
11.12 SUMMARY

A knowledge of international finance helps in two important ways. First, it helps the financial manager decide how international events will affect a corporate and which steps can be taken to exploit positive developments and insulate the corporate from harmful ones. Second, it helps the managers to anticipate events and to make profitable resources deployment decisions before the event occurs. For it the financial manager resorts to various instruments normally used in international financing. This unit attempts to provide us various heads under which international resources can be deployed and the various issues concerned with it.

11.13 KEY WORDS

Acceptance draft : Cheque or draft for which documents such as the bill of lading are delivered upon acceptance of the draft by the payee's bank.

Banker's Acceptance : A time draft which has been guaranteed by a bank stamping it as accepted so that the draft can be sold at a bank related discount rate, not at a rate related to the risk of the issuer of the draft.

Bilateral Trade : Trade between two countries.

Buyer's Credit : Loans to buyers, especially importers from banks.

Counter Trade : A reciprocal agreement for the exchange of goods.

Country Risk : Uncertainty surrounding payment from abroad or assets held abroad due to possibility of war, revolution, asset seizure or other similar political, social or economic event.

Forfaiting : A form of medium-term non-recourse export financing. Involves a series of availed time drafts.

Withholding tax : A tax applied to non-residents at the source of their earnings.

11.14 SELF ASSESSMENT QUESTIONS

1. What do you understand by deployment of resources ?
2. How Letters of Credit and Banker's acceptances facilitate international trade ?
3. Define counter trade. Examine mechanism of counter trade.
4. What do you understand by project finance ?
5. List out the benefits of syndication of loans.
6. Discuss country risk giving examples.

11.15 FURTHER READINGS

1. *Risk Management Systems in Banks*, Guidelines by Reserve Bank of India, 1999.
2. Trivedi and Hassan, *Treasury Operations and Risk Management*, Genesis Publishers, Mumbai.
3. *Banking in New Millenium : Report on Conference of Chairmen of Banks, NIBM, Pune, 2000.*
4. Bhardwaj, H.P., *Foreign Exchange Handbook*, Bhardwaj Publishing Company, Mumbai.
5. Rajwade, A.V., 2000, *Foreign Exchange Risk Management and International Finance*, A.V. Rajwade & Co.
6. Joel Bessis, 1998, *Risk Management in Banking*, John Willey Sons, New York.
7. Maurice Levi, 1996, *International Finance - The Markets and Financial Management of Multi-national Business*, McGraw Hill, USA.

UNIT 12 TREASURY MANAGEMENT : AN INTRODUCTION

Objectives

The objectives of this unit are to :

- understand traditional activities of treasury.
- describe modern financial theory, planning, decision making and general responsibilities of treasury personnel.
- familiarise you with various treasury functions/transactions management of treasury and policy of organisation.
- acquaint you with various risks in treasury operations.

Structure

- 12.1 Introduction
- 12.2 Traditional Functions
- 12.3 Achievements of Traditional Functions
- 12.4 Responsibilities
- 12.5 Applications
- 12.6 The age of uncertainties
- 12.7 Innovation and Risk
- 12.8 Post Industrialisation and Service Economy
- 12.9 Changing Responsibilities
- 12.10 Strategic and Tactical Planning
- 12.11 Summary
- 12.12 Key Words
- 12.13 Self Assessment Questions
- 12.14 Further Readings

2 . INTRODUCTION

Treasury Management function has changed dramatically during the last decade. From a mere facilitator of transactions, with few analytical tools, the task of treasury management has become a dynamic, quantitative function, providing service and often additional profits to the entire organisation. The financial arm, today, is often the life blood of an organisation. Today, the strength of treasury operations is often what distinguishes a lackluster performance from stellar growth in quantity and quality of earnings. In this unit, we will explore that traditional functions in detail, with particular reference to their conceptual underpinnings. With these reference points, we will be able to see how treasury management has changed. The forces behind these changes will be explained and assessed for importance. We will also review some of the important new tools used by treasury managers to achieve the broader, more difficult tasks required in the modern, global business climate.

