TREASURY UPDATE

VOLUME 4, ISSUE 1 SPRING/SUMMER 2010

a Strategic Treasurer newsletter

Treasury Vision: Of Roadmaps and Waypoints

Why preparing for the hike into the financial wilderness is no time to take risks!

Credit Spreads in Valuation | *4*

SWIFT & eBAM | *10*

Developments in Treasury Technology | *13*

Special Report: New Research Sheds Light on Money Fund Risk Factors

Contents.

3 | **Treasury Vision: Of Roadmaps and Waypoints**
Leadership

4 | **An Introduction to the Use of Credit Spreads in Fair Valuation**
Financial Risk Management

5 | **New Research Sheds Light on Money Fund Risk Factors**
Sponsored Content

7 | **Achieving Visibility to Your Liquidity**
Relationships, Hedges, & Counterparties

9 | **SWIFT Benefits: Options and Considerations for Corporations**
Sponsored Content

10 | **SWIFT and Electronic Bank Account Management**
Treasury Technology – SWIFT

13 | **Developments in Treasury Technology**
Technology Column

Is it Time to Invest in Your Mind?

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Microsoft Corporation

"...No treasurer faced with managing through the dynamic years ahead will want this book far from his or her fingertips."
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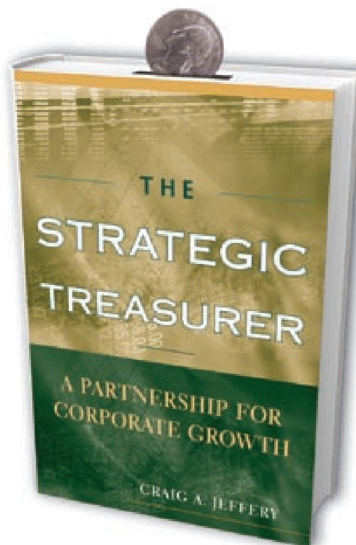
Hanesbrands, Inc.

"...captures the essence of what it takes to be a strategic treasurer and valuable business partner. It is an extremely practical resource for anyone seeking to learn more about the strategic, technical, and operational aspects of leading a successful treasury organization."
John Tus, vice president and treasurer
Honeywell International, Inc.



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Treasury *Update*

A Strategic Treasurer Newsletter

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Mission Statement
Treasury Update, a resource for Treasury professionals, is published bi-annually to raise awareness of key Treasury items, issues, and events; assist with tactics and strategies; and enable Treasurers and their organizations to be more resilient, effective, and efficient.

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Treasury Vision: Of Roadmaps and Waypoints

The Big Bang is for Theorists, not Treasurers.

Leadership

Any good Treasurer must be a visionary. Being able to see what the future looks like and having the ability to describe it in aspirational terms (the 'I have a dream...'), is more than just an emotional plea. It is the required first step in the journey to being a strategic Treasurer with a strategic Treasury department. Beyond the rah-rah aspects of vision, a fair amount of real work is required, although this should not be taken as a minimization of what is required to establish and socialize the vision for Treasury.

Map/Compass/GPS Analogy. If you take a group on a planned weekend hike (versus a Friday afternoon hike on which you got lost and wandered for the entire weekend), several key activities and tools to optimize the opportunity for success are required. While success can be different for various groups and people, let us assume "success" means you get where you intend to go at the approximate time you expect to arrive, while fairly closely following the planned route. Of course, lack of life-threatening injuries or loss of possessions also adds to the level of success you hope to achieve.

One of the required tools for this hike to be successful is the right set of maps. This map set should contain your starting and ending points as well as your route. Additionally, you will mark waypoints along the path, such as a favorite camping spot, a scenic view, or a water stop. Knowing and seeing these waypoints confirms you are on the right path. Your compass indicates which direction is north, and you can use it in combination with your map to determine the direction you ought to go—but make sure it isn't one of those cheap compasses charged in the wrong direction. The compass by itself won't tell you where you are, but it is a useful tool nonetheless. However, a Global Positioning System (GPS) can tell you where you are (you may have loaded the waypoints into it, which is a best practice) and track your progress and distance in an extremely accurate manner. The GPS will provide two coordinates which can be referenced on your maps—if you brought the right ones—to provide further confirmation of your location in relation to your trip plan.

Waypoints (or interim steps). On a short hike, loading in waypoints may be a bit too much work or even unnecessary. However, in unfamiliar territory, loading them is very useful. Backtracking for six tenths of a mile (one kilometer, or click) is less disheartening than discovering you followed another trail that veered off and took you three hours off course.

Finding water sources is also crucial, as faucets aren't conveniently located on trees, and no one can carry all of the water they need for an entire weekend.

Below are examples of situations that can arise on a hike, along with their analogous examples for reaching Treasury's future state.

Minimalistic Map Use. Bringing only the maps you 'need' on a trip appears to be a good idea for saving space and money. However, if you arrive at your planned water stop—a mountain stream—and discover it is completely dried up, your route may need to be altered. Not having a contiguous map in your backpack may mean you must completely alter your route and miss the great vista. However, if you had packed the extra map, you might be able to see a bigger stream only a half click away that would get you back on track, with only a one-hour delay, and still see the great vista. *A similar situation emerges with Treasury. Having a clear roadmap to where you are taking Treasury and ensuring you have allowed enough flexibility in your set of roadmaps to alter your trip without throwing away all of your planning are both vital.*

Unfamiliarity with Using the Tools. In the backwoods, whenever you see someone unwrap their GPS for the first time and insert the batteries, a barely audible 'are you kidding' comment might escape your lips. To depend on a tool you haven't used—or may only use on this one trip—and haven't tested can be quite dangerous. Typically, there isn't a GPS Help Kiosk out in the woods with a helpful

(*continued on page 11*)

