

Risk Management Systems

2011

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Analysing the Possibility of Loss



Today when corporate treasurers gather together at different industry events, the question of risk

and how to protect one's business from the volatile markets quickly becomes a hot topic for discussion. All treasurers, no matter which industry they operate in, have had to cope with the sheer unpredictability of the markets.

Interestingly, even when companies are not directly impacted by commodity price volatility or foreign exchange (FX) fluctuations, the treasurer is worried about the knock-on effects.

In terms of what risk keeps corporate treasurers awake at night, those polled in the *gtnews* 2011 Treasury Risk Management Survey, identified liquidity, FX and counterparty risk as the top three risks they will face over the coming 12 months. This guide takes a closer look at each of these, and examines how treasurers can use technology and specialist resources to measure, manage, and mitigate the risks they face, and add value to the business at the same time.

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editor, a buyer's guide to risk management systems

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Reducing Risk *in a* Volatile World

In order to reduce their risk exposure, corporates have to address the volatility in the marketplace, be it foreign exchange (FX) or commodity price fluctuations, or as a result of the political and social turmoil that erupted across the Middle East earlier this year, writes **Joy Macknight**.

For the second year running, liquidity, foreign exchange (FX) and counterparty risk are the top three risks facing corporate treasurers over the next 12 months, according to the *gtnews* 2011 Treasury Risk Management Survey. Operational risk moved up to fourth place this year, and interest rate risk dropped one place to fifth position.

The survey found that top risks differ depending on where an organisation is located. For companies based in the Asia-Pacific, central and eastern Europe (CEE), and North America regions, liquidity poses the most important risk. For Latin America-based organisations, interest rate risk is paramount. Organisations located in the Middle East/Africa and western Europe reported concerns regarding FX risk above all others.

Risk concerns also vary across company size, as measured by annual revenue. The survey found that FX risk appears to be a major concern across all revenue classes, although its rank varies. It is of greatest concern to those small companies with revenues of less than US\$10m. FX and liquidity risk are of

equal importance to those organisations with revenues of US\$1bn or more. For the largest companies - with revenues greater than US\$10bn - counterparty risk is paramount.

Jeffrey Wallace, managing partner, Greenwich Treasury Advisors, highlights the difficulty in ranking top risks because companies operating in various industry sectors, and either single or multiple countries, will experience different pressures.

"The risks that a technology company such as IBM faces are different than those that an oil company such as BP faces. It also depends on the scope of a company's business: a utility company in Baltimore, for example, that operates domestically will not consider FX risk as an issue," he explains.

But one aspect that all corporate treasurers have had to deal with over the past few years is the sheer volatility in world markets, whether in FX or commodity price fluctuations or as a result of the political and social turmoil that erupted across the Middle East earlier this year.

Unpredictability: FX, Interest Rates and Commodities

FX

"One issue that cascades across everything is the volatility seen in the marketplace - and no asset class has been immune to this," says Justin Brimfield, senior vice president (SVP) of corporate development at Reval. "The FX market, for example, has experienced significant fluctuations. Treasury groups need to understand where their exposures are in order to hedge effectively."

Paul Bramwell, senior vice president, treasury solutions, SunGard's AvantGard corporations business, agrees: "FX has been an increasing focus in the past few years, particularly in 2010 with the global currency crisis and the partial meltdown of the euro, with the bailout of Ireland and the PIGS [Portugal, Italy, Greece and Spain] countries. We have not seen that level of interest in FX risk since 2000."

In the *gtnews* 2011 Treasury Risk Management Survey, the majority (63%) of respondents indicated that their primary hedging strategy

objective in managing FX risk is to protect the organisation from adverse market conditions. Only 8% of organisations reported that they hedge at the most favourable levels in order to gain competitive advantage. One in five organisations indicated that they do not have an FX hedging policy.

The sizeable number of organisations without a hedging strategy reflects the fact that, until recently, it seemed to be acceptable for companies to report currency fluctuations affecting their profit and loss (P&L) in their earnings statements. However, as those swings got bigger, there was an increased awareness that even if a company had a positive swing, this could be a bad thing.

"This highlighted the fact that a company didn't know what its risks were and hadn't hedged them," explains Bramwell. "Any fluctuation is a bad thing: if it goes in a company's favour, then it was lucky; but if it goes against the company, then it can wipe out an entire quarter's profit. The underlying rational for a treasury in terms of FX risk is removing any fluctuations from the business."

When fully hedged, a company doesn't need to worry if cross-currency spreads increase: if its underlying business goes down in terms of FX value, then the FX hedges will go up in value and offset the dip in the market. However, many companies do not have people in the treasury department that understand FX risk, nor do they have the tools available to mitigate the risk. "Companies need to have people within the organisation that understand where the risks

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One issue that cascades across everything is the volatility seen in the marketplace

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lie, plus any natural offsets that it might have, and the instruments available to go out and hedge those risks," explains Bramwell. "The situation is then compounded by the fact that these instruments are incredibly complex."

Interest rates

A market risk that is coming to the fore is the looming interest rate changes. Despite being held at historically low levels since the onset of the financial crisis, most countries are now looking to raise interest rates, which will have implications with regard to borrowing rates and associated hedging exposures.

According to the *gtnews* survey, organisations are using different hedging tools to manage interest rate risk in 2011 than they did in 2010. The share of organisations that used swaps increased from 52% in 2010 to 74% in 2011. Further, a greater number of organisations used forward rate agreements (FRAs) in 2011 (42%) than in 2010 (27%). A modest share of organisations used bond futures and/or options (16%); swaptions (10%) and bank-accepted bill futures (6%).

"Companies have historically wanted interest rates to be fixed so that they could manage the risk associated with rate changes," says Bramwell. "Although this risk has subsided over the past few years, it is now critical to plan out what the cost of cash is going to be in the next several years."

Reval's Brimfield argues that companies need to use technology in order to fully understand how the interest rate increase will impact them. "They

need to stress-test their portfolios to understand what it means if rates go up by 25 basis points [bps] or 50 bps. Treasurers need tools and processes that allow them to understand their risk and exposure, and ensure that they are making effective transactions that will allow them to hedge and then report on that over time," he says.