12.2 TRADITIONALFUNCTIONS

To say that financial management is critical to all businesses is an obvious truism. But to observe that the task of financial management has changed dramatically in recent years is less obvious. In terms of products and technologies many industries evolve slowly. With

primitive capital markets, the main task facing corporate treasurers was securing funds for expansion. Earnings and asset values, as reported in various accounting statements were often unreliable. With insider trading and manipulation, stock prices fluctuated widely. The average person had neither the means nor acumen for playing bond and stock markets. As a result of these conditions, some of which played a role in the Great Crash of 1929, the purpose of the financial managers was as largely a legal function. Even after the reforms of the 1930s, finance was still taught as a descriptive, institutional subject. It was not until the 1950s, using rigorous mathematical methods that such issues as under were addressed :

- The purpose of Financial Markets and Innovation;
- e The Optimal Mix of Securities;
- How Securities are Priced?
- How Investors make Investment Decisions?

Both the asset and liability sides of the balance sheet became much more interesting, especially from the standpoint of how they are related,

New tools for analysis were created. Most importantly, the above intellectual achievements, led to a general theory of finance, which financial managers utilize for both day to day as well as the long-term challenges facing the organisation. We will review these achievements as well. Besides, we will examine some of these traditional functions of financial managers, beginning with general responsibilities and thereafter turn to specific applications.

12.3 ACHIEVEMENTS OF TRADITIONAL FUNCTIONS

Intellectual Achievements :

During the 1950s and 1960s, the science of finance, from humble beginnings, grew into a widely accepted and used general theory addressing the issues mentioned above.

Although research since then has enhanced and refined these achievements, it is arguable that the foundations achieved by such luminaries as Kenneth Arrow, Fischer Black, Eugene Fama, Milton Friedman, Harry Markowitz, Merton Miller, Franco Modigliani, Paul Samuleson, William Sharpe, Joseph Stiglitz; will rest secure for a long time to come. Without attempting an exhaustive literature review, from the standpoint of treasury management, it is useful to take note of this intellectual heritage and the key concepts which are created.

Net Present Value

Investments involve the exchange of known amounts of cash today for expected returns in the future. Given what we have in hand, the fundamental question is always how much is the future worth. When we calculate Net Present Value, we are determined whether the investment or project is worth more than it costs. All treasuries utilize this basic but critical method of analysis. Using the relevant cost of capital, managers will discount future cash flow to determine their present worth. The methodology underlying NPV, permits millions of shareholders of vastly different backgrounds and expectations, to participate in the same enterprise through bonds and shares, with one view in mind : maximize the net present value of the investment.

Capital Asset Pricing Model

The Capital Asset Pricing Model is a centre piece of modern financial theory, because it gives treasury managers and other financial professionals a meaningful and manageable way of thinking about the required return on a risky investment. Or, how one trades off risk and return. The model is attractive because it specifies two kinds of risk, those which you can diversify away and those which you cannot, - market risk. Market risk is measured by beta, which is a measure of the extent to which a particular investment is affected by a change in the aggregate value of all assets in the economy. The most important risks, are those which are not diversifiable, which is why the required return on an asset increases with its beta. The model is a cornerstone of the practice of financial management.

Efficient Capital Markets

The third fundamental idea upon which modern financial theory is based is that the prices of securities accurately reflect available information and respond rapidly to new information as soon as it becomes available. Although expressible in different strong and weak versions, the idea merely says that capital markets are very competitive. Of course, some people will use available information better than others. The point, however is that there are no easy ways to make money in such markets; where prices generally reflect true values.

Value Additivity

The fourth principal of modern finance is that the whole is equal to the sum of the parts. This rule applies to investments and the corporate structure of organisation. For example, if a petroleum company decides to diversify into the prepared food business, an activity where there is no clear synergy such as transferable technology or decreasing average costs, the new company will not be worth any more than its constituent parts. The principal of additivity also applies to capital structure, other things equal an organisation's capital structure does not affect the value of the organisation: So long as the total cash flow generated by the organisation has not changed, its value is unchanged. With the same cash flow, value is independent of capital structure.