An Introduction to the Use of Credit Spreads in Fair Valuation

Financial Risk Management

Credit, or default, risk refers to the risk [or possibility] that the issuer of a fixed income security, [a corporate bond, for example], may default, (i.e., the issuer will be unable to make timely principal and interest payments on the security.) Credit risk is gauged by quality ratings assigned by rating [agencies]." (Fabozzi F. The handbook of fixed income securities. 3rd ed. p. 33.) This risk impacts the net yield—the "credit spread"—of a corporate bond over the "risk-free" rate of government bonds. As pointed out by Fabozzi, investors in corporate debt, however, are more concerned with changes in the "perceived" credit risk of an issuer rather than with the actual risk of default since the perceived risk impacts the valuation of their investment through the adjustment of the credit spread. As other investors anticipate a worsening situation for a corporate bond issuer, the yield they would require over the risk-free rate increases (the credit spread widens), which lowers the fair market value they are willing to pay for the bond. Yields / interest rates and bond prices have an inverse relationship.

Corporate practitioners engaged in hedging their financial risks with over-the-counter (OTC) contracts are also subject to credit risk or the possibility that their counterparty to the hedge transaction—an interest rate swap, for example—may default. Further, corporate stakeholders have become increasingly aware of this risk in light of the financial crisis of 2008 and the collapse or potential collapse of several large financial institutions. Measurement of credit risk in derivatives is complicated by the fact that the future is uncertain—the derivative's value can move in the company's favor (a positive value) and out of the company's favor (a negative value) over time. The current market value of the derivative only represents the potential gain/loss today and does not account for future changes in value. It is no longer safe to assume that your hedges are secure, given the fact that you deal with only highly rated counterparties and are diversified among several of them.

"In light of the confusion, practitioners have endured a number of challenges in fair valuing their derivative hedge instruments specifically related to the credit adjustment component."

In light of this risk, practitioners should be employing more sophisticated, analytical techniques to value both their current and future exposures to account for the possibility of default by their counterparties. Further, many corporate users of derivatives have been subjected to amendments to their ISDA agreements by their counterparties with respect to credit exposure, including the addition of cash or other collateral requirements based on thresholds for various credit rating levels or other credit events, should they occur.

Such credit exposure and suggested analyses notwithstanding, companies have also been impacted in their financial reporting and valuation of derivatives by changes to accounting principles, namely FAS157 *(Fair Value Measurements)*, which have impacted how companies value their derivatives used in hedging.

The issue of fair valuation is an ongoing hot topic. Given that, this article focuses on the choice of the credit spread(s), with an overview of the mechanics used for adjusting the fair value of hedge instruments for both the company's as well as the counterparty's credit. It also highlights some of the implications of these credit adjustments to FAS133 *(Accounting for Derivative Instruments and Hedge Activities)*. It is simply an overview, and is not intended to be a comprehensive "white paper." The reader may be referred to other sources for information on specific topics.

FAS133 (ASC815) Requirements

FAS133 has always required companies to consider the creditworthiness of their hedge counterparties in complying with hedge accounting principles. For example, Statement 133 Issue (DIG Issue) No.G10 *(Cash Flow Hedges: Need to Consider Possibility of Default by the Counterparty to the Hedging Derivative)* specifies that "the entity must be aware of the counterparty's creditworthiness (and changes therein) in determining the fair value of the derivative." Other issues, including No.G7 *(Cash Flow Hedges: Measuring the Ineffectiveness of a Cash Flow Hedge under Paragraph 30(b) When the Shortcut Method Is Not Applied)*, as well as No.G9 *(Cash Flow Hedges: Assuming No*

(*continued on page 6*)

New Research Sheds Light on Money Fund Risk Factors

Sponsored Content - Capital Advisors Group

BACKGROUND

Money fund due diligence is among several topics du jour with corporate investors. Prior to the Reserve Primary Fund "breaking the buck" in September 2008, loss of principal and liquidity in a money market fund was barely a concern for most corporate cash investors. Much has occurred in the fund industry since then, and the investing public should no longer count on the government to be the knight in shining armor. We believe it is now crucial that investors have due diligence methods to critically evaluate the risks of money fund investing.

Unfortunately, few options are available for the typical corporate investor. In retrospect, few, if any, of the traditional measures, from credit ratings to portal reports to fund commentaries, proved completely effective in avoiding funds like Reserve Primary. The knowledge of a particular fund's characteristics such as its weighted average maturity (WAM), average credit rating, and exposure to specific asset classes seems no more helpful, since funds with a few similar characteristics may still have significantly different risk profiles.

As a regular part of the investment process at Capital Advisors Group, we evaluate the creditworthiness of money funds in our portfolios routinely and often are faced with the same challenge. Due to our liquidity mandate for cash portfolios, prime money funds often represent our largest credit concern. With no suitable off-the-shelf solutions, we set out several years ago to develop a practical, intuitive, and effective fund evaluation tool for ourselves.

WHAT DOES "RISK" MEAN IN A MONEY FUND?

First, it is important to understand exactly what risks we are trying to identify, avoid or minimize. In simple terms, the myriad of risks associated with a typical fund can be reduced to two items: the loss of principal when a fund breaks the constant dollar share price and the loss of liquidity when fund management decides to halt redemptions. While credit risk is generally well understood and feared, liquidity risk often can be a larger threat to investors—and may be too often overlooked. Furthermore, these two risk factors can often be intricately related.

It is not difficult to argue why liquidity risk management is more critical than managing credit risk, although both are important. We think the previous version of SEC Rule 2a-7 already did a reasonably good job in limiting portfolio credit risk, so much so that shareholders of the Reserve fund are now expected to lose no more than 1.25% of principal.* On the other hand, having lost access to an asset pool designed for day-to-day usage can be devastating and potentially deadly to a company if alternative liquidity is not readily available. History shows that when a fund is forced to halt redemptions, it often ceases to be a going concern and enters into an unwinding process that may take weeks or months. It is for this reason that our own money fund due diligence process focuses heavily on several liquidity risk factors.

