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Contemporary Issues in Finance
Managing financial risks

Martin Upton

To help me explore the issues of financial risk management and, in particular to show how financial risks are managed in the business world, I'm delighted to be joined by Neil Henfry, the Group Treasurer of Boots, the United Kingdom's leading health and beauty retailer and Paul Outridge, the Head of Treasury at De La Rue, the world's largest commercial security printer and paper maker. Managing company risks involves an active relationship with the banking sector... and here to represent that sector I'm pleased to have Hor Chan of the international banking group ABN Amro. First, can I turn to you Neil - what are the financial risks that arise in the business at Boots?

Neil Henfry

Thank you Martin. We would say there are six main financial risks. First of all there would be liquidity risk. Secondly, there would be counter-party credit risk. This would be particularly with bank counter-parties and also when we've got substantial amounts of funds to deposit. Thirdly, the currency risk; relatively small at Boots but it would be primarily around purchasing goods for Christmas from the Far East, which might be dollar related, and also sales in our Republic of Ireland stores, which would be euro related. Fourthly, interest rate risk; this arises from the debt we've got on the balance sheet – about £600 million – and also, at the current time, cash we've got on the balance sheet – about £700 million – and making sure there's no interest rate mis-matches between the two of them. Fifthly, like any corporate treasurer, there'd be operational treasury risk arising from having a small team and needing to ensure there is segregation of duties, such that fraud can't take place. And finally, a large risk for an organization like Boots, would be pensions risk.

Martin Upton

Paul, is it the same at De La Rue?

Paul Outridge

Yes that's right. Certainly I'd agree with Neil on the principal areas of financial risk that we also face at De La Rue, although I think the emphasis for us is slightly different. As a major UK exporter foreign exchange risk is certainly the most significant risk that we face, and managing that is a key part of our treasury operational management. Following on from foreign exchange risk simply would add that liquidity risk and counter-party and credit risk are also similarly important. Liquidity risk, ensuring that there is sufficient cash available in the right currency at the right time and in the right place, is a key area for all treasuries. With regard to credit risk and counter-party risk, again we have a surplus of cash on the balance sheet – it's in making sure that institutions with which we deposit our cash have sufficient credit ratings to ensure they will be there tomorrow when we want to receive the cash back.

Martin Upton

Well Hor, if I can turn to you – risk is the nature of banks' business, so I suspect that your list will contain every financial risk in the financial dictionary.

Hor Chan

Yes, Martin, I imagine that's right. Our biggest risk, of course, as a bank is credit risk. If you look at the assets of any bank the biggest category there is really the loan portfolio. So, when we lend money to people, of course we have to be reasonably sure that they will be paying us back and that's where the credit risk comes in. I think the second category which overlaps partly with Paul and Neil's is what we would call market risk – but perhaps they've separated it out slightly into foreign exchange and interest rate, which of course it includes, but then we would also put in equity risk or commodity risk from our trading books and so on. The third

category is operational risk, which is increasingly important nowadays with the new regulations coming in, Basel II and with the ratings agency focus on these nowadays. There is much more emphasis on that. Perhaps the fourth one I'll mention is one again that overlaps with Paul and Neil, which is liquidity risk, and about being able to fund ourselves and have enough cash to meet our obligations. And just to wrap up on a few other risks which we face, these would be legal risk, reputation risk and business risk. We approach risk in a very different way to corporates. We're really looking at risk as an opportunity… an opportunity which, as long as it generates the return which is adequate for the capital we're using on this risk, then we probably should be taking it, provided of course it doesn't impact on our reputation. So, yes we are in the business of taking on risk, rather than necessarily getting rid of all the risk. And sometimes, indeed, we would even take on risk deliberately when we have a particular view of the markets, because we feel that's an opportunity to speculate, if you like, and make a bit of extra money. Of course, it's so difficult nowadays for banks to make money in the traditional lending business. We have to supplement it by taking, in a sense, a few more risks in different areas to try to increase our returns.

Neil Henfry

I think there's one other thing that Hor brought up there about banks take views of markets. It would probably be true to say, I think, in the corporate world these days that most corporates do not take any views on markets and therefore you don't get into speculation and speculation could be that you don't hedge something, even though you've got the exposure. But we tend not to take views on markets and you tend to just hedge irrespective of whether you might personally think dollar/sterling is going to move in one direction – personal feelings don't come into it these days.

Martin Upton

I guess, if you're on the Board of Boots, you might find it understandable if you take a business decision to launch a product which ends up failing and losing money but, if you lose money on foreign exchange speculation, I think the Board members might find that inexplicable.

Neil Henfry

That would be absolutely right which is why most corporates don't do it these days.

Martin Upton

Thank you. I want to drill down now to what actually happens when you want to manage those risks. It's one thing to say – okay, I've got foreign exchange risk, I don't like it, I want to get rid or it; I've got interest rate mis-match risk, I'm borrowing floating, I'm lending fixed – what do I do about it? What transactions do I do? And how might I use derivatives? Neil, can I turn to you?

Neil Henfry

I think the first one, on the funding liquidity is, what we do is, make sure we've got access to a variety of funding mechanisms so we have a euro NTN shelf programme, to be able to issue public bonds off. We've got a credit rating from Standard & Poors & Moody's, to be able to issue public bonds. But, more importantly in many ways is committed financing, so that having undrawn committed facilities from banks, so that you've got the ability at any time to be able to draw down funds on same day basis in case something happens. And the key thing there, really, is to make sure you fund before you need the money, so that you're not kind of held ransom to the markets. And, there's quite an important example recently on that, where Philip Green made his phantom bid for Marks & Spencers – all of a sudden, not just Marks & Spencers, but many of the retailers in the UK had a lot of trouble accessing capital markets because of rumours about – could it happen to them as well? So,if you'd been wanting to go to market at those few months you wouldn't have been able to. And so that's why you always need your committed financing and things like that to stand behind it. You asked me about derivatives.

We do use them for currency so, when we are hedging our US dollar imports for Christmas trading, we use straightforward FX forwards and spot deals to hedge those, we've got some

interest rate swaps to be able to convert the fixed rate bonds into effectively floating rates, which then the interest rate risk matches off against the cash that we've got.

Martin Upton

Paul, what's your experience?

Paul Outridge

Our exposures and our risks are much more concentrated on the foreign exchange side and our policy is fairly straightforward for those. We again use plain vanilla forward contracts to hedge our foreign exchange exposures. We do, within the treasury department, have the ability to use currency options, for example, should we choose. But, in practice, it's something that we have not used in the last three or four years. So, they're there as an instrument that is available to the treasury department, if it so chooses, but in practice, straightforward forward contracts provide the level of cover that we need for the vast majority of our exposures.