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Market Risk

Assessing Market Risk

Treasurers need more resources to accomplish portfolio goals

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Institutional treasury departments are at a tipping point in their evolution. When I began my career in institutional cash in 1991, clients typically rolled repo or kept their money in traditional bank accounts earning little or no interest. Today, I have seen treasurers invest in securities they don't understand, don't know how to price nor have the resources to do either. Regardless of the impressions that may exist, institutional treasurers are not typically greedy. Their compensation is not based on earning an extra basis point on their investments. To the contrary, treasurers know their jobs are on the line if their portfolios are not safe and liquid.

Until now, many treasury departments have been able to get by with the few resources they have, typically because nobody, including their auditors, asked for more information. Senior people at the institution, including the board, would not ask about more detailed portfolio valuation or modeling because there were no signs there were urgent problems. In today's market, immediate, daily answers to the following questions are becoming not just important, but essential:

- How much risk is embedded in the short-term cash portfolio?
- What happens to the portfolio if short-term interest rates fluctuate?
- Is the portfolio managed within our investment guidelines?
- Is my portfolio valuation, or the valuation that I receive from my asset manager, accurate?
- Can the portfolio earn more without adding more risk?

Many institutions including corporations, state and local governments and financial firms still don't have the right controls in place and the proper reporting capabilities to ensure they are prepared to deal with the current or next market crisis. Institutions will learn that their independent auditors will be working to ensure their clients are better prepared. In the past, auditors primarily required institutions to report on their holdings, the value of these holdings and their categorization as cash or longer-term, etc. Traditionally, the treasury department has not been an area where auditors put a lot of focus relative to other parts of the firm.

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Times have changed. In addition to asking the traditional questions, auditors will now likely be verifying that the institution has:

- adequate investment guidelines in place
- controls in place for the purchase of these securities
- a process to demonstrate that the securities they purchase are in compliance with their guidelines
- a process in place that flags guideline violations
- process in place to elevate, discuss, report and act upon guideline violations
- a full understanding of the securities they are holding
- securities pricing using a reliable third-party source
- an understanding of the duration and credit risks of the securities they purchase
- a process in place to monitor these risks and
- a process in place to elevate, discuss, report and act upon highlighted risks.

This is easier said than done. Imagine the level of complexity when an institution is working with multiple investment providers who have multiple and varying ways of trading, pricing and reporting their data. Now envision a corporate treasury department, which is a cost center for the company and is generally thinly staffed, having to satisfy the auditor's request.

One of the greatest challenges is providing pricing from a third-party source and a fair and accurate modeling of the price of securities that don't have a CUSIP or unique identifier that enables the institution to simply look up the price. If they are lucky, their treasury department has a Bloomberg or Reuters subscription where they can look up securities that have a CUSIP. Many of the companies I talk to use Excel spreadsheets to track their holdings and have to call their brokers to provide them with a value of some of the securities they buy.

According to a recent article in the Wall Street Journal, "the SEC is considering recommending companies explain how they got the market-value number, disclose the extent to which that number depends on financial models, and provide the potential variability of that number, or how firm or sensitive to change it is, and a reasonable range." Again, the challenge is that treasury departments have little to no budget to buy risk analytic software that provides them with pricing ability and ways to model and measure their risk.

There are many treasury people who are dealing with this situation or trying to show they are dealing with this situation by moving all of their cash to U.S. Treasuries, etc. This has resulted in an unnecessary loss of return and an increase in liquidity risk. Treasury people want to go to their bankers for advice and sometimes find their "investment" contact is more specialized in banking systems or cash management than investment management. I believe the answer will be that treasury departments move to liquidity providers that provide robust and flexible information and reporting tools delivered by people with experience in institutional investment management.

About Aron Chazen

Aron Chazen is a Managing Director of Treasury Curve, LLC. Prior to co-founding the firm, Aron was part of a team that founded the $250 billion Global Cash business at J.P. Morgan. As a Managing Director at J.P. Morgan, Aron was responsible for running the Global Cash business in the Americas providing asset management solutions for corporations and public sector clients.