5.5.1 Treasury Policy

Unit: Unit 1 – Treasury Strategy

Module: Module 5 – Treasury structure

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Summary: A look at how overall financial strategy is translated into a policy which can be used as a way to control how treasury plays its part in implementing the overall strategy. We look at two examples of risk policies in particular. We recall a distinction between policies surrounding overall form risk management and those applying to the management of treasury.

Keywords: board of directors, treasury risk management committee, core elements of treasury

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Learning outcomes:

1. Treasury is required to play a role in supporting overall group strategy and risk management and needs to be instructed on its role.
2. Treasury's job can be partly summarised as to:
   a) facilitate growth
   b) protect the return
   c) ensure that the risk profile conforms with board policy / shareholder expectations
   d) match the timescale of treasury decisions to business activities
3. Treasury must set policies to meet company policies.
4. Many treasury policies will require cooperation with other departments.
5. Treasury policy can be departmental or about overall risk management.
6. The five core elements are a good way to tackle a risk register and allow treasury to be a risk manager.
7. A common policy format is most useful to ensure that all factors are considered.

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1 Introduction

We have seen the influences in the design of a treasury and how it might be organised to meet the needs of the firm, perhaps using outsourcing or various structures to achieve this. We now consider how treasury might be instructed formally to carry out the role of supporting the firm.

Treasury cannot operate in a vacuum and must not operate in silos. To remind ourselves of the root of power, we reprise Exhibit 1:

Exhibit 1: Roles and responsibilities

Management level	Roles and responsibilities
Board of Directors	• Establishes treasury objectives within the context of corporate policy and objectives. • Approves the control process. • Establishes Treasury Risk Management Committee (TRMC) as a committee of the Board. • Reviews the TRMC's recommendations on treasury policy, strategy and performance. • Approves any significant or material changes to treasury policy and strategy.
Treasury Risk Management Committee (TRMC)	• Oversees compliance with policy and procedures. • Establishes measures and reviews treasury performance. • Establishes and reviews annual treasury budget. • Approves changes to policy and strategy that do not require Board approval.
Finance Director or Chief Financial Officer	• Responsible for management of treasury and finance departments. • Approves treasury strategy and any changes that do not require Board or TRMC approval. • Reports to TRMC and Board on treasury activities and performance.
Treasurer	• Manages the treasury function. • Implements policy through detailed operating procedures. • Develops policy and control procedures. • Documents compliance and performance through reports to the Finance Director, the TRMC and Board of Directors. • Approves treasury initiatives and transactions within level of authority.

Of course there may be variations on this but essentially treasury must have objectives and policies and strategies which derive from the overall strategy of the firm. Company policy and

strategy must be reflected in how the treasury is managed and if we view the business problem as:

- what to invest in
- how to finance those investments
- how to manage the risks arising

Then treasury needs policies in financing and risk and these can probably best be phrased in terms of a risk management framework.

Treasury's job can also be seen as to:

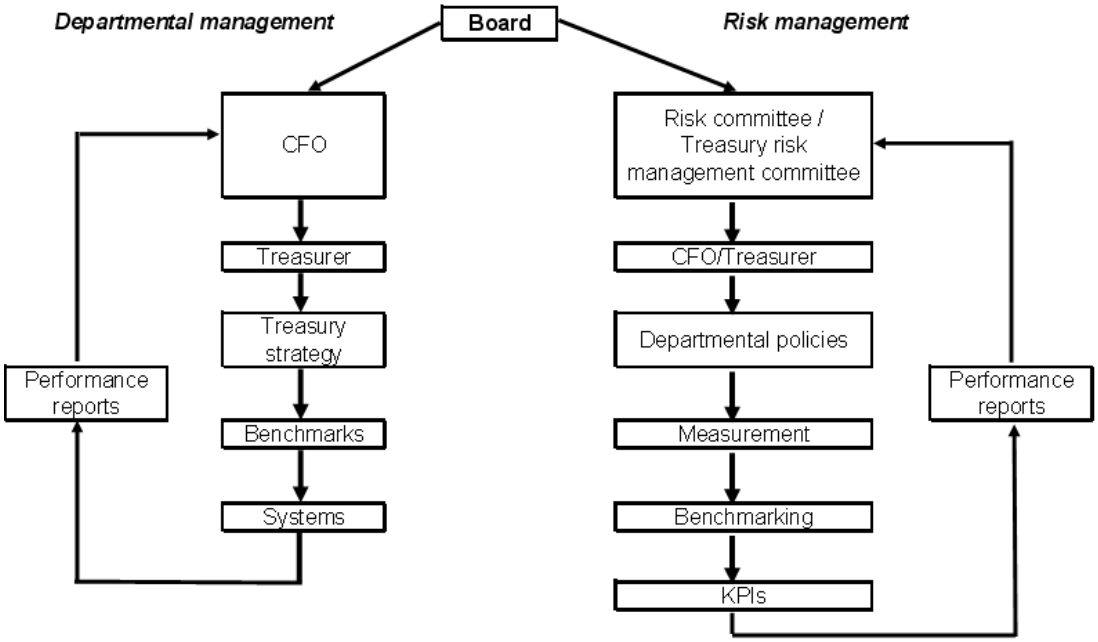
- Facilitate growth by ensuring that adequate funds are always available to support it.
- Protect the return on financial assets, and provide the finance to enable commercial
- activities to make their expected returns.
- Ensure that the firm's financial risk profile conforms with board policy / shareholder expectations.
- Match the timescale of treasury decisions to business activities.

