Treasury Operations and Control

Treasury Operations

1. Money Market Deals
- Outright Purchase / Sale of Securities (GSs/T-Bills)
- Repo (Borrowing)
- Reverse Repo (Lending)
- OMO (Open Market Operation)
- Clean Lending
- Clean Borrowing
- Investment Portfolio Securities. (IPS)

2. Outright Purchase of Securities (GSs/T-Bills)
- Purchase through Auction/ Primary Dealers (PD)
- Primary dealers are those banks which have been authorized by RBI to participate in the auction.
- RBI circular is received for auction of securities.
- On auction date bids are sent in a sealed envelope to RBI.
- Results are declared by RBI.
- Purchase confirmation /contract is made by the bank.
- The successful bids are entered into system and processed.
- RBI credits the bank's SLR/CRR account with the amount of successful bids after receiving Cheque/ECS.

3. Purchase through Secondary Market
- Securities are purchased through secondary market (Banks and Financial Institutions) for- RBI Statutory Liquidity reserve (SLR) purpose.
- Trading Purpose
- RBI cheque is auto generated from the system.

4. Outright Sale of Securities (GSs/T-Bills)
- To raise liquidity of Bank.
- Sale contract is made by the bank.
- Securities are sold directly or through brokers.
- Deal slip is verified / authorized for completeness.
- Movement of securities is made through SLR/CRR account and

- SBP cheque for the sale price is received.

5. Repo (Borrowing)

- Sale of securities (GSs/T-Bills) with a promise/contract to repurchase on an agreed rate and future determinable date.
- Transactions are governed by an agreement, Master Repo Agreement (MRA) only between the two parties.
- Repo deals are done within the parameters and limits set by the banks internally.
- Deal done / input at front office is forwarded to Operations for processing/settlement.
- Deal ticket and confirmations are generated through the system.
- Account (SLR/CRR) letter is printed, signed and delivered to the broker/counter party and RBI cheque received there against.
- Broker or counter party returns one copy of the contract duly signed.

6. Deal Maturity Procedure

- System generates Deal Maturity Report.
- Generates RBI Cheque from the system.
- Broker delivers counter party Account (SLR/CRR) letter.
- Designated signatories sign RBI cheque with the Account (SLR/CRR) letter.
- RBI Cheque and Account (SLR/CRR) letter is handed over to the broker for onward deposit with RBI.

7. Reverse Repo

- Purchase of securities (GSs/T-Bills) with a promise/contract to re-sell on an agreed rate and future determinable date.
- Reverse Repo contract is made to increase security holding to utilize generated liquidity.
- Verifier in Operations retrieves deal ticket on screen, obtains relevant documents and matches accuracy of content and relevant terms and conditions.
- Authorizer authorizes after counter checking.

8. Deal Maturity procedure

- System generates Deal Maturity report.
- SLR/CRR letter is generated from the system.
- SLR/CRR letter is signed and given to the broker /counter party.

- The cheque is received from the counter party and deposited with RBI along with SLR/CRR letter.

9. Open Market Operations (OMO)

- OMO is a tool used by central bank to inject or to with draw excess liquidity from Money Market.
- Notice for OMO is given by RBI for Sale/Purchase (i.e. Repo/Reverse Repo) of Securities (i.e. T-Bills) only for specific tenor.
- In case of Purchase of Securities by banks, RBI mop up liquidity from the Market i.e. Banks Reverse Repos.
- In case of sale of securities, RBI inject liquidity in Market i.e. banks Repos.
- Bids are invited through fax.
- OMO result is announced on OTC (Tele/Fax)
- The successful bidders enter into Repo/Reverse Repo contract with RBI.

10. Repo / Reverse Repo (OMO) Maturity.

- In case of maturity of Reverse Repo (i.e. lending by banks/FIs to RBI)an SLR/CRR letter is sent to RBI authorizing RBI to debit the bank's Security Account. RBI directly credits Banks /FIs current account with principal plus interest.
- In case of maturity of Repo (i.e. borrowing by banks/FIs from RBI) Auto generated cheque is sent to RBI and RBI directly credits Banks / FIs SLR/CRR account with related Securities.