SPECIFIC RISK MONITORING

Liquidity risk can come in many forms. Through our methodology, we find it useful to isolate two major types of forces that may bring such stress onto a fund: internal and external.

Internal stress may come from the makeup of a fund's investment portfolio and through the strength of the fund sponsor and management team. Among factors unique to a fund portfolio are its weighted average life (WAL), how maturities are laddered, diversification of non-government securities by sector, industry and issuers, the use of complex securities, and the risk of repurchase agreement (repo) dealers. Additionally, a mismanaged fund is a direct source of risk to shareholders. In our fund assessment, we look closely at the funds' sponsors and their management teams using fundamental techniques to evaluate the manager's resourcefulness and the sponsor's willingness to step in for contingency support.

External stress may come in the form of systemic/macro events or shareholder risk. Such external factors can play a major role in a fund's risk characteristics. A run on a single fund may result in a "contagion" of runs on the entire family of funds due to their interconnectedness of the securities held and of the shareholders. In our research, we work to identify tell-tale signs that help to reveal when there is market risk.

PUTTING THE FACTORS TOGETHER

To conclude, we think our methodology presents a unique way of evaluating prime money fund risk. While ratings agencies reviews of money market funds typically reflect current facts, our research offers a more forward looking assessment. For instance, of the 169 domestic prime funds that are rated by Moody's, all but two are rated AAA.** We think it's important to look deeper. Our credit scores, while derived from a rigorous process of converting various factors into scores, convey our relative view and offer the investor a clearer and more convenient means to compare funds.

**Bloomberg Businessweek, Reserve Got $170 Million for $785 Million Lehman Debt (Update2), April 14, 2010*

***As of 1/1/10, as presented on Moody's Global Managed Investments Ratings List*

Lance Pan

Lance is Capital Advisors Group's Director of Investment Research. He is responsible for assessing the risk of various asset classes in order to safeguard the investments of Capital Advisors Group's clients. His role includes creating advanced credit approval and surveillance procedures, issuing credit driven investment opinions to the company's trading desk, and providing credit based investment strategies to Capital Advisors Group's portfolio management team.

Capital Advisors Group has recently introduced its FundIQ money market fund research. For more information on FundIQ please contact us at sales@capitaladvisors.com or call us at (617) 630-8100.

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(**Credit Spreads:** *continued from page 4*)

Ineffectiveness When Critical Terms of the Hedging Instrument and the Hedged Transaction Match in a Cash Flow Hedge) either specify or imply that "the likelihood of the obligor not defaulting is assessed as being probable." Prior to FAS157, however, such assessments of creditworthiness were more qualitative vs. quantitative.

FAS157 (ASC820) Requirements

FAS157 provides principles on how the valuation of currently fair valued assets / liabilities should be accomplished. According to May 2008 FASB article "Some Facts about Fair Value," the statement "clarifies the fair value objective and establishes a framework for developing fair value estimates … It is intended to convey to investors that value of an asset or liability at the measurement date (current value), not the potential value of the asset or liability at some future date." Fair value (FV) is the price that would be received or paid to transfer an asset or liability in an orderly transaction (not in a "fire sale") between market participants at the measurement date. For an asset, this may be referred to as the "exit price," while for a liability, the FV may be referred to as the "transfer price." The FV is always from the perspective of the reporting entity.

FAS157 establishes hierarchies or "levels" of valuation calculations, with emphasis on maximizing the use of observable inputs, quoted prices, or readily available market data used in valuation models, for example. The statement specifies the category for the FV level based on the following criteria:

- Level 1 is the unadjusted quoted price in liquid markets, such as the NYSE quoted price of a stock or NYMEX futures price. A price for an OTC derivative provided by a third party such as your counterparty or other pricing service would not constitute a Level 1 value.
- Level 2 is a calculated value based on observable market inputs that are reasonably available in the absence of quoted market prices such as an interest rate swap based on the closing Libor rate curve. This level covers most OTC derivatives pricing / valuation.

FV Level	Priority
Level 1	Quoted Prices
Level 2	Observable Inputs
Level 3	Unobservable Inputs

- Level 3 is a calculated value based on internally derived assumptions / unobservable inputs such as volatility and/or other components, including derived forward price curves or a valuation based on a unique, internal model.

The point is that FAS157 provides only guidance on how the fair valuation of financial instruments that are currently being fair valued should take place. As such, it requires the reporting entity to include credit spreads or other adjustments for creditworthiness in the valuations. Classification of the FV is based on the lowest level that is "significant" to its fair value, which can be influenced by credit adjustments if such adjustments are significant as well as unobservable, i.e., internally derived. This statement has not only increased volatility in financial reporting (recall the impact to financial institutions' financial statements amid the financial crisis), but has also caused confusion. Moreover, while it provides principles or guidance to fair value calculations, it does not dictate how to arrive at such values. On the other hand, it has been noted that both auditors and the SEC may have their own rules in analyzing valuations.

The Challenges

This FV principle is not only a hot topic among corporate practitioners but also has received increased focus among the auditor community. Unfortunately however, there is no established consensus on the methodologies being employed among companies at this time; the consensus continues to evolve. See fasb.org for more information on FAS133, FAS157, and related issues as well as to confer with external auditors.

In light of the confusion, practitioners have endured a number of challenges in fair valuing their derivative hedge instruments specifically related to the credit adjustment component, such as:

- Which credit spread(s) to use—bond spreads, credit default swap (CDS) spreads, or others?
- How should the credit spread(s) be employed—flat spread or spread curve?
- What should the credit adjustment be applied to—net value, net cash flows, or all cash flows?
- What if the credit component is not observable?
- What is the impact of credit exposure mitigation terms in contracts—collateral posting or other margin requirements contained in a Credit Support Annex (CSA) to an ISDA agreement?
- What is the impact to hedge accounting, specifically effectiveness assessment and the measurement of ineffectiveness, if the derivative is now fair valued under a credit adjustment, but the exposure may not be?

