credit crisis starting in 2007 has tested the relationship approach to banking. While for many this has meant a renaissance of relationship banking, it has also seen many banks simply withdraw from markets where they had operated, letting down their customers in the process. For example, while many larger creditworthy companies have found few problems in funding through the crisis the banks have made it very difficult, restricting credit and increasing prices, for smaller and lesser credits. Some banks have retreated to their own domestic markets, for example the syndicated loan market shrank rapidly during the crisis as foreign participating banks withdrew. Morgan Stanley, Goldman Sachs and similar banks continue in their specialist roles, despite becoming more like commercial banks. There are now many threats to the business models of commercial and investment banks alike, as the pressure of regulation builds and M & A business continues to dwindle.

Risk management phase 2: Growing currency dealing and euro-currency lending in the 1970s fuelled the internationalisation of financial markets. It accelerated into full-scale globalisation in the 1980s, aided by major advances in communications and data processing technology and by economic policies to increase competition. Interest rate swaps appeared in 1982[1], the first of a new family of derivatives which fundamentally changed the corporate's ability to manage risk. Cross-currency swaps, options, futures and Forward (or Future) Rate Agreements (FRAs) followed. The instruments were now in place to allow the banks' financial engineers full rein to demonstrate their ingenuity.

Early use of some of these products resulted in misunderstanding or mis-selling, depending which side of the fence you sit on. See accompanying document 1.4.1a "A Case Study on Bankers Trust: How they lost trust", a case study involving the sale of derivatives by Bankers Trust (subsequently acquired by Deutsche Bank) to Proctor & Gamble amongst others. Corporate treasuries had to raise their game. Large corporations have avoided the spotlight in this area for some time but the mis-selling goes on. From European countries wanting to cut current expenditure and squeeze into the EURO, to small businesses in the UK and issues around mortgage backed securities, it goes on and on.

Tax management phase: As funding markets globalised and diversified, the opportunity to create tax efficient structures by exploiting the favourable features of one or several other jurisdictions materialised. For example, in the UK it was common to structure ownership of

[1] Coincidentally or not, in 1982 the personal computer was launched by IBM, one of the parties to the first interest rate swap.

some overseas companies and to pass loans through Netherlands-based vehicles. Co-ordination centres (Brussels, Dublin) are another instance.

Corporate finance phase: In the mid-1980s, corporates looked for improved efficiency by selling poorly performing existing businesses, looking for growth by acquiring new ones and diversifying to spread risk. The result was a period of intense activity in Leveraged Buyouts (LBOs), Management Buyouts (MBOs) and Mergers and Acquisitions. The related requirement for valuing businesses and for new funding, sometimes highly leveraged, exposed treasurers to corporate finance activity much more than before.

Shareholder value phase: The inter-relationship of funding and risk management resulting from financing structures such as LBOs, has blurred the boundaries between the finance function and the treasury function. The need for both functions to find a broader framework for decision-making has driven each to embrace corporate finance theory and to concentrate on longer-term returns to shareholders. This had led to further divestment and acquisition activity, usually aimed at creating one or a few core businesses, which have the potential for global leadership.

Risk management phase 3: Since the mid-1990s a few corporates have been moving towards a group-wide concept of risk management. The objective has been to develop unified procedures for identifying and managing risks over the whole firm. Treasurers are well placed to play a lead role in this development because of their Risk Management expertise, particularly in companies where they already look after insurance risk and pensions. The trend to Enterprise (Wide) Risk Management ("ERM" or "EWRM") has been reinforced by recent guidelines on internal control, which require boards to review annually the nature and extent of all significant risks and the company's ability to respond to such risks effectively.

