Financial Services

Spring 2003

Ernst & Young

Quality In Everything We Do

Treasury Operations Survey

Which path are you on?

ACT



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1. Executive Summary

In this survey we invited members of the Association of Corporate Treasurers (ACT) to respond with an assessment of the current state of treasury operations in their organisation. The objective was to provide a reference point against which organisations can assess their own situation. The number and breadth of the responses we have received persuade us that the results contained in this report will indeed provide a useful reference point.

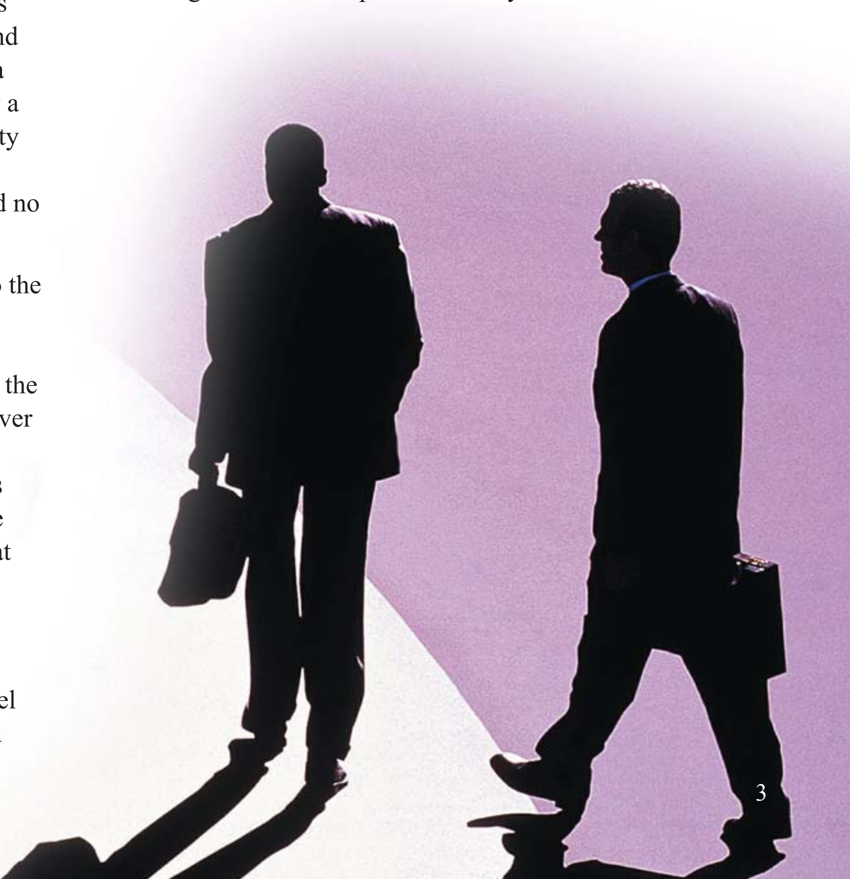
Highlights from each of the areas we investigated are contained in the following section. Inevitably any overall conclusions run the risk of generalisation which masks the range of responses which we received. However there are a number of themes which are sufficiently common and frequently commented upon to be worthy of mention.

Some of the most significant messages concern the position of treasury within the company. In the current environment of focus on risk management within the organisation we would have expected a significant level of Board interest and involvement in the treasury area. In fact, Board level monitoring of treasury activity was found in less than 50 per cent of companies that responded and more active involvement, for example through a treasury committee, in less than a quarter. Only a limited number of respondents monitored activity through regular performance reporting and a surprisingly high proportion felt that it delivered no added value.

Looking at the position of treasury in relation to the wider business this appears to be somewhat anomalous. Treasurers almost unanimously see themselves as advisers to the business units and the majority actively promote their services. However treasurers are somewhat critical of the business units in terms of their understanding of business risks, the quality of the information they receive from the business units and the timeliness of that information. As one example, one-third of respondents receive daily cash forecasts with a variance of more than 10 per cent.

Considering future developments, Treasurers feel that they will move in a more strategic direction with less focus on transaction execution and more on an advisory and broader risk management role. The picture of the current state of play suggests that there remains a lot to be done to achieve this, both in terms of raising the overall level of risk awareness in the business and in terms of securing recognition of the importance of this at Board level. However external events seem to be pressing in this direction. For US-listed companies the provisions of Section 404 of the Sarbanes-Oxley Act reinforce existing requirements to have a sound risk management and control system in place. From the accounting side, IAS 39 puts more emphasis on risk identification and reporting and may lead to consideration of different ways of managing risks. When it comes to the impact of the derivative and hedge accounting standards, it is clear that there remains a lot of work to do.

Whatever the specifics of their organisation, Treasurers clearly foresee no end to the combination of external drivers and internal pressures which will continue to provide challenges over the coming years. We hope that this report will provide them with useful material when considering how to develop their treasury function.





2. Highlights

Governance and Management Information

- Board level monitoring of treasury activity in less than half of respondents and Board involvement in a Treasury Committee in less than a quarter
- Regular measurement of treasury's performance in only 35 per cent of respondents
- Information received by treasury from business units generally regarded as unsatisfactory
- Business units generally regarded as having only a fair or poor understanding of risks, whereas Executive Management understanding was solid
- Most respondents have some form of treasury policy and procedures manuals covering some or all areas of treasury operations

Treasury Structure and Staffing

- Three-quarters of respondents regard their treasury as 'cautious' rather than 'aggressive'
- Some indication that smaller treasuries anticipate an increase in size over the next two years whereas the larger ones feel that downsizing is more likely
- Outsourcing of some treasury operations or related functions in one-third of respondents. Further outsourcing is being considered by 40 per cent of respondents overall but in a much higher proportion by those who have already done some outsourcing
- 30 per cent of respondents rely on spreadsheets or manual methods of record keeping rather than a specialist treasury management system
- Over 70 per cent segregate front and back offices

Liquidity, Cash Management and Funding

- Cash flow forecasts are regarded as a key element of liquidity management but in general are not regarded as particularly accurate
- Liquidity reserves representing over 20 per cent of net debt are maintained by two-thirds of respondents
- The key features of funding policy are spreading the debt maturity profile and diversification of funding sources
- Syndicated bank facilities represent the most important short term and eurobonds the most important long term funding source
- The key features of investment policy are counterparty credit risk and the maturity profile of deposits
- Counterparty credit limits are almost universally adopted, most commonly based on credit ratings

Financial Risk Management

- The Treasurer's role still revolves around the core financial risks - liquidity, foreign exchange, funding and interest rates
- Less than half of respondents undertake any systematic exposure analysis
- Virtually all respondents are planning to undertake some analysis of the impact of hedge accounting standards but very few have completed their IAS 39 assessment. The main impact is foreseen as being on treasury procedures rather than policy or strategy
- Hedging of interest and foreign exchange rate risk is predominantly undertaken with the aim of limitation rather than elimination of risk
- Interest rate risk is typically managed through a fixed/floating debt ratio, most commonly within the range 40-60 per cent. Swaps are the principal instrument used to manage this risk
- Around 80 per cent of respondents manage foreign exchange translation risk. Whilst the most common technique is by matching assets and liabilities, almost 60 per cent of respondents also use derivative instruments
- Foreign exchange transaction risk is typically hedged over a 12 month time horizon. The most prevalent strategy is to hedge all

committed exposures and a percentage of forecast exposures

- There is a continued move towards the use of internet portals for dealing foreign exchange
- Amongst those respondents with commodity price risk, hedging is less prevalent and is more likely to be seen as a means of obtaining competitive advantage

The Future

- Other than day-to-day operational matters, Treasurers are regularly involved in corporate finance, structured finance and trade finance
- In addition to greater involvement in the above, they also expect pensions and overall business risk to become significant issues for them over the next few years. Developments in technology may facilitate this move
- In contrast, several see operational tasks and transaction execution as becoming less important
- The importance of managing commodity price risk is expected to increase.

3. Governance and Management Information

Relationship with the Board

Board level involvement in the area of treasury is most commonly limited to setting, approving and reviewing policies (Chart 1). More active involvement, such as input into strategic treasury decisions, is considerably less common. Board-level monitoring of treasury is found in less than half the companies we surveyed, and involvement in a treasury committee in less than a quarter.

Given the current focus on the role of the Board in understanding the key risks of the business and ensuring they are effectively managed and controlled, we are surprised by the lack of Board involvement in the treasury. This concern is highlighted by a respondent who wanted **"greater board involvement, discussions on policy and a dedicated treasury committee"**.

Board Reporting

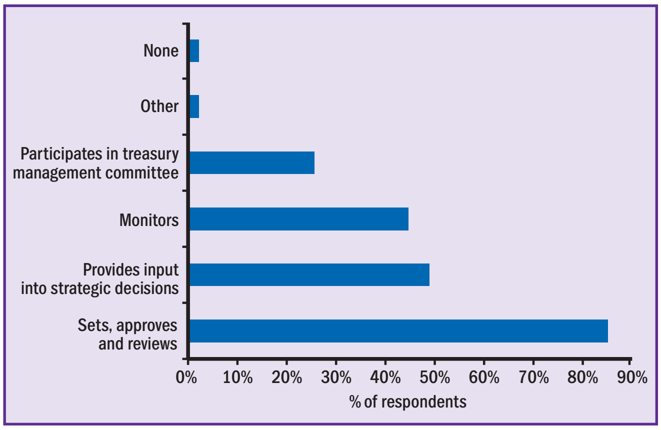
Treasury reporting to the Board reflects the lack of active management, with only the funding position being reported in a large majority of companies. Cash levels, foreign exchange exposures, and the position on banking covenants are only reported to the Board by between 50 and 65 per cent of respondents (Chart 2).

With regard to reporting the principal risks to the board (i.e. foreign exchange, interest rate and commodity price risks) the proportions reporting are broadly in line with the proportions of respondents exposed to those risks. Of all respondents, the proportions reporting on the risk were:

- Foreign exchange 62 per cent;
- Interest rates 55 per cent; and
- Commodity prices 13 per cent.

Exception reporting was relatively unusual with less than half of the respondents reporting on non-compliance with policy and breaches of limits. We also find the fact that only 26 per cent of respondents are reporting credit exposure to the Board a surprise, given the current tough economic conditions in which the rate of default has been increasing.

