Defining Treasury Success

Establishing and Automating Treasury Metrics

Treasury Strategies

The Power of Experience®

How do we know when treasury is operating effectively? That is the key question many of our corporate clients are asking. They are looking for meaningful metrics that can quickly highlight how various treasury functions are performing.

This need for metrics is most urgent in times of market turmoil and economic distress, when speed, compliance and efficiency are in demand. However, it's a tremendous challenge to identify which activities should be measured, and how to quantify that activity in a meaningful way.

There is a significant opportunity right now for corporations to leverage treasury technology to automate Key Performance Indicators (KPIs), as well as compliance and performance metrics. Through our work consulting with corporations around the world, Treasury Strategies has identified three steps to take in order to establish effective KPIs:

1. Set overall objectives for the financial function and understand how treasury will support those objectives.
2. Decide on the specific operational, investment and strategic treasury activities needed to support financial objectives, and identify the factors that will determine success versus failure for each.
3. Establish processes and technology needed to execute and track these activities, as well as measure and report on progress toward achieving these objectives.

Objectives

The first step is to understand the overall financial goals of the corporation and set objectives for treasury to support those goals. To set objectives, there are several questions to ask:

- Is our objective to minimize risk?
- Is our objective to have visibility to all of your cash worldwide?
- Is our objective to reduce errors within treasury operations?
- Is our objective to streamline your banking structure?

What Should be Measured

Treasury should determine the critical activities it will manage to help achieve the previously set objectives. Now it's time to drill down within each objective to determine parameters for monitoring ongoing performance. For example, if one objective is to ensure sufficient liquidity, treasury might designate its corporate finance, investment and cash management functions as necessary to help meet that objective. Within each of those activities, treasury would define exactly what to measure to determine the extent to which treasury is helping to maximize liquidity.

Most of the activities treasury would manage to support organizational objectives fall into three basic categories:

Operational Activities

Executing and settling financial transactions such as investments, FX and debt.

Portfolio Analytics

Tracking performance of investments, foreign exchange derivatives, commodities and debt, as well as compliance with corporate and regulatory policies.

Strategic Initiatives

Managing risk or leading efforts to enhance shareholder value in ways beyond traditional treasury.

Most companies focus their metrics on operational activities, thus analytic and strategic activities are often overlooked. However, it is crucial to report meaningfully across all three categories. Strategic KPIs are more difficult to track and report. As our clients undertake these activities, they are asked for progress—sometimes it's fairly evident.

The KPIs listed below are directional illustrations. Specific KPIs for your company would be determined by industry, as well as the size and scope of treasury.

Operational KPIs

KPI	Examples
Cash Concentration Balance	• Ending balance—the objective is to get as close to zero as possible and monitor any amount remaining in the account.
Cash vs. Forecast	• Set a target amount for the maximum variance between cash and forecast.
Total Number of Bank Accounts	• One metric is 100 bank accounts per billion of revenue. But for companies with $20 billion or $30 billion in revenue, this metric may be too high.
Bank Fees	• Discus hard dollar fees and soft dollar earnings from business with the bank to ensure they all make sense on an ongoing basis
Investments	• Benchmark against a 3-month Treasury Bill or 3-month Euribor. • Track returns, both yield and interest income, against meaningful numbers. • Perform risk analysis, i.e., impact of a significant change in interest rates or the yield curve on investments.

Analytical KPIs — Foreign Exchange

<table>
<tr><th>KPI</th><th>Examples</th></tr>
<tr><td>Percentage of Exposure Hedged</td><td>
Possible % for hedges for forecasted exposures:
<table>
<tr><th>Duration</th><th>% of Exposure to Hedge</th></tr>
<tr><td>1-3 months</td><td>100% of the forecast</td></tr>
<tr><td>4-6 months</td><td>80-90%</td></tr>
<tr><td>6-12 months</td><td>70-75%</td></tr>
<tr><td>12-18 months</td><td>50%</td></tr>
</table>
Companies with longer product cycles could hedge further out (18-36 months – 25%)
</td></tr>
<tr><td>Earnings per Share Impact of Unhedged Versus Hedged</td><td>Some clients use .01 EPS impact to assess the success of their FX hedging strategy and determine whether any action is required.</td></tr>
<tr><td>Trades Competitively Bid</td><td>Two or more competitive bids from banks on FX deals.</td></tr>
<tr><td>Bank Bidding Performance</td><td>Monitor winning bank for specific currency, interest rate, and commodity transactions.
Many companies have a list of 10 banks for competitive bidding. The top three typically compete for the business. The winning bank stays at the top while the other two drop to the bottom of the list.</td></tr>
<tr><td>Hedge Performance</td><td>Do-nothing comparison — how did forward contract hedge perform vs. do-nothing or option instrument.</td></tr>
</table>