Option Theory

The final cornerstone of modern financial theory is theories on the pricing and behaviour of options. In finance, options refer to the right to buy and sell a security or commodity in the future terms before hand of which are fixed. For a time in the future, an option with specific pricing, timing, delivery, quality provides the right to sell or purchase a security, a commodity, or foreign exchange. Options have long been part of the product repertoire, although beyond looking at the forces of supply and demand, it was not known how to evaluate them. It was the pioneering work of Fischer Black and Myron Scholes who showed how to evaluate and price these products. Today, the use of options forms a critical ingredient in the risk management functions of the modern treasury manager.

12.4 RESPONSIBILITIES

Using the above theories, the financial manager's primary task is to plan for the acquisition and uses of funds or capital so as to maximize the value of the organisation. In this regard, general responsibilities include the following four areas:

a) **Forecasting and Planning :**

The financial manager must interact with other executives as they make short and long term, strategic and tactical plans for their organisation's future. While forecasting and planning for the organisation the manager should consult all relevant people for their views and inputs, so that he could make a more reliable and practical plan for the organisation.

b) **Major Investment and Financing Decisions :**

On the basis of long-run plans, the financial manager must raise the capital needed to support the organisation's growth. The economic growth and technological change imply that competitors are always on the horizon, therefore growth in sales and revenues is an on-going objective. This requires increased investments in plant, equipment and current assets necessary to produce goods and services. The financial manager must help determine the optimal rate of sales growth, and he or she must help decide on the specific investments to be made as well as on types of funds to be used to finance these investments. Decisions must be made on the mix of internally generated funds versus funds which are available externally. Should such funds be in the form of debt or an equity? Should debt be of a long-term or short-term nature?

c) **Co-ordination and Control :**

The financial manager must interact with executives in other parts of the business if the organisation is to operate as efficiently as possible. All business decisions have financial implications, and therefore all managers both financial and otherwise must take this into account.

d) **Interaction with Capital Markets :**

The financial manager **must** deal with the money and **capital** markets. **Seldom** it is prudent or desirable to use only internally generated funds for growth, and to be always matched in assets and liabilities.

From the above, we see that **the** general responsibilities of financial managers involve decisions such as which investments their organisation should make, how these projects should be financed, and how the organisation can most effectively manage its existing resources. Success in these areas, using the new tools of finance mentioned above, will lead to the maximization of the value of their **organisations** in the interest of **shareholders**, as well as serve the broader interests of those who work for the organisation along with those who deal with them.

12.5 APPLICATIONS

Let us now discuss some of the traditional activities in which corporate treasuries are involved. No organisation is identical and therefore the importance given to these various activities may vary, but they are all important. **We** note that while some of the methodologies have changed, the applications remain critical to **any** corporation. **We** will look at **some** of the following traditional functions of treasury management:

a) **Banking Relationships :**

There are a myriad of ways in which the modern treasury manager uses and relies upon **relationships** with banking and other financial institutions. Without describing the purposes in detail, in developing and maintaining good relationships with various banks, the treasury manager is ensuring that the bank's resources, technology, and expertise will be available to him whenever **required**. It might involve access to trade finance or to facilitate sales to a customer in another country. It might involve the investment bank which structures and places the new rights issue to raise equity capital for expansion. It involves a dealing room of the bank through which **commodity** options may be purchased to manage the value of a **running** inventory. Banks clear cheques, supply credit information, etc. The possibilities are as varied as the nature of business. Developing and maintaining relationships with financial institutions, especially one whose strengths are virtually related to an organisation's needs, is a good business practice.

b) **Cash Management :**

How much of an organisation's assets should it hold in cash a "non-performing asset" is an ever present question facing the management of both the smallest partnership and the largest transnational corporation. Statistical surveys reveal wide differences in the **percentage** of **assets** held in cash or fully-liquid securities. Synchronisation of disbursements and receipts reduces the **need** of maintaining idle assets such as cash, although having a positive float-the difference between an organisation's cheque book balances and the balance shown on a bank's books, **may** be used advantageously. The treasury manager in deciding how much of an **organisation's** assets to hold in **cash** must look at some of the following to reason out :

