Treasury management

Introduction

The lesson learnt from the global financial crisis (GFC) is that a bank could go under if it failed to manage its liquidity risk even it was profitable. Basel III, the third in a series of accords issued by the Basel Committee on Banking Supervision, introduced a number of compliance requirements for banks such as liquidity coverage ratio and net stable funding ratio to safeguard against future liquidity risk. According to the United Nations World Investment Report[1], Multinational corporations (MNCs) have since tightened their defence by increasing their liquidity level through cash held by the 5,000 largest firms increasing as a percentage of assets from eight percent pre-crisis to eleven percent by 2013. However, holding high cash buffer is inefficient given the close to zero bank deposit interest rate. This article addressed the important topic of treasury management, defining the key concepts of treasury management (what and why), discusses the application (how) showing some case study and provides an outlook of the future development of treasury function.

Key concepts

What are the functions of treasury management?

Treasury functions	Why	What
▪ Cash management ▪ Cash forecasting	Liquidity risk Cash conversion cycle (working capital)	Cash reporting and control Cash pooling structure Cash forecast and planning
▪ Investing corporate cash	Return enhancement Credit exposure limit	Investible asset class Asset allocation strategy
▪ Financing ▪ Credit rating agency relation ▪ Investor relation	Refinancing risk Liquidity risk Duration mismatch risk ALM risk	Short term: bank loan usually floating rate Long term: corporate bond usually fixed rate Credit rating
▪ Treasury risk management	Foreign exchange risk Interest rate risk Commodity risk	Over the counter derivatives Exchange traded derivatives
▪ Bank policy ▪ Bank relation	Optimised use of banking facilities	Master bank agreement at headquarters level
▪ Treasury management system (TMS)	End to end straight through processing (STP) data flow	Connectivity with internal ERP (e.g. Oracle, SAP) and external (e.g. Bloomberg)
▪ Corporate finance	Complex treasury transaction risk	Spin off, M&A, IPO Project finance
▪ Intra-group financing	Reduce unnecessary external borrowing	Use in-house surplus to fund deficit position

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What are the division of work between Accounting/Finance and Treasury function?

Illustration	Accounting/Finance	Treasury
Payment	Invoice approval; payment processing	Set up banking arrangement
Hedging	Hedge accounting; bookkeeping	Execute hedging transaction

According to PwC Corporate Treasury Survey 2017[2], "Treasury can be considered more of a range of services and process than a department". On a worldwide basis, PwC estimated "companies potentially can unlock US$1.1 trillion from working capital". Therefore while treasury and accounting/finance function perform different roles, there should be more integration and collaboration between the two.

Application

The following is an integrated framework that a company can adopt to effectively implement a treasury function that includes three levels of management activities:

Level 1: governance level

Level 2: supervisory and management level

Level 3: operational level

As an illustration, the board of a listed Chinese real estate company listed in Hong Kong has recently set up a Risk Committee in response to new stock exchange listing rules effective January 2016. Upon the request of the board, the CFO was asked to prepare a Risk Assessment Report and a Risk Mitigation Strategy to address liquidity risk, refinancing risk and interest rate risk. Level 1 requires the Board to set risk tolerance limit (how much risk or loss the company can afford and desire to absorb) and approve hedging strategy. Level 2 requires the management (CFO/treasurer) to quantify the exposure and recommend hedging strategy. Level 3 requires execution of the treasury transaction which included the front, middle and back office work to ensure the segregation of duties. The transaction will then be accounted for and mark-to-market by the accounting team.

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Policy	Process	People	System
Resources			

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Case study

Treasurers can use the bank and capital market to improve cash visibility and control, reduce funding cost and customise the hedging solution to fit the needs of the company.

	Risk factors	Treasury solution
Cash management	A Chinese MNC is expanding its international operations but its cash in multiple currencies are managed by local offices	The treasurer adopts a global cash pooling solution to sweep the cash into a header account to minimize foreign exchange risk and maximize the central cash pool to obtain the best investment return
Financing	A major power company has to raise long term funds to finance renewal energy investment	The treasurer sets up a medium term note (MTN) programme to allow it to issue bonds at short notice by private placement or public market issuance
FX risk management	The power company issue USD bond but its revenue is in HK dollar	The treasurer uses cross-currency swap essentially converting USD into HKD liability.
Interest rate risk management	A quasi-government body has significant financing that is exposed to interest rate risk	The treasurer adopts, with the board approval, a 40%-60% range for fixed rate as a percent of total funding. It uses interest rate swap to adjust the ratio.

A reference of industry good practice is available from the “Preferred Financing Model”[3] developed by MTR.

Outlook

In 2016 the Hong Kong Government introduced the new Corporate Treasury Centre policy[4] and qualified treasury profit will be taxed at 8.25% which is half the standard corporate income tax rate of 16.5%. More importantly, offshore interest expense is tax deductible against offshore interest income.

The following are development which will affect treasury management in future:

Development	Likely effect
Fully phased-in of Basel III in 2019	Financing and hedging costs to go up
Mandatory adoption of IFRS9 in 2018	Easier for corporate treasury centres to achieve effective hedge
Base Erosion and Profit Shifting rules	Intra-group interest setting to be arms length
Belt and Road Initiative	Increased treasury need for corporate treasury centres
RMB internationalisation	Hong Kong as treasury hub for offshore RMB

Since 2014 China Overseas Direct Investment (ODI) has exceeded Foreign Direct Investment (FDI) into China. More MNCs especially Mainland Chinese companies will set up corporate treasury centres in Hong Kong to manage their international treasury function, making use of the motivated and highly educated pool of labour in the territory, and the support from government policies. Their corporate treasury centres can then be structured as an in-house banks[5] to achieve a number of economic benefits.

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Conclusion

As "black swan" event becomes a daily routine, the treasury function of a company will become increasingly challenging. Treasurers need to have both the technical expertise and the soft skill to collaborate with various internal and external stakeholders to create value for the company.

Footnote

1. United Nations World Investment Report 2014 p. 29:
   http://unctad.org/en/PublicationsLibrary/wir2014_en.pdf
2. PwC Global Corporate Treasury Benchmarking Survey 2017, pp. 5-6
   https://www.pwc.com/gx/en/services/audit-assurance/assets/the-virtual-reality-of-treasury.pdf
3. Preferred Financing Model in MTR 2016 Annual Report: p. 107
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4. PwC newsletter on New Corporate Treasury Centre Policy
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The author has been the HKICPA QP Assessor for over 15 years and a fellow member of the Institute since 1992. He was the President of CIMA Hong Kong in 1997 and the Chairman of the Hong Kong Association of Corporate Treasurers during 2000-2012. He is Founding Chairman of IACCT (China) established by HKACT in 2006 to promote treasury best practice in China. He has been appointed by the Hong Kong Monetary Authority as Board Member of the Treasury Markets Association since 2006 and a member of the Working Group on Corporate Treasury Development since 2012. He held positions of Director of Finance/Treasurer of one top 10 global shipping conglomerate for six years and the Regional Director and Treasurer of AIA/AIG for over 13 years. He is currently the Director of PwC Consulting specialized in treasury advisory practice in Greater China.

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