11. Bifurcation of Portfolio Revaluation of Securities

As per RBI directives banks may keep their securities into following categories

1- Held to Maturity (HTM)

- Hold it till maturity.
- Securities shall be carried out at amortized cost.
- NOT required to be Revalue.
- Once the security is classified as HTM no subsequent shifting to available for sale or held for trading.

2- Held for Trading (HFT)

- Acquired for trading.
- Taking advantage of short-term market / interstate movements.

- Securities are to be sold within 90 days from the date of their purchase.
- Surplus / Deficit on Revaluation shall be taken into P/L.
- Shifting from held for trading to AFS or held to maturity generally not allowed. It will be permitted only if not sold within 90 days with prior approval.
- Accounting entries for Revaluation are passed on daily basis and reversed on the next day morning.

3- Available for Sale (AFS)

- The securities which do not fall within the previous two categories will be classified assays
- Shifting to / from Available for Sale with approval, reason for shifting should be recorded.
- Any permanent diminution in value of AFS or HTM will be provided for by charging it to P/L A/c.
- Revaluation of Available for Sale shall be taken to Surplus / Deficit A/c.
- Permanent diminution i.e. declining in value of securities due to rising interest trend.

12. Call Lending

- Lending of funds from one bank to another counter party over night or for a specific agreed tenor at a pre-determined interest rate.
- The funds are lent clean i.e. without securities.
- Banks earn profit.
- Deals are executed within parameters / limits set by the banks internally.
- Deals executed at front office are forwarded to operations through system.
- Verifier/Authorizer in operations retrieves deal ticket on screen, obtains relevant documents and matches accuracy of content and relevant terms and conditions.

13. Call Borrowing

- Borrowing of funds from one bank to another counter party over night or for a specific agreed tenor at a pre-determined interest rate.
- The funds are borrowed clean i.e.withoutsecurities at MIBOR.
- Banks may borrow funds to meet their minimum daily Cash Reserve Required (CRR) by RBI or for Trading purpose.

- Verifier /Authorizer in operations retrieve deal ticket on screen, obtain relevant documents and matches accuracy of content and relevant terms and conditions.
- MIBOR is average rate of Bid and Ask arrived at by the quotation of different banks.

14. What is Risk

- RISK is the uncertainty surrounding events and the impact of these events on expected outcomes.
  OR
- RISK is the chance that events or Actions will not have their previously planned / desired outcome.

15. Risk Categories

- Credit Risk
- Inability or unwillingness to repay
- Includes
- Cross Border
- Settlement Risk
- Sovereign Risk
- Operational Risk
- Regulatory Risk
- Internal Control Risk
- Technology Risk
- Documentation Risk
- Security Risk

16. Market Risk

- The risk associated with volatility in the movement of market rates for commodities,
  exchange rates, interest rates and liquidity.
- The impact of this risk can cause a variation in the net asset value of a bank.

17. Key Steps in Market Risk Management

- Risk Identification
- Risk Measurement
- Risk Limits/Appetite
- Risk Monitoring

- Organizational Set Up

18. Liquidity Risk

- Liquidity risk is the current and prospective risk to earnings and capital a arising from banks inability to meet its obligations.
- Liquidity risk arises from a failure to assess market conditions which may affect the bank's ability to liquidate assets quickly and with minimal losses.

19. Liquidity Risk Management

- Liquidity risk is managed through a gap analysis showing the maturity profile of the bank's assets and liabilities within various time bands.
- The cumulative negative gap in any time band should not exceed a certain percentage say 15 of cumulative liabilities.

20. Risk Management Policy

Individual Dealers Limits

- Individual Dealers should be assigned limits apartheid experience and expertise.
- Intraday / Overnight Limits
- Lot size Limits
- Tenor Limits
- Instrument Limits

Stop Loss Limits

- These limits should be established in a way that it restricts the amount of Loss/Risk for each type of Products. It should be established on the basis of past performance, profitability and expertise of Dealers / Dealing Room.

