The Fundamentals of Treasury and Liquidity Management

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Agenda

What is Treasury?

What are the key treasury disciplines we need to know?

Treasury Framework and Government

• Financial Risk
• Funding
• Liquidity and Cash
• Operations
• Reporting
Why Treasury Management is important?

To run a business you need cash!

Effective treasury management centralises the organisation’s liquidity which also assists to minimise interest, credit and currency risks

Ineffective treasury management can seriously damage or destroy an organisation

“Without knowing it, the directors bet the company on the market consensus of the exchange rate and got the call completely wrong.” SMH, July 2002

Stephen Bartholomeusz - Pasminco collapse
Scope of Treasury Risk Management

Risk Management
The process of maximising return while minimising risk within capital constraints

Risk Control
The independent identification, measurement, anticipation and reporting of:
- Risk (credit, market, operational)
- Return
- Capital utilisation
Role of Treasury

To quantify and manage the organisation’s exposure to financial risk, i.e.

— Liquidity Risk
— Funding Risk
— Interest Rate Risk
— Foreign Exchange Risk
— Commodity Price Risk

To quantify and manage the organisation’s exposure to risk as a result of treasury activities, i.e.

— Credit Risk
— Operational Risk

Project evaluation, payments, insurance, tax
Treasury and the ‘Six Pillar’ Model

1. Treasury Framework & Governance
   - Organisational structure
   - Roles and Responsibilities
   - Policies and procedures
   - Risk Management Framework
   - Infrastructure and systems

2. Financial Risk
   - Interest Rate Risk
   - Counterparty Credit Risk
   - Foreign Exchange Risk
   - Commodity Risk
   - Energy Risk
   - Insurance

3. Funding
   - Financial Planning
   - Source of Funding
   - Terms & Conditions
   - Loans Management

4. Liquidity & Cash
   - Managing Daily Cash Position
   - Managing Internal liquidity
   - Periodic Cash Flow Forecast
   - Managing Banking Relationship
   - Bank Account Structure

5. Operations
   - Inter-Company Settlements
   - Treasury Settlements
   - Bank Reconciliation
   - Accounts Payable
   - Accounts Receivable
   - Accounting and Tax

6. Reporting
   - Cash Flow Report
   - Loans Report
   - Investment Report
   - Foreign Currency Report
   - Exception reports
   - Board reporting
# Treasury Maturity Assessment – using ‘Six Pillar’ Model (Example)

## Treasury Framework

<table>
<thead>
<tr>
<th>Organisational Structure</th>
<th>Roles &amp; Responsibilities</th>
<th>Policies &amp; Procedures</th>
<th>Risk Management Framework</th>
<th>Infrastructure &amp; Systems</th>
</tr>
</thead>
<tbody>
<tr>
<td>No separate Treasury Structure</td>
<td>Finance function - no separate treasury personnel</td>
<td>No Treasury policies and procedures</td>
<td>Non Existent</td>
<td>Excel / register based systems</td>
</tr>
<tr>
<td>Treasury with decentralised organisational structure</td>
<td>Separate Treasury but limited role delineations, differing functional expertise and poor segregation of duties.</td>
<td>Informal Treasury policies and procedures</td>
<td>Rudimentary</td>
<td>Rudimentary treasury system supported by spreadsheets</td>
</tr>
<tr>
<td>Treasury organised on traditional lines</td>
<td>Treasury personnel with standard segregation of duties and standard role delineation and adequate functional expertise</td>
<td>Approved policies and procedures with limited enforcement and limited senior management involvement.</td>
<td>Standard</td>
<td>Standard non-integrated treasury systems with manual processes</td>
</tr>
<tr>
<td>Centralized Treasury structure with strong functionality</td>
<td>Treasury with strong functional expertise, segregation of duties &amp; clear role delineation.</td>
<td>Advanced, approved policies and procedures which are embedded into processes and enforced</td>
<td>Strong</td>
<td>Advanced integrated treasury system with automated processes</td>
</tr>
</tbody>
</table>

### Where we could be

### Where we want to be
What is risk appetite and why is it important?

An organisation’s risk appetite is a level of risk that the organisation is willing to accept in pursuing the profit goals it has set for itself.