- **Transactions :** Cash Balances are necessary in day to day business operations. Routine payments and collections require that a portion of assets be kept in cash.
- **Precautionary Balances :** The less predictable the **organisation's** cash flows,, the larger such cash balances should be, although if an **organisation** has good access to borrowed funds, its need to hold cash will be smaller. A purchase of replacement inventory after an industrial accident, or having funds on hand to make a legal settlement; are all examples.
- **Speculative Balances :** Some cash balances may be held to take advantage of any bargain **purchases** that might arise. For example, buying-up inventory from a distressed or **bankrupt** seller.

c) **Long Term Financing :**

Although we have mentioned that an important role of a **treasury** manager is to

develop banking relationships, the financing of specific projects is a critical task. In general, it is desirable to connect a particular project, for example, a new plant or new division or new product to a particular tranche of financing capital. Using a general "pool of funds" approach for various projects does not relate the cost of funds to the project, and therefore renders it difficult to measure the return on borrowed capital. Traditional long-term debt instruments, as used by treasury managers, may be in the form of a term loan, which is a contract in which a borrower agrees to make a series of interest and principal payments on specific dates to the lender. Unlike raising equity capital for an expansion, term loans are quicker to obtain, and usually more flexible. Finance may also be raised by issuance of bonds, which are promissory notes backed by the credit worthiness of the organisation. Deciding which type of financing is best and how to structure it is the role of treasury management. The treasury manager must look at interest rates both now and into the future, along with the affect of borrowing upon the organisation's capital structure and condition. Always, the question is the marginal impact upon the overall position of a discrete decision, such as how to finance a new product line or expansion.

d) **Credit Management :**

Although one hears much of corporations being "lean and mean" and cutting costs to the bone, ultimately the generation of revenues comes first. Unless an organisation's products are in demand, unless sales are healthy, profits will not be generated. To maintain and grow sales, although pricing, quality, advertising are important, credit policy is often a critical factor. In fact, at times it may be an excellent source of revenues in itself, and actually enhance sales. Our willingness, on average, to enter into hire purchase agreements rather than paying cash is an obvious example of how the provision of credit may actually enhance sales. In developing Credit Policies, Treasury Managers must evaluate and analyse the following considerations with respect to their client base :

Credit Period : How long do buyers have until they must pay for their purchases?

Discounts : Are there any discounts to encourage early payment? Will it attract new customers? Will it reduce the collection period?

Credit Standards : What are the financial requirements of a customer in order to qualify for credit. A credit rating agency such as Dun & Bradstreet, ICRA, CRISIL or Standard and Poor, might be utilised. The five "C's" might be utilised : Character, Capacity to pay, Capital showing debt to assets ratio, Collateral, and Conditions of the general business climate.

Collection Policy : How does an organisation follow-up on slow paying accounts? Remember collection agencies and attorney are an expensive option.

e) **Dividend Policies :**

A study at Harvard Business School recently reported that the present capitalisation of many major organisations is purely result of their investments over the last decade or so. Assets from the early 1980's would today have a negative economic value. On the capital which was invested, on an average the return was below the market index. In the other words, the shareholders of many blue chip corporations, would have been better-off, if all earnings has been paid as dividends, rather than being retained. From the standpoint of treasury management, the question is what should have been done to maximize the value of shareholder investment?

Observations such as the above have led to a great volume of research on optimal dividend policy. According to the Value Additivity principles observed above, an organisation's dividend policy should have no bearing upon its capitalisation in the securities market, because an investor should not value a dollar of dividend more than a dollar of capital gain, apart from tax consideration. This argument is known as the Dividends Irrelevance Theory, according to which the value of the organisation is determined only by its basic earnings power and its business risk. Income produced by assets, not how the income is split in what matters.

An alternative view is that the cost of capital increases when the organisation's dividend pay-out is reduced. Known as the "Bird-in-Hand" theory, this approach to

dividends more highly than expected dividends more highly **than** expected capital gain, because the latter is less likely. So, **therefore**, the mix between dividends and capital gain achieved through retained earnings does matter. Which is **right**?

Empirical research has not yet settled the issue, but treasury managers must take into account both perspectives, especially if they see their shareholders as making **similar** types of **investments**, with disbursed earnings, i.e. dividends. Are investors going to use dividends to buy-into capital gains from other organisations?

