

TREASURY



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Achieving Visibility to Your Liquidity

Part I

The recent and continuing turbulence in the financial and economic markets reemphasizes the truism that “Cash is King.” This is a King that certainly needs protection. To adequately protect your cash requires having timely visibility to organizational liquidity and to any potential threats to this liquidity.

Visibility that is too late is analogous to driving while looking in the rearview mirror. It is of little use to the treasurer. Discovering you have exposure to Lehman Brothers one week after a significant event can evoke feelings of inevitability. Achieving a sufficient level of visibility requires work and organization. During times of stability, treasury feels pressure to avoid spending significant amounts of time or money organizing for highly unlikely events. When everything is in turmoil, there is great pressure to quickly put current information into the correct hands. Nevertheless, collecting this information

in a timely manner doesn't just happen. Preparation is necessary for gathering information systematically, which allows treasuries to analyze the situation accurately and then act quickly.

In this article, several of the steps and perspectives for achieving visibility are outlined. However, Chapter 17 in *The Strategic Treasurer: A Partnership for Corporate Growth* (Wiley & Sons, Inc. 2009) covers this material in far greater depth.

While it may be possible to predict some turbulent events, it isn't likely all can be prevented. Nonetheless, treasurers must ensure that their groups are organized and prepared to address events as they unfold, with a much higher level of data, analysis, and confidence than would otherwise be the case.

The three steps related to preparation and response build on other work for which the treasurer is responsible, including capital structure, treasury structure, and relationship management.

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STRATEGIC TREASURER is recognized as the leading provider of advice and implementation assistance in treasury and risk management technologies.

Our practice areas include:

TREASURY AUTOMATION

- Treasury Workstation (Client server, ASP)
- Risk Management
- Reconciliation
- Bank Account Administration

FINANCIAL RISK MANAGEMENT

- Risk Management Framework
- FAS133 Assistance

TREASURY MANAGEMENT

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Hedging Can Potentially Exacerbate a Firm's Cash Flow Volatility

The above statement may seem counterintuitive. However, we should be well aware of the premise of risk management—to mitigate cash flow volatility. Nevertheless, due to the effects of hedge *ineffectiveness* per FAS133, some volatility may remain in net income, albeit non-cash volatility. But, more importantly, excluding the impact of a poorly executed strategy, hedging can potentially exacerbate a firm's cash flow volatility when margin or other collateral requirements are involved, typically due to an entity's weak credit standing.

The risk of margin calls, or the requirement to potentially post cash collateral against the net-unrealized loss on the hedge portfolio, may become a fact of life for more entities. Given recent events, there is a heightened awareness of counterparty credit risk—on both sides of the trade—leading more counterparties to push for collateral stipulations in their CSA (credit support agreement of the ISDA). Further, there is talk of eventually requiring over-the-counter (OTC) derivative trades to settle through a centralized clearing mechanism much like exchange-traded instruments, which require initial and daily maintenance margin deposits.

A margin call can be a severe risk to liquidity reserves. You are no longer just concerned about your current period's exposures and their potential impact on your cash. Now, as you hedge long term and at higher levels, you are concerned

with the potential volatility of your entire hedge portfolio many months—or even years—into the future. Given the volatility of certain underlying exposures hedged (oil prices, for example), margin risk can be significant and very difficult to predict. This added risk can potentially overwhelm the benefit of the initial hedge objective—to mitigate cash flow volatility and make it more difficult than it already may be to execute an effective hedge strategy.

Consider the case of U.S. airlines.

The credit ratings of most have dropped below investment-grade status since early 2000, leading their counterparties to require them to post cash, or a suitable substitute (i.e., a L/C), as collateral if the value of the hedge portfolio drops below a pre-determined threshold.

