TREASURY AND RISK MANAGEMENT

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Introduction:-

The last few years have seen treasury management evolving from a supportive and secondary financial function in most organisations to a central and primary decision making concern. Identifying, measuring and managing the risk exposure faced, designing and putting into place appropriate risk management systems and modifying them in the light of changing external conditions and internal requirements has become a core financial activity and in many cases a strategic tool for survival and competitiveness.

Treasury practices are changing as corporations become increasingly focused on optimizing resource use in all departments- including the finance function. The treasurer's job function and strategic responsibilities are also changing. An important shift is underway that implies far-reaching changes to both treasury and the role of the treasurer with the common denominator being a shift towards value creation. Treasury at leading edge corporations are evolving into strategists and "service assembles" for a much wider range of functions.

Treasury is no longer just about cash management. It encompasses investor relations, credit terms, stock control, forex, assets, short term assets and liquidity management. This means adopting a more "commercial" and less hands-off administrative role in handling inventory, supplier's stocks, and assessing general business conditions.

The adoption of a through treasury policy can be an invaluable aid to the day-to-day running of an organisation. By spelling out the roles and responsibilities of the team and defining future framework and requirements, the good ship treasury will be far better equipped to navigate the treacherous waters of global cash management.

- ***Treasury Exposure:-***

  A treasury exposure can be defined as the potential impact on an entity's cash flow, of changes in the financial price or the value of an asset or a liability. Treasury risk is the degree to which the value or cost of exchange rate and interest rate commitments can vary and thus ultimately impact a firm's cash flow. Thus treasury management in essence involves the identification of an exposure before attempting to manage it.

- ***Corporate Risks:-***

  Companies are concerned with a wide variety of risks. Risk can be defined in two ways- transferable and non-transferable.

  - ***Transferable Risks:-***

    Transferable risks are those which can be hedged with risk management products i.e. it is possible to export transferable risk out of the firm. An example of a transferable risk is a foreign exchange exposure which can be hedged by fixing a rate with a bank at which a future transaction will go through and in effect transferring the risk from company to the bank. The company's treasury policy will generally dictate how much risk it wants to pass on and how much it wants to retain.

- ***Non-Transferable Risks:-***

Non-transferable risks are business risks which must be borne by the company. For this reason it is important that the firm has a distinctive competence in the relevant areas. For example, a pharmaceutical company's non-transferable risks would include the prospect that a competitor's research developments might make their product outdated.

Treasury risk exposures that are transferable can be defined in terms of those risks which are ***committed*** and those which are ***uncommitted***.

➢ ***Committed:-***

Committed or transaction exposures are those foreign exchange or interest rate risks to which the firm is revocably committed. These will include firmly negotiated sales and purchase contracts and other committed financial flows such as interest payments, dividend payments and tax payments.

➢ ***Uncommitted:-***

Uncommitted or strategic exposures are defined as those potential transactions which can be anticipated part of the firm's business. The company might not be committed to such transactions but it is probable they will occur. Such risks may include anticipated future currency inflows from sales, or currency outflows for raw material purchases. They may also include anticipated financial flows; interest payments; dividend and tax payments. Transactions such as an acquisition or capital expenditure can also be considered as uncommitted exposures. The identification of such uncommitted exposures requires a detailed analysis of business and an understanding of its future growth and development plans.

- ***Hidden Risks:-***

In addition to the type of risks already discussed, it is important to be aware of some of the less obvious risks which may arise.

- ***Balance sheet exposure:-***

In the context of treasure risk, balance sheet exposure is the potential revaluation risk when foreign currency denominated assets or liability feature on balance sheet. It represents a potential change in the balance sheet rather than an effect on the cash flow. Financial hedging of balance sheet exposure can be tax inefficient because while hedging losses are not tax allowable, hedging profits are fully taxed. The best solution may be to create a matching asset or liability on the balance sheet which, in the long term, may prove more cost efficient.

- ***Competitor exposure:-***

Competitor exposure is often ignored in the management of treasury risk. It can take different forms.

A company may compete exclusively with firms which have the same interest rate or foreign exchange risk profile. If they pursue a different hedging policy this may create a competitive advantage for them. Competitors may also have a different foreign exchange risk profiles. Exchange or interest rate movement can introduce new competitors.