Other considerations which **treasury** management must take into account in deciding on dividend policies are such **factors** as Signaling and Client Segmentation. Changes in dividend policies are often regarded by the stock market as indicative of an organisation's overall health. Increasing earnings might say that the **organisation** is doing well, although it might also say that the organisation's management **has** nothing else on the agenda to do with retained earnings. **Client segmentation** refers to the perception by the **investing** public of the **organisation**. Is the **organisation** a high risk, **small** capitalisation growth stock with good ideas for further investment **with** retained earnings?; or is it a stable, blue chip concern of which investors expect a consistent modest return? The former type of concern seldom pays large dividends if at all; while the latter invariably pays reliable returns. Investors in the high risk concern are there for the potential of capital gain; while investors in the stable blue chip concern are **looking** for regular income. In deciding upon dividend policies, treasury **management** must take into account who their shareholders are and what they are expecting.

f) **Insurance** :

Few of us have not at one time **insured** something, be it a motor car, a house, or **the** commercial assets of a business. Insurance may cover all **manners** of **business risks**, including the health of key **executives**, industrial accidents, industrial unrest, physical losses, business interruption, to **mention** only a few. **Although** an exhaustive review of the **insurance** field is beyond the scope of this discussion; it is important to note that many treasury managers have recognised that the topic should not be considered in isolation. Insuring against the loss in revenues from a fire at a factory may not be that different from the loss in revenue if there is severe decline in market share, or even a dramatic fall in prices. As the theory of insurance is that the transfer of risk to organisation better able to manage it represents a gain in general, perhaps there are times when such risk should be borne internally, i.e. self-insure. Thus comparing historically, **premium** payments **with** refunds can be very useful guide the net benefits of insurance. A good treasury manager thinks comprehensively.

g) **Pension Management** :

A pension fund is a pool of funds established by an organisation to pay the pension benefits of retired workers. Annually pension funds invest billions in securities markets. Generally, the earning on a pension fund are tax deferred, that is the retired worker only pays taxes upon the retirement, when presumably he or she faces a lower marginal tax rate. The management of such funds are one of the many traditional roles for the management of treasury departments. Although, like insurance, the management of pension funds is a **specialised** field in which the advice of outside experts is often useful, it is generally the role of treasury management to set the objectives and coverage for the fund and monitor its performance.

12.6 THE AGE OF UNCERTAINTIES

Role of **treasury** has come about in response to the changing economic and financial environment. If there is one word to describe how business is today versus half-a-century ago, the word would be 'risky'. Measured by the range of possible outcomes in any business scenario, measured by how rapidly various trends fluctuate, measured by variance in **key** operating **parameters**, measured by the pace of technological change; the world is clearly a riskier place than it **was** at the end of the Second World War.

Several key events played a role in triggering this **transformation**: The collapse of the Bretton Woods fixed exchange rate **regime** and suspension of the dollar's convertibility into gold in late 1991, and the **Petroleum** Embargo of **1973**. Exchange rates suddenly

became much **more** volatile. The prices of crude oil and **petroleum** products reached levels never before imagined, and forecasts were that prices would rise even higher. Socio-political unrest in key western countries raised the spectre of sovereign risk, as well.

12.7 INNOVATION AND RISK

Financial Implications

It was soon after the collapse of the Bretton Woods Agreement and the **ending** of fixed parity between the US Dollar and the Gold price in the early 1970s, that the Chicago Mercantile Exchange introduced the **first** successful exchange-traded currency futures. It **is** widely **argued that** such products as **futures** and options were introduced and became popular as a means to manage the new risks found in the business environment. Known as derivatives, they are derived from underlying markets, such as commodities or foreign exchange, which had now become unstable and volatile. In 1975, interest rate futures contracts followed, which allowed **one** to establish **the** future cost of lending and borrowing. By 1982, half-a-dozen **exchanges** had introduced various interest rate **futures** contracts, converting very short to longer-term borrowings.

