Financial Markets Books

Treasury Services

IN COMPLIANCE WITH THE ESMA GUIDELINES

Treasury

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Introduction

All organisations have incoming and outgoing cash flows. Managing these cash flows is the core task of the treasury department. The treasury department is responsible for ensuring that an organisation has sufficient financial resources to operate at all times and for optimising interest earnings on any liquidity surpluses. That sounds simple enough. And it would be simple if an organisation's cash flows were entirely predictable. If that were so, a treasurer would be able to determine exactly when and for how long money would have to be borrowed or invested.

Reality, however, is less straightforward. Cash flows are notoriously unpredictable, both in terms of timing and volume. The sales and purchases of companies, for instance, can never be forecast with 100% certainty. But even if that were possible, there might be other uncertainties, such as fluctuations in exchange rates (when operating in international markets) or commodity prices (if these have not been fixed in advance). They will expose a company to FX risk and commodity price risk. Finally, virtually all organisations run interest rate risk because interest payments on their loans in the near and distant future are uncertain. A treasurer's second core task, therefore, is to manage these financial risks.

1 Treasury responsibilities

The treasury department within an organisation is responsible for managing the company's cash flows and account balances, and for managing the associated financial risks. The principal financial risks are liquidity risk, interest rate risk, FX risk and commodity price risk.

1.1 Cash & liquidity management

All companies hold one or more current accounts at one or more banks. The treasury department is responsible for ensuring that the company always has sufficient financial resources to make the required outgoing payments. This is known as liquidity management.

If the company has a liquidity shortage, the treasurer is expected to raise capital to cover the shortfall. Conversely, if the company has a temporary cash surplus, the treasurer is expected to invest these funds or put them on or deposit to earn the best possible return. Alternatively, in the case of a shortfall in one particular currency, the treasurer can also check whether a surplus in another currency would be available to temporarily fill the gap. This is referred to as cross-currency liquidity management.

Treasury is also responsible for the net interest income on the current accounts. This is called cash management. Companies usually receive little or no interest on a credit balance, but are charged a high interest rate on a debit balance. So it obviously does not make sense to keep a credit balance on one account and a debit balance on another. Treasury will, therefore, transfer money from the credit account to the debit account to reduce the debit balance to zero. The difference between liquidity management and cash management is that liquidity management focuses on managing the total of all balances in a specific currency, while cash management aims to ensure the best possible distribution of this balance across the different accounts.

1.2 Interest rate risk management

For companies, interest rate risk usually stems from the fact that some of their loans carry an interest rate that is reviewed from time to time, for instance every three or six months. This is referred to as a floating rate. The drawback of a floating rate is that the

company runs interest rate risk. If the interest rate rises, the company's interest costs go up as well. The advantage, of course, is that the company benefits when the interest rate decreases. Treasury is responsible for measuring and managing the company's interest rate risk. If this risk is too high, it is expected to use financial instruments to fix or set a maximum limit on the interest costs. Interest rate swaps are used to fix the interest rate, while a cap is used to set a maximum limit.

Pension funds and life insurers, also referred to as institutional investors, recognise the fair value of all their future benefit payment obligations on the liabilities side of the balance sheet. This fair value is calculated as the sum of the present values of all future expected benefit payments. The asset side of the balance sheet is used to recognise items in which the pension fund or life insurer has invested the contributions and premiums: equities, property and fixed-income securities, such as bonds. Bonds give rise to future incoming cash flows: coupon (i.e. interest) payments and repayments of principal. The fair value of the bonds corresponds to the sum of the present values of the cash flows that they generate.

For pension funds and life insurers, interest rate risk arises from the fact that investments on the asset side are less sensitive to changes in interest rates than future benefit payment obligations on the liabilities side, one reason being that only some of the pension contributions and insurance premiums have been invested in fixed-income securities, which makes them sensitive to fluctuations in interest rates. The rest has been invested in equities and property. These asset classes are less sensitive to interest rate movements, if at all. On the other hand, fixed-income securities will always have a shorter maturity than the future benefit payment obligations of institutional investors.

The assets of institutional investors are therefore less sensitive to fluctuations in interest rates than liabilities: the longer the maturity, the more the present value of future cash flows will drop due to an increase in interest rates. By contrast, as interest rates fall, the value of the fixed-income securities rises. That may seem like good news, but the

downside is that the value of the obligations will increase even more, and that is bad news.