Commodity prices

Since mid-2010, commodities - such as wheat, steel, cotton, electricity, or crude oil - have been experiencing extremely high price volatility. These large fluctuations are causing headaches for many treasurers. Brimfield uses the example of the airline sector. "In 2009, crude oil was about US\$40 and now it is over US\$100 per barrel. This certainly impacts airline companies and their need to hedge," he says.

At the recent *gtnews* European Treasurers Council meeting, held in London on 7 February, the treasurers in attendance all agreed that commodity risk was a serious concern. Interestingly, even corporates that aren't buying raw materials directly, for example those in retail and the travel industry, are also feeling the impact, as the higher cost is passed on to them. Those treasurers expressed frustration at the difficulty in hedging against commodities to which their company is not directly exposed.

Herbert Broens, head of trade finance, at pharmaceutical giant Bayer, outlines a pragmatic approach to commodity hedging, and also some concerns. "Companies need to determine whether commodity risk will have a big impact on their annual results. If it is not comparable in annual reports, then companies

don't feel any pressure to hedge. It is also important to understand how your competitors are behaving. If you hedge your commodity exposures but your main competitor doesn't and gets lucky, then you have incurred an extra cost that affects your bottom line."

Country Risk: The Rising Threat of Instability

The world is in a state of flux on many fronts, be it political turmoil, a global economic crisis or natural disasters. The recent upheaval in the Middle East - particularly in Egypt, a major regional economy, and Bahrain, a global financial centre - has negatively impacted the trade flows to and from the region.

Even though the general scope of a treasurer doesn't normally extend to being an expert in investment management or insurance, they do need to leverage country risk intelligence. In pensions and related investments, such as sovereign bonds, it is critical to ascertain whether those governments are likely to be stable in future.

Kevin Franklin, director at Maplecroft, says: "There are many issues that would not be typically covered in a standard risk assessment, which often focuses on currencies/exchange rates as a means of informing country risk intelligence when it relates to pensions or investments. However, our research shows that a company can't solely look at these 'lagging indicators', but needs to be proactive and look at the leading indicators of potential risk in a country. Leading indicators are things such as civil liberties and freedom - the underlying issues that influence political stability in a country."

Maplecroft analyses political risk in two ways: dynamic political risk issues such as terrorism, which would be on the forefront of most companies' risk log; and underlying issues, such as those relating to more fundamental human rights, which are issues surfacing in the Middle East and other regions.

"Environment, social and corporate governance [ESG] issues are becoming a more relevant issue for corporate treasurers. In addition, from an insurance point of view, issues such as climate change are going to be highly relevant for certain corporates," Franklin explains. "Our clients are approaching this from different angles: some are looking at country and sovereign bonds, while others are looking at specific issues such as climate change and its impact on insurance. Many are beginning to look at their suppliers' exposure to human rights issues."

Not all corporate treasurers have an expanded remit at this stage, according to Franklin, but the more proactive companies are beginning to ask for this type of information. For example, a large multinational oil company that Maplecroft has worked with over the past five years is now systematically using country risk intelligence throughout the business, including treasury.

"A number of companies are now asking for country risk intelligence for the Middle East. Most of them are in the oil and gas sector but many other industries as well, such as IT and others that have suppliers in the region, are seeking regional information. They are not looking so much at Egypt, mainly because they understand the impacts there, but at the surrounding countries such as Saudi Arabia. Some are even talking about the turmoil cascading through to China, which would have a huge impact on the global economy, oil prices, etc."

To obtain information at country level is one thing, but it is also vital to look

at the companies within that country to get a balanced view of counterparty risk exposure, according to Antony Beckley, order management system (OMS) channel leader, Dun & Bradstreet (D&B). He has seen an increase in treasurers' interest at both the macro- and micro-economic levels. "There could be a good company in a bad country, or bad company in a good country. These things need to be balanced out when taking a full view of overall risk exposure," he explains.

D&B rates country risk in 132 markets and its global commercial database holds data on 188 million businesses around the world. The company uses a dynamic risk assessment methodology that drills down into the socio/political, economic and commercial risk of dealing with specific companies in certain countries. It looks at company risk and the likelihood of a company failing, for example due to bankruptcy, or if a company is going to slow or cease paying its bills.

"Cash inflow is a key issue in cash management," says Andy Craven, head of payments at D&B. "Our mantra is that to be forewarned is to be forearmed. We can highlight to a treasurer which companies are less likely to pay on time. D&B provides an early warning before the event happens, so a company is prepared in advance, instead of reacting to a negative event." Many companies are re-evaluating their business partners and assessing whether they are going to be in business next year, what the potential risks are and what they can do to mitigate those risks.

In addition, Beckley believes that the credit management department and treasury are becoming increasingly involved in the front end of the business, as opposed to just managing risk in the existing customer base. "The credit management department/treasury is now being called on to provide insight for sales and marketing teams for when they are prospecting for new customers. These teams don't want to waste time on companies that are in financial

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The three ‘M’s
of risk - measure,
manage and
mitigate - are core
to a risk strategy

stress, so they use this information to target financially sound companies," he says.

Risk: Measure, Manage, Mitigate

The three 'M's of risk - measure, manage and mitigate - are core to a risk strategy, but for most treasuries it proves to be difficult to incorporate all three. This is mainly due to the lack of resources allotted to this area of the company, whether in terms of technology or staff.

Greenwich Treasury's Wallace explains: "The basic problem is that treasury is not a core function for a non-financial company. As a result, it is generally starved of resources because it doesn't appear to be adding value. This means that it hasn't been able to change that much in response to increased volatility."

And yet treasurers' responsibilities and oversight has increased, effectively compelling them to become more strategic. Dan Miner, general manager, treasury services at 3DeltaSystems, says:

"Treasury departments are much more visible than ever before. Over the past few years, they have emerged from a back office function to one where, during troubled financial times, they are having to give frequent updates, not just to the CFO [chief financial officer] and CEO [chief executive officer] but also the board members, on counterparty risk, liquidity, controls, and compliance with regulatory issues. This area has received much more attention over past few years and is taking treasurers beyond their area of expertise."

In order to be able to quickly respond to these demands, a treasurer must have policies, tools and a good team in place, so that they can measure, track and report on their risk strategy. "The lack of resources has led to optimising what was already in place," says Reval's Brimfield. "But now companies are hiring people to help understand risk policy, and then bringing in technology to help report and manage it."