The **next** step in global derivative developments for managing and controlling risk was the introduction by the Philadelphia Stock Exchange in 1983 of currency options. Currency options linked the futures and options which had risen in the capital markets of key **hard-currency** countries. Currency options and **futures** would lead to the development of many further risk **management** techniques. Without a tool for managing exchange rate movements, global trade and investment can be **very** risky. The treasurer now had an **array** of tools to manage the risks faced by modern global corporations. Without the use of derivative products by proactive treasury managers, many of the **benefits** which we enjoy today from globalisation would not be possible.

By the **mid-1980s**, a revolution in financial, foreign **exchange**, and commodity risk management had taken place through the use of futures, options, swaps and forward rate agreements (**FRAs**), which **are** series of consecutive forward or futures agreements. Such products enabled treasurers to price and transfer risk in a global manner. On the Chicago exchange, for example, the trading volumes involved tens of **million** of contracts **annually**. Derivative exchanges were introduced in New York (New York Futures Exchange) in 1980, in London International Financial **Futures** Exchange (LIFFE) in 1982, in Singapore Monetary **Exchange** (**SIMEX**) in 1983, while 1985 saw financial **futures** were introduced on France's **MATIF**. To **meet** the needs of management of controlling risk, the development of new derivative markets continues, with new contracts appearing regularly. On over **fifty** exchanges around the world some form of derivative instrument is today traded.

From the above we see that **these** markets have not arisen in isolation but in response to the global integration of trade and finance. By being global in scope, such markets have created a mechanism for pricing and transferring risk around the world. **These markets** allow financial officers and treasurers to manage risks efficiently. Today treasurers of corporations, banks and public entities have no excuse for **not** managing unexpected surges in interest expenses, swings in **exchange** rates, or increased commodity prices affecting raw material costs.

Innovation and Risk - Recent Trends

An important feature of **the** growth in **the** use of derivative markets, like futures **and** options, has **been** the evolution and maturing of the Over-the-counter (**OTC**) market. **In India** this market is yet to make a dent. While traded futures and options are suitable for the day-to-day risks by most treasury management, **often** there are situations where only a **custom-made** solution will satisfy specific commercial and financial objectives. **A** new **investment** or an innovative financial structure, may have an unusual **risk/reward** profile. The "financial engineers" using off the shelf futures and options products available on the major exchanges, can devise **one-off** products to satisfy such needs. Often hybrid derivatives have **been** devised to address the combined risks involving several markets. It might be the ratio of gold to silver prices or an equity linked bond. To address **these**

exposures, the treasurer working with the financial engineer might use derivatives in combination, mixing futures and options, currencies and commodities and different maturities; all to achieve a particular objective.

12.8 POST INDUSTRIALISATION AND SERVICE ECONOMY

A quarter century or so ago, referring to the United States for example, nearly one third of the labour force was involved in either automotive industry or the housing sector. The sales of which, at that time, were highly sensitive to changes in medium and long-term leading rates. Like many industrial countries, in the United States, the international sector played a small role, with imports and exports representing merely three percent of the GDP. The service sector played a much smaller role, and information technology did not exist. Throughout Western Europe and the United States, the energy, communications, and transportation sectors operated under a rigorous regulatory framework. Similarly, the role of unionised labour was much greater than today, and of that portion, public sector employees played a small role. Mass discount retailing and micro marketing did not exist. Inventory was "managed" on a quarterly basis, or less frequently. The percentage of debt in corporate balance sheets was proportionately lower. Globalisation of products, tastes and suppliers was not yet imagined. Capital, labour and technology were tied to the domestic economy. Broadly defined goods and services which are taken for granted today did not exist or were only the privilege of the rich. In the United States, the preponderance of the American population lived in north-east and mid-western states, were of northern European ancestry, and had an average age of thirty-two. In Western Europe, wide immigration from the Southern Hemisphere had not yet occurred, and fully half the world lived under the yoke of central state planning. The personal impact of the government was limited. In the US and the UK, the average wage earner required only four days per month to pay for the goods and services provided by the state.

What a great change? It is difficult to think of a place anywhere in the world not effected by the dramatic changes of the last quarter century. By all the measures mentioned above and countless others, the world economy has transformed itself beyond recognition, and by and large it was the result of endogenous, organic factors. How and why these changes have occurred is a subject of on-going research? But certainly it was not the result of state intervention, no matter how much various governments have attempted to promote, facilitate or retard such processes.