(*continued on page 12*)

Achieving Visibility to Your Liquidity

Relationships, Hedges, & Counterparties

In Part I of "Achieving Visibility to Your Liquidity" (Jeffery C. Treasury Update. 2009. 3(1, Spring/Summer 2009):1. Available from: www.StrategicTreasurer.com/Newsletter.), we discussed the heightened need for increased visibility given the market turbulence. We then identified the three major steps related to preparation and being able to respond, which connects to other responsibilities of Treasurers. These three steps included:

- Achieve timely visibility to the firm's liquidity
- Assess threats to organizational liquidity
- Execute rapid decisions according to plan

Part II of the series (Jeffery C. Achieving visibility to your liquidity, part ii. Treasury Update. 2009. 3(2, Winter): 6. Available from: www.StrategicTreasurer.com/Newsletter.) covered the assessment of threats and impacts to an organization's liquidity. We examined direct and indirect areas that impacted liquidity.

In this third part, we will look at relationships, hedges, and counterparties. For many organizations, two or three of these areas require careful review. We will examine them in order, covering the most salient issues. *Please note that this article is not intended to treat the issue exhaustively.*

Maintaining situational awareness can prevent or limit unpleasant outcomes. Maintaining this type of awareness requires leveraging a set of relationships.

A particular county in California invested heavily in Lehman Brothers before Lehman's bankruptcy—and by heavily, we mean very heavily. By their own accounting, they had more exposure (over $100mm) than the next seven largest county or city governments combined.

While much noise has already been made about rating agencies providing information far too late to be useful, there are few excuses for not having a network of advisors, formal or informal, that would provide early alerts and indications of what the market is seeing or doing. Using various proxies for rating information (credit scores, credit default swaps, etc.) is, of course, prudent (to say nothing of appropriate diversification). However, investing a small amount of time each day or each week will allow you to have both a general sense of the market and some specific indications of where the market is concerned. Ignore these relationships, and you put your organization at greater risk.

Hedges (caps, collars, floors or strips, straps, straddles, swaps).
Hedges are often used by corporations and other organizations to reduce volatility in line with the organization's risk appetite. They are not intended, as some have posited, to be "financial weapons of mass destruction" (Buffet W. Letter to Berkshire Hathaway shareholders. 2002.) Merely because they are intended to reduce volatility and not create anything approaching mass destruction does not allow for inaction. They must be managed thoughtfully and carefully. Handling them properly requires using the proper tools and processes.

Proper tools .
To qualify for hedge accounting treatment, which should reduce volatility of the income statement results, requires, in most cases, testing the hedge to see if it is likely to be effective (which is understood to mean "able to accomplish its purpose"). The purpose of the hedge is often to reduce the level of volatility of the identified risk to a particular level or within a range. Tools should help in this effort. The technology tools and processes should support several processes including: hedge effectiveness testing, hedge accounting, and the matching of the hedges to the exposure. Any one of these can identify an unpleasant situation. What alerts you to the fact that there was a hedge on an exposure as you are about to do away with the exposure? For example, suppose you were retiring some variable rate debt that had an interest rate swap on it. What would alert you to the fact that the exposure (the debt) was being removed and was associated with a hedge? Removing the exposure, but leaving the hedge in place, will turn your attempt at minimizing volatility into a 'speculative' transaction. Thus, you would be left exposed to volatility

(*continued on page 8*)

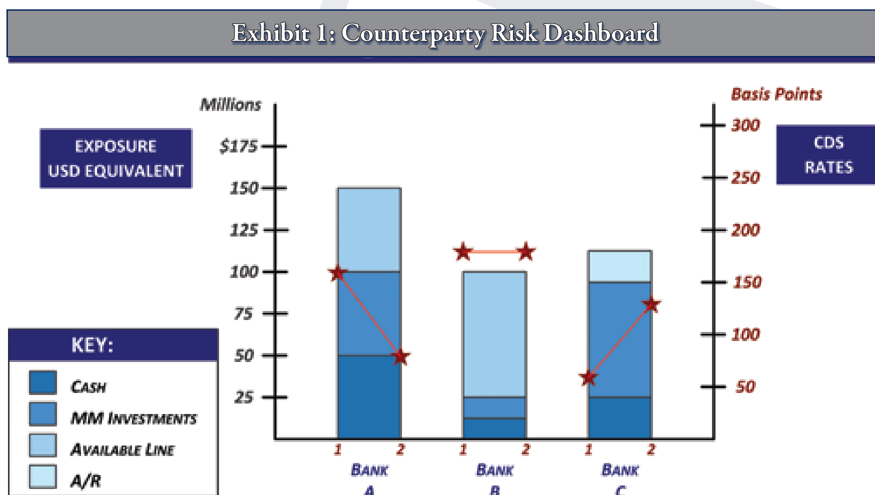
(**Visibility:** *continued from page 7*)

that you neither had before nor intended to take on.

Counterparties (banks, insurance companies, customers, vendors, etc.). Counterparties may be banks that hold your accounts, custody assets, and short term investments. The counterparty may even be an institutional money market fund or all of the holdings of that fund. Customers and vendors can both be counterparties, even if they throw off a different type of risk. Financial institutions who sit on the other side of your derivative contracts are also counterparties.

Exhibit 1: Counterparty Risk Dashboard shows an aggregation of risk by counterparty. In this example, we show two banks with a stacked bar showing exposure amounts by category. There is a second graphic for each bank which shows the last two credit default swap (CDS) rates. The CDS is viewed by many as a proxy for a rating. This qualitative data shows the current position and the recent trend of the CDS rate. This enriched data allows the firm to view both data sets together, allowing for more refined analysis. This analysis may lead to action or a more knowledgeable 'hold' position.