Chart 1: Role of the Board in Financial Risk Management



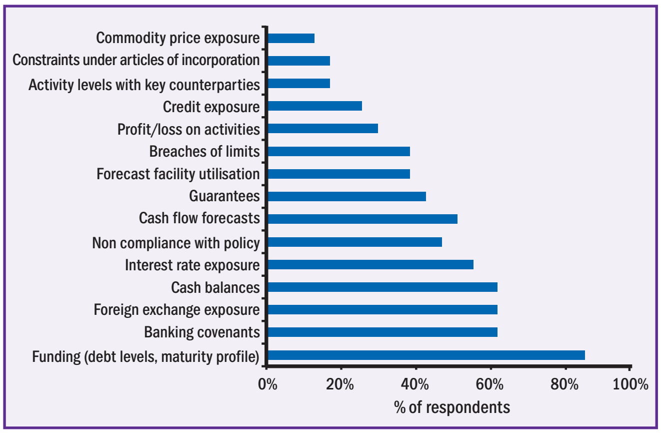
Satisfaction with Treasury Reporting

Respondents were asked to indicate whether there was dissatisfaction with the information flowing to treasury from the business units and with information flowing from treasury to the executive management and to the Board.

Ninety-one per cent had some complaint about information provided by business units. However, only 10 per cent reported some complaint about information provided to the Board and 29 per cent to the executive management. Chart 3 illustrates the difference in the satisfaction with information flowing from the business units and that flowing to the executive management and the Board.

The most common complaints were that the information from the business units is not timely and not accurate. Lack of timeliness was the most

Chart 2: What is reported to the Board



common complaint about information provided to executive management.

This was echoed by one Group Treasurer who would like **"more detailed and timely reporting both internally and externally"**.

There was a clear link between the quality of information provided by the business units and that provided to the executive and Board. Not surprisingly, the ability of treasury to report effectively to the Board depends on the quality of information received from the business units.

Understanding of Treasury Risks

The respondents noted a significant difference in the understanding of the treasury risks and exposures by different parts of the organisation.

The proportion of Treasurers who stated that understanding of executive management was poor or fair was 19 per cent, 40 per cent for Boards, and 74 per cent for business units (Chart 4).

Reasons stated for poor understanding at the Board and executive management levels were:

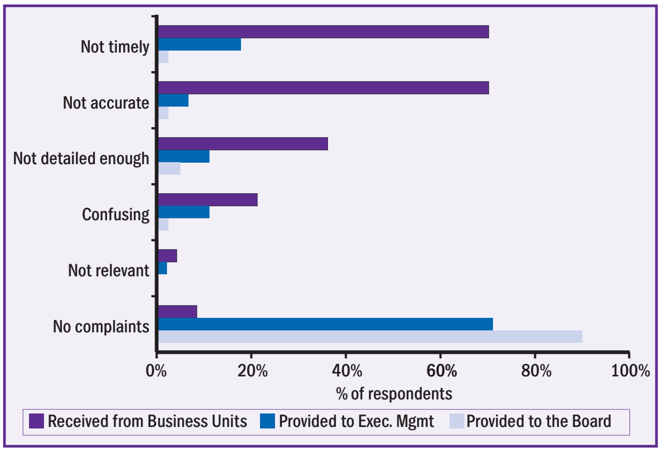
- Lack of treasury and finance skills, (50 per cent);
- Treasury not seen as a priority, (33 per cent); and
- Have a preconceived view of treasury, (17 per cent).

The two principal reasons quoted for excellent understanding at the Board and executive management levels were overall experience of management (47 per cent) and having a treasury specialist (41 per cent).

It is a concern that many respondents consider their business units and Board do not have a good understanding of the treasury risks and exposures faced by the business. Perhaps one way that treasurers could address this issue was suggested by one respondent who, **"would try to spread knowledge of treasury across the Group i.e. have people in key positions more aware of the risk drivers"**.

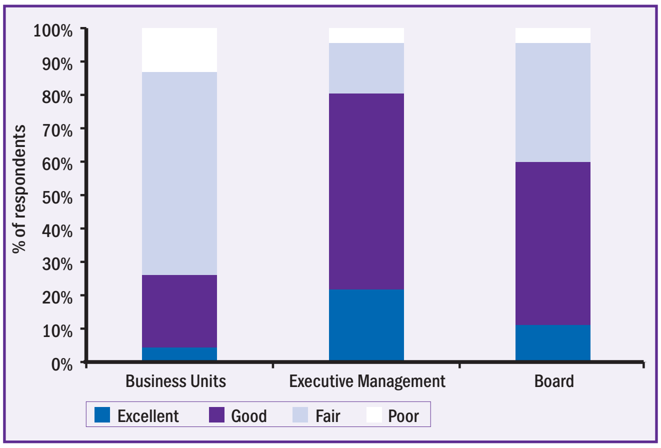
In our experience, Treasurers who promote their services and act as an advisor to the business raise the understanding the business has of the risks, and how treasury manages those risks. However, 70 per cent of respondents are already promoting their services to the business units and 94 per cent are acting as an adviser to business units. This suggests that treasurers should re-evaluate the methods of promotion and advisory activities to ensure greater effectiveness.

Chart 3: Quality of Information



Treasurers could also be proactive in improving their own relationships and understanding of the business, to the benefit of both the business unit and treasury. To that end, one respondent commented that a **"broader development of roles within the business - secondment, support - understanding the business will drive the improvement of the treasury staff"**.

Chart 4: Understanding of Risks & Exposures



For example, if Treasurers have a better understanding of the business, they might gain greater insight into the difficulties of cashflow forecasting by the business units.

Treasury Policy & Procedures

Although virtually all respondents have a treasury policy, almost a quarter of these are informal policies - either a collection of board papers, or in verbal or memo form (Chart 5).

The treasury policy is typically subject to regular review. In the majority of cases regular review of the treasury policy is required, as evidenced by three-quarters of respondents reviewing their policy within the past year. Only four per cent had not reviewed it for more than two years.

In terms of contents (Chart 6), delegated authorities (85 per cent) and authorised instruments (83 per cent) were the most widely included characteristics. Surprisingly, only 52 per cent of respondents included a description of approach in their treasury policy.

The proportion of respondents with a treasury procedural manual covering all areas of treasury is over two-thirds. Forty-six per cent of respondents have not updated the procedural manual within the last 12 months.

Of those who do not have a comprehensive procedures manual, about 65 per cent have a procedures for some sections of treasury. Approximately, 10 per cent of respondents do not have any form of treasury procedures manual (Chart 7).

Performance Measurement

Only 35 per cent of the respondents measure treasury performance and only 19 per cent include performance benchmarks (see below) in their treasury policy.

The main reasons stated for measuring performance were to evaluate the effectiveness of treasury (52 per cent) or to assist in formulation of strategy decisions (28 per cent). Seventeen per cent measure performance at the request of Board and executive management. Only three per cent

Chart 5: Form of Treasury Policy

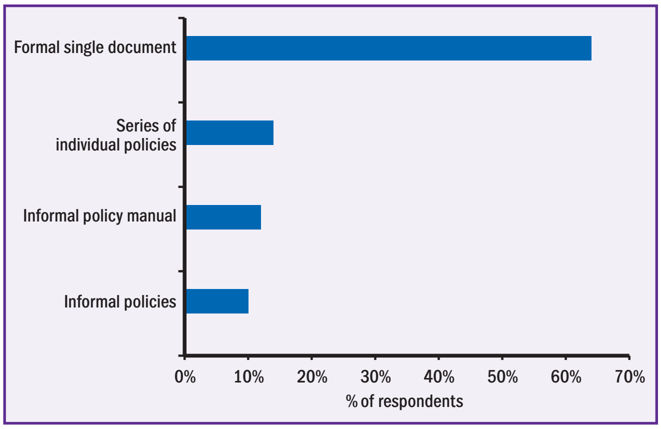


Chart 6: Contents of Treasury Policy

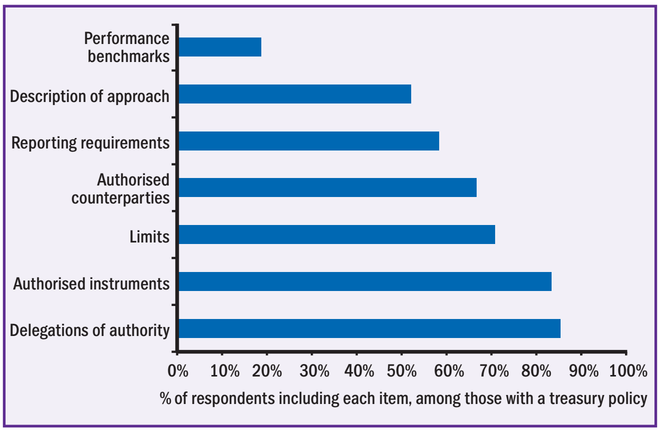
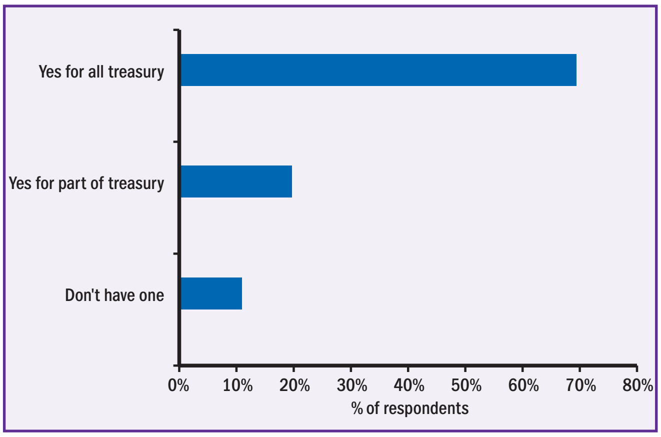


Chart 7: Treasury Procedures Manual



used it as a basis for dealer remuneration or incentives (Chart 9).

The main reason for not measuring performance is that it is not believed to add any value (45 per cent). This reflects a common notion that treasuries are cost centres, rather than revenue centres. In line with this, we noted that fewer than 50 per cent of treasuries charge business units/subsidiaries a spread on lending.

Other reasons for not measuring performance are that it is not required by executive, Board or policy (42 per cent), or that it is due to a lack of resources (13 per cent).

Amongst those measuring treasury performance, about two-thirds are satisfied with the measures.

What is the best way to measure your performance? The majority of those who do use a market-related performance measure, with many others using a budget number. Management should avoid measuring treasury on variables over which treasury has no control. Market-based measures should provide realistic and achievable targets that are meaningful and where performance relative to the target can actually be influenced by the activities of treasury. If the treasury is measured against budget, when market or company circumstances change this will affect the outcome in ways outside the control of the treasury.

Only seven per cent of respondents measure the performance of treasury operational processes. Among those who do, the preferred benchmark for dealing and settlement errors is to use the previous year's result.

Performance Benchmarking

When reporting items to the Board, on average about 40 per cent reported it against benchmarks, with foreign exchange risk being the item most likely to be reported against benchmarks (Chart 10). The main reasons for the lack of satisfaction were that the benchmarks were still in development, or that the current measures were too simplistic.