Regulation phase: Since the credit crisis starting in 2007, the banking sector and credit markets are in relative disarray. The political imperative has been to change the banking sector (as well as the shadow banking sector of financial institutions) along several lines:

- Remove the need for future state / taxpayer support
- Punish the sector for their past misdemeanours
- Reduce pay in the financial sector

While punishment has been a thread which is not publicly stated, it has nevertheless been a key theme for regulation. There is of course a danger that this does not recognise the huge importance of banks to the economy as a whole and punishment directed at banks is specifically not punishment directed at individuals, which is arguably more relevant. We have also seen more scandals involving banks, often to the shock of treasurers who have built relationships founded on trust. Swap mis-selling, LIBOR manipulation, FX manipulation, gold price manipulation, protecting wealthy clients, channelling transactions to avoid sanctions. The treasurer must not lose sight of the fact that banks need transactions to survive, they need to sell. It seems that every day reveals new ways in which individuals were manipulating one market or benchmark after another.

Regulation threatens many aspects of banking that are fundamental to its nature, notably maturity transformation, where banks borrow short and lend long. Maturity transformation is under threat from trends to match funding and keep banks liquid in the short term, and this impacts all credit products – not just loans but also derivatives and trade finance. These are major thrusts of Basel III.

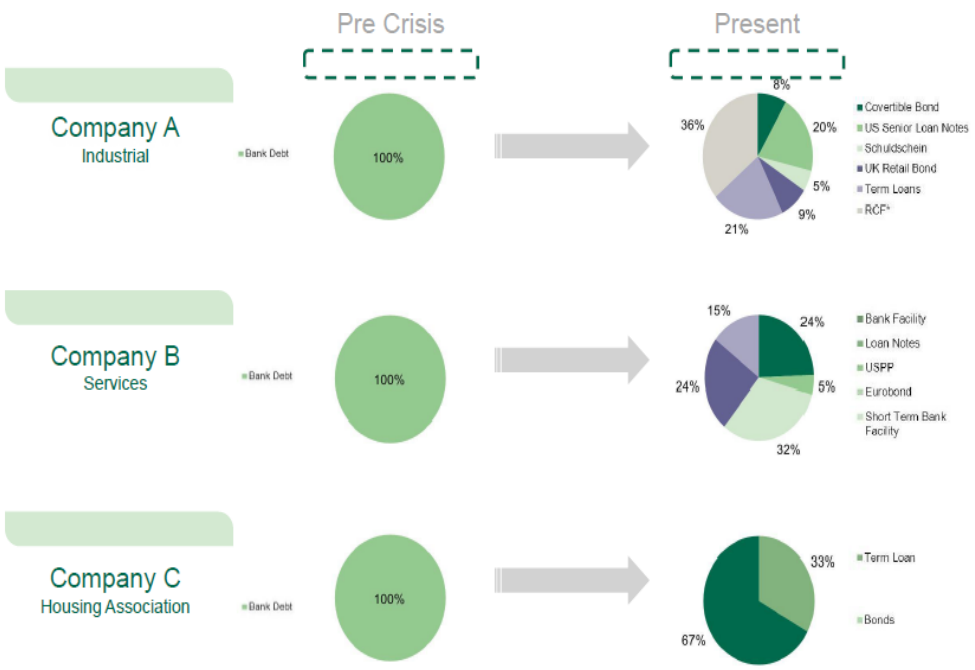
This phase could be argued to be part of a secular decline for banks as they struggle to find a business model which works for shareholders and for regulators. Universal banks face being split back into investment banking and commercial banks (via the Volcker Rule in the US, the Vickers report in the UK and Liikanen in Europe). For non bank sources of capital, regulation is not far away (e.g. Solvency II impacting investments by insurance companies as well as moves affecting shadow banking) and this phase may change treasury focus as finding debt may be fundamentally more difficult.

A possible by-product of this phase is the de-globalisation of banks. As banks have been rescued by governments, these governments don't want to see banks supporting industry outside the home country. In addition, the regulatory approach to 'resolution', or the management of banks in difficulties, also becomes national, rather than international. These factors, plus the search for profitability, leads banks to withdraw from some business lines, withdraw from some jurisdictions and generally become smaller.

Counterparty credit risk phase: Perhaps also part of this phase is something that could be described as the counterparty credit risk phase. Prior to 2007/2008, treasurers were not overly concerned with the counterparty credit risk of banks, arising from cash placed with them, derivatives and undrawn credit facilities. Since then, banks have been downgraded while at the same time, cash deposits have grown considerably. Arguably the role of the treasurer has shifted from being a fund raiser to a fund placer.