Bramwell agrees: "It is a very volatile market and an area where treasury faces a shortage of expertise to manage the risks. We have seen an uptake in corporates hiring staff from banking backgrounds and complex financial engineering backgrounds, to map out where the risks lie and put in place hedging strategies."

He is also seeing an increased interest in technology. "Companies are beginning to realise that to go back to basics and identify where their cash is to avoid liquidity risk, and to be able to report and adequately manage FX and interest rate risk, they need a solution rather than spreadsheets."

Bramwell believes that the value lies with solutions that normalise and aggregate data across the multiple platforms housed within any business. "Most corporates have at least one ERP [enterprise resource planning] system - more likely two or three. But even if they have one, they probably have several versions of the system. Therefore the data is in a different format and needs to be normalised," he explains. "In a 2010 SunGard study, it was apparent that corporations didn't trust the data they were getting - it wasn't timely and was inherently inaccurate. If a treasurer doesn't believe their information flows or where their exposures lie, then what are they going to hedge? They will create exposures by hedging something that fundamentally doesn't fit. Therefore, it is critical to identify what they have, and without a technology solution, it is almost impossible to do that."

The following features will take a more in-depth look at the top three risks facing treasurers: liquidity, FX and counterparty risk.

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Managing Corporate Liquidity Risk

Anne Petrie looks at how companies can assess their liquidity risk and what business processes and tools they can put in place in order to manage it.

The increased cost and scarcity of liquidity in the past few years brought liquidity risk to the top of the corporate agenda. This was evident in the *gtnews* Treasury Risk Management Survey 2011, which found that liquidity risk was the top risk corporates were focusing on - and the percentage prioritising liquidity risk had risen by three percentage points, to 28% from the previous survey in 2010. This reflects the increased focus on cash. "Right now, companies are hoarding more cash since it reduces their risk significantly, even if it does hurt the bottom line a bit. Running lean and mean is not as popular as it used to be," says Azmi Özünlü, financial markets tutor at training provider 7City Learning.

Despite this, many corporates have not yet put formal procedures in place to manage liquidity risk. Banks have changed their approach due to the liquidity buffers being imposed by regulators to ensure they have adequate capital to meet their obligations. Although not compelled by regulation to address liquidity risk in the same way that banks are, corporates can still take a lead from banks in terms of the methods they use, such as stress testing and putting in place the appropriate buffers to deal with the worst-case scenarios. "Banks have typically taken the leading role in managing liquidity risk, because for them it's much more crucial than for a non-financial corporate," Özünlü adds.

Jouni Kirjola, liquidity management product manager at OpusCapita, notes that how much companies consider liquidity risk depends on the geographical areas they operate in. "I doubt many corporates operating solely in an economically mature area such as Europe do it. If they are working globally, in my experience, they are more likely to have put the processes in place."

Identifying Liquidity Risk Areas

Identifying potential areas of liquidity risk - either internally or with the help of external consultants - is the first step towards managing it. James Phillips, head of regulatory strategy at compliance solutions provider Lombard Risk, says that treasurers should analyse both firm- and market-specific risks. "First, they need to look at the core market-wide areas that could introduce liquidity risk such as the potential impact on import, export or oil manufacturing," he says. "The second test is: will this cause risks that are specific to the firm?"

Sources of liquidity risk can be:

- **Intra-day:** International time zone issues could prevent a company from calling on funding from elsewhere in the group, or a human or technical 'outage' could prevent it from meeting an intra-day demand for funds quickly enough.
- **Intra-group:** This will affect larger firms, which are potentially going to have to offer support to, or call on support from, other parts of the group.
- **Cross-currency:** Does the firm have sufficient quantities of required currencies available? "It's all well and good to have plenty of funds in another

“Running lean and mean is not as popular as it used to be”

currency, but if you can't swap them out because of the closure of FX markets, for example, you're still going to have a significant exposure," Phillips notes.

- **Sales revenues:** Companies should consider how quickly this could dry up. Firms that are heavily reliant on one sales strategy, either repeat business or many one-off clients could be forced to change their business model in a hurry.

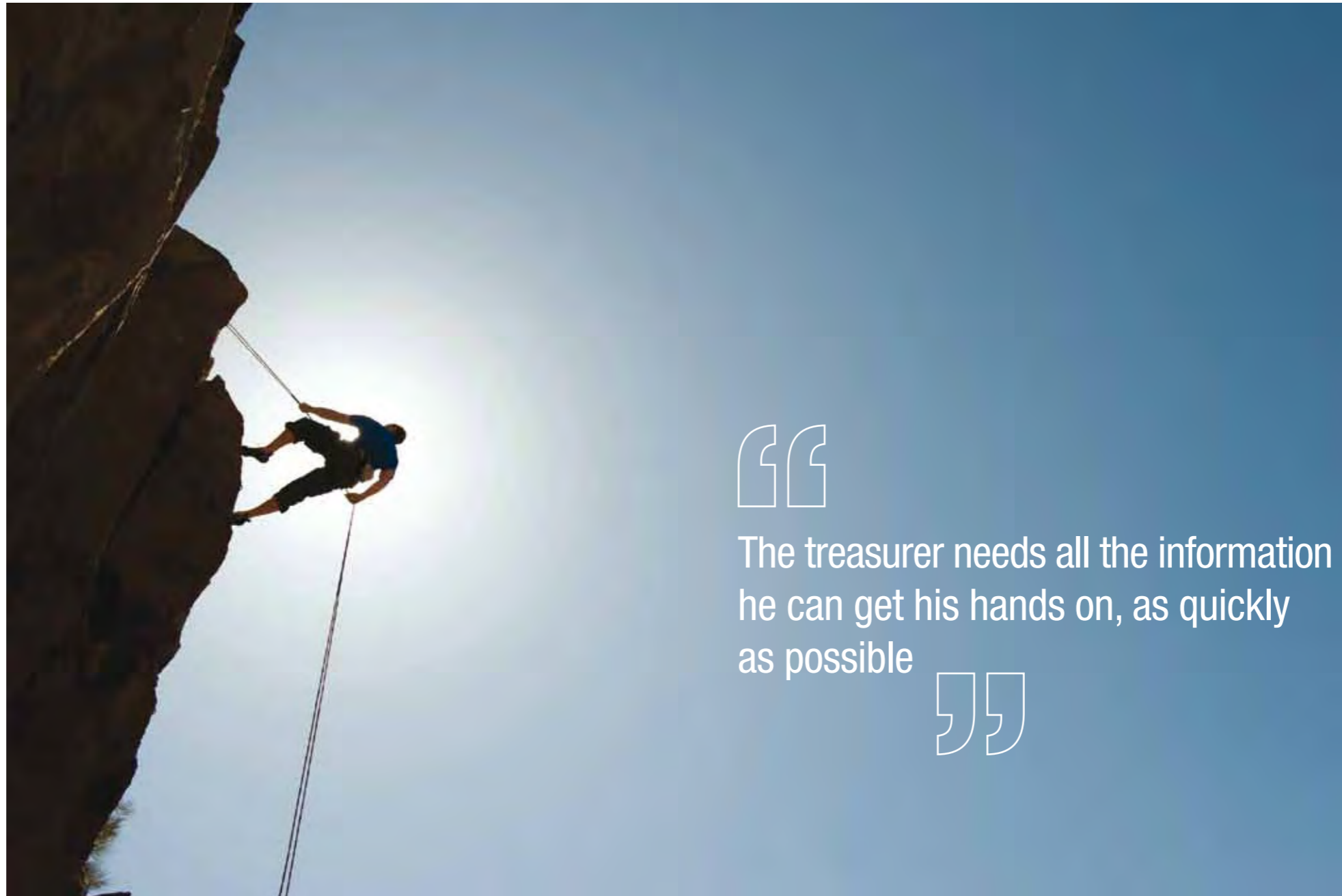
These tests highlight certain exposures that could affect the company's liquidity. With this knowledge, a company can adjust its business model, for example to focus on different areas of business or strengthen banking relationships.

