Risk Management
in the Next Generation Treasury

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Introduction

The treasury industry is changing. The scope and influence of a treasury organisation within the company are growing dramatically, and risk management is one of the primary areas of growth for treasury. As significant financial and economic risks emerge around the globe, these new risk management activities must be executed effectively. Treasury Strategies has found that the most effective strategy for managing these risks is to move treasury to what it refers to as a 'third generation environment'.

Managing Risks and Key Areas of Focus in 2012

Significant financial and economic risks have emerged around the globe. Corporate treasurers are carefully designing their tactics and strategies to ensure they deliver the greatest value to their organisations. There are a variety of significant risks that need to be on treasurers' radar screens and factored into their risk management strategies; these areas include:

- Continued uncertainty in the euro zone;
- Increasing instability in the Middle East;
- Economic concerns in China; and
- Potential for future political gridlock in the US.

The economic issues in Europe have a direct and immediate impact on currency volatility in the region. The impact of the European debt crisis has also brought into question the viability of key financial trading partners. The possibility of a euro breakup and the resulting redenomination of currencies has quickly moved from the realm of impossibility, to a real scenario for consideration. In fact, a variety of breakup scenarios have emerged – a single country exit, multi-country exit, or a full dissolution. Each has its own set of economic and financial consequences for which treasury must prepare.

The political unrest in Egypt, Libya, Jordan, Iran and many other parts of the Middle East has resulted in rising oil prices. It's unclear what the long-term effects will be, but in the short term we know oil prices directly impact the cost of services and products produced around the globe. Treasury will need to play an active role hedging commodities that face pricing fluctuations as a result of rising oil prices.

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China has long been a strong economic force in the global economy. However, this economic giant now faces financial pressures and a slowdown stemming from a real estate bubble and rising debt levels. With a major transition in China's top political leadership pending, it's unclear what actions will be taken to manage these financial concerns. This uncertainty is a major risk to corporations that have invested millions on expansion within China.

Similarly, risks are rising for those organisations that look to China for sourcing their raw materials and rely on manufacturing within the region. As the economy within China fluctuates, each of these areas may experience a ripple effect. The combined impact has a potential magnitude that elevates the importance of having effective financial visibility in China and sufficient coverage from key service providers. Such efforts are essential to maintaining effective funding, liquidity management and hedging activities.

It is an election year in the US, which means the political configuration and financial landscape will remain a question mark until November. Shortly after the 2012 elections, US political leaders will face nearly USD5tr of fiscal decisions that consist of Bush-era tax cuts and the impending enactment of automatic government spending cuts that will trigger in January 2013.

If the political parties align, fiscal decisions will be made quickly and with little impact to financial markets. If political parties are split, gridlock is likely to result and US markets and the US dollar will face material volatility.

Through consulting work with clients, Treasury Strategies has found that the most effective strategy for managing these risks is to move treasury to what it refers to as a 'third generation environment'. The moving process has already begun at many corporations with the growth and expansion of treasury's responsibilities.

Treasury's Growing Scope of Influence

New risks are emerging from unexpected places; these foreign exchange (FX), commodity and counterparty risk management issues are complex and global in nature, which has elevated their importance. They are also just a sample of the new and expanding responsibilities now being managed within treasury functions. As such, treasury's scope of influence and areas of responsibility are changing. Treasury Strategies sees this trend through its work with corporate clients, and in the market at large.

Treasury organisations are now called upon to do much more than the operational activities of a traditional treasury function. Treasury now answers to a wider array of stakeholders with a growing list of needs. External parties require more communication and a higher degree of business intelligence. Equally important are the internal stakeholders who continue to depend on treasury for operational support and now look for strategic advice as well.

Risk management is one clear example of this expanded scope of responsibility and increased sphere of influence. For example, hedging commodity risk has long been in the purview of procurement or sourcing. The long-standing practice of having procurement execute commodity hedges is no longer sufficient given that commodity volatility is as high as that of currencies. Because more treasurers are taking control of executing and accounting for commodity hedges, they are able to view financial risk in a comprehensive manner across the entire derivative portfolio. Regulatory action will continue to force this kind of systemic assessment and execution of risk management activities in the organisation.

What steps should corporations and their financial service providers take to prepare for these key risks they face in 2012 and beyond?

Evolving to Improve Risk Management and Treasury as a Whole

As mentioned previously, the corporate treasury industry is at a crossroads. The continuous improvements in technology, ongoing financial crises and emergence of new risks from unexpected places have combined to usher in a new era in the industry – the third generation of treasury.

To better understand where the industry is headed, it helps to take a step back and review where the industry has been.

The First Generation

Prior to 1970, companies borrowed almost exclusively from banks and kept ample compensating balances. Operating services were accommodations – simple and free. Exchange rates were fixed and liquidity was plentiful. The commercial paper market was just developing. Computers were not used in treasury. Calculators had just been invented. Banking was about relationships.

The Second Generation

Everything changed in the early 1970s with the collapse of the Bretton Woods agreement and the elimination of the gold standard in the United States. Exchange rates fluctuated, liquidity and compensating balances dried up, banks began charging for services and short-term investment markets blossomed. The treasury function changed radically. Financial data became available and was sometimes transformed into information. The first treasury workstations were introduced (by banks) and evolved to become critical elements of corporate treasury management. Early enterprise resource planning systems

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(ERPs) came to market, but they were not initially widely accessed by the finance function.