Diversification phase: Since 2012 there has been huge growth in bond markets, especially the High Yield part of those markets, together with continuing strength in non bank alternatives such as retail bonds (in the UK) and private placements. It looks like this phase in treasury development will be all around diversified sources of finance and the need for treasurers to be able to communicate well with these types of investor. Note that these sorts of markets tend to be 'feast and famine' and perhaps there is also a trend there. Exhibit 1 shows this diversification away from purely bank financing used in some sectors.

Exhibit 1: Shift away from bank financing since 2008



Low interest rates phase: Another feature of these times is the very low interest rates. The low interest rates in the western economies are unprecedented in terms of both rate and timescales. In the past 200 years, long term rates in the US for example have only been lower in the post-war period. Many finance professionals, including bankers and treasurers, have only known low interest rates. Many benchmark rates are negative, many European government and Japanese government bonds carry negative yields and now (2016) many corporate bonds have negative yields. There is even talk about banks charging to carry cash. This has heavy implications for corporate financial management, where the underlying assumptions, such as on this MCT course, include that debt has a cost. Some commentators see low interest rates (and its poor implications for growth) as a major risk to the global economy.

Challenger phase: At the same time as companies are diversifying their sources of finance, challengers to the traditional bank are emerging. As well as new banks offering a fresh approach, payments can be made via PayPal and other platforms, foreign exchange can be traded with non-banks and crowd funding seems to be gaining traction in the SME market.

There have been lots of phases! The pace of change seems quicker and perhaps some are happening together. While we cannot predict the future, there will clearly be new phases to challenge treasury management. One role of the treasurer is to think what they might be.

2 Treasury and the finance function today

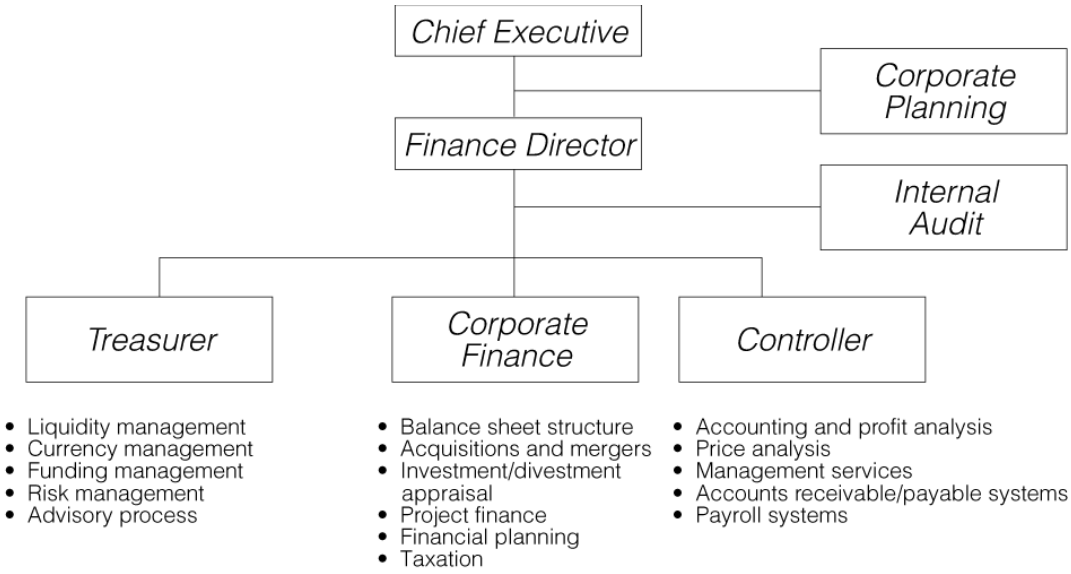
Since most business decisions are ultimately measured in financial terms, it is not surprising that financial management plays a vital role in the operation of the firm. The size and importance of the finance function depends on a number of factors, such as the size of the organisation, the nature of its business, the capabilities of those responsible for financial

management and the capabilities / financial awareness of other key managers and directors of the firm.

