TREASURY TRENDS

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A Treasury Policy to reflect the times

An organisation's treasury policy outlines its risk objectives and establishes a framework and guidelines for managing its treasury risks.

The first step is identifying the various risks to which the organisation is exposed. In recent times, the rankings of these risks have changed. Liquidity and funding risk feature firmly near the top, particularly with the central bank's imminent increases to bank capital requirements. Meanwhile, interest rate risk may have fallen a few rungs, particularly in the current benign inflation environment in which we find ourselves, but it nonetheless remains a pertinent risk requiring managing.

A robust treasury policy should be able to cope with almost any situation that the organisation finds itself in, including the above, but should also evolve with the organisation, and therefore be regularly reviewed.

A treasury policy covers identification, assessment, management and reporting of financial risks. It provides the framework for managing risk. A treasury policy is approved by the Board (or relevant governance overseer) and delegates to management the discretion to operate within defined parameters to manage risks. From a governance perspective, a treasury policy provides comfort to the governance overseer that key risks have been identified and are being managed appropriately, and that compliance with the policy is being reported.

A good treasury policy should stand the test of time by delivering an appropriate (for the organisation) risk management balance between flexibility and certainty throughout the economic cycle. At its roots, the treasury policy should address the organisation's underlying financial risks by providing a framework for risk management decision making. A risk management strategy is built on the foundation provided by the policy.

Without a policy, decisions will become ad-hoc, there will be no clarity in managing those risks, and there will be plenty of scope for management of those risks to be driven by individuals who may have strong views or opinions, for example, where the currency is heading, which typically leads to blame and angst when things go wrong (and they will).

Key points

- **A treasury policy outlines risk objectives and establishes a framework for managing treasury risks**
- **A good treasury policy should stand the test of time**
- **A treasury policy will ensure disciplined risk management**
- **Treasury policy objectives should also align with the organisation's objectives**
- **The treasury policy should also be bespoke**
- **Reporting is a key part of any treasury policy**

Market moves and prevailing prices, such as for currencies, interest rates or commodities, may lead to different hedging strategies and instruments being employed in order to manage the organisation's treasury risks and comply with the policy, but the policy itself should remain unchanged. Most treasury policies already contain enough flexibility to accommodate changing market dynamics by looking beyond historic market norms and statistical measures such as long term averages and standard deviations.

The best time to have a policy is when the world seems to turn bad. A properly structured policy will force disciplined risk management action and provide guidance under the most extreme of circumstances. At such times, it is easy to be swayed by market views or technical analysis. These should undoubtedly form part of the decision making process but not to the point where the future viability of the organisation is put at risk.

Treasury policy objectives should also align with the organisation's objectives. If those objectives change, especially

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to risk preferences or cash flow drivers, a policy should be reviewed and updated in line with those objectives.

A treasury policy should also be based on managing the organisation's risks with the hedging parameters set based on what the risks are and how they are managed within the organisation. For example, an importer with the ability to quickly pass on changes to cost of goods resulting from currency fluctuations has no reason to hedge long term.

Conversely, an exporter who locks in a price today for goods to be delivered and paid for in three, six, or even 12 months' time should have some long term currency hedging. The treasury policy must reflect this organisation's reality.

The policy should also be bespoke and built solely for a particular organisation. We have seen a recent example of a treasury policy that is up for review, only to find it was simply a rehash of a policy that a senior staff member had brought over from a previous working life. The policy in question came from a completely different industry, therefore the risks the policy addressed were completely unrelated.

The treasury policy should address the risks that the organisation faces. If the organisation is a net borrower, the policy should set out the parameters for managing the interest rate risk, liquidity risk, and funding risk. If the organisation is exposed to the fluctuations of the currency, it should have a foreign exchange risk management section. But, if the organisation does not have interest rate or foreign exchange risk, for example, a policy does not need to cover such risks.

Reporting is a key part of any treasury policy. It's no good identifying the risks that an organisation faces if there is no ongoing reporting of compliance with the delegations and parameters which are set to manage those risks.

The treasury report should be regular (monthly, quarterly etc.) and build off the sections of the policy for continuity and transparency. The treasury policy could also set out a benchmark against which performance will be measured and reported. This could simply be the mid-point of the hedging policy parameters or something more complex, but it should be relevant and achievable.

The reporting and benchmarking will also provide a basis for regular reviews of treasury risk management team's performance, strategy, and forecasts, which could be updated or amended if these are proving inconsistent.

While many borrowers have shortened the duration of their interest rate hedging portfolio and lowered fixed interest rate hedging levels over recent years in recognition of a fundamentally lower interest rate environment, this has generally been undertaken within the confines of existing policy control limits. For those organisations that have been reshaped by market dynamics since the Global Financial Crisis, a regular policy review will help ensure that your policy remains appropriate for your organisation and for your risks.

Whether by accident or design, these unprecedented geopolitical and market dynamics are distorting investment decisions, changing historical notions around pricing, and pushing markets to new frontiers. At such times, it is prudent to re-evaluate treasury policies.

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