Chart 8: Proportion of respondents measuring Treasury Performance

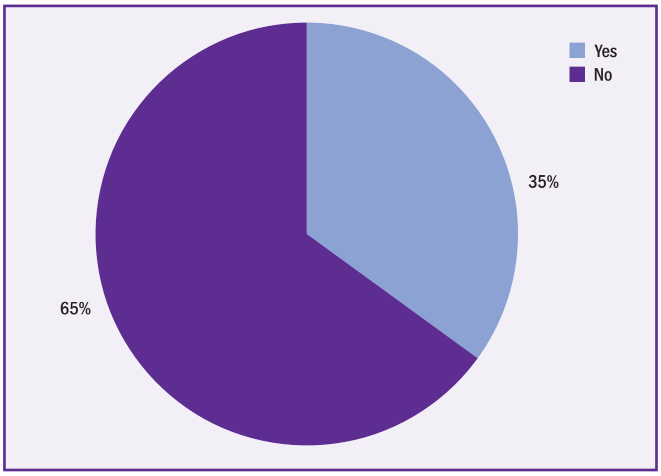


Chart 9: Reasons for Measuring Performance

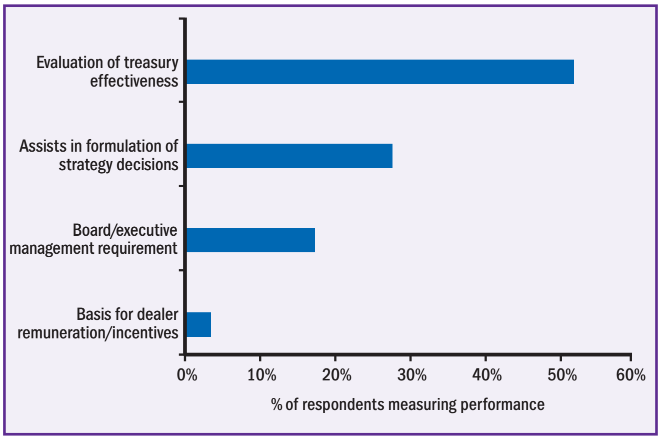
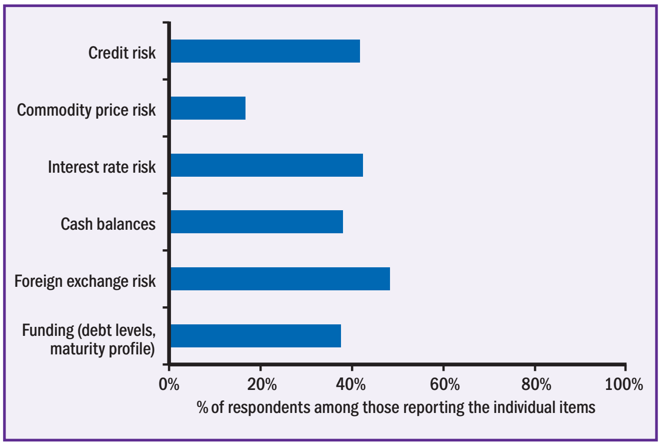


Chart 10: Reporting against Benchmarks



The importance of treasury benchmarking was recognised by one respondent who wanted,

"recognition of treasury as a business. Also that the added value of treasury, if properly controlled and benchmarked, can be very considerable. Most corporate treasuries are very low cost."

4. Treasury Structure and Staffing

Over 90 per cent of the organisations surveyed have a separate treasury unit (defined as having a department or division with at least one person involved primarily in treasury related activities), reflecting the importance of the treasury function in a corporate environment.

Over 50 per cent of companies have a treasury operation outside of the UK. Thirty-six per cent of these reported to the local finance function, with 46 per cent reporting back to the UK and 18 per cent reporting to an overseas treasury.

With the control issues that surfaced at AIB's subsidiary (Allfirst), in Baltimore, there has been a heightened awareness of treasury operations away from Head Office. One Treasurer wanted **"Increased centralisation (or stronger mandate to implement approved procedures at subsidiary level) to deliver more robust control."**

Treasury Activity

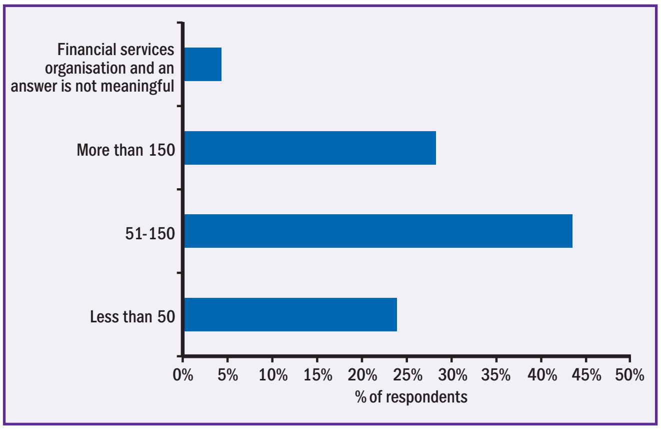
Respondents were asked to estimate the typical total monthly volume of liquidity and risk management transactions (deposits, borrowings, foreign exchange, FRAs, swaps). Overall, 67 per cent of respondents indicated that they conducted between 0-150 transactions per month (Chart 11). Not surprisingly, the level of activity increased with size of the organisation.

Rather than the more traditional cost/profit centre approach, we asked Treasurers to rank their operations on a spectrum from very cautious (i.e. treasury operation's primary objective is to minimise the cost of financing and eliminate financial risk) to very aggressive (i.e. treasury operation's primary objective is to contribute actively to the organisation's profit figure).

Seventy-three per cent of Treasurers surveyed put themselves on the cautious part of the spectrum, reflecting the role of managing the organisation's risk. This illustrates the focus on providing a service to the business, rather than operating as a profit centre (Chart 12).

As we expected, the sector with the greatest proportion of very aggressive treasuries was the financial services sector.

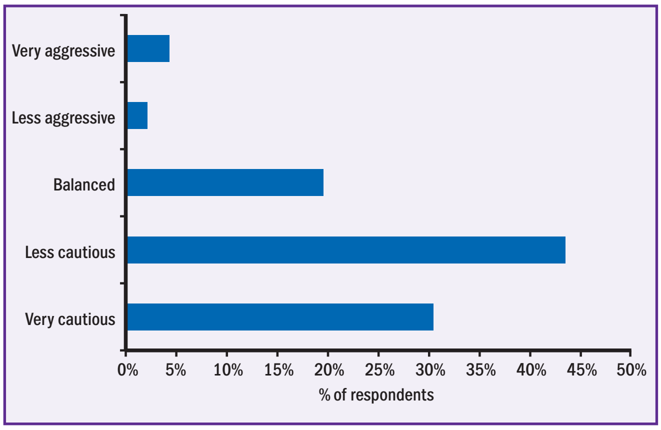
Chart 11: Treasury Activity Level



Treasury Staffing

Respondents were asked about the size of their treasury two years ago, the current size, and the anticipated size in two years time. The proportion of treasuries currently staffed by three or fewer people was 43 per cent. Although Treasurers don't anticipate that this proportion will change significantly, they did anticipate that between 4-8 staff would become the most common size of treasury in the future (Chart 13).

Chart 12: Description of Treasury Operations



Overall, we noticed that larger treasuries expected to employ fewer people, whereas smaller treasuries would like additional staff. This was echoed by a Group Treasurer of a smaller treasury, who said, **"Employ additional people - these would pay for themselves"**. This indicates that the risk/reward balance should be considered carefully where resorces are restricted.

Nearly 60 per cent of treasuries have been resized over the last two years. The most common reasons given were factors such as organisational expansion or change of ownership (37 per cent), internal reorganisation, expanded or reduced scope of treasury operations (17 per cent), and the need to reduce costs (14 per cent).

Of the 55 per cent who anticipate resizing their treasury in the future, the most common reasons given were organisation expansion/contraction (30 per cent), internal factors such as internal reorganisation, expanded or reduced scope of treasury (14 per cent), change in regulatory or accounting/reporting environment (14 per cent), and advances in technology (13 per cent).

Segregation of Duties

Seventy-three per cent of respondents have separate back and front offices. This segregation of duties is enhanced by 58 per cent of back offices reporting to someone other than the treasurer.

Segregation of duties exists between the following tasks:

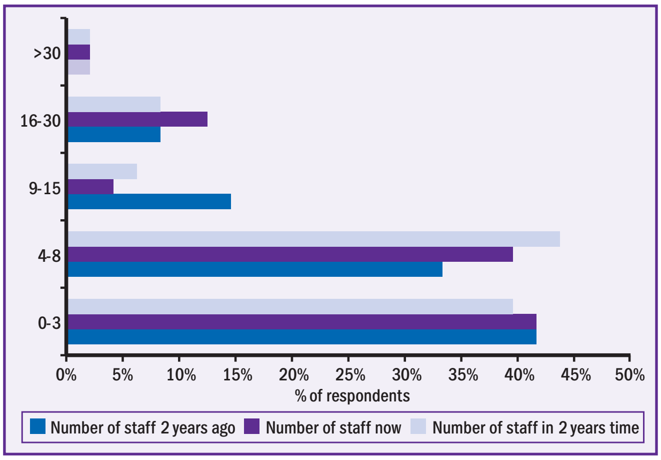
- Over 60 per cent segregate transacting and reporting;
- Sixty-six per cent segregate transacting and settling;
- Sixty-five per cent segregate settling and reporting; and
- Ninety-four per sent segregate transacting and confirming.

It is clear from this response that treasurers recognise the key control function provided by the confirmation process.

The method used by organisations to confirm transactions prior to settlement is most commonly the method used by the bank for confirming with them. The most common method used to transmit confirmations is by facsimile. About 30 per cent of respondents use verbal confirmations, and fewer than 10 per cent do not confirm prior to settlement.

Although uncommon at the moment, we believe there will be an increase in matching confirmations electronically.

Chart 13: Number of Staff



Standard Settlement Instructions (SSIs) are an important control around payments. Only seven per cent of respondents settle trades without SSIs more than 10 per cent of the time.

Outsourcing

The role of Treasurer combines day-to-day treasury management, time-critical and high value transactions and value-added projects. It is therefore not surprising that time and resources can be constrained. These can be eased by appropriate use of relevant skills from outside the treasury, either elsewhere in the organisation or from third parties.

Thirty per cent of respondents have outsourced some function of treasury. The larger the organisation, the greater the likelihood of outsourcing. The most common activity outsourced was treasury internal audit (46 per cent) and accounting (31 per cent). The Internal Audit Department is typically responsible for outsourcing internal audits of treasury. However, we find that in many instances this decision would be driven by Treasurers who are keen for a specialist to conduct the work and draw some added value from the work.

The main reasons stated for outsourcing (Chart 14)

were that of cost efficiency (53 per cent) and that the activity was not a core function (40 per cent). Two-thirds of people who outsourced were either very satisfied or satisfied. Over thirty per cent were fairly satisfied. Interestingly, none of the respondents were dissatisfied.