Stress Testing

Historically, cash flow forecasting has been forward-looking, focused on identifying projected cash flows over, for example, one day, 10 days and one month, to ensure that where net cash outflows exceed net inflows on a given days, the company has enough cash on hand to cover the shortfall. "The treasurer is always looking forward. What happened yesterday is interesting, but he can't change it. He needs to know what is going to happen tomorrow, next week, next month or next quarter," says Chris Rowlands, consultant at financial IT services firm CSC. However, as delays in payments and the possibility of a collapse in supply chains have increased, this is not enough.

Companies are increasingly supplementing this method with considering worst-case scenarios. Özünlü explains: "It is about finding the survival period: how long they can withstand if all the payments to them stop." Phillips adds: "Firms need to look at the tests that are plausible but not ludicrous. There are plenty of potential actions and scenarios that could bring down the firm but you need to look at those just inside the ludicrous ones."

Özünlü believes that more companies should be focusing on stress testing in greater detail: "If anything, we have seen that emergencies do arise more frequently than people thought, so it is a good idea for more corporates to see how long they can withstand one of those situations and what they can do about it." He adds that although larger FTSE 100 companies are already stress testing, among smaller and medium-sized enterprises (SMEs) it remains the exception rather than the rule. OpusCapita's Kirjola cautions against using backward-looking information in place of stress testing. "Corporates need to consider the worst and best case cash flow scenarios, instead of relying solely on the forecast," he says.



“The treasurer needs all the information he can get his hands on, as quickly as possible”

Ideal Balance

Another tool borrowed from banks to mitigate liquidity risk is the ideal balance. This depends on the daily volatility of cash inflows and outflows. More cash should be placed in the buffer if the balance falls below the acceptable minimum, and any excess should be invested.

Using the Asset Buffer

Once a firm has identified the level of liquidity risk it is exposed to, it can determine the size of the liquid asset buffer required. The level of risk a firm is prepared to accept and the size of the necessary liquid asset buffer are directly correlated. In fact, making liquidity risk part of

the culture of the firm is key. "This need to be done, not on an annual basis or on the back of a fag packet, but as part of the discipline of the firm. Senior management involvement and an enterprise risk management culture [are key]," Phillips says. For example, monthly board packs should have an entry covering the current liquidity risk situation as well as short-term forecasts.

Using stress testing tools allows the firms to evaluate changes in its acceptable level of risk and address them accordingly. If risk indicators change to red, firms need to consider whether this is due, for example, to a change in the business model, or the level of external risks.

Or its risk tolerance could have changed, requiring an increase in the size of the buffer.

Achieving Cash Flow Visibility

Good cash flow is essential for managing liquidity risk. As Rowlands points out: "If you have a good strong cash flow, you can survive most downturns in the economy. Ensuring you have enough cash to survive and pay creditors and suppliers and make wage payments is driving a lot of treasurers today. Without cash, they can't function as a business." But how can cash flow visibility be achieved? Having real-time, accurate information about their cash flow is a perennial challenge faced by treasurers

and chief financial officers (CFO) of small companies and global treasury functions alike. "Treasurers are constantly looking for tools to enable them to get cash flow information more quickly and more accurately. And that enables them to handle their liquidity risk - and all their other financial risks," says Rowlands.

Technology

So what technical solutions can companies put in place to get the necessary information in a timely way? The way the information can be gathered varies, with some treasurers using their enterprise resource planning (ERP) system to capture the data, while others have a more

ad hoc way of gathering information, getting different departments in the organisation, for example sales, cash collections, or even logistics and purchasing, to communicate their cash or liquidity requirements directly to the treasury function. Although using spreadsheets to record and analyse cashflow forecasts and liquidity planning may seem rudimentary, it is, as Rowlands notes, quite effective in some ways. "But if you're relying on large ERP systems, you can't often get that information in a timely way," he says. "The treasurer needs all the information he can get his hands on, as quickly as possible - and at the highest level, not just the operating level," he adds.

Using the Tools

Many treasury systems have asset liability management (ALM) tools designed to model the overall shape and size of the balance sheet. However, they are not as useful for analysing cash flow over a relatively short period of time. "If you are looking at the criticality of survival periods for the next weeks and few months, we are really looking at short-term impact tools here rather than necessarily business modelling tools for the longer term," Phillips says.

Data quality is also key for ensuring an agile response to changes in levels of liquidity risk exposure - its usefulness will be negated if the company has to wait a week for someone to cross-check the data. Ensuring data quality requires discipline in the operational end of the firm, to capture data in the right way, as well as good tools to be able to extract and normalise and transform the data into a standard format that can be put into a stress testing engine.