Different organisations and their management will have differing levels of risk appetite (for the reasons below)

A properly set risk appetite will take into account:

- The organisational capacity for managing these risks
- The amount of earnings expected by taking these risks
- The amount of capital available to weather unexpected losses which can occur in spite of good risk management
- Board and management risk attitude
Where is the Risk?

“THE RISK IS IN THE ASSUMPTIONS…..
……you have to make.”
Business is located in earthquake zone:

**Risk Prevention**
- Relocate business

**Risk Reduction**
- Build earthquake resistant plant and buildings

**Risk Transfer**
- Insure buildings/business

**Risk Acceptance**
- Design products/services around earthquake risk
Policy and Procedures

What is a financial risk management treasury policy?

- It is a key ‘plank’ of the organisation’s corporate governance.
- The risk management policy is the key communication tool for laying down the risk appetite of the Board of Directors for the rest of the organisation to follow.
- It should be approved by the board and reviewed on an annual basis.

What is a risk management procedure?

- The activities/processes which enable the implementation of the risk management policy.
- It should be approved by senior/responsible management and periodically audited.
Styles of Treasury Management

Responsive:
• The Treasury executes such transactions as are required to fund the business units on a day-to-day basis
• Risks are dealt with as they arise or as a business unit advises the Treasury of an issue

Proactive:
• The Treasury understands the business and the financial risks of the business
• The Treasury is active in communicating with business units and assisting business units to identify risks and manage financial risks
Types of Treasury Functions

Decentralised
• to business units or regional treasury functions

Centralised
• Agent or ‘central banker’

Cost Centre
• treasury is an ‘overhead’ and is focussed on risk management

Profit Centre
• treasury is expected to contribute to organisation’s profitability as well as manage risk

Needs to match risk appetite and objective
<table>
<thead>
<tr>
<th>Commandment</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>There is no ‘free lunch’ - if it is too good to be true then it probably is</td>
</tr>
<tr>
<td>2</td>
<td>Beware Volatility – e.g. the AUD “goes up by the stairs and down by the elevator”</td>
</tr>
<tr>
<td>3</td>
<td>It is better to under hedge than over hedge</td>
</tr>
<tr>
<td>4</td>
<td>Hedge in haste – regret at your leisure</td>
</tr>
<tr>
<td>5</td>
<td>Hedging to a view – are you feeling lucky?</td>
</tr>
<tr>
<td>6</td>
<td>Vanilla is good – beware of geeks bearing gifts</td>
</tr>
<tr>
<td>7</td>
<td>Expect the unexpected – it can happen to you-stress test</td>
</tr>
<tr>
<td>8</td>
<td>As Warren Buffett has said - “derivatives are like hell – easy to get into, hard to get out of”</td>
</tr>
<tr>
<td>9</td>
<td>A policy you can’t breach is a waste of paper – specificity</td>
</tr>
<tr>
<td>10</td>
<td>Buyer Beware – there is no ‘PDS’</td>
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</tbody>
</table>
### The 10 Golden Rules of Risk Management:

<table>
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| 1    | Understand your profits  
large profits you do not understand are more dangerous than the large losses you do. |
| 2    | Focus on distance  
operational risk increases with the distance from head office |
| 3    | Enjoy your holidays  
people who never take holidays or who always stay late are not necessarily paragons of corporate virtue;  
‘lifestyle’ choices may be used to mask business realities |
| 4    | Prepare to pay  
there is no such thing as cheap risk management |
| 5    | Invest with authority  
the CEO is not the risk control function, but a risk control function without the CEO’s backing won’t prosper |
| 6    | Reconcile with diligence  
reconciliation problems can be an omen for losses: a debit balance in a suspense account is rarely an asset |
| 7    | Track the cash  
accounting entries can be manipulated; cash disbursements cannot. Cash is the fundamental control |
| 8    | Respect business quality  
volume is not a substitute for value |
| 9    | Ensure it adds up  
accounting losses reflect business realities |
| 10   | Watch your systems  
computer systems are an open door into the heart of your business, and their integrity and security is not as complete as you think |
Thank you

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