Thirty-eight per cent are "considering" outsourcing some treasury process in the future. Those organisations that had already outsourced some function of treasury were more likely to outsource in the future. The three functions most commonly stated as being potentially outsourced are: settlements, all treasury functions, and system administration.

Sixteen per cent have or are considering transferring treasury to a shared services area.

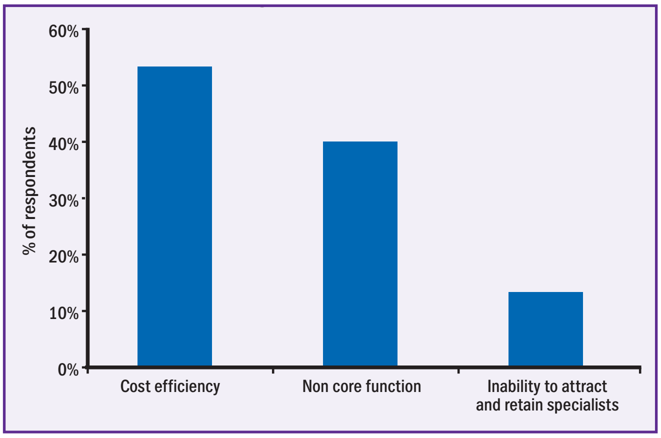
Treasury Management Systems

Seventy per cent of respondents do have some type of computer-based treasury management system (TMS), either a treasury module of an enterprise wide system (e.g. SAP) or a specialist treasury system. Twenty-one per cent of organisations continue to rely only on spreadsheets (Chart 15). From a control perspective, it is a potential concern that organisations continue to rely heavily on spreadsheets. The security features over the use of the spreadsheet applications are generally poor, imposing a significantly higher dependence on user integrity and diligence.

Perhaps not surprisingly, the use of a TMS rather than spreadsheets is more common amongst larger organisations and amongst those with more complex treasury operations:

- For organisations with assets of less than £1 billion, nearly one-half use spreadsheets only, nearly one-half use either a specialist system or an enterprise resource planning (ERP) treasury module, and less than 10 per cent do not use any system;
- For organisations with assets above £1 billion, over three-quarters use a specialist system or an ERP treasury module, and approximately 10 per cent use spreadsheets only or do not use a system;

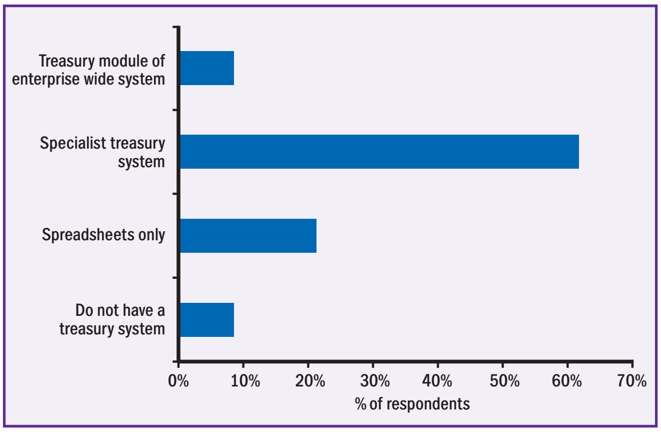
Chart 14: Main driver for outsourcing



- Among those using derivatives, 77 per cent use a specialist system or an ERP module, 15 per cent use spreadsheets only, and eight per cent do not use any system.

TMSs are becoming cheaper and offering greater functionality. Perhaps it is the daunting prospect of selecting, installing and maintaining the new system that is discouraging some organisations from proceeding down this path.

Chart 15: Type of Treasury System used



The degree of connectivity of the TMS to other systems is encouraging, despite the challenges this can pose. Thirty-six per cent of respondents have linked their TMS to their General Ledger and 41 per cent of respondents have linked their TMS to their Electronic Banking System.

Despite the fact that the majority of respondents characterise IT spending as a cost and approximately 80 per cent of respondents spend less than £50,000 per annum on their treasury IT systems, there is nevertheless recognition amongst Treasurers of the importance of IT. This was evidenced by one respondent who simply said **"Better Systems,"** when asked what changes they would like to make.

In addition, another respondent said, **"Technology now enables the corporate treasury to be less beholden to the banks and their own systems. The banks are now working to add value for the corporate sector in more specific ways."**

Disaster Recovery Plan

Eighty per cent of respondents have a disaster recovery plan (DRP). However, 31 per cent indicated that they had a DRP but had never tested it, six per cent had a DRP and tested in more than 2 years ago, and eight per cent had a DRP and tested it between one and two years ago. Encouragingly, over 55 per cent had a DRP and had tested it within the past 12 months.



5. Financial Risk Management

The Treasurer's role still revolves around the core financial risks - liquidity, foreign exchange, funding and interest rates. Other issues do appear selectively, but are still regarded as of secondary importance in most cases.

Chart 16 shows that cash and liquidity management is regarded as the most important treasury function, being included as one of the top three functions by 78 per cent of respondents. Foreign exchange management was also very important, attracting 69 per cent of responses. Given these traditional responses, it is evident that the concept of the Treasurer as a more broadly focused risk manager has not yet been widely adopted.

Risk Management Committee

Over half of the organisations have a formal risk management committee that meets regularly.

For companies that are taking a proactive approach to risk management, we regard it as important that there are regular meetings to discuss current market developments and how the treasury should react.

Exposure Analysis

Less than half of the respondents indicated that they perform exposure analysis. This usually takes the form of sensitivity, stress testing or value at risk analysis. Those most likely to undertake it were the larger organisations with over £3 billion of total assets.

Chart 17 shows that among those undertaking exposure analysis, interest rate risk management (74 per cent) was the most common followed by foreign exchange (52 per cent) and funding/liquidity risk (48 per cent).

Risk Management Approach

In line with the "cautious" approach adopted by respondents (previously mentioned), when it comes to risk, the focus is on removing or limiting risk (Chart 18). The rationale is much more one of risk limitation than risk removal. Only around seven per cent of companies hedge to remove all risks, which is fewer than those that do not hedge at all.

Chart 16: Most important Financial Risk Management Function

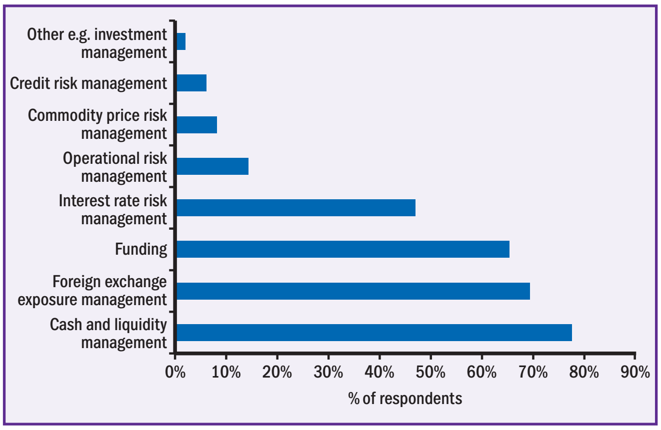


Chart 17: Risks on which Exposure Analysis is performed

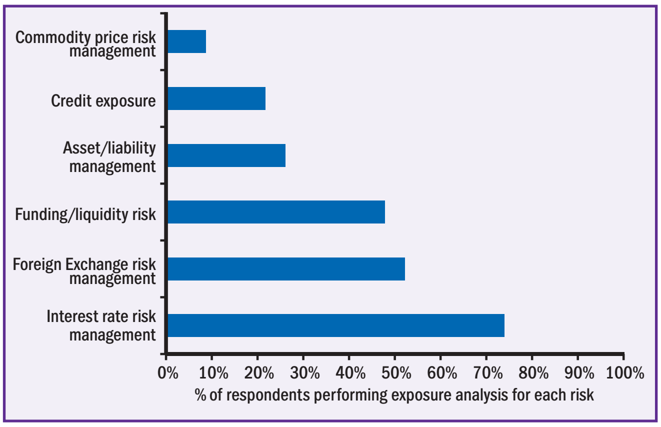
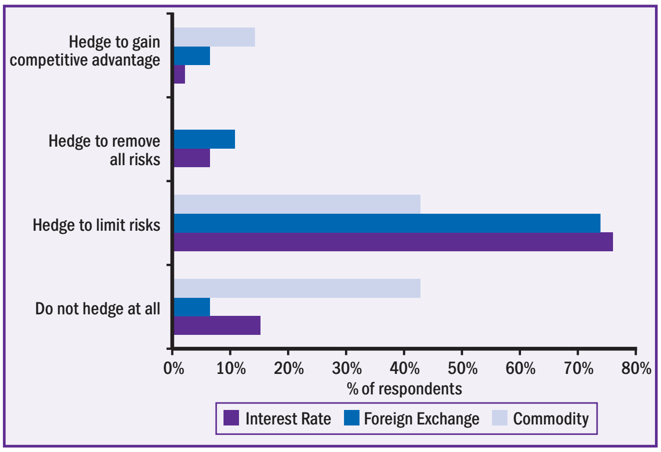


Chart 18: Risk Management Approach

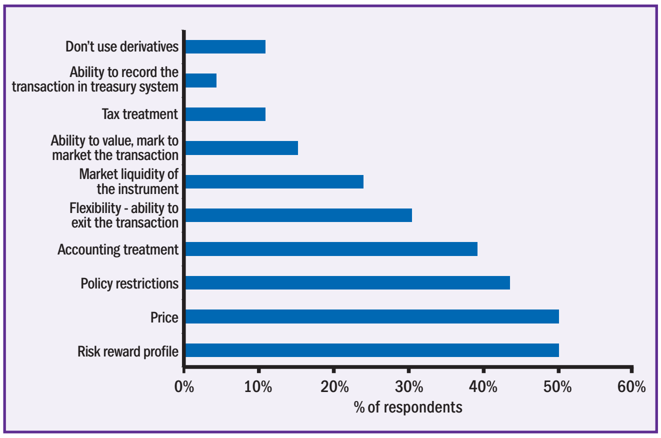


However there is a significant difference between the hedging activity relating to commodity risk and interest rate/fx risk. The former is much less likely to be hedged, and when it is, the rationale is more likely to be to gain a competitive advantage than to reduce or eliminate risk.

Chart 19 illustrates that when hedging risk, the factors most important in determining which derivative instruments to use are price, risk-reward profile, policy restrictions and accounting treatment.

Eleven per cent of those exposed to some financial risk stated that they did not use derivatives.