Case in point: (WSJ, "Airlines Grab Cash Amid Crunch" 12/30/08) Amid declining oil prices several airlines had to post collateral to trading partners against their fuel hedges (UAL \$900mm, AMR about \$550mm, and Delta \$1.1Bln). Further, Delta indicated that for each \$5/barrel drop in oil price, they would need to post an additional margin of \$100mm during that period. The airlines did, however, expect these margin requirements to ease. Many hedges executed at higher price levels were expected to roll off during the first half of 2009. Even though the airlines indicated they had adequate cash reserves to manage this volatility, the potential risk to their liquidity, even if temporary, was severe and difficult to predict (one would have to be a predictor of oil prices). Moreover, the margin risk could limit their ability to effectively hedge a large

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SWIFT Corporate Access Heats Up in New York



As evidenced by the great turnout at the SWIFT Corporate Workshop* in New York in March,

SWIFT's potential applications within a corporation have moved to the top of mind for many corporate treasurers. Driving this movement are the goals of global visibility of liquidity, reduction of risk and cost through improved straight-through processing, and flexibility to operate inside a common banking framework not dependent on any one bank. SWIFT is certainly a great tool and may be appropriate for your business, especially given both the growing functionality and the growing number of players on the network. As the network expands in size and capability, the advantages grow exponentially. For example, new capabilities around automated account maintenance could greatly improve treasury efficiency for an onerous process. Moreover, trade services features will become increasingly functional as additional corporates take advantage of the offering.

We at Strategic Treasurer believe a great number of corporate treasury departments will desire to gain access to the SWIFT network; therefore, we will continue to assist treasurers indirectly by hosting SWIFT Corporate Workshops and directly by working with them through a thoughtful process of deciding whether to pursue SWIFT or to evaluate other bank connectivity options. (next page)

What *are* your plans regarding SWIFT Corporate Access? Have the changes in SWIFT network access methods and the newly offered SWIFT services altered your business case?

A conversation with Strategic Treasurer could help you effectively leverage SWIFT. (Contact Ric Thompson at 678.466.2230 or ric@strategictreasurer.com.)

*These Workshops are jointly hosted by Camino Consulting and Strategic Treasurer. For detailed information, see our website www.SwiftCorporateWorkshop.com. ✦

STRATEGIC TREASURER'S Top 10 Automation Pitfalls

Pitfalls 10-8 can be found in the previous issue of Treasury Update (Volume 4). For a copy, contact TreasuryUpdate@StrategicTreasurer.com.

7. Lack of Formal Team Structure

Who needs a formal team structure? The answer is, "You do."

But you say, "We have a small treasury. We are all working on the project, so why do we need a formal structure?"

There are three basic reasons: communication, accountability, and authority. Someone needs to communicate the goals, responsibilities, needs, timeline, and milestones. Someone needs to be able to hold others to the task as well as be accountable for moving the project forward. And lastly, someone needs to be in charge and have the authority to break the logjams. This is why high level sponsorship and understanding of a project are vitally important.

If the project is worth doing, it is worth having a project plan and a team. No single person can handle a treasury project. If you have a one-

person treasury staff, you *will* need help on the project.

6. Kicking the Tires

"Kick the tires and light the fires" (military aviation definition of an inadequate aircraft preflight inspection).

This usually ends up with tragic results. Similar results will occur when poor due diligence is applied to a treasury automation project. Any vendor can snow you with an unscripted demo of a gee-whiz product.

It is what is under the hood that matters.

5. Everybody's Doing It

This stereotypical teenage comment covers the concept that it is safe to follow the crowd—or it is a defensible argument to follow what others are doing. Of course, where others are going may be based upon other standards and needs and have nothing to do with you. Also, just because others have done something does not make what they have done a good decision by itself, either.

Make your decisions based upon your *needs* and *what makes sense* for your organization. What others have done may provide information and insight into your situation but should not be the guiding factor—or *blind* guiding factor.

4. "Get it up and running, and then we'll fix our problems."

This is somewhat akin to "As-is-Blindness" (Pitfall 9 in the previous issue of *Treasury Update*); however, it usually strikes *after* the initiation of a project. In this case, a mad rush is made to get software up and running so someone can say, "It is up and running." Often this results in little usable functionality and a product so completely foreign to the user that it cannot be used, or it results in automated processes that were broken in the beginning. Now, they are just broken, automated processes. ✦

-Ric Thompson

Look for the last three Pitfalls in the next issue of Treasury Update!



Is Your Treasury Technology a Bit Dated?

Despite attendance being down at many treasury management conventions, the treasury technology sessions continue to experience full attendance. Strategic Treasurer consistently emphasizes in these sessions that many companies are taking a fresh look at their existing treasury technology suite and deciding whether to revamp existing systems or re-tool by acquiring new ones. Many users of Thomson's Treasury Manager workstation (previously Selkirk's) are acutely aware of the need to review their situation as Thomson *discontinues support* for this product at the end of 2009.