It is crucial to make every effort to analyse the rivals' activities and seek to understand their risk profile as much as possible. This is an exposure element which is often overlooked. Its implications for the firm may be as important as their own foreign exchange exposures. If a firm can define its competitors exposure with some precision it may choose to include them in its statement of value at risk. If not, then it should atleast keep them in mind when designing a risk management policy.

- ***Macro-economic interest rate exposure:-***

Macro-economic interest rate exposure is defined as the sensitivity of the business to a significant movement in the general level of interest rates. If interest rate increases have an adverse impact on sales and profitability for a firm then it should consider factoring it into its value at risk. If the impact is not predictable the company may not be in a position to include it in its value at risk. If the impact is not predictable the company may not be in a position to include it in its value at risk. It should, nevertheless, be borne in mind.

- ***Some of the Priorities in Corporate Treasury:-***

  - Maintaining adequate access to liquidity
  - Improving working capital utilisation
  - Increasing overall organizational effectiveness through better funds management
  - Tightening global control and coordination
  - Balancing financial provider relationship
  - Redefining hedging strategies and processes
  - Improving operational risk controls
  - Increasing functional/systems security and recoverability

- ***Looking for a Rationale: Why Manage Risk?***

  - For all companies, active management of risks can meet two very important needs. Firstly, it can protect the enterprise from financial shocks. Secondly, it can make future cash flows more predictable.

  - For larger entities, another advantage accrues in the form of a higher market rating given to corporations with stability of cash flows- the share price impact is likely to be positive. Shareholders value the predictability and stability delivered by a risk management policy.

  - Prudential risk management also improves a company's credit worthiness and enhances its ability to borrow. Bankers do weigh in the value of well planned treasury risk management policy. By adopting a policy suited to its own unique needs a company can provide protection and security to its cash flows and also give a clear signal that the riskiness of the business will not be increased at the expense of the bankers.

- ***Time Horizon for Risk Management:-***

A currency or interest risk management decision is only for a limited period of time. Pursuing the management of risk too far into the future is to ignore the fundamental uncertainty that surrounds the business. The optimum time horizon for risk management varies from sector to sector as well as between organisations.

If new business is negotiated on the basis of individual once off contracts, the exchange rate exposure may be predominantly of a transactions nature. This will only require currency management over a short time horizon. By contrast firms in a low margin, highly competitive environment may find adverse exchange and interest rate movements fundamentally undermining and eroding their business. They need to take a much longer perspective on the management of interest and exchange rate exposures. This is vital if the firm has a long product manufacture, delivery, sales and payment cycle.

This puts the spotlight on the adaptability and flexibility of the treasury management practices of a firm which should weigh the following of factors:

- ❖ Degree of competitiveness in the market and the margin on goods sold.
- ❖ Length of product manufacture, delivery, sales and payment cycle.
- ❖ Ability of the firm to establish new product lines, new markets and new input sources.
- ❖ Behaviour of competitors in the context of risk management and the possible emergence of new competitors.
- ❖ Flexibility of the company's cost base and its adoptability in responding to changes.

The fundamental principle in defining a time horizon for risk management is simply that a company should manage its exposures sufficiently far into the future to allow itself the opportunity to adapt to adverse change in currency and/or interest rates.

- ***Quantifying Treasury Risk :-***

  - ***Value at Risk Analysis (VAR) :-***

Within the financial services arena, a risk management technique widely used by banks to assess the financial risk exposure is Value at Risk or VAR analysis. This technique is also used by many corporate treasures to assist in the formulation of their risk management procedures.

Value at risk is a statement of potential loss. It does not say that such a loss will happen but it represents the potential for loss in particular circumstances. It is based on the assumption that a degree of a volatility will occur in the future similar to that which has happened in the past. This is a benchmark which can be used to predict greater or lesser volatility in the future.

- ***Identifying Exposures:-***

The company should begin with an audit of its committed exposures as well as an analysis of its uncommitted exposures over an appropriate time horizon. After establishing the volume of the company exposures, the next step is to identify the financial risk that the company attaches to such exposures.
It is helpful for the firm to have a single figure as a measure of its risk (such as VAR), which accurately represents the potential for loss through adverse exchange/interest rate movements.