Chart 19: Factors in determining which instruments are used

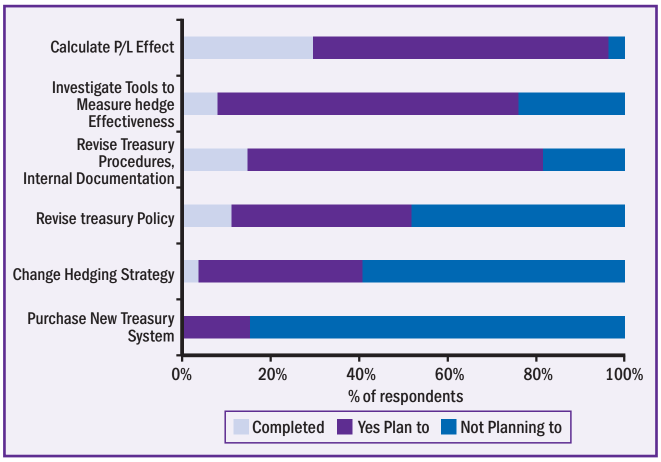


Impact of IAS 39 / FAS 133

When it comes to the impact of the derivative and hedge accounting standards, it is clear that there remains a lot of work to do. Sixty-four per cent of respondents have considered the possible impact of the new accounting standards. However very few respondents have completed their assessment, and of those that have started it, the majority are only at the stage of calculating the potential earnings impact (Chart 20).

Over 80 per cent of respondents are planning to revise treasury procedures for the new standards, however significantly fewer are planning to revise their policy (52 per cent) or strategy (41 per cent). It will be interesting to see if this changes as organisations work through the earlier stages of the impact analysis and understand the full earnings implications that the standards have. When asked what will be the greatest impact on treasury operations over the next five years, one respondent stated that, **"Accounting disclosures will be primary"**. We believe that this is a major area for Treasurers to focus on in the near future.

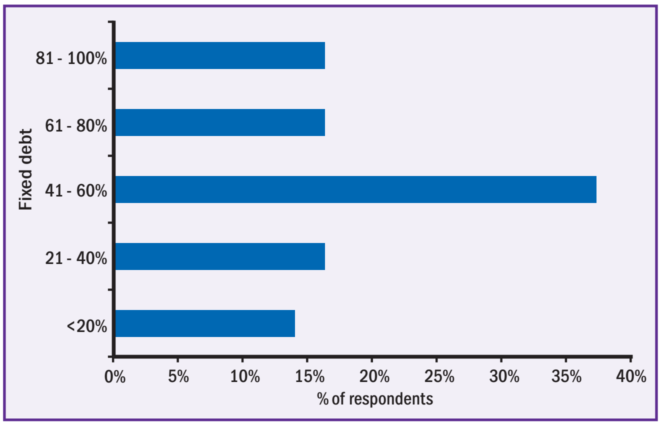
Chart 20: Proportion having assessed FAS 133/IAS39 impact



Interest Rate Risk Management

Sixty-one per cent of respondents manage their interest rate risk via a target ratio or range of debt. Of those that use a fixed/floating debt ratio target, the most popular range was between 41-60 per cent (Chart 21).

Chart 21: Current fixed / floating debt ratio





Nearly 20 per cent of respondents did not have a policy on interest rate risk.

Eighty per cent of respondents use derivatives to manage interest rate risk. Of those respondents who use derivatives, the instruments used to manage interest rate risk are listed in the chart below, along with the proportion of respondents using them. Swaps were used by every respondent to the survey, followed by forward rate agreements. Option based products were used by around 30 per cent, mainly in the form of swaptions (Chart 22).

Of those who hedge their interest rate risk, 84 per cent mark to market their debt and interest rate derivatives. The purpose for marking to market was more likely to be for accounting disclosure than internal reporting, (58 per cent for accounting disclosure only, 36 per cent for both internal reporting and accounting disclosure, six per cent for internal reporting only).

Foreign Exchange Risk Management

Eighty-five per cent of organisations are exposed to foreign exchange risk.

Translation Risk

The proportion managing translation risk is just under 80 per cent of those exposed to it. Most respondents were managing it using natural hedging techniques (82 per cent), such as matching foreign currency assets and liabilities. However 58 per cent use derivative instruments.

Transaction Risk

Of the exposure types hedged by our respondents:

- Over half hedge forecasted transactions;
- Forty-one per cent hedge contractual commitments; and
- Thirty-nine per cent hedge on balance sheet amounts (e.g., receivables and payables).

Of the exposure proportions hedged by our respondents:

- Seventy-five per cent hedge all committed exposures and a range of forecast exposures; and
- The remainder hedge a range of all exposures.

Chart 22: Instruments used to manage Interest Rate Risk

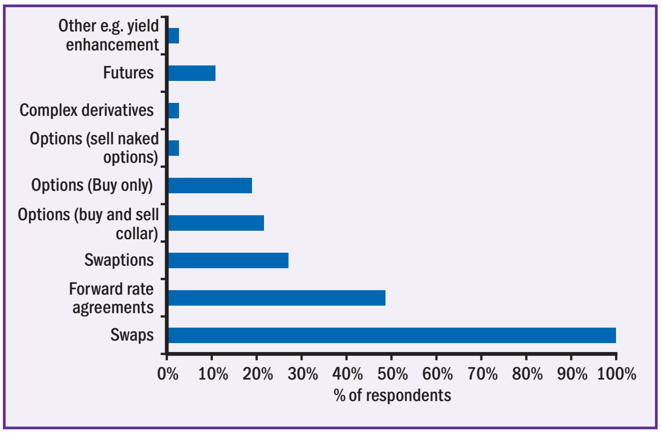


Chart 23: Time horizon for managing Foreign Exchange Risk

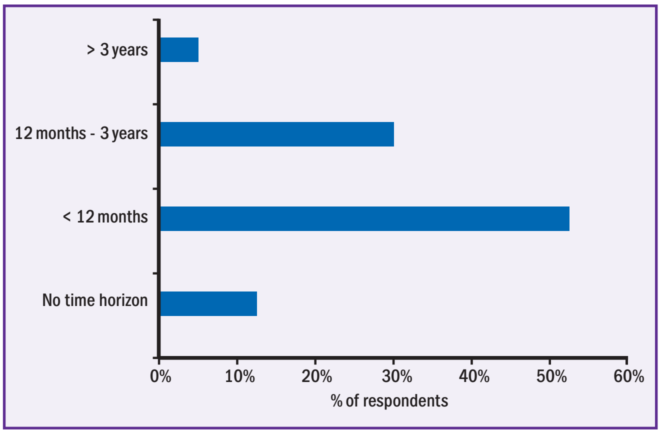
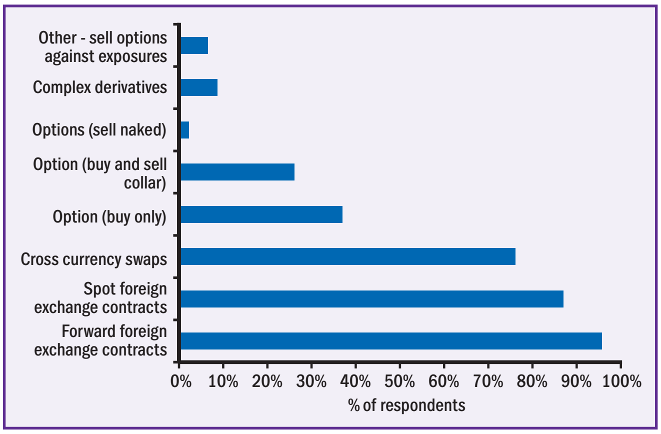


Chart 24: Instruments used to manage Foreign Exchange Risk



About 80 per cent of those exposed to foreign exchange risk have offsetting exposures. Most respondents hedge the net exposure.

Chart 23 shows the profile of time horizons used to manage foreign exchange risk. Most organisations manage the risk within the next 12 months.

Forward foreign exchange contracts are the predominant instruments used to manage foreign exchange risk (96 per cent). Spot foreign exchange contracts and cross-currency swaps are also widely used (Chart 24).

Over three-quarters mark to market foreign exchange hedges.

The method used for transacting foreign exchange is evolving rapidly towards the use of internet portals, with the use of the phone anticipated to decrease from 84 per cent to 60 per cent over the next two years (Chart 25). Some respondents commented that they would be more likely to use a multi-bank platform for simple trades and use the phone for more complex deals.

Commodity Price Risk Management

Forty-seven per cent of respondents were exposed to price risk for at least one commodity, with the exposure to oil and gas price risk being the most commonly managed (70 per cent). Chart 26 provides a break down of the types of commodity price risk managed.

Of those exposed to commodity price risk, approximately 41 per cent don't hedge, 27 per cent hedge forecast cash flows and 23 per cent hedge both forecasted and committed exposures. Others methods include being long/short or committed exposures only.

The time horizon for commodity price risk management is typically longer than for foreign exchange risk management, the most popular time horizon being between one and three years (57 per cent), rather than up to 12 months (Chart 27).

Chart 25: Delivery channel used for transacting Foreign Exchange now and likely to use within two years