Sourcing the data from different systems within the business is also an issue. "That is one of the big challenges firms will have if they look to put improved automation around liquidity stress testing - the non-commonality of different bits of data relating to the same type of cash exposure, Phillips says. "There may well be vertical warehouses associated with supply chain, with money flow, funding, supply of ingredients or whatever it may be but is there fundamentally one set of information that can give a true picture over time?"

Conclusion

Liquidity risk has only recently come to the top of the corporate agenda, with mitigation techniques still in their infancy. But the continued focus on cash flow means that putting a strategy in place to manage it is crucial. As Lombard Risk's Phillips summarises: "The speed with which liquidity impact can occur is dramatically quick and having funding available in short order is critical."

Economic Uncertainty Brings FX Risk Into Focus

Managing foreign exchange (FX) risk is a key responsibility for corporate treasurers. There are different types of FX risk that require attention, as well as a variety of regulatory and compliance issues to address. **Ben Poole** examines these challenges and the variety of tools and techniques available for treasurers to mitigate and manage FX risk.

The importance of FX risk management is accentuated over periods of uncertainty, which is a reason for its rise in prominence of the past few years. But what constitutes FX risk? For the purposes of this feature, FX risk is made up of the following elements:

- **Transaction risk:** The risk of value changes when a transaction executed in foreign currency is measured in the functional currency.
- **Translation risk:** When a company has subsidiaries with assets or liabilities denominated in a functional currency other than the reporting currency of the holding company. Most multinational companies (MNCs) are heavily exposed to translation risk.
- **Economic risk:** The future impact on cash flows and earnings of a company as a result of long-term changes in FX rates.

Typically, the management of transaction risk has been the main focus of corporate treasurers. Transaction risk tends to be comparatively easy to identify and manage using traditional hedging instruments, and often generates a high degree of management focus due to its visibility in terms of creating profit and loss (P&L) volatility.

Translation risk receives less focus, according to Kevin Lester, director of risk management and treasury services at Validus Risk Management, and *gtnews* contributing editor: "Translation risk is an area that is often overlooked, at least in terms of the implementation of FX hedging strategies, largely due to the fact that it does not directly impact cash flow, and as a result hedging translation risk can lead to cash flow mismatches between hedging instruments and underlying exposures."

Despite its low profile, translation risk can have important repercussions, particularly in terms of lending covenants, which are measured using accounting metrics that are impacted by currency volatility. As such, it is often the case that the issue of translation risk deserves greater focus than it currently receives in many companies, particularly in situations where a high degree of leverage is employed and there is significant risk of breaching lending covenants.

Vikram Murarka, founder of Kshitij Consultancy Services, agrees, but sounds a note of caution. "Translation risk can be given more attention,

but then it is correspondingly more difficult to hedge balance sheet items in a cost-effective manner," Murarka notes.

Economic risk is also an area which deserves more attention, as it represents the long-term risk that currency volatility poses to the value of the company, and "is arguably the most important category of FX risk," says Lester. As the impact of economic risk goes far beyond the reporting of FX gains and losses, and can relate to more fundamental strategic issues such as competitiveness and geographic expansion, the more abstract nature of economic risk can pose a challenge for corporate treasurers. However, the significance of economic risk to commercial strategy can also mean it is an area in which the treasurers can add considerable value to the business.

Tools for Treasurers

When it comes to the tools available to treasurers to help manage FX risk, these can be divided into two main categories:

1. Internal risk mitigation tools.
2. External hedging tools.

Internal risk mitigation tools involve minimising the exposure or impact of FX risk on the company by adjusting internal business processes. These tools include intercompany netting programmes, risk-sharing pricing or supply contracts, and developing natural hedging opportunities (either through capital structure adjustments or commercial adjustments). According to Lester, companies are becoming more focused on maximising the use of internal risk mitigation techniques (and this trend will likely continue over the next 12 months), as it allows them to:

- Minimise hedging costs.
- Maximise credit availability (through a reduction in FX credit line usage).
- Reduce the complexity of hedging implementation (e.g. hedge accounting requirements).
- Eliminate risk substitution (i.e. exchanging FX risk for counterparty risk or liquidity risk).

External hedging tools (FX forwards, options, structured products, etc) remain essential tools for managing residual FX risk (after internal tools have been fully exploited). "The popularity of structured products, particularly those involving complex derivatives or leverage, has certainly waned since the onset of the financial crisis," explains Lester. A key reason for this is that many of these structured products contained 'short volatility' components, in the sense that they involved writing options to subsidise the cost of hedging. As such, they were disproportionately impacted when volatility spiked as a result of the financial crisis, and many hedging programmes did not perform well as a result.



Every company has a unique set of circumstances and different market views



"Such products seem to be slowly re-emerging as FX volatility has begun to decrease, and this trend will likely continue as long as volatility remains contained," says Lester. "This could be a dangerous trend, and treasurers should ensure that hedging products are robust enough to manage risks effectively in highly volatile markets."

Looking at strategies treasurers are currently employing in this area, André de Klerk, financial risk manager at Moneycorp, suggests corporates are using a blend of financial products with different weightings over different periods. "Most of the companies we advise use a combination of spot, forwards and FX options to achieve an appropriate result for a particular requirement," says de Klerk. "Every company has a unique set of circumstances and different market views - using the right products at the right time is important."

FX Hedging Strategies

With these tools in place, treasurers need to ensure that they have efficient hedging strategies in place. The main areas that treasurers need to pay attention to include:

- Establishing clear hedging objectives.
- Establishing quantifiable and visible risk key performance indicators (KPIs).
- Ensuring hedging performance is regularly benchmarked against KPIs.

"The setting of risk KPIs and hedging performance measurement is an area which could often be improved," comments Lester. "In the absence of such benchmarking activities,

hedging programmes will often be judged on the basis of whether or not the hedge made money, thereby ignoring the original hedging objectives, as well as the performance of the overall portfolio (including the underlying exposure). Such an approach will often lead to hedging activities that actually increase FX risk, rather than decrease it, as the focus becomes the hedging P&L, rather than the achievement of risk management objectives which are aligned with overall corporate strategy." In this case, it is essential to have quantifiable risk KPIs that are regularly monitored, and used to recalibrate hedging activity as necessary to meet the company's risk management objectives.