Monitoring of Limits

- Banks set various limits for various transactions with different weight age.
- Clean Placement Limit
- Repo / Reverse Repo
- Securities maturing within one-year limit
- Securities maturing after one-year limit

Best Practice in Treasury Management

Most professions nowadays have established best practice. A more or less universally accepted way of conducting the business of their profession and presenting the results of their work, using fairly standard methodologies and presentation formats. This is especially the case of service professions. Accountants will present their perception of a company and its business in the standard profit and loss accounts, balance sheet and source and application of funds formats, with a standard set of notes. Likewise, auditors have a standard methodology and format for the conduct of an audit and presentation of the results. These professional bodies have evolved these standards over years of practice and development. Any two accountants or any two auditors will conduct their work and present the results of their work in the same way, in fact, producing more or less the same set of reports or statements.

This is not the case with the treasury profession. There is no universally accepted way of conducting the business, except in some very limited aspects, and there is no standard way of presenting the results of the work. Two treasurers would come up with their own different ways of managing the business and would present the results in quite different ways. Indeed, if two treasurers were each to make a presentation on the same company's treasury business, one would not necessarily recognise them as relating to the same company.

This is a bad situation for treasury management. It is one reason why we have had 'scandals'. It is also why we have the ridiculous situation today where the accounting tail is wagging the business risk and treasury management dogs, under the International Accounting Standards (IAS) rules. If the treasury profession had established its own best practice methodologies and presentation formats, then this would not be the case. From a treasury management perspective, the best solution to IAS 39 at present is that it be parked until the treasury profession has developed its own best practice for its own business; then the two professions could work together for a best solution.

It is time to begin to develop treasury best practice. In this write-up, it is not possible to do this, but I will attempt to scope out what is meant by best practice in treasury management. It is only a beginning. However, I am working with some partners at present to provide a complete methodology for best practice treasury management and I expect this will be published later and will share it soon.

Some Key Principles

Corporate treasury should have its own equivalent of the profit and loss statement, balance sheet and source and application of funds. These formats or templates should cover the key aspects of treasuries' business. These need to cover:

- Treasury policy statements;
- Treasury governance arrangements;
- Treasury strategy presentations;
- Risk management;
- Treasury operations including dealing, treasury procedures, treasury controls, reporting and disclosure; and
- Treasury ethics

With a standard methodology for conducting the business in these areas as well as universally accepted formats or templates for presenting the results.

Treasury matters are complex even to the professionals. They are even more so for the layman. Apart from the treasury professionals in a company, all others involved are 'laymen'. This includes the board and corporate management, sometimes even the finance director, depending on his or her background. These people, though, are not 'laymen' when it comes to the profit and loss and balance sheet statements, because they have become comfortable with the standard presentation of them over the years and are now reasonably well versed in them. Likewise there is a need to have consistently standard presentation of treasury matters, in non-jargon understandable manner, to enable directors and senior managers, who are the decision-makers and authorisers/approvers of much of the treasury activity, to play a proper role: Essential governance.

Treasury management systems (TMS) should be developed to deliver as much as possible of the standard formats with all TMS reports adhering to these standards. Accounting systems adhere to accounting standards. However, not all of these treasury formats will be able to be produced by a TMS. So, it is necessary also to have standard formats for presentations which do not emerge from TMSs.

Context and Significance

Each company needs to undertake the exercise of establishing the treasury dimensions of the business in the context of the overall business. It needs to establish treasury's significance compared with other aspects of the business and its potential impact on results. This will ensure that it receives necessary and appropriate 'corporate attention'. It is too often that boards will spend endless hours on the detail of a new warehouse, which has little or very known potential impact on the business, yet ignore the treasury aspects of the business, whose impact potentially dwarfs that of the warehouse project.