As an organisation grows, the importance of the finance function typically results in the evolution of a separate finance department – an independent organisational unit linked to the chief executive or board of directors through the finance director.

The three functions of financial management can be split between: treasury, financial control and corporate finance. While in smaller companies these functions may be distributed through a single finance department, in larger corporates they may be individually resourced as shown below.

Exhibit 2: The finance function



Apart from its strategic responsibilities, the treasury function within an organisation is responsible for managing its financial assets and liabilities. This includes the management of cash, funding and liquidity, credit, banking relationships and financial risk such as those involving foreign exchange, commodities and interest rates. The focus is on the risks which threaten the group's financial assets and the (after-tax) cash flows associated with both assets and liabilities; and on the efficiency with which risks are mitigated.

Financial control is about stewardship, reporting, and the mechanics of accounting and finance. This area of finance deals with such topics as statutory accounts and returns, price and profit analysis, payroll systems, preparing management accounts and budgets, collecting and disseminating timely management information, operational aspects of creditors and debtors, managing relationships with auditors, etc.

Corporate finance is the link between broad corporate strategy and objectives and the role of finance in attaining them. Because of its strategic nature and high profile, this role may be reserved for the finance director or a specialist though increasingly with technical support from the treasurer. The general area of responsibility covers: overall corporate performance assessment, capital budgeting, capital structure, mergers and acquisitions,

investment/divestment appraisal, project finance and taxation. The focus is on funding risk and capital investment risk. In some organisations, particularly when little merger or acquisition activity is envisaged, corporate finance has become the responsibility of the treasurer. In other organisations, corporate finance is a specialist function, especially in those which are growing (or shrinking) rapidly through mergers, acquisitions and joint ventures. As such complex strategic initiatives consume an inordinate amount of financial management time, they are often left to specialist lawyers and financiers.

3 The ACT competency framework

The core knowledge base of treasury has been defined by the ACT in a "Competency Framework". These form the basis of the professional qualifications, using a four level skill set:

Strategic
Managerial
Operational
Tactical

Exhibit 3: The ACT Competency Framework

This can be found at:

https://www.treasurers.org/competencyframework

It is also useful to recall previous versions of this taxonomy as they have become part of treasury jargon. Split over five sections, they were called "The Pillars of Treasury" or "the Five Core Elements of Treasury."

1. Cash and liquidity management
   - cash budgeting and short-term cash flow management
   - bank accounts and payments and collections mechanisms
   - short-term borrowing and investment

2. Capital markets & funding
   - short-term facilities
   - bank term debt
   - capital market term debt
   - equity funding, especially of subsidiaries and joint ventures

3. Corporate financial management
   - cost of capital management including the taxation impact
   - capital structure management
   - capital investment criteria
   - valuation for acquisitions, disposals
   - distribution policy

4. Risk management
   - dealing in the financial markets
   - currency exposure management
   - transaction and translation exposures
   - interest rate risk management
   - pension risk management
   - credit risk management
   - insurance
5. Operations and controls
   - policy development
   - structure and role of treasury function
   - liaison with operating units, the Board and providers of finance
   - controls
   - reporting and accounting
   - tax and legal considerations

4 Shareholder value

There is now almost universal acceptance that creation of (sustainable) shareholder value is the dominant corporate goal, based solidly on corporate finance theory about the direct relationship between risk and return. (Note that the concept of shareholder value creation as being the *dominant* corporate goal does not exclude the consideration of other stakeholders or corporate social responsibility (CSR)).

Aswath Damodaran's *Applied Corporate Finance* textbook is built around this idea[2] which he then divides into three key supporting decisions: the investment decision, the financing decision and the dividend decision.

At its most basic, Shareholder Value is the present value of estimated future cash flows, so the firm must establish a product-market competitive position which will deliver sustainable returns to shareholders consistent with the risks inherent in the business and its markets.