Kshitij's Murarka adds: "We think that treasurers need to re-look at their preference for the 'natural hedge'. They can increase the profitability of their companies - without changing the risk profile - by asymmetrically hedging both payables and receivables. A natural hedge is a lazy hedge, producing lazy results."

Mark Warms, general manager, Europe, Middle East and Africa (EMEA) at FXall, suggests that the main area for treasurers to pay attention to in their hedging strategies is assessing which trading methods they are using for a specific situation. "Electronic trading provides treasurers with a choice of execution strategies and it is important that choice is based on a thoughtful process that is appropriate for the specific trading situation," Warms explains.





Treasurers have often required complete end-to-end workflow solutions that encompass all aspects of trading and reporting to meet global compliance standards and thus manage their risks. "Execution quality analytics tools are becoming increasingly important for treasurers, providing them with a comprehensive trade performance overview, as well as metrics to measure the effectiveness of their trading strategy, while at the same time enabling regulatory compliance. End-to-end integration of treasury management and hedge accounting systems with trading and settlement tools is a best practice for both risk management and operational effectiveness," notes Warms.

The Role of Technology

FX risk management technology can be divided into five main categories:

1. Market data.
2. Dealing systems.
3. Transaction/position management.
4. Risk analytics.
5. Risk reporting/accounting technology.

According to Lester, there is significant overlap among providers within these categories. "Most of the major TMS [treasury management systems] vendors do incorporate FX risk management functionality within their core systems, which facilitates everything from operational process management, such as deal capturing and basic reporting, through to more analytical functionality, such as risk measurement and sensitivity analysis."

There are also specialised technology providers who focus on specific aspects of the risk management process, such as hedge accounting, deal life cycle management, exposure visibility and risk management dashboard development. "The current trend is moving away from 'all-in-one' providers, where a single system is used for all aspects of FX risk management from operational to strategic, and towards an integrated solution where best-of breed providers are selected for their specific core competencies," suggests Lester.

When it comes to the more analytical or strategic elements of FX risk management, the preferred tool for many corporate treasurers is still the traditional spreadsheet (ideally populated with data extracted directly from their TMS or accounting system to minimise data entry requirements and errors). Lester suggests that this is likely to remain the case, despite the advancements made by systems providers, due to the need for flexibility when performing FX risk analysis. "Different corporate treasuries have very different approaches and requirements when it comes to risk measurement and

analysis, making it very difficult for a third party system to meet the diverse needs of the corporate treasury market," he adds.

Murarka agrees that the spreadsheet model is here to stay, but that technology providers can look at that as a starting point for the more complicated solutions they develop. "The most important technology that treasurers need is a software that can track and collate all their FX exposures on the one side and all their hedges on the other side. The software should look and feel like Excel, but should work internally as a supercharged database management system," he says.

Regulatory Environment

Looking to the future of FX risk management, regulation is a key 'unknown' that corporates will have to pay particular attention to, according to Moneycorp's de Klerk. "The greater regulation of OTC [over-the-counter] derivatives is certainly a concern for corporate treasurers. The biggest fear is that it will make hedging more expensive."

New rules outlined under the Dodd-Frank Act in the US and the European Markets Infrastructure Legislation in Europe, are placing new requirements on OTC derivatives to be secured with cash collateral. Although corporate users of hedging instruments thus far secured an exemption from both regulations, they will still be required to report their hedging activities, monitor positions and provide detailed information to prove that their hedges are constructed to cover commercial risk as allowed by the rules.

Over the past few years, the credit crisis illustrated some of the limitations of current hedge accounting regulations, and accounting bodies are working on replacement standards. Unfortunately, accounting rules have been one of the things that caused treasurers to avoid hedging. "When these accounting regulations were first introduced, they became so important that they superseded the business rationale for hedging. I am glad to see a seismic shift after the financial crisis and rightly so," says de Klerk. Economic and financial drivers are now far more important in determining a hedging policy than the accounting implications.

Conclusion

FX presents a highly visible risk that treasurers need to manage as part of their daily responsibilities. These challenges come in a variety of forms, and with the OTC regulations looming, it is a risk that will remain of critical importance in the future. There are tools and techniques available for treasurers to mitigate and manage FX risk, and it is important for every treasury department to give a thorough evaluation of what their needs are in this area, and to select the appropriate tools for the job.

Feeling the Squeeze: Post-crisis Counterparty Risk Management

Issues such as corporate credit rating strength and regulatory pressures in the derivatives market are meaning that treasurers are finding counterparty risk to be one of the most dominant topics in their overall risk management strategy. **Ben Poole** examines the current challenges, plus the solutions available to help corporates mitigate and manage their counterparty risk.

Traditionally, treasurers dealt with financial counterparties and only occasionally managed risk exposures relating to business customers. This is something that has changed since the credit crisis, according to Frank Wendt, director at KPMG Financial Risk Management: "In the post-crisis reality, companies have learnt that counterparty risk must be managed in a holistic way. A proper counterparty risk framework identifies all material counterparties which, for example, should also include suppliers."

In order for this holistic approach to be successful, Wendt points out, the treasury department cannot work in isolation. "Different functions - such as purchasing, credit and collection, treasury and risk management - have to work together to share practices, internal and external data, people's expertise and systems. Additionally, companies need to develop and implement policies and procedures around counterparty risk and have adapted them to changing regulatory and market conditions," notes Wendt.

Supplier risk continues to rank as one of the biggest challenges that companies face today. Dan Reid, vice president, credit risk division at Triple Point Technology, says: "Suppliers are caught in the middle between high and volatile commodity prices and costly, scarce liquidity from banks. Prices and volatility are in the biggest swing since 2008, and treasurers need to evaluate the credit worthiness and ability to deliver of their entire value chain so they can deliver against their own objectives."

Another striking change in counterparty risk management in recent years is the fact that corporates now have to conduct serious counterparty risk analysis on current and potential banking partners, caused by the series of collapses and massive losses experienced by the banking sector during the crisis. Christopher Finger, head of research and communications at MSCI, says: "What has changed since the financial crisis is that banks, even the large broker-dealers, can present material counterparty risk. Rather





than focusing mainly on smaller institutions and considering bank risks as minimal, it is now necessary to scrutinise exposures to banks, and to be proactive in managing those risks.”

Counterparty risks on all sides are greater than they were five years ago, meaning that corporate treasurers need to be not only vigilant, but proactive in managing and mitigating these risks through modern solutions.