The capital of institutional investors will decrease as a result of a decrease in interest rates; so they too are exposed to interest rate risk. It is the treasurer's task to keep the interest rate-related fluctuations in the institutional investor's capital within set limits. These limits are set by an Asset & Liability Management (ALM) Committee. In practice, the treasurer of an institutional investor is expected to lengthen the maturities of the assets and shorten the maturities of the liabilities to reduce interest rate risk. This is usually done by transacting interest rate swaps and bond futures.

As for banks, both the asset and liabilities sides of the balance sheet consist almost entirely of interest rate-sensitive items. The items on the asset side (usually loans) have a longer maturity than the liabilities (deposits and bonds). Basically, the interest rate risk profile of banks is a mirror image of that of pension funds and life insurers.

So an increase in interest rates is bad news for banks. At banks, too, the treasurer's task is to keep the interest rate risk within the limits set by an ALM Committee, which is usually called the Asset & Liability Committee (ALCO). In practice, the treasurer of a bank is expected to shorten the maturities of the assets and lengthen the maturities of the liabilities. This is usually brought about by transacting interest rate swaps.

1.3 FX risk management

Many companies import or export goods and/or services. If these are billed in a foreign currency, the company's costs and income as expressed in its own functional currency can be adversely affected by fluctuations in exchange rates. This is referred to as transaction risk.

In addition, some companies have foreign subsidiaries. The parent company is required

to report the value of its subsidiaries in euros every year. If the exchange rate of the foreign currency has decreased, the value of the subsidiary will fall in euro terms and so will the parent's capital. This risk is referred to as translation risk. Added to this, any profit which the subsidiary generates and transfers to the parent company will usually be denominated in the foreign currency. As a result, apart from the translation risk the parent company also runs a transaction risk.

Treasury is responsible for measuring the extent of the company's FX risk. If this risk is too high, it is expected to transact certain financial instruments, such as a FX forward or an FX option, to reduce the exposure.

If pension funds or life insurers have invested some contributions/premiums in countries with a different currency, they are also exposed to translation risk. If the exchange rates of the investment currencies fall, so will the value of these foreign investments in euro terms. The treasurers of pension funds or life insurers will also use FX forwards or FX options to hedge this risk.

Banks, for their part, hardly engage in importing and exporting activities. Their only real FX risk relates to their foreign subsidiaries. Moreover, banks that extend loans in foreign currencies generally raise funding in that same foreign currency for this purpose. The foreign currency asset item, therefore, is exactly matched with a liability item in the same foreign currency.

Alongside translation risk, banks and pension funds also run transaction risk because income from subsidiaries/investments is often also denominated in a foreign currency.

1.4 Management of commodity price risk

Many companies use energy carriers and commodities in their business processes. Production companies, for instance, use fuel and raw materials such as steel, transport companies and airlines are major consumers of fuel, and flour processing plants use

energy carriers as well as vast quantities of wheat and other grains. The prices of commodities fluctuate strongly in the world markets, often even more so than exchange rates. These price movements can have an adverse impact on the financial performance of companies. This risk is referred to as commodity price risk. Fuels, raw materials and agricultural products are collectively known as commodities. Treasurers can hedge the price risk of commodities through commodity derivatives.

2 Treasury management policy

Most organisations have drawn up a Treasury Management Policy. This Treasury Management Policy is a document that formalises all aspects of the company's treasury function.

2.1 The goal of the treasury department

The first aspect that needs to be addressed in the Treasury Management Policy are the goals of the treasury department. Most treasury departments are cost centres. The purpose of the treasury department is then defined as limiting the company's financial risks and achieving the best possible interest income without running extra risk. This purpose applies to the treasury departments of all not-for-profit organisations such as public authorities and housing associations. Most commercial companies actually also adhere to this purpose for their treasury department.

Some, however, see their treasury department as a profit centre. They do not just seek to generate a profit from their production or trading activities, but also from speculative trading in the financial markets. Some large treasury departments even have their own dealing room where traders, for instance, actively buy and sell currencies with a view to benefiting from exchange rate movements.