2 Treasury and risk policy

Some or all of the company's policies will have implications for treasury – either explicit or implicit, and treasury must then maintain their own policies to meet the company policy. Many treasury policies will require co-operation with other departments and a prime example is the foreign exchange risk policy from risks arising in trading where strong liaison with sales, marketing and procurement are required.

The specifically financial nature of the treasury involvement in risk means that treasury is often managed according to the process shown in Exhibit 2. It shows how the CFO, to whom the treasurer normally reports, fits into this process. The issues surrounding risk management, as part of the overall risk policy, are dealt with principally by committee, whereas issues of managing the department, such as human resources aspects and capital expenditure, are dealt with by the CFO. Whatever the structure, however, it should be clear that treasury must not be managed in a silo; it must be a full part of the firm.

Exhibit 2: Treasury policy process



Company and financial policy in an organisation should define expectations about growth, return, risk, and timescale, and the board will expect treasury to support these plans. If we look at the five core elements of treasury we can see how to create a 'risk register' for treasury where treasury can support the objectives of the firm. This then allows treasury to tackle its job by being a risk manager. This approach is tackled in Exhibit 3 and shows how these five core elements of treasury relate to growth and return criteria, and to the "classic" treasury risks.

Exhibit 3: The five core elements[1] of treasury, growth, return and risks

Core element	Growth	Return	Treasury risk
Capital markets and funding	Assured access to bank and capital markets may be required to finance growth plans or refinance existing debt.	Cost of finance should be minimised.	• Liquidity risk • Refinancing risk
Cash and liquidity management	Cash must be available wherever in the world it is required, while minimising use of capital markets.	Cash invested must earn market return.	• Liquidity risk • Counterparty risk
Corporate financial management	Capital structure must support	Cost of capital to be minimised.	• Currency risk (translation) • Interest rate risk

[1] Also reflected in the ACT Competency Framework

Core element	Growth	Return	Treasury risk
	growth plans sustainably.		
Treasury operations and controls	Trading operations to be supported.	Treasury operations to be tightly controlled.	• Fraud risk • Operational risk • Business Continuity risk
Risk management	Risk to be taken where rewards are to be found. Unrewarded risks to be minimised.	Returns from operations to be protected.	• Currency risk • Commodity risk • Interest rate risk • Counterparty risk

3 Example risk policies

Using the structure for a risk policy that we have seen from the readings on risk management, we will look in detail at two example policies to deal with two of the risks seen in Exhibit 3; both of which should lie at the core of treasury responsibilities.