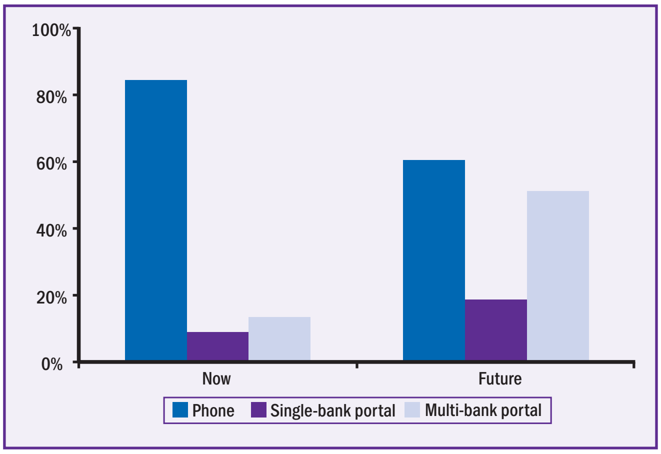


Chart 26: Commodities managed by those exposed to commodity risks

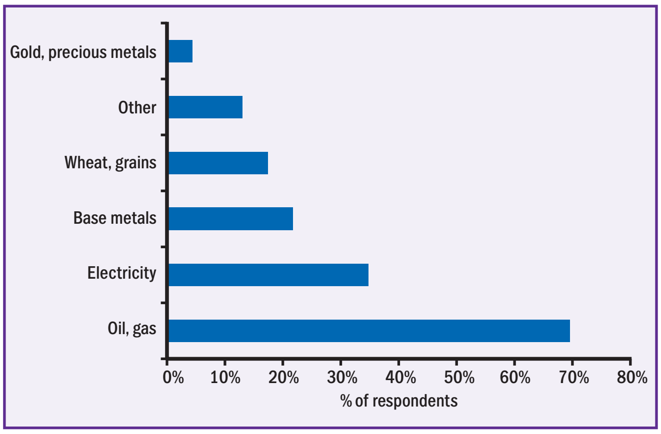


Chart 27: Profile of time horizon for Managing Commodity Price Risk

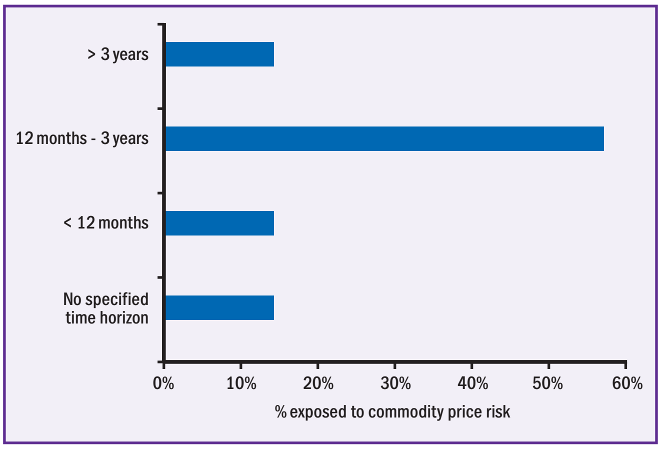
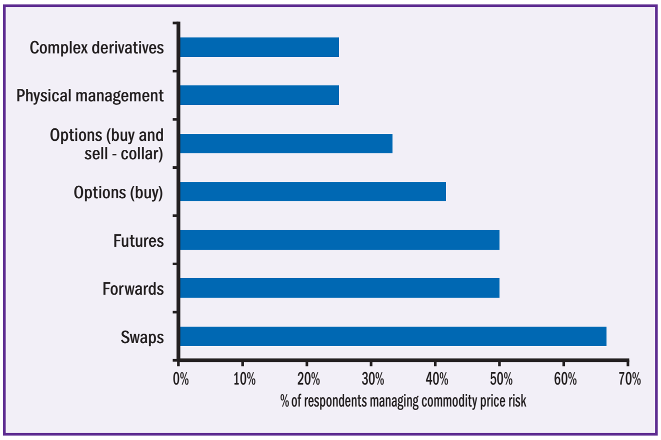




Chart 28 shows the instruments used to manage commodity price risk.

Chart 28: Instruments used to manage Commodity Price Risk





6. Liquidity, Cash Management and Funding

Eighty-eight per cent of respondents indicated that they have a liquidity policy.

Respondents were asked to indicate the time horizon over which they performed cash flow forecasting, and whether they were satisfied with the forecasts. Chart 29 below shows that cash forecasts are more common on a monthly and yearly basis, than for shorter time periods. In general, the level of satisfaction was greater for the shorter-term than longer-term forecasts.

Respondents were also asked about the accuracy of their daily cash flow forecasts. About one-third reported a daily variance of more than 10 per cent and a further 20 per cent did not know how accurate they were (Chart 30). Given this we found it surprising that only 10 per cent reported dissatisfaction with the effectiveness of the daily cash flow forecast.

Fifty-seven per cent of treasuries receive information from the business units by way of regular written submissions and 23 per cent receive it via a report through a financial support system. Approximately 20 per cent are forced to rely on verbal advice.

Cash flow forecasting is one of the Treasurer's key tools. A failure to recognise the importance of cash forecasting in the business can inhibit the effectiveness of the treasury operations. One way of overcoming this is through a demonstration of the necessity of the information and a clear message from senior management.

Liquidity Reserves

Half of the respondents have a policy of maintaining liquidity reserves, of which committed facilities are the most common form. The level of reserves varied across the respondents with most organisations keeping over 20 per cent of their net debt level in reserves (Chart 31).

Any reduction in committed facilities is likely to be driven by cost. Prudent and diligent Treasurers will have undertaken careful analysis of their future requirements and planned for the management of cash flow shortfalls, under both forecast and extraordinary conditions.

Chart 29: Cash Flow Forecasting

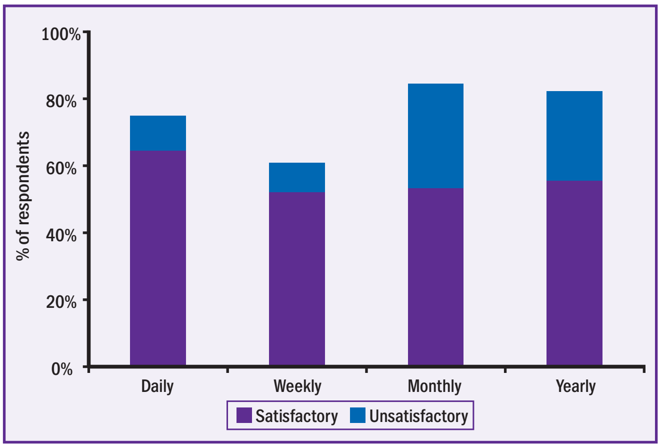


Chart 30: Variance between Actual and Forecast Daily Cash Flow

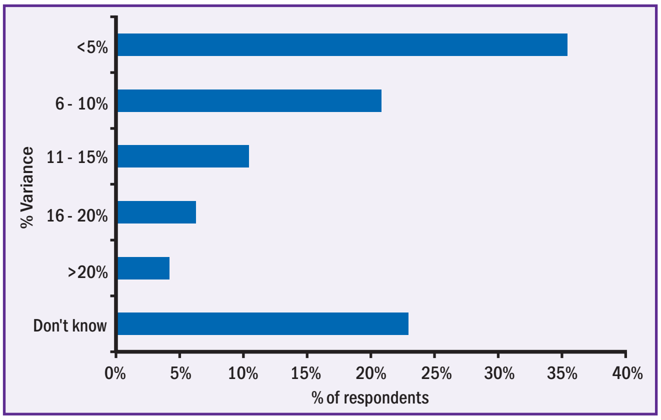
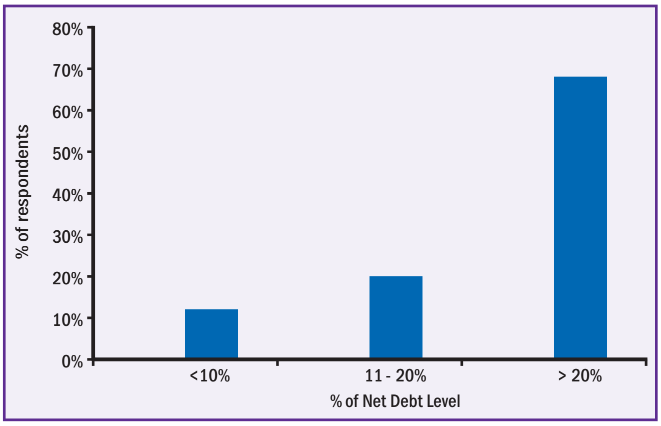


Chart 31: % of net debt maintained as Liquidity Reserve



Respondents identified which factors are important in determining the level of liquidity reserves required. The three most important factors are economic downturn, possible acquisitions and unexpected capital expenditure (Chart 32).

The continued economic uncertainty is a primary reason for firms' maintaining reserves. This back to basics approach is aimed at ensuring that companies don't run out of cash.

Banking Relationships

Most survey respondents have at least 15 banking relationships. The financial and operational savings must be balanced against the risk of concentrating business with a small number of banks.

The organisations most likely to deal with more than 15 financial institutions are from financial services (the most aggressive treasuries).

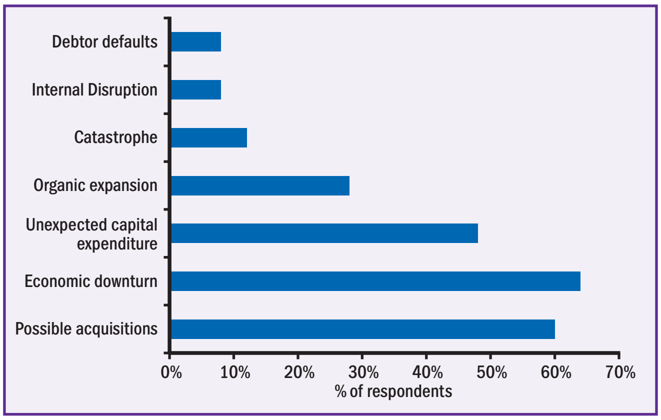
Use of up-to-date ISDA documentation was reported by 79 per cent of respondents. However, on the 9th January 2003, the International Swaps and Derivatives Association announced the publication of the 2002 Master Agreement, the successor to its 1992 Master Agreement. The fundamental structure and fundamental credit and tax protection embodied in the 1992 agreement are preserved in the 2002 agreement. There have, however, been many changes in the detail of those protections, either to clarify and extend them, or to adapt them to current and likely future market conditions.

It is expected that leading market participants will study the 2002 agreement closely with regard to their credit, legal and risk management policies before adopting it as the form on which they will do business.

Bank Accounts and Payments

Ninety-four per cent of respondents use electronic banking. The proportion of respondents indicating that the treasury controls all bank accounts is around 50 per cent. The larger the organisation, the less likely that the treasury controls all bank accounts.

Chart 32: Factors determining level of Liquidity Reserve

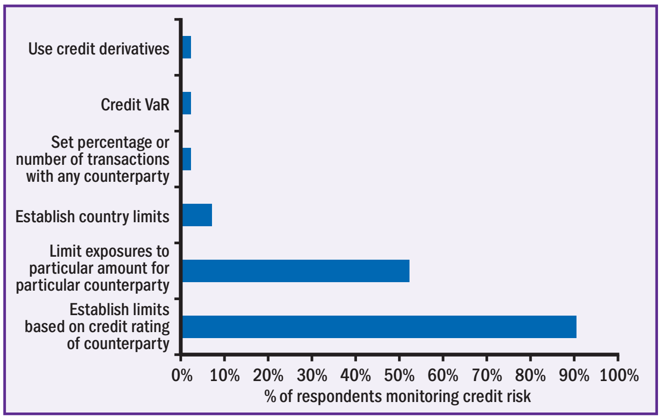


Cash concentration methods are used by 46 per cent of respondents on a cross-border basis.

Credit Risk

The percentage of organisations monitoring treasury counterparty credit risk is very high, at nearly 87 per cent. For those that do manage credit risk, 90 per cent establish limits based on the credit rating of the counterparty. Chart 33 illustrates that the other main method is limiting exposures to particular counterparties.

Chart 33: Management of Credit Risk



Over one third of respondents use fair values to calculate their credit exposure on derivatives positions, 33 per cent use a percentage of nominal, and 9 per cent use potential risk. Approximately 20 per cent of respondents do not measure the risk.

Of those who measure credit risk, approximately 37 per cent do so daily. Unfortunately, 63 per cent monitor their credit risk less frequently.

Over 70 per cent of treasuries review their credit limits when a material change to the counterparty occurs (e.g. credit rating upgrade or downgrade).