Today, the buyer for a major retailing organisation such as Benneton or the Gap, can take notice of a fashion trend, and in less than a month have it designed, manufactured, marketed and stocked in outlets throughout the world. Today, software engineers situated in distant parts of the globe hold "virtual meetings" to discuss the production of software code. Today, investors looking for an attractive bond can browse the internet searching for the highest yield. Consumer loyalty to goods and services lasts as long as the next product is launched. Watching exchange rate trends, corporate managers allocate production to plants throughout the world. Gone are the days of blanket advertising : today, modern "data mining" and data surveying techniques allow a corporation to target its customer with pinpoint accuracy. With knowledge of regional demographics, national chain stores are able to adjust the goods they feature to satisfy local tastes. From head office, the head of marketing for a major petroleum company can adjust prices to the time of day, in a thousand service stations, by merely sending through coded computer instructions. Just-in-time delivery of raw materials and parts to the factory gate ensure smooth production without money tied up in inventory. Out-sourcing of required goods and services for which an organisation has no comparative advantage in producing, allows management to focus upon core activities.

The ways in which the global economy has changed in the last quarter of twentieth century are virtually limitless. The above anecdotal observations are only here to remind us that given these dramatic trends, to imagine that the job of treasury management should be unchanged, would be foolish. Higher levels of technology imply higher rates of return, however the "cost" is that the world has become a riskier place. Proactively and dynamically, treasury management must define their responsibilities as broadly as possible, taking into consideration the new upsides as well as the new downsides which

12.9 CHANGING RESPONSIBILITIES

The 1970s saw treasury management attention diverted to such pressing problems as :

- Inflation and its affects upon accounting;
- Deregulation of financial institutions into broad service corporations;
- Dramatic innovations in the use of computers for analysis and telecommunications for receipt and transmission of information;
- New and innovative methods for financing long-term investment; and
- Unprecedented volatility in the economic environment.

It was not that the financial manager's primary task of planning for the acquisition and uses of funds or capital so as to maximise the value of the organisation and facilitating transactions, had changed. Rather the task of doing this in a world of floating exchange rates, globally competitive labour forces, rapid technical change, etc., had become significantly more difficult.

Traditional Treasury - As a cost centre :

- Treasury as a facilitator of transaction flows of business units.
- Treasury with a process orientation towards risk.
- Treasury with a reactive strategy towards business development.

Modern treasury managers who are ready to meet the challenges of the post-industrial information age, may be modelled as either service centre, or as a profit centre. Defined functionally, the two approaches would include the following responsibilities :

The Service Centre Treasury :

- New trading orientation
- Development of innovative risk management techniques
- The application of such techniques to business units
- Minimisation of overall financial risk.

The Profit Centre Treasury :

- It has its own profit and loss account,
- It undertakes exposures with no specific match with the natural exposure of the organisation.
- Gains and losses. are used to offset underlying exposures at a consolidated level,

Now, the obvious question is which one is better? Which approval is correct? Well, it all depends on what is your organisational policy? Certainly the service centre model of modern treasury management is the more prudent of the two approaches. It addresses the needs of the corporation from the standpoint of the challenging and dynamic world in which the modern, global corporation operates. The profit centre model does that as well, but by taking on new exposures which may or may not directly offset losses, or enhance gains of operational profit centres. The profit model transforms the cost or service centre approach into a dynamic unit which may contribute to the quality and quantity of earnings.

The risks of the profit centre model, however are significant. Performed correctly, it can add greatly to bottom line, badly, however, the results may be disastrous. The experiences of two major trans-national corporates are worth keeping in mind. General Electric is arguably one of the world's most successful corporations. With a product base not dissimilar to Germany's Siemens Corporation, GE earned twice the rate of return on equity. How did it all happen? According to some experts, the secret is in the management of GE Capital Corporation, which not only facilitates and enhances the sale

of everything from refrigerators to industrial turbines, but operates as a profit centre, with a dealing and trading operation which rivals any major commercial bank. When exposures are undertaken by treasury management without any specific match to underlying activity, purely for profit, things may go wrong. The spectacular losses by certain American, British, German and also Indian Corporations in the use of derivative exposures are notable examples. Creating additional risks for the possibility of profit when core business activities in which the organisation is supposed to have an advantage are ignored or not properly facilitated, is hard to justify. In deciding which approach to the management of treasury is favoured, the organisation should evaluate its strengths, and if those are not equal to those of a GE Capital, probably the service model should be favoured.