The Third Generation

Now in the third generation, treasury is increasingly focused on becoming the company's financial nerve centre. Information is no longer sufficient to meet the demands of external stakeholders, including regulatory bodies, investors or counterparties, or the internal demands of board members, business units or senior management. Intelligence – the strategic application of information to generate and monitor liquidity as well as mitigate risks – is required now.

We are on the cusp of this third generation, and treasury organisations that embrace this evolution will be able to effectively manage risks as well as maintain their businesses. The treasury function will serve as the financial nerve centre of the organisation – an analytic and technology hub – that provides end-to-end business intelligence and strategic advice to the company's board, business units, creditors, customers, suppliers, shareholders, rating agencies and regulators.

In the third generation, it is becoming increasingly critical for corporate treasuries (along with their providers) to adopt new approaches and tools that are now required to fully and successfully execute the role of the financial nerve centre.

Moving to the Third Generation

To manage all this change and actually achieve the third generation, treasury must ensure it has a clear understanding of the organisation's overall financial objectives in order to strategically support all of treasury's stakeholders.

Once a clear understanding is established, treasury can articulate a vision for what its future state will look like. Only with a clearly articulated vision can treasury position itself as the financial nerve centre, thus commanding resources, technology, and a seat at the table to manage risk and other strategic initiatives.

Part of that vision will include a new set of tools required by treasury to effectively manage and prepare for huge changes such as those outlined earlier regarding commodity risk, currency risk, political change and regulatory uncertainty.

The Tools Necessary to be Effective in the Third Generation

Technology is the essential ingredient to achieving the third generation. As the scope of treasury's activities grows and its sphere of influence expands, treasury must leverage technology tools in order to do it all. Data integration is essential to become the financial nerve centre capable of providing intelligence across the organisation.

Today's corporations are finding that data is trapped or siloed. Too often, treasury struggles to obtain real-time, accurate data and activity forecasts from business units. The solution is a sophisticated, yet easy to use technology system.

New reporting options (ad hoc, standard reports and digital dashboards), risk analytic functions, sophisticated hedge accounting and integrated market data allow for treasury to monitor its performance and function optimally.

A recent client story is an excellent example to illustrate the concept of a treasury that leverages technology effectively and operates as the financial nerve centre of the company. Treasury Strategies worked with a multinational client to define a treasury technology mission statement that laid out the requirements for the overall desired architecture. This vision called upon technology to maximise visibility to risk, automate compliance with policy and controls, and ensure efficient processing, accounting and reporting of treasury transactions. The client also required a scalable, low maintenance platform that would not burden IT resources, and provided a low cost of ownership. The client selected a software-as-a-service (SaaS) solution that achieved all its needs.

Finally, streamlined bank connectivity is also part of the executional component of the third generation. SWIFT for Corporates, a service whereby corporations can access the global financial network for financial messaging best represents this paradigm. More and more companies are moving toward the SWIFT platform to connect to banks and financial institutions through a single pipeline, thus eliminating a network of host-to-host legacy connections. SWIFT can support a growing number of services, which now includes reporting for balances, payment execution, trade and securities matching, payment exceptions and investigations messages and bank account administration documentation. More and more organisations are deploying SWIFT when they transform their technology architecture.

Next Steps

Continued uncertainty in the euro zone, instability in the Middle East, uncertainty in China, and potential political gridlock in the US are four significant risks to the financial operations of companies operating around the world.

To effectively manage these risks, treasury needs evolve into a financial nerve centre. The first step is for treasury to ensure it understands the organisation's overall objectives and how the financial function can strategically support all of its stakeholders. The second step is to establish a vision for the future of treasury. Finally, treasury must establish the technology tools necessary

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to enable performance of its expanded responsibilities.

The global economic and political crises we have experienced truly demonstrate the need for strategic treasury planning. As a third generation treasury operation, your treasury will be better equipped to manage risks and provide end-to-end business intelligence and strategic advice to a growing list of stakeholders now and into the future.

Mike Gallanis
As a Partner of Treasury Strategies, Michael Gallanis leads the firm's Corporate Practice Area, providing consulting support to organisations in both the public and private sectors. He helps clients strengthen their treasury infrastructure and operations so they can maintain a strong strategic presence within the organisation. His work includes treasury management diagnostic reviews, cash forecasting development and implementation, bank consolidations, collection system reviews, treasury technology, bank cost analyses and bank selection processes. Mr Gallanis received his MBA from Roosevelt University following a BS from Eastern Illinois University, US. He is a Certified Treasury Professional and Certified Public Accountant.

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Laurie McCulley is a Partner of Treasury Strategies and leads the Treasury Technology Consulting Practice. She brings a wealth of knowledge and expertise to clients from her 28 years of experience in corporate treasury and bank capital markets. She drives value for clients by combining her expertise in treasury technology with an in-depth knowledge of treasury operations. She works with clients to select, implement and optimise technology solutions. The result is a treasury function with effective policies and procedures that are supported with integrated technology systems. Ms McCulley is a Certified Treasury Professional, and she earned her BA with honours in International Relations from Pomona College and her MBA from Seattle University, US.