Only one quarter of respondents indicated that the treasury is involved in managing credit exposures generated by non-treasury transactions. Treasury's role in these circumstances is to monitor credit exposures against limits (35 per cent), evaluate counterparties and assign limits (24 per cent), or develop/review credit policy for non-treasury counterparties (41 per cent).

Just under 40 per cent of respondents monitor and manage settlement risk.

Funding

More than 90 per cent of respondents have a funding policy. The key features of these funding policies are:

- Spreading the maturity of borrowings/facilities - 72 per cent;
- Diversification of funding sources - 60 per cent;
- Minimum level of undrawn facilities - 38 per cent.

Overdrafts (93 per cent) and uncommitted bank facilities (69 per cent) are the most widely used short term borrowing sources. When ranked in importance, committed facilities - syndicated (46 per cent) and overdrafts (45 per cent) came out top.

Bonds/MTN from the European markets (49 per cent) are the most widely used long term sources. In terms of importance, bonds from the Euro market (46 per cent) and US market (22 per cent) are the most important. Long term bank funding (20 per cent) is also important (Chart 35).

Chart 36 shows that seventy-four per cent of respondents have an average weighted debt maturity above 3 years and 49 per cent have a longest debt maturity exceeding 10 years.

Eighty per cent of respondents indicated that

Chart 34: Most important Short Term borrowings

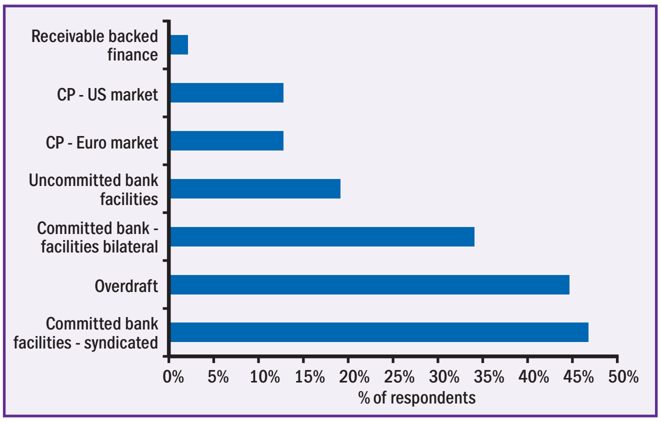


Chart 35: Most important Long Term borrowings

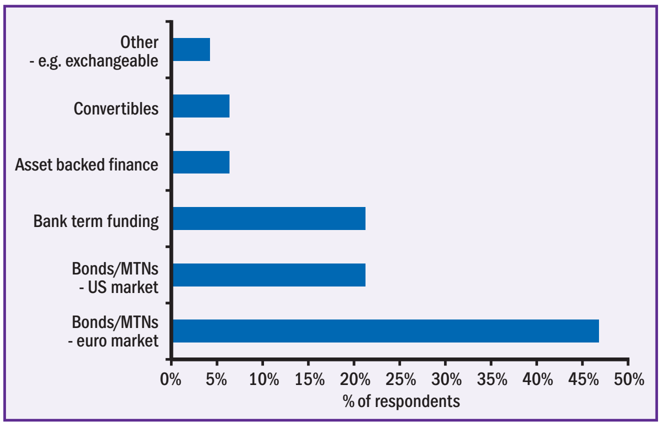
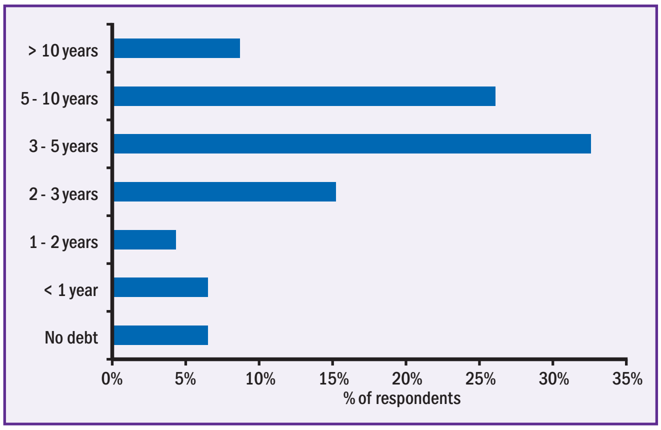


Chart 36: Average maturity of debt



liquidity needs are taken into consideration in determining the length of debt maturity (Chart 37). Other notable factors considered are interest rate (52 per cent), asset life (22 per cent), fees (15 per cent), and market appetite (15 per cent).

Chart 38 highlights an analysis of average credit margins achieved across all facilities and shows that over 65 per cent of those respondents with a credit rating of BBB or above (investment grade) achieved a margin of less than 0.75 per cent per annum, while for those with a rating less than BBB (non investment grade), only 47 per cent achieved a margin of less than 0.75 per cent per annum.

With economic uncertainty more attention is being paid to debt levels and gearing. However, only thirty per cent of respondents have a targeted gearing ratio (net debt: equity). For those respondents that had a targeted gearing ratio, we expect two factors that may raise concerns:

- Decreasing equity levels as a result of poor earnings; and
- Companies looking for bargain acquisitions during these uncertain times.

One Director of Group Treasury stated, **"future acquisitions could raise debt levels closer to gearing constraints in borrowing facilities"**.

Off-Balance Sheet Financing

The proportion of respondents making use of off-balance sheet financing is just under 40 per cent. The percentage of funding that is off-balance sheet is typically less than 20 per cent. The reason given for using off-balance sheet transactions is to reduce risk, rather than reduce gearing.

Although the most popular type of off-balance sheet financing is still the operating lease, 22 per cent have established special purpose ownership structures.

Investments

Almost all respondents have an investment policy. The key features of the investment policy are:

- Counterparty credit risk - 87 per cent;

Chart 37: Factors determining length of debt

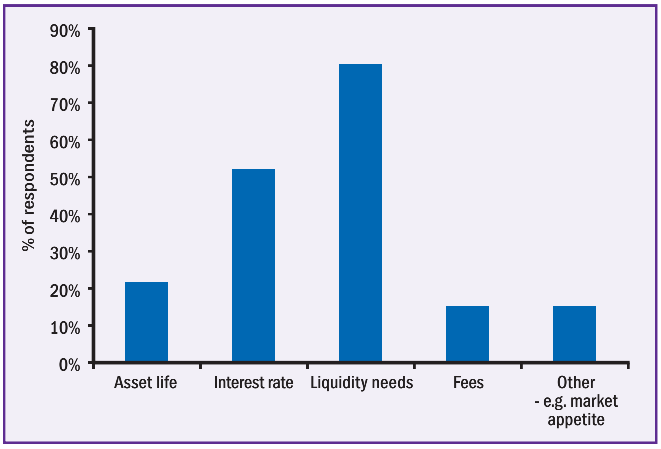


Chart 38: Average Credit Margin for Respondents

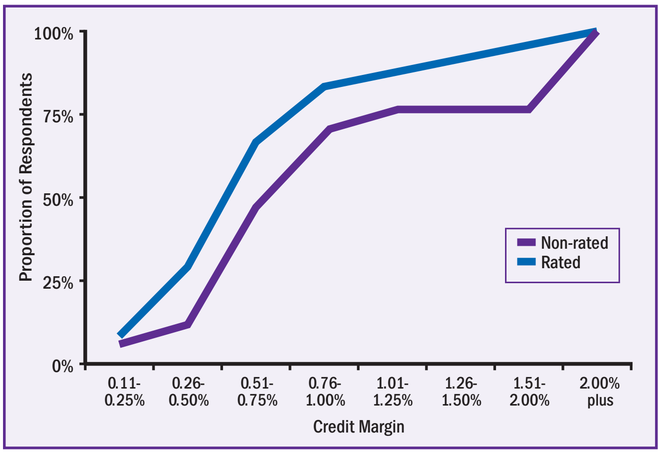
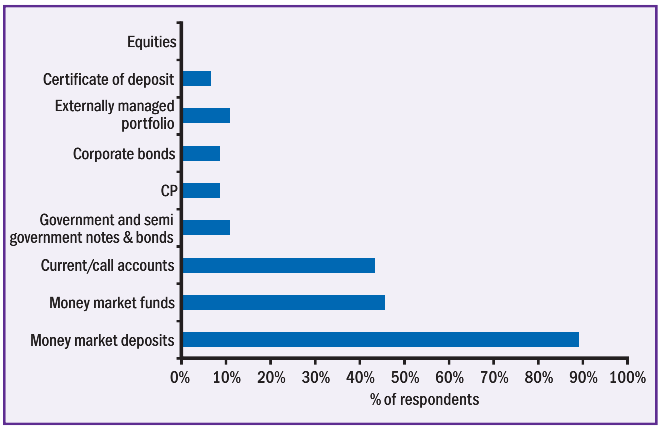


Chart 39: Most important Money Mark Investments used



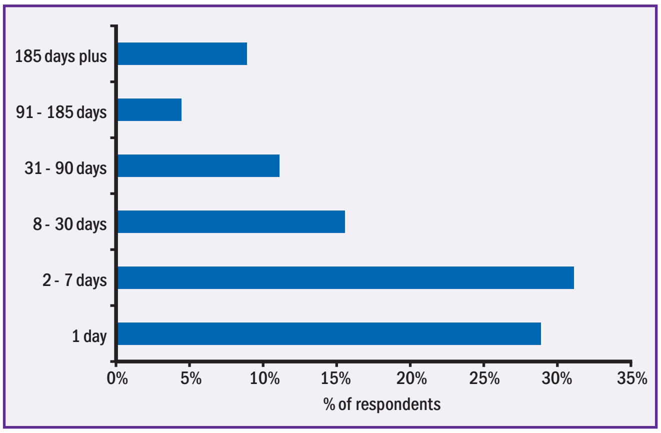
- Maturity profile of deposits - 69 per cent.

Money market deposits (89 per cent), money market funds (44 per cent) and current/call accounts (44 per cent) were the three most important investments used by respondents (Chart 39).

Cash is typically held short. Over 60 per cent of respondents have investments with an average weighted maturity of less than one week (Chart 40). The reasons are not clear. The current flat yield curve may be a driver for holding investments short but equally the unsatisfactory nature of some cash forecasts may also lead to Treasurers preferring to remain liquid.

The clear message from respondents is that achieving the maximum return is not the most important objective for the investment of surplus funds, as it would compromise liquidity and credit.

Chart 40: Average weighted maturity of investments





7. Current and Expected Direction of Treasury

Treasurers are increasingly involved in tasks that were traditionally outside the scope of treasury operations. To try and gauge the degree of this change, we compared what treasurers are doing now and what they are forecasting for 2005.