The present value of estimated future cash flows is broadly the sum of those cash flows divided by a discount rate, usually the Weighted Average Cost of Capital ("WACC") less a factor for growth when considering the value of the firm as a whole.

$$\text{Shareholder value} = \frac{\text{Expected Future Cash Flows to Equity}}{(\text{WACC} - \text{g})}$$

So, to maximise shareholder value, we need to maximise cash flows, minimise WACC and maximise growth. The focus on maximising cash flows roughly translates into maximising profitability, generally within the domain of accounting-oriented financial control, although treasury may be responsible for ensuring that accounting profit is converted to free cash for

[2] Damodaran A. Applied Corporate Finance. 2015. 4th edition. Wiley. See Preface, page V.

equity holders. The focus on minimising WACC is on managing the sustainability and volatility (risk) in the cash flows, and arranging tax-effective low-cost funding, all of which are in the natural domain of the treasurer. The point of including the growth factor g separately is to identify treasury's role as a support function, facilitating growth by ensuring that the right financial solutions are available at all times to facilitate the business strategy.

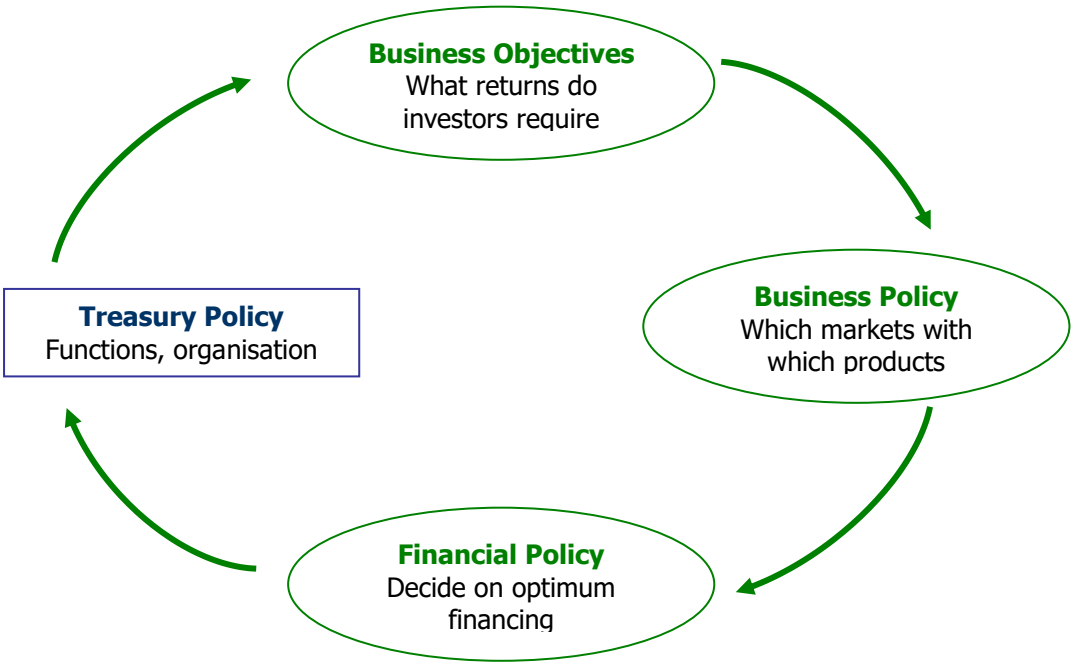
Despite this approach, which is a broad foundation for what we teach, it is always useful to see opposing views. Read 1.4.1b "Lift the curse of shareholder value".

5 Financial strategy drives treasury strategy

As the firm exists to increase shareholder value, this should be the main driver of its business objectives.