Strategic Treasurer efficiently helps firms maximize technology, information, and clean processes to meet their organization's needs. A multitude of reasons beyond discontinuing a workstation (i.e., Treasury Manager) drive the urgency of deciding when and how to move to a new technology platform. Strategic Treasurer highlighted this in a recent webinar, "Why Consider Changing Your Treasury Management System?"

Discussion highlights were:

- **Platform obsolescence and older technology.** With rapid development and improvements in technology and various services, moving to new technology can provide many dramatic advantages.
- **Ineffective Technology.** Some technology offerings are not robust or flexible enough to complete

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(Visibility continued from page 1)

Step 1: Achieve timely visibility to the firm's liquidity. The treasurer must guard cash and sources of liquidity for the organization. Achieving clear visibility to these items is essential. Information management and technology are critical tools used to achieve this goal.

Step 2: Assess threats to the firm's liquidity. Perform regular reviews to identify and measure organizational liquidity and factors that can negatively impact liquidity. These factors include internal items (i.e., capital expenditures) and external situations (i.e., counterparty deterioration).

Step 3: Execute rapid decisions according to plan. As worrisome or unexpected market and government events unfold, or threats to the firm's liquidity arise, the well prepared treasury group will be able to respond according to plan or reassess the situation and react promptly to unexpected developments.

Visibility to Liquidity Requires Data

The information necessary for visibility resides in various locations. Much will reside within treasury systems, the financial records of the organization, the treasurer's mind, or in a spreadsheet controlled by a particular operating area. Accessing other external data and intelligence can range from headline oriented news to rating information.

Exhibit A shows some of the items directly related to liquidity that treasury will need to access for visibility purposes. Moving from the left hand side of the chart to the right requires more work and yields greater visibility. Please note that an

electronic connection will not by itself alert you to the rapid decline of a major counterparty or of a bank that is intent on pulling an uncommitted line of credit. These, and other threats, must be factored into your visibility plan.

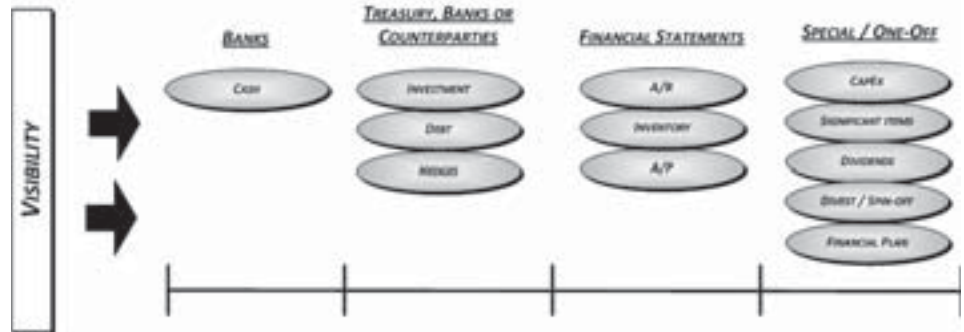


Exhibit A: Visibility to Treasury Items

A sample process of identifying your goal of visibility to the steps for achieving visibility is summarized in **Exhibit B**.

