The 7 deadly sins of treasury

The view from the boardroom may seem fine but, warns ***Richard Allan****, many directors could be unaware of the enemy within — the company's own treasury operations.*

With corporate treasuries currently under fire from the regulators for permitting some of the excesses of the 1980s, and with major losses announced recently both in Australia and overseas stemming from treasury operations, it seems timely to focus on the reasons for the problems being faced by corporates and their boards.

This article identifies the most common mistakes open to a treasury to make. It is designed to assist directors to assess whether their own operations are committing any of the seven deadly sins of corporate treasury management.

1 Ignoring interactions

Interactions come in all shapes and sizes, with no two companies, even those in the same business, equally affected by movements in the financial markets. Many businesses have deliberately diversified to ensure that they have a portfolio of exposures and a more robust bottom line; others have the ability to pass their exposures on to other parties.

For example, if there is a major increase in the price of oil, car-owners normally get more upset than petrol retailers, for the retailers simply increase the price at the pump, passing the exposure through to the end-users.

Often companies make the mistake of divorcing their foreign-exchange hedging from their underlying business — so treasury manages the foreign exchange exposures without reference to the product being sold. This can be fatal, as offsets are often now either ignored or misunderstood. Beware the centralisation of exposure management (as distinct from the commendable centralisation of dealing and of cash management).

2 Using the "do-nothing" benchmark

A salutary tale may help to explain this issue.

Once upon a time there was a board of directors which decided to establish a treasury to manage the company's foreign-exchange exposures. The directors also decided to measure the treasurer's performance in terms of what he did — eg, comparing what hedge contracts he took out with what would have happened had he done nothing.

The treasurer decided to cover 10 per cent of his $US100m exposure, leaving 90 per cent uncovered to benefit from any strengthening of the $US. Sadly, the $US weakened.

What was the final result?

- Every hedge contract that the treasurer took out made money. As a result the board gave the treasurer a bonus.

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However —

- the company lost heavily on the unhedged 90 per cent of the exposure.

What went wrong? The treasurer had been given a bonus for presiding over a disaster — not, presumably, what the board had intended. In the reverse situation, had the treasurer turned out to be correct in his guess as to the direction of the $US, his 10 per cent cover would have lost money (while the uncovered 90 per cent benefited), and he would have been penalised accordingly.

The critical thing about benchmarks or performance measures is that they bias behaviour towards them. Thus, if the treasurer in the above case wanted to be guaranteed to hit budget, he should have done absolutely nothing — perhaps even spent the year on the golf course.

One sign of non-performing treasuries is the use of the phrase "monitor carefully" in submissions to the board. It normally guarantees reams of analysis but virtually no recommendations. It is the classic phrase of the active procrastinator.

If you really want to bias the treasurer towards doing nothing, why not retrench him now and save yourself a lot of reading time?

3 Using currency forecasts as a performance measure

At the start of every year since 1982, *The Sydney Morning Herald* and the Melbourne *Age* have published the foreign-exchange forecasts of more than 30 leading economists from financial institutions, corporations and universities. The idea was to forecast the Australian dollar/US dollar exchange rate twelve months hence. In the ten years during which this survey has been conducted, the range of these 30-or-so forecasts has included the actual end-of-year rate on only two occasions.

In fact, only once has the consensus that the Australian dollar will go either up or down been correct; they have almost invariably not even been able to pick whether the Australian dollar will appreciate or depreciate.

The reason for such an appalling performance lies in efficient market theory; in rational markets all known information is already factored into the exchange rate. This leaves only unexpected events (oil-price shocks, Gulf wars, changes in government monetary policy and the like) to affect the price. All that economists are left to estimate is the unforecastable. And yet companies often use these forecasts as the basis of budgeting or of setting performance measures for their treasuries.

Because governments often use interest rates as a policy weapon, and manipulate them for this purpose, they are slightly more predictable. But it is still no way to budget for a business.

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4 Assessment by hindsight

As with Sin No. 3, this particular sin has to do with performance measurement or the lack thereof. It is easy enough to go around after the battle bayoneting the wounded, but it is hardly good board procedure. Yet in the area of treasury management the absence of proper performance measures is one of the most common errors of omission.

Performance measures must be quantifiable, robust, identifiable in advance (or at least concurrently), be related to risk and include costs as well as benefits.

Because it is difficult to set treasury performance measures, and perhaps also because of the increased legal requirements for directors to exercise due diligence in this area, a common but somewhat draconian solution in recent times has been to reduce, or even close down, treasury operations. This is partly based on the fact that it is rare to find anyone post-auditing the "do-nothing" option. In the area of treasury operations it seems that it is better not to do the wrong thing than to actually do anything right — ie, Sin No. 2

5 Confusing end targets with intermediate targets

The worst contemporary example of this phenomenon involved practically the entire banking industry, over much of the 1980s, chasing market share and turnover — and providing incentives to their staffs on this basis. They seemed to lose sight of the fundamentals of banking and of the ultimate goal of maximising the value of the bank. The consequences were fatal in some cases and financially crippling in many, many more.