Exhibit 1: Counterparty Risk Dashboard



All data for counterparties is not in the same system or format. Let's look at a few simple examples the Treasurer is concerned about:

- **Customers.** Customer master data information shows up in different places with different names and different customer numbers. This is true whether you are working on a single ERP instance or whether you have a number of different accounts receivable systems. This customer information must be aggregated. Various methods of aggregating the information range from the relatively easy level to the major-project level. Describing the levels and methods would fill a chapter in a book; however, the need to have all of this data aggregated in order to see total exposures is vital. As this information is ranked by exposure on an aggregated basis, it can then be enriched by credit and/or rating information which allows a more useful view of the data and is now regarded by more firms as a requirement.
- **Treasury-Centric Information.** Many Treasury Workstations (TWS) have been adding capabilities to their counterparty risk reports. These are focused on: bank balances, investments, hedges, and credit facilities. These features are not designed to include customer exposures or to pull the ultimate counterparty of an institutional money market investment, whether used directly or acquired through a portal. While the expanded capabilities are nice, most firms will find they still have to do the work to go the rest of the way.
- **Money Market Funds / Investment Portals.** What are the holdings of the institutional money market fund you purchased through a portal? Some portal providers and visibility vendors offer an easy and more current way to see through to the ultimate holdings and counterparties. To date, these offerings look at their universe but do not give a broader view of counterparty exposure.

The broader view must be achieved either through more manual processes, dependent upon people, or by deploying various levels of technology.

Treasurers must know what they can see and what they can't see. Then, a process to gather this information to ensure total visibility must be employed. This process can be managed through a people-intensive approach, or it can use current technology. Using the phrase 'you don't know what you don't know' as an excuse not to have visibility to counterparty exposures is not a good idea. When companies begin to explore their counterparty risk as part of a visibility initiative, they are almost always surprised to discover that their exposures are significantly different than they expected. It is now possible to know what you didn't know, *if* the problem is approached correctly.

Craig Jeffery

SWIFT Benefits: Options and Considerations for Corporations

Sponsored Content - Axletree Solutions

SWIFT (The Society for Worldwide Financial Interbank Telecommunication) has clearly proved its value for "Corporates" (non-financial institutions) by supplying a single, secure, standardized platform and generating many forms of cost reduction and risk mitigation, rendering an average ROI of 200 - 400% (even without counting intangible benefits). Early participants such as GE, Microsoft, Chevron, DuPont, and Novartis are now joined by somewhat smaller Corporates who use SWIFT both for international and domestic *financial messaging* and for a host of other value-added services.

A Corporate has to make a critical decision early on regarding the mode of connectivity to SWIFT. Make this decision carefully, because reversal later on can incur substantial loss of time and money.

Option A: Connect to SWIFT "Directly" (in-house architecture). Since SWIFT requires highly specialized knowledge, those who opt for "Direct" connectivity often contract Professional SWIFT Consulting services (a "SERVICE PROVIDER"). Benefits of the "Direct" option include full control / independence / no intermediate link involved.

Option B: Connet to SWIFT "Indirectly" (outsource the connectivity to a SWIFT "SERVICE BUREAU"). Benefits of "Indirect" connectivity (outsourcing) include lower costs, faster time to benefit, and less distraction from the core business. To avoid an increased IT overhead, most (80%) of Corporates now choose Indirect connectivity to SWIFT.

FACTORS TO CONSIDER WHEN SELECTING A SWIFT SERVICE BUREAU / SERVICE PROVIDER	HOW AXLETREE SOLUTIONS, Inc. MATCHES UP
A Service Bureau must offer the same strengths as does SWIFT: Availability (99.9995%), Security, Resilience, Non-repudiation, Guaranteed Delivery	Axletree matches all criteria through separate production/backup/testing/hot disaster recovery servers; independent UPSS power grids and backup generators: preventive monitoring of all systems; Business Continuity Planning. All are verified by SAS 70 Type II and SWIFT Audit Reports.
Track Record: Tenure of Clients	Axletree has never lost a Client to another Service Bureau.
Specialization in SWIFT	For over nine years, Axletree has been exclusively dedicated to Clients in all aspects of SWIFTNet connectivity.
Resources and Qualifications	Axletree has the largest Team of SWIFT-specialized staff in North America, combining SWIFT Certifications with extensive hands-on experience.
Scope of hosting varies from simple connectivity to fully managed services	Axletree offers fully-managed, end-to-end hosting, guiding you every step of the way to provide you with complete "Peace of Mind."
Applying SWIFT Products ensures compliance to SWIFT standards	Axletree exclusively uses SWIFT products (or approved by SWIFT) to insure compatability with new SWIFT releases and upgrades.
Value-added products and services	The Axletree Marketplace offers the largest selection of Value-added services, including Cash Reporting & Funds Transfers, Electronic Bank Account Management, Exceptions & Investigations, IBAN, Reconciliation, Automation of Documentary Credit, all presented under a "single window."
Location	Axletree's facilities are owned, located, and operated in the United States. With today's interconnectivity, proximity to Client's location is not a factor; worldwide service coverage is.
Support Coverage / Time Zones	Axletree offers 24 x 7 x 365 global support.