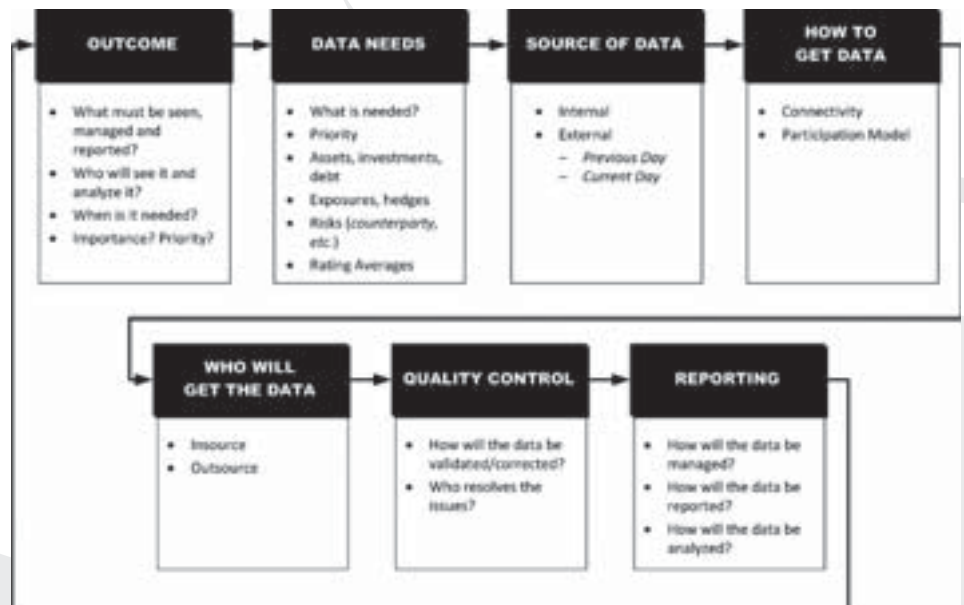


Exhibit B: Visibility to Treasury Items Process Chart

Requirements to Achieving Visibility

Several near-universal prerequisites and requirements exist for achieving visibility to your liquidity. These include:

- Rationalizing banking relationships and banking structure.
- Optimizing the number and quality of counterparties.
- Connecting through Networks such as SWIFT or Data Consolidators.

Look for Part II in the next *Treasury Update*, where critical aspects concerning assessment of threats and impacts to an organization's liquidity will be addressed. ✦

- Craig Jeffery

(Technology continued from page 3)

the tasks modern treasury departments require.

• **Market Pressure and Business Demands.** Turbulent markets create greater exposure and attention. Ensuring your organization has timely and complete information is no longer a nice-to-have option.

The demands in treasury have never been greater; treasury staffs are spread thin, leaving little margin to effectively consider how to best evaluate and manage corporate access to banking information, transactions, and a host of emerging services. Strategic Treasurer exists to assist you with your treasury and treasury technology needs. As SWIFT partners, experienced treasury practitioners, and consultants, we at Strategic Treasurer are uniquely positioned to help you develop a strategic vision, build a business case, assess appropriate technology, implement solutions, and optimize your processes.

Is *now* the right time for a dialog regarding treasury technology's ability to meet your treasury needs? (Contact Craig Jeffery, at 678.466.2222 or craig@strategictreasurer.com.)

What would indecision cost you? ✦

**(Hedging continued from page 2)**

portion of their fuel requirements for any term except the short-to-medium horizon with any type of fixed price contract, such as swaps or forwards, or requiring greater use of options in the hedge portfolio, a potentially expensive solution depending on market conditions.

The question then is: Do margin requirements limit or even negate the value in hedging? Entities generally hedge to avoid financial distress and/or provide predictability for management to plan.

Hedging then impacts a firm's value in several areas by:

- Reducing the size/cost of liquidity reserves.
- Mitigating the risk of underinvestment.
- Providing flexibility in capital structure choices.

Hedging only buys time, but the ability to execute on that strategy is severely limited when faced with the risk of cash calls, as it adds an additional element of cash flow unpredictability. This added level of uncertainty likely played a key role in airlines being under-hedged during the run-up in oil prices throughout much of this decade. Uncertainty hurts value as it impacts management's ability to plan and execute with confidence.

So, what do you do? Quit hedging? Use only options? It depends. The strategy begins with your exposure and deriving a hedge objective. Next, you must be able to analyze the potential impact of the portfolio's fluctuations and any margin call's impact to your cash reserves. This is where effective risk management systems—and there are many—can be an aid. Whether you choose options

over fixed-price instruments is, as always, a cost-benefit decision, but now there is an added benefit to the use of options, i.e., a cap, as the value cannot fall below zero; cash is paid up front for this “insurance.”

In conclusion, I'm still in the camp that believes hedging adds to a firm's value in general, but that value—or the ability to maximize it—is obviously mitigated due to the risk of margin. Further, if you are not exactly sure about what you are doing in the first place, i.e., you don't understand how margin calls may impact you, then hedging could potentially destroy value if you are not careful. As always, thorough analysis and critical thinking is the best prescription. ✦

- David W. Stowe, CFA

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 - Craig Jeffery - "The Differences Between Treasurers and Controllers"
 - August 19 - Atlanta
- **SIBOS**
 - September 14-18 - Hong Kong
- **SWIFT Corporate Workshop**
 - Autumn 2009 - Location TBD
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 - October 4-7 - San Francisco
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