Using Technology to Gain Visibility Over Counterparty Risk

Technology can help corporate treasurers gain visibility over their full exposure to any of the counterparty risk sources previously mentioned in a number of ways. David Williams, senior director - head of fixed income architects at S&P Valuation and Risk Strategies, outlines some of the ways technology can assist: “First, you need a complete database that links individual companies to their ultimate parent obligor. Tying in a security-to-entity view as well is helpful when looking at individual securities. Technology can be used to take a list of entities (or securities) to which you have exposure and build several views on your ultimate exposure,” explains Williams. “It’s interesting to do this analysis and see that your actual exposure to individual entities or sectors is greater than originally thought.”

Technology can also allow a treasurer to generate a view across several credit indicators. “You may have several tools or solutions that you use to put together your credit management framework. It’s hard to point to a single

indicator that gives you a complete view, so it’s important to pull information together that, taken collectively, gives you a more complete view,” says Williams. This credit spectrum would include market-driven views of credit risk and more fundamentally driven indicators of credit worthiness, alongside the traditional credit ratings provided by the ratings agencies. “You will also need this view across unrated entities, so you will need to make sure you include ways to look at the credit worthiness of unrated entities,” Williams adds.

Additionally, technology can help treasurers look at hundreds or thousands of entities. “Use technology to do all of your legwork, such as monitoring for early warning signs of trouble and providing a score across several indicators. Find the hot spots, and then use your precious human capital to dig deeper into where you really need to focus,” advises Williams.

Taking a critical look at the technology offerings available, KPMG’s Wendt cautions: “The systems around ERP [enterprise resource planning] and financial supply chain management offer several solutions to deal with counterparty risk. However, the degree of integration to provide, for example, one holistic counterparty risk dashboard is not yet fully available.”

Currently, corporates have to work through data warehouse and data mart structures. Online analytical processing (OLAP) reporting software is then able to identify the total exposures toward any counterparty. “This is an important one-time

effort and investment, as a commercial customer can be a commercial supplier and a financial counterparty at the same time,” says Wendt.

The Role of Credit Ratings in Counterparty Risk

Credit ratings are a way to express the underlying probability that a counterparty might not perform to expectations. According to Chris Dias, partner at KPMG Financial Risk Management, some ratings tend to be reactive and treasurers should consider rating methodologies that are proactive (mostly option and equity-based expected default frequencies). “However, the probability is essentially a given and cannot be influenced, so a treasurer has to manage the exposure and severity of a non-performance event. This fact leads the treasurer to manage the expected and non-expected loss from counterparty risk,” explains Dias.

There are a number of strategies that a treasurer can employ to react to negative credit rating changes, including:

- Reduce the exposure by reducing trade limits or adjust contractual terms and conditions (on single obligor level).
- Diversify the risk by trading with more counterparties or distribute trades more intelligently through assessing credit risk correlations (on portfolio level).
- Transfer risk by buying risk protection from an external party (on single obligor and/or portfolio level).
- Self-insure counterparty risk by anticipating losses that potentially can be incorporated in the firm’s pricing (risk based pricing approach).

- Using all of the above in combination.

S&P’s Williams agrees, pointing out that as credit worthiness degrades, credit policies typically call for increased monitoring, reductions in exposure to the entity, or potentially triggering risk mitigation strategies such as moving to all cash transactions.

“What’s important here is to do your best to catch signs of trouble early, and have a clear policy on how to respond to deteriorating credit worthiness. Credit ratings provide one entity’s opinion regarding the credit worthiness of a company. For example, long-term issuer credit ratings are designed to reflect a particular credit rating agencies’ opinion of credit worthiness over the long term,” says Williams.

But what else can treasurers use? There are other indicators, such as market-implied ratings based on either the credit default swap (CDS) market or equity markets (through equity-driven credit models), or fundamental driven models, which are based on inputs from the company financial statements such as revenue, interest coverage, leverage, etc, that will generate probabilities of default or estimates of credit worthiness that are typically mapped to ratings scales.

“Using a holistic view across these indicators, you can start to formulate a view on where there may be trouble. For example, is one of the market-implied ratings indicators diverging significantly from the long-term issuer credit rating? What has been the trend in probability of default? This can be examined both by using structural models driven by equity price, as well as those generated by models that are more fundamentally driven,” explains Williams.

Another important point in this regard is to check that the correct indicators are in place for unrated or even private companies. “The spectrum of indicators is wide for companies that are public and rated, but this narrows rapidly as you move from public-rated to public-unrated, and on to private companies,” cautions Williams. It is therefore important to have an integrated set of tools that degrades nicely as the set of available information is reduced.

Best Practice Counterparty Risk Mitigation Strategies in the Derivatives Market

The derivatives market is a key area where regulators are attempting to tackle counterparty risk head-on. The Dodd-Frank Act and the EU September 2010 proposal, including Markets in Financial Instruments Directive (MiFID) and the Market Abuse Directive (MAD) reviews, aim to increase transparency and oversight, provide more stringent collateral and capital requirements, and reduce operational and counterparty risk through

Proactive Steps for Large Corporates to Mitigate Counterparty Risks in Their Supply Chain

Counterparty risk can be context-sensitive and the risk elements react differently in different situations. Solutions exist that help large corporates mitigate counterparty risk in the supply chain by generating real-time alerts in an easy-to-understand graphical representation. Charu Kirti Jain, senior business consultant at Information Mosaic, outlines some of the considerations such a solution could include:

- Assessing concentration and overall exposure with a specific counterparty in the supply chain.
- Monitoring rating agencies’ views of the counterparties and using these in conjunction with internal intelligence and views to help maintain internal benchmarks and standards.
- Adequately measuring a variety of factors such as geo-political conditions, exchange rates, taxes and duties to assess counterparties and associated risks.
- Checking on counterparty dependencies, links and entity-level relationships, to identify any areas of vulnerability.
- Simulating what-if scenarios and gauging the impact on the underlying transactions and linked products.
- Simulating strained scenarios for counterparty and identifying alternate routes in the supply chain.
- Tracking any changes in counterparty attributes outside defined tolerances.
- Leveraging historical data of past activity, default behavioural patterns, transactions, and performance to support the decision making process while choosing a counterparty.

clearing and reporting requirements. Surveying the landscape, Triple Point Technology’s Reid notes that regulators are attempting to stabilise and strengthen the markets by legislating less risky market rules, while commodity companies are in a mad scramble to avoid being labelled as a speculative trading company and the attendant reporting and capital requirements.