In the corporate arena there are many instances of treasuries (or boards of directors) setting intermediate targets without realising the consequences for their business as a whole.

A recent example was where interest rates fell below the (optimistically) budgeted target of 15 per cent and the company immediately locked them in for five years. Sadly, rates continued to fall — to less than 8 per cent — and the company which beat all budgeted requirements on its borrowings found itself under serious threat from its much more cost-effective competitors. In one masterstroke, treasury had overachieved on target performance and wiped out the profit margins of the underlying business.

6 Divorcing treasury from the business units

Putting any cost centre in operational control can lead to a misallocation of resources. If it is not object-driven and bottom-line-oriented (for long-run benefits) then it is highly likely to be counter-productive.

An example may help.

The treasury of a building products company decided to introduce a "sweep" system into the management of the firm's cashflows. All business units deposited funds in their local banks and the money was automatically transferred to head office. No intra-group interest payments or charges were made — after all, they were simply accounting entries.

The result was that the business units no longer had any interest in cash management, as it did not affect their reported profits. They tried to turn this to their advantage and increased credit terms with customers from seven to 30 days. Sales rocketed and large bonuses were earned.

Unfortunately for the company as a whole, working capital costs increased more than sixfold — the average collection period quadrupled and the increased volume of sales required even further injections of working capital underpinning the sales drive.

The business units made record profits while the firm overall actually lost money, as the margins on the building products were lower than the costs of funding the additional working capital.

A simple internal system rewarding good funds management and penalising bad management was then introduced. The problem vanished, as all parties now had proper incentives to manage properly.

7 Technological overkill

Million-dollar settlements systems that reduce errors from 2 per cent to 1 per cent are hardly smart investments — yet they exist. Treasury systems originally designed for banks (or by banks) are being widely marketed to corporates with operational features, reports and controls far more appropriate to financial institutions than to corporates. As a result, some reports put to boards are quite unintelligible, providing information inappropriate to the directors.

Beware, too, the outside expert. Often they have all the answers; it's just that they don't understand the problems.

Remember that a computer is simply a high-speed moron — it can make a mistake 10,000 times faster than any human. So ensure that the systems people know what the board wants as an end-product. And above all, beware a system which takes more than six months and six people to complete.

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Seven suggestions

Directors do not want to lose valuable management time (in the business itself or in court) in rectifying surprises emanating from their treasuries. Some ways to avoid this are:

Set business-related goals: Avoid the use of interest-rate or foreign-exchange forecast rates as targets. Instead, set business goals such as return on assets or margins on sales. The critical levels of interest/exchange rates will normally then become obvious.

Pre-set triggers, sunset clauses: Determine the critical financial and economic indicators for your operations and use them as an automatic warning system. For example, if interest rates rise by more than 2 per cent this may automatically trigger an agenda item at the board meeting on the company's borrowing mix (fixed/floating). Above all, avoid the danger of "monitoring carefully" without benchmarks in place.

Nest performance measures: Ensure that the board's goals are translated into appropriate goals for the finance functions. Thus if, for example, the board determines that it wants to remain exposed to its underlying product (eg, nickel, coal etc.), a policy of full cover in treasury would be inappropriate.

Commission an independent audit: It is a useful exercise occasionally to have an outsider assess the treasury operation, particularly in terms of the way its performance is measured. It is also an obvious part of the due diligence process.

Ensure business units concur with treasury goals: To reduce the risk of ignoring interactions with commodity prices, competitors' behaviour or consumers' buying patterns, business units' goals should be set before treasury's goals — and the directors of operational units should take part in the setting of these treasury targets.

Avoid endorsing the "how" instead of the "what": Do not get fooled by the glamour of financial engineering. Determine the end-results required and then, and *only* then, invite tenders for the most cost-effective solutions.

For example, what you may want is the protection of a minimum level of profitability; how you achieve this may well be through the use of financial instruments such as options.

Check for "cuckoos": Conservative companies should not have entrepreneurial treasuries. An inappropriate structure (too small or too large a treasury operation) may cripple a company. If one believes in efficient markets, then above-normal returns are likely to be generated only by taking above-normal risks. So beware of hiring a deal-maker as a risk-manager. ■

Acknowledgment is made to Mr Ronald G. L-Liesching for his article in the 1990-91 "Risk" Directory on the sins of risk management from a financial market practitioner's perspective.