As well as day-to-day treasury matters, the Treasurers that responded to our survey are currently responsible for the following activities:

- Corporate finance and structured finance (77 per cent)
- Trade finance (37 per cent)
- Project Evaluation (28 per cent)
- Dividend Policy / Share buy-backs (28 per cent)

Looking to the future, in addition to greater involvement in the above, many expect the following to take on greater significance:

- Pensions
- Overall Business Risk
- Commodity Price Risk Management

When we asked respondents what the principal drivers of change will be, some respondents mentioned external factors such as IAS 39, Basel II and the possibility of the UK joining the Euro. However more referred to internally generated changes with the balance shifting from operational tasks to a greater focus on strategic issues and broader risk management. Developments in technology may facilitate this if embraced by Treasurers.

Another significant change is expected to be the increased importance of managing commodity price risk. It will be interesting to see if this involves greater use of established products (e.g., agricultural or base metal futures) or more towards new areas such as weather derivatives.

When asked to provide thoughts on the future of treasury, respondents commented:

"Less involvement in execution of transactions, more strategic, advisory, control of risk emphasis."

"Hopefully more driven to be even more risk focused, rather than purely operational."

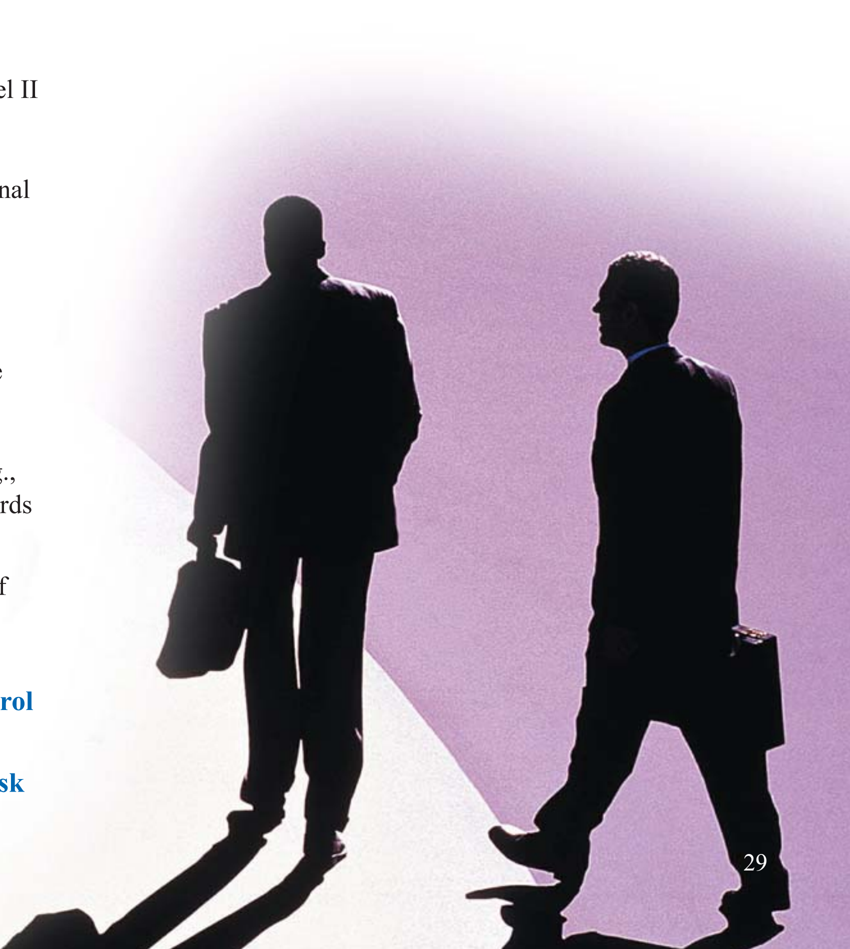
"Basel II will influence appetite for corporate risk and price."

"The Euro: if the UK joins, implications for hedging and bank products."

"Increased centralisation of Risk management functions, particularly in the extension to energy/commodity risk management."

"Embedded risk in contracts, transfer of risk from customers, and risk management rather than financial risk management."

There is little doubt that the role of the Treasurer continues to evolve.





8. About this Survey

Background

The survey was conducted by Ernst & Young's Financial Services Risk Management practice in conjunction with The Association of Corporate Treasurers (ACT). Thank you to those of you who participated.

The objectives of the Treasury Operations Survey 2003 were:

- To provide a reference point to analyse aspects of modern treasury operations and financial risk management practices in the United Kingdom;
- To share experiences and assist organisations of all sizes in these areas;
- To identify the latest trends in aspects of Treasury controls and performance measurement in the operations and financial risk areas; and
- To provide an update on the impact of technology on some treasury processes.

Respondent profile

We invited all ACT members to respond to our Treasury Operations Survey. Over 50 responses were received, of which 35 per cent are in the FTSE 100. Respondents were typically from Corporate Treasuries, and had management responsibility, like Finance Directors, Treasurers or Treasury Managers. Total assets provided a means for classifying the organisations according to size, the range being from less than GBP500 million in total assets to over GBP10 billion. Approximately, 20% of the responses were received from the five asset sizes. Organisations indicated whether they were controlled from the UK or overseas, (UK 72 per cent; Overseas: 28 per cent). Organisations were also classified according to ownership. The groupings were: privately owned firm, government owned, listed or unlisted public company.

Responses also came from a wide variety of industries, including Manufacturing (18%), Retailing and Wholesaling (16%) Engineering, Construction and Chemicals (16%) and Services (10%).

The main findings of the survey were summarised in the June edition of "The Treasurer" and made available at the ACT's UK Treasurer's Conference, held in association with EuroFinance Conferences, in Brighton 29 April - 1 May 2003. The final report is available on the ACT website www.treasurers.org and the Ernst & Young website www.ey.com/uk. Additionally, the survey gave respondees the opportunity to benchmark against their peer group.

If you have any questions about the survey, please contact Mike Henigan, ACT on (020) 7213 9728 or Daniel Moore, Ernst & Young on (020) 7951 8023.

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ACT Technical Director



9. The Association of Corporate Treasurers (ACT)

The ACT continues to meet the need of those involved in treasury. In this year, as in previous years, we remain committed to supporting and providing the financial community with expert treasury, risk and cash management information.

For our growing worldwide membership, we provide specialist qualifications, training and publications tailored to individual needs. Our attention to detail and commitment to quality ensures that the ACT is recognised as a leading provider of treasury products and services.

Our aim is to meet the needs of our membership by:

- Representing the views and best interests of treasurers
- Adding value to membership through career enhancing services such as Continuing Professional Development (CPD), regional group meetings and symposia
- Providing topical and essential conferences and training
- Remaining the premier provider of treasury information and support - which has been greatly enhanced through our comprehensive website, ACTonline
- Developing our qualifications to meet the changing needs of the treasury profession.

If you would like to join, or would like information on any of our activities, please contact us at:

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A copy of the survey is available from www.treasurers.org

  

10. Ernst & Young's Global Treasury Advisory Group

Ernst & Young has a global network of seasoned treasury professionals who can provide support in an increasingly sophisticated environment. The services we offer include:

Treasury Process Review

Full analysis and review of all treasury functions with a risk and opportunities gap assessment against leading industry practice. This can be used to provide assurance to the Board.

Treasury Structure

Development and implementation of innovative treasury organisational structures meeting the business goals of a company whilst maximising the efficiency of the various functions within treasury and taking account of governance requirements.

Cash Management

Review of a company's cash collection and disbursement mechanisms, bank relationships and account structures on a worldwide basis to effect efficient management and investment of funds.

Risk Management

Comprehensive process that addresses the impact of market, credit and operational risk, reviews and develops risk management strategies, policies and procedures, and develops management information to monitor the risk.

Asset and Liability Management

Comprehensive review of a financial institution's asset/liability management processes from both the business and regulatory perspective. The review addresses management oversight, data, risk measurement methodologies, modelling assumptions, controls, management reporting and risk limits.

Treasury Systems and Technology

A wide spectrum of treasury software related services including needs assessment, RFP development and scoring, and vendor selection.

Disclosure

Advice on the latest disclosure and regulatory requirements, including Sarbanes-Oxley, SFAS133 and IAS 39.

In addition to the UK, the Treasury Advisory Group is also represented in Continental Europe, North America, Asia and Australia.

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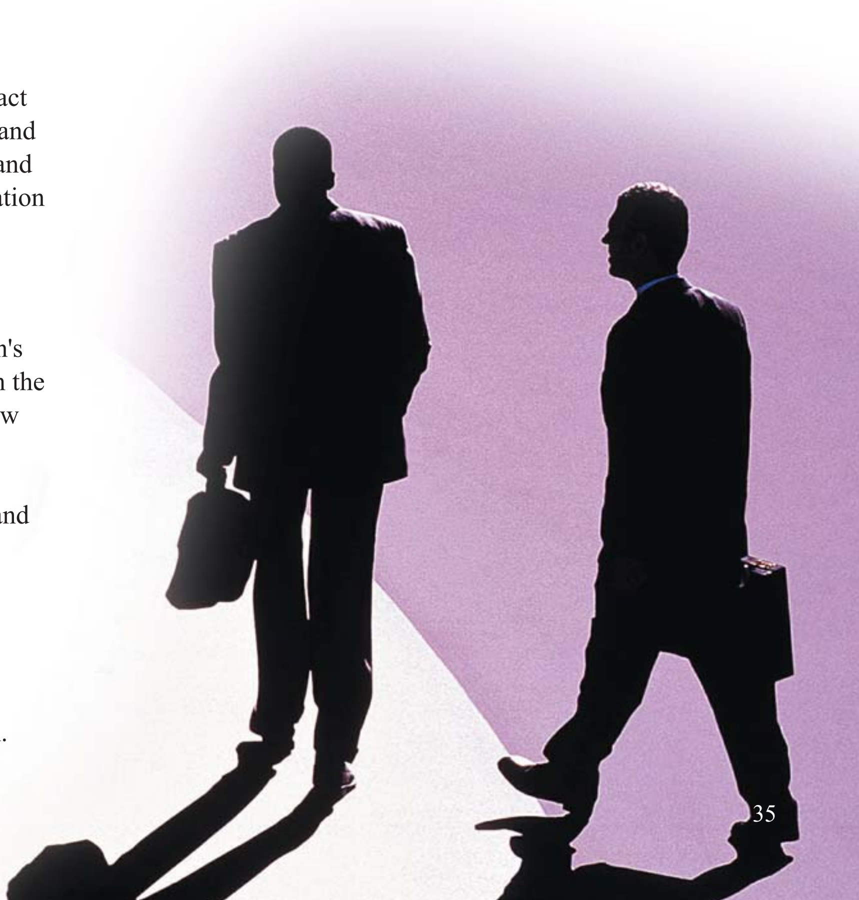
A copy of the survey is available from www.ey.com/uk



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