In a corporate organisation, treasury does not have an independent role. It is there to support the business. Critical is the alignment of stated treasury objectives with stated financial objectives (which should be aligned with the business objectives), and this is a definite management responsibility. Otherwise, treasury can act counter to the company's financial objectives and this too frequently happens. As part of their corporate governance responsibilities, boards and corporate management must ensure that treasury operations dovetail with financial objectives in spirit and in practice.

Core Treasury Activities

As well as setting treasury in an overall business context, it is also necessary to assess the elements of treasury and where the main risks and potential impacts are located. Once identified, those elements which are to be focused on need prioritising. This extends to commodity price management. These prioritised elements then are the key or core treasury activities to be managed.

All too often, treasury resource is focused on operational detail, while missing the big picture. It is the responsibility of corporate and financial managers to ensure the proper balance between daily operational pressures and strategic management of the key and core areas.

Treasury Governance

Much of corporate governance comprises treasury issues, because this is where much of a company's risks are located. There is a need for clearly documented treasury governance arrangements. These should include:

- Organisation;
- Roles and Responsibilities;

- Management Process;
- Reporting Lines;
- Authority;
- Decision-making;
- Key governance, documents (Policy statement, authority, permissions and restrictions, etc.)
- Management information;
- Performance management; and
- Audit.

It is surprising how many companies are lacking in this respect. Standard formats should set best practice standards with a consistent presentation of all of these components. It should be a matter of governance for the board and corporate managers that they are in place and observed by the company.

Management and Decision-Making

Corporate treasury is complex and it operates in the difficult environment of financial markets. Yet decisions have to be made on an ongoing basis, by executives in treasury, the treasurer up to the board. In my view, having effective decision-making is one of the key requirements of best practice in treasury management. In many companies this does not exist, because general corporate regimes for decision-making are applied to the treasury activity, for which they are not suited.

A structured approach is essential, one which will:

- suit the dynamic financial market environment in which treasury operates;
- recognise the scale and significance of the business being done; and
- Enable informed decisions be made.

Standard methodology and formats for presentation will facilitate effective decision-making.

Treasury Policy

Corporate treasury is a high risk business in most companies. It needs to be well regulated. The starting point of regulation of treasury, after governance, is policy. Unfortunately, many companies either do not have formalised policy statements, or they are inadequate or inappropriate for the business, or they are 'dead on the shelf' and not observed. Responsibility for such situations rests with a company's board.

An effective policy in corporate treasury is difficult to construct. Most companies struggle with it. Those with the expertise are too close to the subject matter. Treasurers have difficulty in pitching it at the right level, determining a suitable format and deciding the content, especially the specific policy provisions. It is an area where treasury management would benefit enormously from an accepted best practice standard format or template, pioneered by the treasury profession.

Treasury Strategy

As with treasury policy, many companies do not develop and implement adequate treasury strategies. Instead treasury just acts and regrettably all too often just reacts, doing transactions or 'deals'.

A treasury's performance is much more determined by the strategies it develops and successfully implements rather than by the 'basis-point 'or two achieved in a 'good deal'. I have made this statement often, but it goes unheeded. Strategy sets the big picture and determines most of a treasury's performance compared to transactions which are the minnows of treasury's performance.

How can a corporate treasury align its performance up with its corporate financial objectives, if it does not develop and pursue strategies to do so? It is essential that corporate treasury develops strategies. These should be presented in understandable language to the board for approval and then implemented. It is a governance matter for companies' boards to ensure this.
Developing an effective treasury strategy is another difficult task for companies and for treasurers. It is a key area where standard best practice formats or templates are needed, again to be pioneered by the treasury profession.

Risk Management

Corporate treasury often contains the highest risk to a company's business. In one energy sector company I worked for, treasury risks, including commodity price Risk, was by far the greatest variable and risk to a five-year energy price commitment that was given to government. This is not unusual.

There is an absolute need for treasury best practice methodology and formats for risk management. This is where decision-making is key. Those being asked to make the decisions must be in a position to make them on the basis of proper understanding of the risks their business faces.