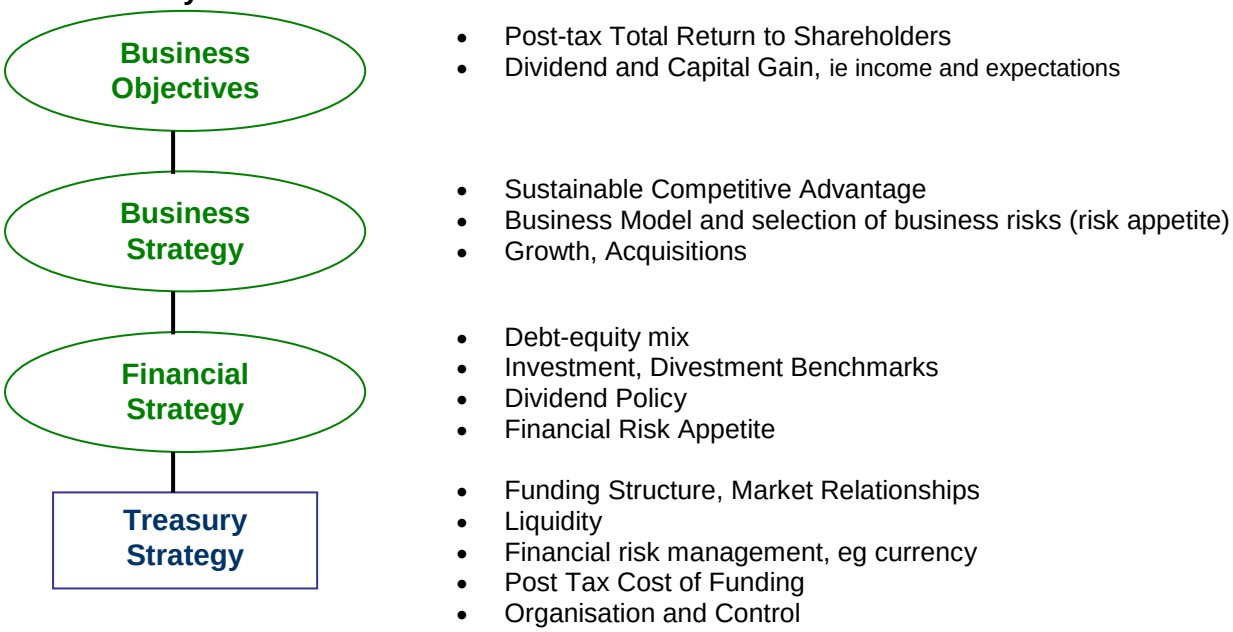
We can draw a feedback loop to show how businesses continually adjust their behaviour at the functional level to changes in competition and the environment and periodically review strategy to accommodate major shifts.

Exhibit 4: Business, finance and treasury links



At both the functional and strategic levels these adjustments are iterative and the boundaries between functions often get blurred in the process. Nonetheless it is necessary to determine a key focus for each function in order to clarify responsibility and accountability and avoid duplication or gaps in the system.

Exhibit 5: Key focus of functions



Senior Management should focus on ensuring that post tax total shareholder return is the driver for product-market investment decisions.

Business strategy needs to focus on developing and sustaining competitive advantage in order to protect excess returns (i.e. to ensure that the expected cash flows to shareholders meet or preferably exceed their risk-weighted required returns). For larger corporates, particularly those with global market leadership aspirations this will often involve substantial acquisition programmes to generate economies of scale and scope, with consequent funding implications for treasury.

Financial strategy and treasury strategy overlap. However, it is possible and indeed necessary to draw some boundaries between the two.

An obvious way to do this is to view financial strategy as the framework for treasury strategy and treasury operations. Finance policy sets out the guidelines for capital structure, for instance:

- the degree of leverage (typically the most important financial risk) which is seen as optimum
- hence investment and divestment hurdle rates such as weighted average cost of capital
- dividend levels to satisfy both shareholders and allow for the funding requirements for growth.

Within this broad framework treasury ensures the availability of all types of funding as efficiently and flexibly as possible. It manages the significant risks to cash flows which are readily traded in financial markets, notably currency and interest rate risks but also potentially commodity, credit, pensions, business continuity, and weather risks. It prescribes and monitors the financial dimensions of investment (and divestment) decisions to make sure that shareholder value interests as expressed in the financial strategy are served. And it creates an organisation structure within which all of the above can be controlled.