- ***Defining the acceptable level of exposure:-***

In general, firms will have greater capacity to react and adapt to adverse movements in exchange and interest rates if they time to do so. The objective of defining a limit is to ensure market movements do not adversely affect the firm in a way that might seriously threaten its viability or undermine the confidence of its customers, staff or debt and equity holders.

Such a limit is generally hard to establish. It can however be said that, in principle, over the course of a financial year, firms should not put value at risk greater then they hope to generate through the business in that time. In essence, the value at risk during the year must not exceed the anticipated net earnings over that time.

- ***Formulation of a Treasury Policy:-***

- ***Writing the Policy:-***

The formulation of a risk management policy will raise many key issues for the firm. There are no generic policies or limits. Every company's policy is a unique proposition and should be consistent with the culture of business and should be fully understood by senior management across the business.

- ***Reviewing Current Practice:-***

This will involve looking at the current role of treasury within the organisation. All aspects of treasury risk need to be reviewed and analysed to establish how they currently impact the treasury risk. It is vital that senior management recognises and embraces this wider understanding of foreign exchange and interest rate exposure. The scope of what to include will vary of course of depending on company size. Specifically the risk management policy should set objective to minimize long term strategic exposures.

- ***Draft Policy:-***

The policy document will specify the details of the controls in relation to the processes identified earlier. Each process should be detailed under the following headings:

- Definition- describes the meaning of the procedure.
- Interpretation- how much will be covered by the policy
- Responsibility- who will ensure that the policy will be followed
- Review:- this will state how often this policy will be reviewed

In larger companies the treasury policy should be more detailed. The policy should make the distinction between the Management Controls and the Operational Controls. Adherence to an appropriate control framework will significantly limit the treasury risks faced by the company and will provide protection for the Corporate Treasurer in his or her role.

- ***Review of Draft Policy, Approval and Implementation of Final Policy:-***

This step in the completion of the treasury policy is critical. Each area of the company affected by the policy will review the policy procedures relating to it. Any ambiguous aspect of the draft policy can be clarified at this stage before the final policy document is submitted to the senior management for approval. After securing the necessary approvals the final step would be to implement the policy.

- ***Annual Review:-***

The financial risk of a firm is dynamic and ever changing. The treasury risk management policy needs to be reviewed regularly to ensure it reflects these changing circumstances. It should also be subject to ongoing evaluation through the course of year.

- ***The Golden Rule: Striking the right balance:-***

To decide what treasury policy is right for a company there are three key questions that need to be addressed:

- What is the weight of financial risk as a proportion of the firm's total risk?
- What is the gap between the firm's natural financial risk profile and its desired financial risk profile?
- What is the company's expertise in financial risk management?

The greater the weight of a company's financial risk as a proportion of total risk , the greater the need to control that element of business.

- ***Conclusion:-***

- Risk limit can be relaxed as we move out in time but risk should be tightly controlled in the short term.
- Specific risk limits should be set by those who understand the details of the firm's business.
- There is merit in framing risk limits as a proportion of projected earnings. Diversified currency and interest rate exposures generate less risk than exposures denominated in a single currency.
- It should be noted that although the VAR model is the most popularly used model it is not foolproof. The model's deficiencies surface in times of major crisis or during extreme volatility. It is also dependent upon accurate initial assessment of the firm's position. Despite these limitations, the VAR model offers treasurers or finance directors the best tool for assessing their firms risk exposure.

The current business environment has raised the bar for corporate treasurers globally. Financial mangers across all industries are aggressively working to improve operations, increase efficiency and enhance control. As a result of economic and legislative pressures, the traditional dynamics of finance and treasury management have changed. Organisations are faced with budgetary and staffing constraints, as well as a heightened emphasis on controls. For these reasons, it is essential that companies make the right decisions, the first time, and do everything within their power to optimize operational performance. By choosing the right resources, developing the right approach and through proper execution, financial managers can drive initiatives that will make a significant difference to corporate earnings and control.