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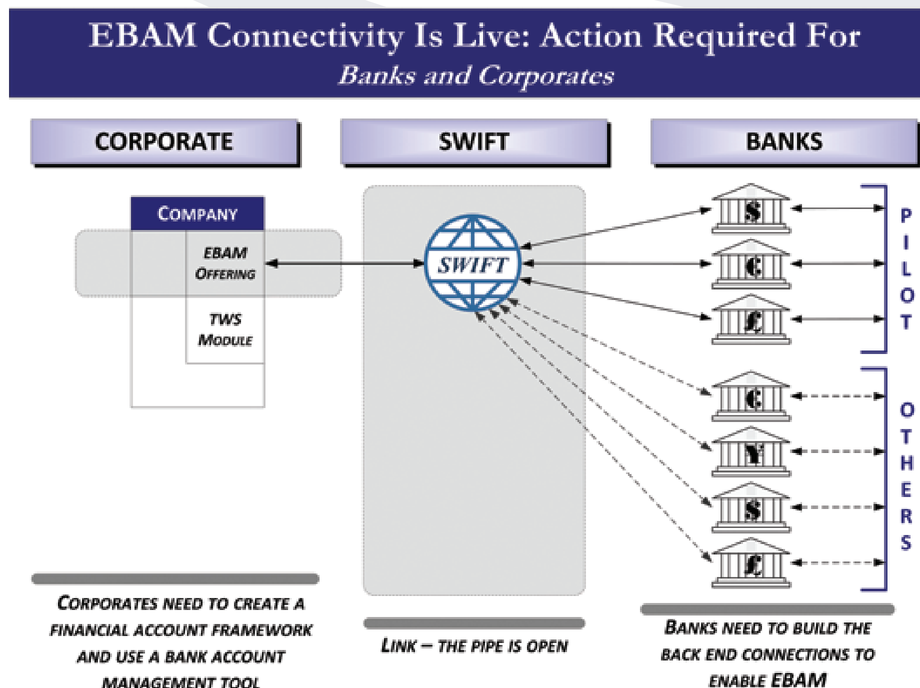
SWIFT and Electronic Bank Account Management

Treasury Technology - SWIFT

In August 2009, we (Strategic Treasurer) wrote a blog article on Bank Account Management that poked fun at one common method of Bank Account Management we have observed, namely the Post-it® Note. (See http://blog.strategictreasurer.com/TU/?p=26.) When SWIFT announced in their recent newsletter to Corporates that Electronic Bank Account Management (eBAM) was live, we started to believe that the Post-it® Note and fax might finally be put out to pasture when it comes to bank account management tools. (Carlo Palmers, Issue 4 Q2 2010, Corporates on SWIFT, SWIFT: 7.) We hope, at least, that this signals the beginning of the end of the Post-it® Note method of account management.

eBAM is a series of 15 eXtensible Markup Language (XML) messages that provides a framework for a corporate customer to manage account opening, account maintenance, account reporting (on account products, controls, and other specifics), and account closing, electronically via SWIFT. There are no "Know Your Customer" (KYC) provisions in any of these messages. eBAM assumes an existing bank-corporate relationship where the legal documents allowing the electronic process to occur have already been signed. This eliminates the need for KYC documentation in this process. The effect of eBAM is to get rid of paper, increase control, automate workflow, decrease time, and standardize the process for the corporate. It also promises great benefits for the bank, such as increased straight-through-processing (STP), better control, less paper, lower cost, and increased internal standardization.

"....44% would switch banks to get better service, standardization, and automation through eBAM processes."



These MX messages provide a solid framework and useful messaging standards. However, to allow for the inevitable additional paperwork that will be required by each financial institution, it is possible to group a BAM message with the required PDF or Word documents in a file archive to establish a link between the documents and the initiating message. Additionally, there are provisions in every eBAM message for digital signatures, even though Digital ID from SWIFT has not yet hit the street. How to use the digital signatures, including provisions for signing the whole document, or only part of it, as well as provisions for multiple signatures, is currently left to the institution and the corporate customer to decide.

SWIFT has provided vital leadership that should enable more rapid, streamlined, and automated bank account management, but this is really only the *pipeline* for the communication and the standard, enabling concise communication. The *key* will be the products developed by the software vendors, now that there is a usable standard. We know that IdenTrust (with Bank of America), Weiland, and Speranza are working in this space, and with the recent acquisition of Speranza by Wall Street Systems (http://www.finextra.com/News/Fullstory.aspx?newsitemid=21327), it will be interesting to see if any of the other workstation vendors decide to offer this functionality in a more robust manner than the more common basic account management capabilities.

Finally, eBAM alone will not usually provide the business case for a corporate to join SWIFT. However, it may be the incremental change that causes the business case to tip in favor of SWIFT for many corporates that are managing large amounts of bank accounts. According to a 22 February 2010 article by Finextra.com, a 2009 survey of corporate Treasurers (conducted by Finextra.com) said that 44% would switch banks to get better service, standardization, and automation through eBAM processes. (Pegasystems Inc. September 2009. On-boarding and electronic bank account management for corporate treasuries. White paper.) We won't be shedding any tears for the demise of the fax, and we are certain that most companies can find better uses for their Post-it® Notes.

Action: For organizations with more than 100 bank accounts, it is time to formalize your financial account framework and policy. This must cover your banking structure, controls, and management processes. For those firms that take some simple steps today, they will realize significant financial benefits and process improvements. Happily, this will set your organization up for the superior process that eBAM promises as the adoption of eBAM by banks develops. Ask your banker about their timeline for adopting eBAM.

Ric Thompson
Sr. Technology Analyst & Leader of Strategic Treasurer's Treasury Technology Practice

(**Treasury Vision:** *continued from page 3*)

customer service agent available to train you on its use at a moment's notice. What if the batteries have lost their charge or are defective, or the GPS is defective, or it is set to a scale different from your map's scale? *Well, some Treasury professionals launch out on significant journeys or projects thinking they'll just get the hang of their new Treasury tools along the way.* Besides the fact that survival is often an excellent motivator, this "learn-as-you-go mentality" often falls into the 'too risky' category. Get the right tools, learn how to use them, and you have a resource to help you either in your planning or hiking along the trail—or both.