2.2 Risk hedging policy

If a treasury department is a cost centre, then the Treasury Management Policy sets out how the identified financial risks are to be managed. The most cautious strategy would be to mitigate all identified risks. Sometimes, however, the Treasury Management Policy allows for selective risk hedging. The treasury department then determines whether the risks need to be hedged based on its own assessment of the development of prices and rates on the financial markets.

If the treasury department is a cost centre, then its role is restricted to conducting transactions that will reduce actually identified financial risks.

Organisations that use derivatives to hedge their risks must ensure that the scope of the derivatives contract matches the scope of their risk exposure. If the risk decreases or disappears entirely, there is an over-hedge, as a result of which the derivative that is used to hedge the risk will take on a partially speculative character. The organisation then runs the risk that the value of the derivative may fall sharply during its remaining maturity resulting in a loss. To prevent this, the scope of the hedge must be adjusted to the new situation as soon as an over-hedge has been identified.

If the organisation has purchased options to hedge its risk, on the other hand, it will never run the risk of entering into a speculative position. The option premium, after all, has already been paid and the option's value will not drop below zero during the remaining maturity. The situation is different with written options. They carry a greater risk and are not necessarily suitable for a hedging strategy.

2.3 List of approved instruments

The next aspect in the Treasury Management Policy involves drawing up a list of financial instruments which the treasury department is permitted to use for its activities. When an organisation is faced with financial risks, the use of derivatives is almost

unavoidable. These days, therefore, nearly all organisations are permitted to use derivatives. But derivatives come in many different shapes and sizes. Some, such as a FX forward or an interest rate swap, are easy to understand, but others can be extremely complex. Complex instruments should not be on the list of approved instruments unless the company has a professional treasury department. We would note that even simple derivatives can lead to severe losses – often due to lack of expertise or greed.

2.4 List of approved counterparties

As well as a list of approved instruments, the Treasury Management Policy usually also contains a list of parties which the treasury department is allowed to do business with. In financial jargon, these are called counterparties. Earlier, banks were included in such lists without too many questions asked, but since the credit crunch and, for instance, the Iceland banking crisis, non-banks have become increasingly aware that banks are not by definition super-creditworthy. A counterparty limit is, therefore, set for every approved counterparty. This limit is the maximum amount for which the treasury department can enter into transactions with this party. Counterparty limits place a ceiling on the credit risk. Multinationals often conduct extremely large transactions with more than one bank because the scale of the transaction exceeds the limits for the individual banks.

Most derivatives are conducted over-the-counter (otc), meaning that they take place outside of an exchange with a bank acting as counterparty. This applies to, for instance, forex forwards, interest rate swaps and commodity futures. Over-the-counter contracts give rise to a counterparty risk; if the bank acting as a counterparty fails and the derivatives contract is dissolved as a result, an organisation can lose money. This was what happened when Lehman Brothers went under. For this reason, otc derivatives transactions are subject to a counterparty limit as well.

2.5 Supervision

Finally, the Treasury Management Policy must describe the set-up and control structure of the treasury department. First of all, the responsibilities of the various sub-departments must be formalised. Treasury departments of large companies often have a separate front office and back office. The front office's role is to conduct the transactions, whereas the back office is mainly responsible for confirming the transactions with the counterparty and sending payment instructions. This segregation of duties is essential. If these duties are not segregated properly, an ill-intentioned individual who has both transaction and payment authority can make themselves the beneficiary of a transaction. And if the dealer is also authorised to send confirmations, there is the risk that they will hide these to prevent the transaction from being recorded in the books. This is what went wrong at Barings.

An authorisation list must be drawn up to show who is responsible for what. This list would have to include the authority to make outgoing payments or to conduct certain financial transactions. This authorisation list must also be sent to the bank so that the contact persons there know who they are allowed to do business with. If the company uses an auto-dealing system to conduct transactions directly with the bank, all required technical safeguards and restrictions must be in place to ensure strict segregation of duties and prevent non-compliance.

The Treasury Management Policy also specifies who is responsible for the supervision of the treasury department and how the treasurer is expected to report on the policy pursued. The supervision is often entrusted to the Executive Board or a special Supervisory Committee such as the ALM department. One important condition is that the appointed supervisors must have sufficient financial expertise to understand the highly specialised nature of the treasury activities. Unfortunately, this is not always the case.