Analytical KPIs – Counterparty Risk

<table>
<tr><th>KPI</th><th>Examples</th></tr>
<tr><td>Assessing the Bank's Financial Health</td><td>

Credit rating — Lehman's A credit rating at the time of bankruptcy caused companies to implement other metrics, such as:

Credit default swap (CDS) spread < 150 basis points for 1 year CDS
Tier II Capital
Tangible common equity
Probability of default

</td></tr>
<tr><td>Percentage of Counterparty Limits Used</td><td>

Some companies set their mark-to-market derivative limits based on the credit rating to measure % used. Examples are listed below. The appropriate amount is based on volume of derivative activity.

<table>
<tr><th>Rating</th><th>Sample Limit</th></tr>
<tr><td>AAA</td><td>$20 million</td></tr>
<tr><td>AA</td><td>$10 million</td></tr>
<tr><td>A</td><td>$1 million</td></tr>
</table>

Some metrics for money market funds include:

Maximum amount in any single fund
Minimum investment in rated fund
Maximum investment in a fund as a notional amount

</td></tr>
<tr><td>Total Exposure to a Counterparty</td><td>

Total counterparty exposure limit is highly dependent on activity and asset levels. Several examples include:

AAA - < $1 Billion
AA - < $500 Million
A - < $100 Million

</td></tr>
</table>

Strategic KPIs

KPI	Examples
Long-Term Funding	• Annual funding amount required based on forecasts for capital expenditures, merger and acquisition plan, and any longer-term objectives. Existing debt capacity and facilities are also considered.
Mix of Fixed and Floating Rate Debt	• 60% fixed vs. 40% floating or 50% fixed vs. 50% floating or 40% fixed vs. 60% floating
Credit Rating	• A significant measure for accessing credit and how the market views the company.

Technology

Treasury technology tools provide the means to track and report on your treasury's performance. The technology tools you leverage can range from a full Treasury Management System to a treasury intranet, bank websites, investment and multi-bank FX portals, and data companies like Bloomberg and Reuters.

A Treasury Management System (TMS) is the primary technology used to aggregate data from banks and subsidiaries, as well as track and report on financial transactions. A TMS often facilitates visibility to cash as well as the execution of cash forecasts. TMS vendors are adding functionality to incorporate compliance to policy limits, broader counterparty reporting and greater portfolio analysis. All of this functionality is critical to enable measuring and assessing the metrics outlined above.

Treasury intranets are often used as the central hub for the company's financial policies and procedures. They are also used to share materials and communicate with colleagues in multiple locations.

Bank websites are offering far more robust functionality. Beyond checking balances, now it's possible to track intercompany loans and take advantage of working capital tools.

Treasury Strategies' market research reflects the rapid adoption of trading portals in every region. Some trading portals allow straight-through processes for confirmation and settlement activities. Many KPIs can be tracked and reported through these portals, but this functionality often goes unused.

Money market funds and providers are making great strides by adding compliance limits that are customized to your company's investment policies.

Market data companies such as Bloomberg and Reuters provide a variety of ways to obtain data. Increasingly, treasuries are turning to these sources for data imports on counterparty risk into a treasury technology platform in order to evaluate that risk.

Each of these tools provides a valuable function that, when integrated, enables automated reporting in the form of a dashboard. It's important to note that while implementing or updating technology may seem like a daunting task, it's a necessary expenditure that no company can afford to avoid.

Next Steps

How will your organization move forward? There are three steps to getting started:

1. Understand the financial organization's overall objectives.

2. Identify the activities treasury manages that are critical to the success of those organizational goals.

3. Define realistic performance expectations and parameters for each activity.

Treasury technology is necessary in order to establish the most effective tracking and reporting on the performance of these metrics. With a solid framework of processes and technology, treasury can ensure stable and reliable support.

The global economic and political crises we have experienced over the past few months and years have truly demonstrated the need for effective treasury performance and have underscored the urgency for metrics to quantify that performance. Measureable and meaningful reports that are supported and automated by an integrated technology infrastructure are the new norm. Without these resources, treasury has no means for supporting the organization and no way of telling whether its actions are advancing or deterring from the organization's critical objectives.

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