Route Plan. Hikers can often be lost for days before anyone knows they are missing. They never told anyone where they were going hiking, what route they were taking, or where they would stop. This lackadaisical approach can work when everything goes according to plan, but sometimes hikes—*and Treasury projects*—don't go according to plan. *Filling out the route map and letting people know what you are planning to do is extremely important.*

Critical Path Concepts. If you need three water stops on your weekend trip, they need to be spread out in time. You can't plan all three water stops for Friday night and expect not to get a dehydration headache on Saturday afternoon. Some things must be intentionally scheduled.

You can't speed up a pregnancy from nine months to one by putting nine women on the task. Some activities are single-threaded, take time, and must be planned accordingly. For a hike this may mean we have to cross the river at the bridge and then hike for another hour before we arrive at a campsite with water. *This is just as true with Treasury projects which may have a number of critical path items that must be done in sequence. For example, we must have connectivity to the bank to pull down transaction information before we can map all of the transactions to the general ledger. There are often those in Treasury who are willing to rush the testing and parallel activities to make up for poor planning and executive decisions made along the way which can threaten an entire project.*

Guides? We don't need them. Exploring is fun, as there is a sense of adventure in it. When going through uncharted territory, particularly on longer trips, having an experienced guide along makes immeasurable sense. *Guides can help you learn which mistakes to avoid and help you correct the ones you've made, before too much damage (time and/or cost) has occurred.*

Sidetracked. When hiking along your planned route, it is amazingly easy to get off track. You are following a well marked trail and making good time when suddenly the trail diverges, and you follow the broader path—especially if it is a bit downhill. The smaller, slightly uphill, spur trail—the one you are supposed to follow—passes through your line of sight as though it is invisible. You are making great time on the broader path, and you comment to your hiking companions, "We should be at camp by now. Hey, we aren't supposed to cross a river...." After examining your map for a while, you determine your current location, and you identify the point of departure from your planned route. Now, the uphill climb to the original route begins, with spirits a bit dampened, but at least you are making good time. *In Treasury, it is just as easy to get sidetracked if you*

(*continued on page 12*)

(**Credit Spreads:** *continued from page 6*)

Approaches to Credit Adjustments

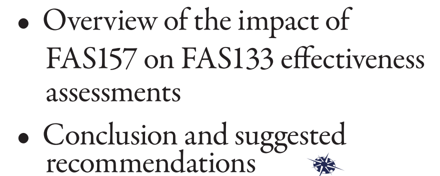
Although confusion exists in a number of areas regarding FV, this article attempts to address only a few of the issues at this time, including a recommendation for which credit spread(s) to use and various, basic methods for employing the credit spread(s) in fair valuation.

As mentioned, there is no single or right way of calculating the credit adjustment. As with any valuation technique, the methodology should be appropriate, logical, transparent, defensible, consistent, and reproducible by others. Further, the process and parameters should be well documented and disclosed in the notes to financial statements where required.

More on the Use of Credit Spreads in Fair Valuation

For a more complete overview on the use of credit spreads in adjusting the fair value of derivative hedge instruments, the reader is referred to the complete version of this article: *The Use of Credit Spreads in Fair Valuation*, which is available for download at http://www.strategictreasurer.com/resources/newsletter. The article continues with a look at the following areas:

- Credit spreads – the alternatives
- Credit Default swaps – defined
- Methods for the use of credit spreads in fair valuation – from simple to more complex



- Overview of the impact of FAS157 on FAS133 effectiveness assessments
- Conclusion and suggested recommendations

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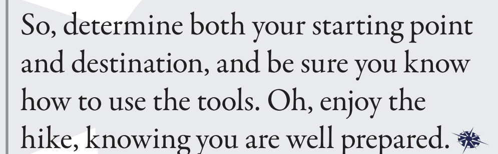
(**Treasury Vision:** *continued from page 11*)

aren't looking at the destination as well as looking at your next waypoint. Following the map or plan is vitally important. It is easy to accomplish a large amount of work (making good time) only to find it was ineffective (not going in the right direction).

Flexibility. No plan seems to remain as it was envisioned. As soon as reality is confronted, changes will likely be necessary to keep you on track to reach your overall goals. *If you have the proper guides, the right tools and experience using those tools, and you keep checking your maps along the way, you can be flexible while remaining focused on reaching your objective. Every step moves you toward your destination. Safely. On time. And on budget.*



So, determine both your starting point and destination, and be sure you know how to use the tools. Oh, enjoy the hike, knowing you are well prepared.

Craig Jeffery
Founder & Managing Partner Strategic Treasurer

Developments in Treasury Techonology

Technology Column

This column is a regular feature of Treasury Update *and is designed to superficially explore some of the recent developments in the Treasury technology space as well as offer a bit of light commentary. For some, these items may be news. For others, our interpretation of what is happening may provoke valuable thoughts.*

Pleasing developments continue in the Treasury Technology space across a wide front of services and product sets. Quite notably, mergers and acquisitions have been uncharacteristically quiet, with the exception of Wall Street System's acquisition of Speranza in late April.

Risk

1. FINCAD Development - FINCAD continues to quietly expand their offerings, which are delivered via two service models:

- The Excel add-in (FINCAD Analytics Suite for Excel), a long-favored option, continues to grow from an adoption standpoint across the network, delivering a multitude of financial product valuation models as an add-in for MS Excel, providing the flexibility of Excel for the valuation of trades/hedges.
- Over the past year, their SaaS model options—known in FINCAD's world as Fair Value Insight and The Perfect Hedge—have experienced a strong uptake in users. The SaaS model is fully hosted and is delivered, as hosted models are, via the web. These two models provide the ability for fair valuation and basic hedge accounting in a closed-end environment.

Working Capital Management Tools

2. Collection Management - Three providers currently appear to hold the most traction in this space, while the use of this software is growing rapidly due to a focus on receivables during challenging times. Collection management tools let credit and collection departments prioritize and order their work as well as follow up automatically. These tools allow for a prioritized (based on size or risk level) and rapid follow-up on collection activities, including calls, emails, and phone conversations.