Risk	Description	Comment
Liquidity risk	This is a risk that faces every firm	This is a risk which is not tradable and really only has downside risk
Pre-transaction currency risk	This is a risk that firms face when issuing price lists or submitting bids for capital type projects. It involves liaison between treasury and operations	This is a tradable risk and so can have upside as well as downside

3.1 Liquidity risk policy example

As a reprise on the nature of liquidity risk, it arises from three broad sources:

Source	Description	Policy response possibilities
Risk that organisation cannot be funded as a whole	This risk threatens the future of the organisation as failure will lead to insolvency as liabilities go unpaid.	• Funding diversity • Limit funding from one source • Headroom minima • Refinance limits in any one period • Rating targets and consequent financial ratio targets • Competitor reviews • Bank relationship strategy • Investor relationship strategy • Permitted instruments • Documentation strategy • Working capital strategy

Source	Description	Policy response possibilities
Risk on invested cash resources	The risk that cash or similar non business investments cannot be realised as cash to make business investments.	• Permitted instruments • Permitted counterparties • Limits on counterparties • Limits in jurisdictions
Risk that individual countries or subsidiaries have either excess cash or cannot easily be funded	This risk drives the cash management process design and incorporates approaches to countries where, for example, exchange controls make common techniques difficult to use.	• Cash forecasting • Subsidiary capitalisation policy • Intragroup loan policy • Country review policy • Intragroup settlement policy

We will now take overall funding risk and see how a policy to manage this risk might be constructed in an organisation which is quite large. Of course this is a part of the financial strategy. We will use a standard policy format to construct the ERM approach to this risk (as the board might see it). Example 1 shows the Company (i.e. Board) level policy response and Example 2 shows the detailed treasury policy:

Example 1: Company liquidity risk policy (dealing with overall funding risk)
Policy name: Group funding policy.

Policy objective: This policy is designed to ensure that the group can always be funded to meet its obligations and growth plans.

Policy direction: The Group seeks to maintain access to banking and capital markets by targeting a specific credit rating and by limiting exposure to key financing issues. Departure from policy allowed only if plan allows recovery within 2 years.

Risk measurement:
- credit ratings
- financial ratios
- refinancing limits
- headroom forecast
- competitor reviews.

Benchmarking
- credit rating, + ratios of: Net debt / EBITDA; EBITDA / Interest; Free cash flow / Net debt
- % of debt maturing in any 12 month period
- headroom minimum
- minimum of three types of finance.

Responsibility/oversight: Board

Procedures: CFO and Group Treasurer to control all issues including debt investor relationships.

Decision making: Major financings to be approved by the board. Investor relationship strategy to be responsibility of CFO / Group Treasurer.

Policy key performance indicators (KPI) reporting/feedback: Monthly report on all benchmarks and forecasts of benchmarks. 6 monthly report on investor relationships and competitors.

Continuous improvement: Annual board review.

Example 2: Treasury liquidity risk policy (dealing with overall funding risk)
Policy name: Group funding policy.

Policy objective: This policy is designed to ensure that the group can always be funded to meet its obligations and growth plans.

Policy direction: The Group seeks to maintain access to banking and capital markets by targeting a specific credit rating and by limiting exposure to key financing issues. Departure from policy allowed only if plan allows recovery within 2 years.

Risk measurement
- credit ratings
- financial ratios
- refinancing limits
- headroom forecast
- competitor reviews

Benchmarking
- Credit rating, + ratios of: Net debt / EBITDA; EBITDA / Interest; Free cash flow / Net debt
- % of debt maturing in any 12 month period
- headroom minimum over two year forecast period
- minimum of three types of finance.

Responsibility/oversight: Group Treasurer

Procedures:
- Group model to be kept up to date for 2 year rolling forecast to assess all ratios and headroom
- Rating agencies to be given updated model every 6 months
- Competitor review every 6 months
- Market report of instruments every 6 months
- Capital market presentation every 6 months

- Financing plan for next 2 years refreshed every 6 months
- Bank relationship group to be established and policy reviewed every 6 months
- CFO and Group Treasurer to control all issues including debt investor relationships

Decision making: CFO to approve bank relationship strategy. Major financings to be approved by the board.

Policy key performance indicators (KPI) reporting/feedback: Credit rating and associated reports

Continuous improvement: Annual board review.

