Toxic positions

TREASURY PROFESSIONALS SOMETIMES FIND THEMSELVES IN THE UNDESIRABLE ROLE OF SURGEON FOR UNWANTED, UNNEEDED AND PERHAPS ILL-ADVISED HEDGING POSITIONS. SCOTT RAEBURN SUGGESTS SOME REMEDIES

Financial assets that are worth either less than was originally paid for them, or less than the value they were expected to attain, are an unfortunate fact of life. Often it's not a case of one asset, but a portfolio of positions to be dealt with.

They can be referred to in polite company as legacy assets. For internal meetings we can be a little more direct and use a term like toxic positions. At home they are "that stinking mess that landed on my desk because nobody else wants to touch it".

They come from a variety of sources; some are generated for good reasons, such as planned long-term investments or hedging that was reasonably expected to be needed, or bundled in with an acquisition. Others come from not-so-good reasons like unauthorised, speculative (rogue) trading or even just errors. The cause, however, is just a historic detail and playing 'could have, should have, would have' will not make the situation go away.

Sorting out this kind of problem often falls to treasury, either because that's where the situation was created in the first place, or because treasury is deemed to have greater expertise in dealing with financial asset positions.

There are four broad strategies that can be taken: sit and wait, clear-cut, controlled disposal or trade out.

But that's jumping ahead. Like a doctor with a patient, you have two principal tasks to perform: diagnosis and treatment selection. And they have to occur in that order.

Questions to assess:

- What assets are involved – forward contracts, options, rate swaps, shares, cash balances in devalued currency?
- How much value is involved? Not just the asset's spot value, but what it is currently showing at in the accounts or declarations to third parties – a now impaired nominal value?
- What are implications and constraints on different courses of action that we know about?
- Who else knows, or needs to know, about the situation? Do we need further technical support, funding or authority to deal with the situation? Does the CFO or bank need to

be advised? Is there a legal issue as well?

- When does a solution actually need to be in place? End of the day, month or year? When will any relevant cash flows or valuation impacts occur if no other action is taken? Options obviously time out; forwards need to be either settled or rolled; currency account balances or share positions don't in themselves have time constraints.
- Where within the business are the problem assets held? Are they within a central unit, or distributed within one or more areas of the actual business?

With a full assessment of the situation we can begin to see clearly what is actually there. Using timelines for when the fixed cash flows will occur for the different business units involved, we can draw a 'pain map' to identify what challenges lie ahead. Remember to include a bubble on the end of the timeline for cash flows that don't have a fixed date, such as selling shares you want to clear out, but don't have to. This would be the 'evil twin' of the business's normal cash-flow plan; combining the two would give early warnings of any liquidity shortfalls. As the medical profession puts it so well: 'first do no harm'.

Listing the various items to deal with, if it's a portfolio of problems, gives better granularity when it comes to selecting an appropriate treatment for each issue – they won't all necessarily be best handled in the same way.

A final couple of things to consider before beginning the actual clear-up: firstly, are there similar problem positions out there that would be best dealt with at the same time? An amnesty period to get other issues on the table and sorted out before they become bigger problems might be a good idea, depending on the original cause of issue. Secondly, how the matter is being discussed internally might need to be addressed, especially if you need support for some of the required actions when people are worried about reputational damage from being associated with a train wreck, even if they're not responsible. Clearly labelling a clean-up and recovery situation as such might be embarrassing, but means it can be honestly treated as the necessary housekeeping operation that it is.

The treatment strategies each have strengths and weaknesses. The best one depends on the type of problem in relation to the business situation. And more than one can be used. As detailed in the box above, sometimes there is a silver lining.

The treatment strategies are as follows:

Sit and wait

Doing nothing is always a possibility, and might be better than rushing into action simply for the sake of doing so. This approach is especially appropriate if a cool and calm assessment indicates that the current situation can't really deteriorate any further. A bought option position that is no longer needed and out of the money might not even be worth the effort of selling. Wait and let it time out and just book the premium.

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MAKING THE BEST OF IT

Sometimes there are opportunities in adversity – be ready to find them.

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Plan for a possible situation where some elements within a problem portfolio of assets can actually be released at profit (either when initially assessed or due to developing market situation, this will need monitoring). Optional loss date – talk to your tax professionals about when would be the best timing to realise a loss.

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For issues already embedded in business, for instance liquidity impact from rolling a hedge at a really bad rate that the market has since partly recovered from, this might actually be worse than the current close-out... so a clean-up would at least look like an improvement.

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Warning signs – does this relatively minor problem indicate there is something bigger and more serious out there? Catching it early might avoid it growing, or at least allow more time to find a solution.

However, in other cases inaction could be a really bad idea, for example, where somebody has written an option that should be covered at noticeable cost, rather than "gambling on survival" that it doesn't become a catastrophic loss.

Clear-cut

Simply shutting down all the problem positions immediately and walking away. The upfront financial pain is potentially highest, but if it's affordable, this approach allows a rapid return to concentrating on the real activity of the business. When there are multiple small hits to take, this might be the best option, rather than tying up a lot of time and effort for marginal savings.

Controlled disposal

Clearing positions on a preplanned timetable allows some more control as to when losses are realised, though that might mean the value impacts are less predictable. If it is to be effective, it requires accurate cash-flow estimates of both the problem assets and business. Otherwise it amounts to merely hoping the rest of the business can generate enough to cover the loss from closing out positions.

Trade out

Treating the assets as an active trading portfolio, regardless of original intent, and releasing parts of them as and when the market moves to predetermined target levels. This gives more control over the value of impacts depending on the close-out levels selected, to limit loss or even generate a profit, but does so by giving up control of timing. When cash is limited, and the asset's nature doesn't dictate imminent cash flows, this method of clearing out the problems as and when they can be afforded might effectively be the only choice.

In summary: an accurate objective assessment of the situation and clear plan of how to deal with the challenges of toxic positions should help nurse your firm's finances back to health. Of course, if everyone had taken that approach in the first place there might not have been an issue to begin with. Time for some preventative medicine?

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