CORPORATE FINANCIAL RISK MANAGEMENT[1]

*"Doing nothing" **IS** doing something! If company directors and managers ever legitimately had the option of "doing nothing" about the management of their financial risks, those times are long gone - unless, of course, such individuals enjoy defending legal actions initiated by disgruntled shareholders. This paper discusses some of the fundamentals which companies ought to recognise and practise so as to avoid "ugly incidents" occasioned by deficient financial risk management.*

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The specific financial risks to be discussed here are interest rate risks and exchange rate risks.

Interest rates and exchange rates are merely prices which, in a partially or wholly deregulated financial market, may fluctuate in accordance with relative competitive demand and supply pressures throughout the course of any trading day.

If interest rates and/or exchange rates always moved in a company's favour, the issue of financial risk management would become a non-issue. The fact of life is, of course, that these important market rates may well move **against** a company and thereby result in larger than anticipated outgoings and/or reduced receivables. It is quite conceivable that these unanticipated cash flows may be of such an adverse magnitude that the subject company is rendered insolvent.

What then should a company do to protect itself from adverse exposure to financial risks? This is a difficult question, to which there are all too few necessarily "correct" answers.

Some time ago when financial markets were much more regulated (and, consequently, there was little price fluctuation), companies may well have "done nothing" about managing interest rate and exchange rate risks. This may have been a "decision" taken by default, or it may have been a considered decision. Regardless of the decision path, the "do nothing" position perhaps counter-intuitively entailed the company "**doing something**" - namely, entering the business of **speculating** on interest rates and exchange rates! This can be a very risky business - so risky, in fact, that banks (the perceived "experts" in financial risk management) choose **not** to be in this business.

Given a company clearly has a choice, many companies decide to concentrate on their **core** commercial activities and take a **risk averse** position on interest rates and exchange rates. What they must then do is formulate and implement a **financial risk management policy** which (i) articulates their philosophical attitude towards financial risk, thereby implying a particular level of

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"cover" against adverse rate movements and (ii) stipulates the company's requisite limits, controls and authorities that will be imposed upon those finance personnel who deal in the company's name in financial markets. In so doing, an attempt is being made to prescribe operating conditions which make it as difficult as possible for financial "ugly incidents" to occur.

Let us now consider some important (and arguably vital) policy elements.

In proceeding to articulate some prudent internal controls, it is sensible to draw upon the dealing room practices of professional dealers - not because professionals necessarily do everything "correctly", but because financial risk management is the professionals' **core** business and, as a consequence, they institute and maintain rigorous, well defined, closely scrutinised standards which tend to stand the test of time.

Trading objectives: a natural precursor to instituting a range of specific internal controls is the articulating of a company's **financial markets trading objectives**.

The two "extreme" approaches to defining these objectives are to have the corporate treasury area act as:

- a financial markets trading **profit centre** or

- an area whose brief is to **eliminate all financial risks** as and when they arise, and to do so without regard to trading profitability.

An intermediate approach to defining financial markets trading objectives might also be considered where, for example, a **primary** objective of risk elimination might be specified and some speculative trading allowed **under tightly controlled conditions**.

Authorised markets and financial instruments: those financial markets to which a company's financial traders will be permitted access, together with the financial instruments in which they are authorised to deal **must** be articulated. Particular care must be taken to ensure that corporate dealers have appropriate expertise to deal in authorised markets and instruments, and that senior management also has sufficient understanding of the broad technical characteristics of, and potential risks attaching to, any instruments to which the company's dealers are permitted access.

Relevant financial markets to be considered for authorisation purposes include:

- physical or "deliverable" markets: cash money markets, and spot and forward foreign exchange markets

- exchange traded (ET) financial derivatives markets (eg futures)

- over the counter (OTC) financial derivatives markets [eg forward rate agreements (FRAs), swaps and options].

If the use of particular financial derivatives is authorised, relevant senior management should be aware that while the appropriate use of financial derivatives in financial markets may help eliminate financial risks, if those financial derivatives are used in isolation from any corresponding underlying commercial transactions, **that use of financial derivatives may actually increase the financial risks to which the company is exposed**!

Limits: every transaction undertaken in a professional dealing room is subject to **limits**. Again, banks are sufficiently street-wise and risk averse to know that having anyone dealing in their name in an unlimited fashion is an unequivocal recipe for financial disaster.

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Professional treatment of limits is an aspect of financial risk management that ought to be emulated in corporate treasury practice. Unfortunately, companies tend to be far less rigorous than banks in instituting and then enforcing limits on dealers. In particular, corporations should follow professional practice which dictates there is only one fate for a dealer who knowingly **breaks** a limit - and that is instant dismissal!

Authorities: anyone dealing in a corporate name should be notified **formally** by senior management as to their dealing responsibilities and limits. Moreover, the names of authorised corporate dealers should be communicated to all dealing counterparties - especially banks' professional dealers (who should anyway have already made a blanket, ongoing request for such information).

Financial control: as a minimum -

- all financial deals must be documented

- financial deals should be confirmed on the deal date and by signature on contracts forwarded by the professional counterparty

- there should be a strict segregation of dealing and confirmation functions. No **one** person should be in a position to control (or even influence) **both** functions. While this highly important control stipulation may present compliance difficulties in a small corporate financial dealing environment, the principle nevertheless remains that oversight of the dealing operation which is independent of the dealers themselves is **vital**.

- appropriate, timely internal management reports on financial day trading and open positions taken should be available, and open positions should be reviewed in relation to limits

- a company's internal and external auditors respectively should **both** understand the company's financial risk management policy and dealing system.

Risk management performance assessment: the current value of all financial markets transactions into which a company has entered should be periodically assessed by "marking to market" all "exposed" positions. The company will thereby be forced to focus attention on all financial exposures relative to "where the market is now" (even if this proves painful) and the extent to which the company is "out of the money" or - hopefully - "in the money".

Financial risk management policy review: policy should be reviewed formally on a periodic basis (eg annually) so as to ensure current policy remains appropriate to the company's ongoing risk "appetite", commercial activity, profitability and financial markets developments (eg price trends and/or volatility).

Some final words of warning for corporate financial risk managers: **the price of solvency is eternal vigilance.** One should never become complacent because of past "successes" or take one's eye of the risk management ball.

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