- **Sungard's AG GETPAID**, a long-time leader in this space, faces increasingly stronger challenges from two SaaS providers of late. (See next two bullet points.)
- **D&B Collection Manager** - This system targets most mid-sized to larger firms. Its obviously tight integration with D&B's credit data and SaaS model makes this an easy set-up and allows them to rapidly scale their customer levels.
- **CreditPoint** - This offering's capabilities seem to be focused on small- to medium-sized firms needing an affordable collection management tool.

Collection Manager and CreditPoint are the two primary SaaS provider offerings allowing for an extremely rapid set-up, which is primarily accomplished because the technology infrastructure is already up and running. Furthermore, the use of the most current technology facilitates a quick configuration of the system and all necessary follow-up rules. Reporting is a differentiator among these three systems.

These three great tools advance staff efficiency, risk-based collections, and effective working capital management. For mid-sized firms to the largest multinational, at least one of these solutions should be able to meet their collection needs if they have a corporate client base.

Connectivity as a Service (CaaS)

3. Connectivity as a Service – includes service bureaus and data consolidators.

With an increase in the use of CaaS (as one of the more obvious Strategic Treasurer predictions and as one that is now well established in the real world), the clear benefits of having assistance with connecting to banks and other partners are increasingly understood, whether these benefits are accomplished through SWIFT or other means. This expanded use of connectivity service providers (data consolidators, which include a number of banks), service bureaus, etc., has relieved corporations of much of the thankless work they previously absorbed. Most organizations, even those preferring to do everything

"Does Wall Street System's acquisition of a former partner, Speranza, signal a new direction in their 'center of the chessboard' strategy?"

(continued on page 14)

(**Technology:** *continued from page 13*)

themselves, find CaaS providers to be far better suited for this task. We see continued certification of service bureaus as outsourcing providers, with both Axletree and BankServ possessing SAS 70 Type II certification for their data center and processes. We believe all service bureaus and data consolidators, over the next 12-18 months, will follow suit as a defensive requirement. This follows the adoption of SAS 70 Type II certification with other types of service providers such as Treasury workstations using the Software as a Service (SaaS) delivery model.

Forecasting

4. Bottomline Technologies has rolled out an interesting tool set called C-Series™, which currently has two separate modules, C-Series™ Cash Reporting and C-Series™ Wires. Bottomline also has plans for more modules in this product line, with each being an individual module capable of standing on its own. C-Series™ Cash Reporting is an API for Excel combined with other database services to provide a better look-through for receipts and disbursement forecasting. C-Series™ leverages SWIFT's Alliance Lite functionality to access bank data and other database tools (SQL) to interrogate internal ERP information. These tools enable C-Series™ Cash Reporting to connect directly, in view mode, with accounts payable or accounts receivable data and track the actual status of what has been paid, received, or disbursed by the bank. This can then be compared to the historical forecast, enabling additional clarity for the next forecast. This system is not a Treasury Management System, but it does take advantage of some good data connectivity capabilities to streamline portions of the forecasting process.

The Progression of Visibility Tools (Counterparty Exposure and Risk Management)

As companies endeavor to meet the increasing demands to achieve better visibility, the information challenges present themselves in sequence.
In achieving better visibility to counterparty risk, for example, we find commonality in approaches to solve the emergent information challenges. Treasury groups seem to respond in a manner that demonstrates a fairly consistent methodology as they step through the options.

1. Companies start out with roughly handled spreadsheets, trying to gather information and data from multiple sources to show exposures to counterparties.
2. Outside data entered into databases and spreadsheets requires Treasury to continue refreshing this data. It often resides in disparate databases with different formats and must be consolidated to show that exposure.
3. First generation BI tools begin to be viewed and deployed to pull and gather this data. As changes are required, the recursive process of first generation BI tools gives way to second generation BI tools.
4. Second generation BI tools combined with enriched data are helping firms answer the questions, "Where is my exposure? What's the value of that? What directions are my counterparties heading in? How do I do additional analysis as the demands for reporting change?"

A number of Treasury workstations have added features for counterparty risk which tend to work very well when all the data sits within the Treasury workstation. The challenge comes when the data sits in different locations. This data needs to be fed in and then must be normalized or modified. The ultimate solution for visibility across a number of fronts oftentimes will contain some second generation BI tools.

Craig Jeffery

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AFP Annual Conference
November 7-10, 2010
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Letter to Readers

We hope you enjoyed this issue of the *Treasury Update* newsletter! What began four years ago as a four page newsletter with a small distribution has expanded to 16 pages with thousands of readers around the world. Thank you for your help in making this newsletter better with each issue. We try hard to deliver useful and timeless content without giving away all of our secrets.

Readers of past issues will notice that, with the expansion of the magazine, there are a few ads and some excellent sponsored articles. We are delighted that other Treasury solution providers recognize the value of this newsletter; like them, we believe it has significant value for our readers.

Strategic Treasurer is a Treasury consulting firm with our North American office in Atlanta and our Western European office in London. We stand ready to advise and help corporations, government entities, banks, and technology firms meet their Treasury and business goals through our consulting and outsourcing services. On the adjacent page, you can see our four main practice areas for corporations: Cash/Treasury Management, Working Capital Management, Financial Risk Management, and Treasury Technology.

If you aren't feeling more pressure to manage risks, drive efficiency, and improve visibility, it is likely you aren't working in finance. From emerging risks with counterparties, instruments, and countries, simply maintaining the status quo puts your organization at risk. As consultants in Treasury, we work with our clients to solve their old and newly emerging issues gracefully.

If we can be of any service, or if you just want to discuss your situation, please contact us at +1 678.466-2220 (North America) or +44 (0) 20 3178 8705 (Europe). I would be happy to take your call directly at +1 678.466-2222 or email at craig@strategictreasurer.com.

Until then,

Craig A. Jeffery, managing partner
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