“Companies need to prepare for this evolving and fluid regulatory landscape by consolidating and automating their data and systems so that they can avoid onerous reporting/capital requirements, respond quickly to rulings and directives, and take advantage of international regulatory arbitrage opportunities as different geographies apply against different timetables,” advises Reid.

Unfortunately, however, accounting standards suffer from inconsistencies within the financial markets, particularly in the area of derivatives valuation and risk exposure methodologies. According to Bipin Patel, principal consultant at Rule Financial: “It will take many years for accounting standards to approach the current best practices used in the derivatives markets to manage counterparty risk. However there are a number of accounting standards initiatives - such as FAS 157 and IAS 39 - that do address derivatives pricing and valuation methods.”

A number of the challenges that treasurers are faced with in the accounting area are due to uncertainty over the ultimate outcome of the Financial Accounting Standards Board’s (FASB) and International Accounting Standards Board’s (IASB) deliberations over financial instruments and hedge accounting, as well as the degree of convergence between the two bodies on these

topics. “In our experience, many corporate treasurers are uncertain about the relevance and implications of new global accounting standards to their treasury operations,” explains Chris Duffy, director at KPMG Financial Risk Management.

However, in less than two years, treasurers will have to address the financial reporting requirements of IFRS 9 (covering financial instruments), the final IFRS standard on hedge accounting, and the new FASB Accounting Standards Updates (ASUs) on the same topics. And there’s more: “Treasurers will need to respond to the outcome of the SEC’s determination of whether to incorporate IFRS into financial reporting requirements for US public companies, and the potential timetable for IFRS conversion,” says Duffy.

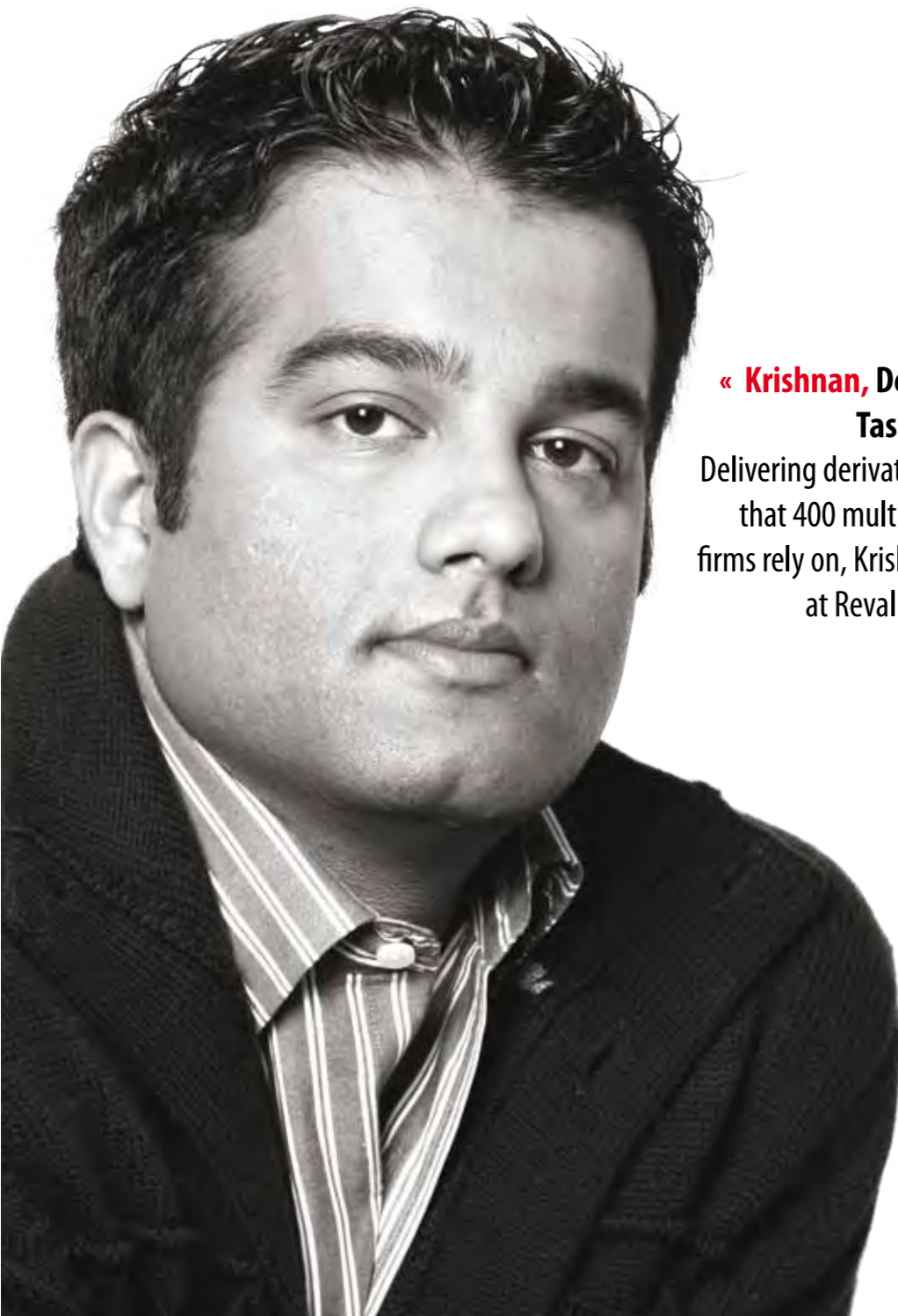
While the dust is still to settle on this rather fragmented regulatory landscape, it is clear that treasurers need to be paying close attention to what the future may have in store, and to plan accordingly to ensure that they are prepared for whatever comes their way.

Conclusion

Counterparty risk is particularly prominent for treasurers in the post-credit crisis environment. Relationships with banks, suppliers, customers and other business partners all need to be under scrutiny, and all the while the regulatory movements pertaining to counterparty risk also need to be scrutinised. But by showing vigilance and forward planning, corporate treasurers are capable of mitigating and managing these risks, and adding value to the business while doing this. The key is to be proactive in your strategic planning.

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