12.10 STRATEGIC AND TACTICAL PLANNING

Although corporations and organisations have always planned for the future, the treatment of the planning function as a separate entity usually falling under the management of treasury is a relatively new business innovation. Like the development of the service centre approach to treasury or the use of derivatives, the planning function has grown in importance because of the service centre approach to treasury or the use of derivatives, the planning function has grown in importance because of the dynamic environment in which we live. Problems and issues never imagined several decades ago, are today the stuff of management meetings. Today, still, many corporations neglect planning because the process requires thinking about the future, and the future is always uncertain. Although a full discussion of the topic of planning and management is beyond the scope of this unit, some thoughts and guidelines will facilitate the process.

The planning function is part and parcel of treasury and financial management. A capital budget cannot be conceived, a source of funding identified, a risk management strategy developed without having a view of the future. Planning for the future starts with an intimate and realistic understanding of existing products, divisions, markets, profits, returns on investment, cash flow, availability of capital, research and development abilities, and the skills and capacities of personnel. How is the organisation performing today? From understanding the present, we construct predictions of the future. Forecasts prepared by divisions must be evaluated by the management of treasury for reasonableness. Are they consistent with one another? In taking the lead on this important task, treasury management should consider the following guidelines for planning.

Activity 1

- a) List the traditional functions of a treasury manager.

.....
.....
.....
.....

- b) The four general responsibilities of a finance manager are :

.....
.....
.....
.....

12.11 SUMMARY

To summarise the unit we need to follow and understand the guidelines to plan treasury management as under :

- Create an awareness of the need for planning.

- Assess how well the divisions have integrated the plans into their respective programs. Are they consistent?
- Create a means of implementing continued planning so that the divisions will complete any unfinished plan or revisions during the coming financial year.
- Determine what standards for measurement, if any, the divisions have in setting goals.
- Determine if the plans are consistent with capital budgets and technological resources.
- Promote the idea that divisions should consider a wide range of possible projects. The ranking can come later.
- Assess the reasonableness of goals, so as to devise a long-term corporate goal.
- Determine whether the resources, capital, manpower, and technology are available to implement the selected plan.
- Establish a programme for monitoring the plan's implementation, it mustn't be filed away.
- Look for synergies between divisions in constructing and implementing the plan.

12.12 KEY WORDS

Profit Centre : The centre which transforms the cost or service centre approach into dynamic unit which may contribute to quality and quantity earning.

Strategic Planning : Planning for the future by corporates,

Tactical Planning : Planning on the spot at given point of time.

12.13 SELF ASSESSMENT' QUESTIONS

1. What are the traditional functions of Treasury ?
2. What is modern financial theory? Illustrate your answer giving five fundamental ideas/principals.
3. Write short notes on General responsibilities of a treasurer.
4. What are the traditional activities in which corporate treasuries are involved,
5. Write short notes on :
 - a) Financial innovation and risk
 - b) Treasury Management : changing responsibilities

12.14 FURTHER READINGS

1. *Risk Management Systems in Banks, Guidelines* by Reserve Bank of India, 1999,
2. Trivedi and Hassan, *Treasury Operations and Risk Management*, Genesis Publishers, Muinbai.
3. *Banking in New Millenium : Report on Conference of Chairmen of Banks, NZEM,* Pune, 2000.
4. Bhardwaj, H.P., *Foreign Exchange Handbook*, Bhardwaj Publishing Company, Muinbai.
5. Rajwade, A.V., 2000, *Foreign Exchange Risk Management and International Finance*, A.V. Rajwade & Co.
6. Joel Bessis, 1998, *Risk Management in Banking*, John Willey Sons, New York.
7. Maurice Levi, 1996, *International Finance : The Markets and Financial Management of Multi-national Business*, McGraw Hill, USA.