3.2 Currency risk policy example

As a reprise on the nature of currency we recognise that currency risk arises from four broad sources:

Source	Trading / ownership	Description	Policy response possibilities
Transaction risk	Trading	The risk of exchange rate movements affecting the value of items transacted in a foreign currency and which have been contracted but not yet paid or received and converted to domestic currency. They are on balance sheet items and include exports, imports, intercompany loans, interest, charges and dividends.	• Hedging policy - Hedge beyond certain risk limits
Pre-transaction risk	Trading	The risk of exchange rate movements on cash flows generated by transactions not yet contracted but probable or possible, e.g. exports sold on a foreign currency price list set in advance for, say, six or twelve months; contract tender price quote which has a foreign currency element.	• Pricing policy - Review competitors - Pass risk to customers or suppliers • Price list review frequency - Review competitors • Tender policy - Hedge beyond certain risk limits - Limit quotes outstanding
Strategic risk	Trading	The impact on competitiveness of	• Move major cost locations

		exchange rate movements which do not reflect relative changes in operating cost inflation, e.g. competition from imports which become relatively cheaper than domestic product.	• Switch supplier base • Match revenue and expenditure by currency • Seek new markets • Sell businesses to reduce issue • Buy businesses to reduce issue
Translation risk	Ownership	The impact of exchange rate movements on the translation of overseas subsidiary accounts, e.g. impact on balance sheet ratios such as gearing and net worth which may lead to a breach in loan covenants; impact on profit and loss ratios such as interest cover. This can extend to the risk of cash flow by currency to debt by currency.	• Protect book gearing • Protect book net worth • Maintain Net Debt / EBITDA ratio by currency • Maintain interest cover by currency (in each case depending on covenant pressure or earnings pressure)

Note that these risks allow gains to be made as well as losses and this might influence policy responses. This opportunity exists where the risks are tradable.

We will now take one aspect of the above risks, pre transaction risk, and see how a policy to manage it might be constructed in an organisation which is quite large and where the risk is important, perhaps a company selling major capital goods where tenders for contracts (i.e. competitive pricing) are common for its products. We will use the standard policy format to construct a board level policy response and the detailed treasury policy.

Example 3: Board pre transaction currency risk management policy
Policy name: Pre transaction currency risk management policy

Policy objective: This policy is designed to ensure that the group is not heavily exposed where a price for product has been committed to (by price list or quotation) prior to commitment by the customer.

Policy direction: The Group seeks to maintain competitiveness in quoting and offering customers choice, while protecting margin so that the risk on all quotes does not exceed USD X million in total or USD Y million on 95% VAR basis over the life of quotes, taking

100% of forecast exposure under price lists and all quotes where chance of win exceeds 50%.

Risk measurement
- unhedged price lists and forecast take up of quotes
- quotes outstanding
- quotes under preparation
- VaR
- competitor reviews

Benchmarking: Exchange rates

Responsibility/oversight: Board

Procedures: Head of Sales and Group Treasurer to control all issues.

Decision making: Quoting basis faces veto by Head of Sales and Group Treasurer, moderated by CFO. Market coverage allowed, any cost and benefit to be born 75% Sales, 25% Treasury

Policy key performance indicators (KPI)
- quotes outstanding unhedged less than X million
- VaR under assumptions less than Y million
- quotes under preparation

Reporting/feedback: Weekly report on KPI

Continuous improvement: Annual board review

Example 4: Treasury pre transaction currency risk policy
Policy name: Pre transaction currency risk policy

Policy objective: This policy is designed to ensure that the group is not heavily exposed on issue where a price for product has been committed to (by price list or quotation) prior to commitment by the customer.

Policy direction: The Group seeks to maintain competitiveness in quoting and offering customers choice, while protecting margin so that the risk on all quotes does not exceed USD X million in total or USD Y million on 95% VAR basis over the life of quotes, taking 100% of forecast exposure under price lists and all quotes where chance of win exceeds 50%.

Risk measurement
- unhedged price lists and forecast take up of quotes
- quotes outstanding
- quotes under preparation
- VaR

- competitor reviews

Benchmarking: Exchange rates, volatility, currency correlations

Responsibility/oversight: Head of Sales and Group Treasurer to control all issues.

Procedures:
Head of Sales to produce:
- price list forecast take up
- quotes outstanding
- quotes under preparation
- currency costings
- competitor review

Group Treasurer to produce:
- exchange rates, volatilities and correlations
- hedge performance

Decision making: Head of Sales and Group Treasurer, with vetoes, to decide: hedging of outstanding price lists and quotes; price for future quotes.

Policy key performance indicators (KPI)
- quotes outstanding and under preparation
- VaR
- Hedge performance

Reporting/feedback: Weekly report on KPI

Continuous improvement: Annual board review

Currency risk management shows clearly the need for the treasury to stay close to the business in order to understand how the business generates financial risk, and conversely how financial risk management affects the business. As importantly, it must educate the business about how commercial decisions generate financial risk.