Accepted formats are needed to identify each item of risk and its magnitude. Once this is done, hedging plans can be developed with various levels of residual risk and potential up-side gains and down-side losses agreed after stress testing the proposed plans.

The treasury profession needs to address urgently the setting of standard methodologies for managing risk, strategies, decision taking and transacting. How to account for them should not be driving the debate and setting the standard.

Reporting and Disclosure

There is a need for standard reporting in treasury, from the basic operational reports to board level management information. Each company determines everything uniquely about how it reports its treasury's activities. Not so the accountancy profession, they have their minimum best practice standards. In general, the quality of reporting in treasury is poor and poorer the higher up in a company treasury activities are reported. It is no wonder that boards struggle with this aspect of their businesses.

The treasury profession needs to establish a recommended suite of reports for all levels. This will provides a framework within which each treasury can develop its own reports, but with the minimum scope for variation.

Disclosure, which includes reporting on treasury's activities in companies' accounts and annual reports and financial statements to the market, has seen some progress, mainly by accountants and auditors, not treasurers or their profession. There is still no consistency of practice when it comes to treasury disclosure to shareholders. It ranges from total absence, through minimal reporting, to meaningless detail (detailed list of all borrowings) and all of a seldom reasonable standard.

The treasury profession should develop, agree and promote a standard best practice disclosure format.

Operations, Procedures and Controls

Unlike accounting or audit departments in companies, treasury does not have a common basic methodology for the conduct of their business. There are some basic principles in relation to segregation of duties, dealing procedures, etc, but these are often inadequate. Corporate management often does not have good comprehensive best practice guidelines from which to work. As a result, we have all too frequent scandals; incidentally most of which never reach the media. There needs to be for a manual of best practice, with methodologies and templates, which should form the basis for treasury operations in companies.

Such a manual should incorporate a procedures manual with sufficient detail and clarity that enables back-up staff to operate in an emergency. These are difficult to construct and compile. So again a well developed format or template, based on best practice, should be developed and promoted by the treasury profession.

Treasury is a high risk and sensitive area, with a great deal of potential for error, fraud and loss. As a result, it is an area of particular need for effective controls which prevent any ‘events’ and/or detect them as soon as possible.

There is a need for a proper specification of the dozen or so key controls for corporate treasury and guidance as to how they might be implemented, not just a simple list of headings. Best practice methodologies and formats should be set out these specifications. Internal audit should fool-proof test the controls at least annually, using a treasury-specific approach and methodology.

Disaster Recovery

Effective disaster recovery should give treasury the ability to be up-and-running within half a day of a serious outage of normal business. It is not just systems and data back-up, but also the resource and facilities needed to enable the business to proceed. For companies where treasury is a significant part of the business and where it has the potential for major impact on performance, then effective disaster recovery arrangements are needed.

Again, it is an area where most companies are not well provided for. It is time that some quality guidance is given to what standards are needed and what the solutions are. We need a blueprint template of how to implement disaster recovery arrangements, both initially and going forward.

Treasury Ethics

Business ethics are of particular relevance to the treasury. Here large deals are transacted in a particular manner where verbal/telephone business is the norm, particular types of relationships are formed and 'hospitality' is common. All of which are ethically very sensitive for their company.

Each company should have a treasury ethics statement, which all treasury and corporate managers Involved must specifically sign up to. Audit should also focus on this aspect.

This is another area where a universally accepted best practice format would be of great benefit to companies.

A Time for Action

Regrettably, there are no universally accepted best practice treasury management methodologies and formats or templates. The treasury profession has been in existence long enough to be able to put this right in a short space of time. I would like board directors in particular to read this write-up. They will then know what the issues are and where they stand. They will also know how poorly they are served and how poorly they are positioned for decision-making from a corporate governance perspective. They should insist on treasury practice in their companies along the lines outlined in this write-up and look to the treasury profession to fast-track the development of best practice standards.