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ENHANCING THE STRATEGIC POTENTIAL OF TREASURY

By Pascal Vogt and Clemens Elgeti

BANK TREASURY DEPARTMENTS HAVE had their hands full over the past several years contending with sustained low interest rates, balance sheet volatility, and a slew of regulatory requirements. But while treasuries have strengthened their liquidity buffers, implemented mandated ratios, and established the role of treasury as a neutral steering function, the core treasury operating model at most institutions has not transformed fully enough. And that's hamstringing treasury's ability to act as a strategic partner to the business.

Maturity transformation, for instance, is getting more attention these days, but it's still common for various business units to run their own liquidity gaps—a situation that can introduce risk and reduce the overall profit-and-loss benefit. Similarly, banks have done a decent job of implementing the mandated liquidity management ratios, such as the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR), but in most cases, the balance sheet implications of these ratios are not fully considered in bank-wide steering and pricing decisions. Likewise, management of treasury positions, such as interest, liquidity, foreign exchange, and collateral, is often spread across different front-office IT systems.

A number of regulatory changes add to the steering challenge. The leverage ratios introduced under Basel III, for instance, are expected to rise to 5% or 6%. The push ensures that capital adequacy levels remain strong, but it also means that banks must work harder to manage the impact on the balance sheet. Under new Fundamental Review of the Trading Book (FRTB) rules, high-volume and short-term transactions, such as money market and repurchase agreement (repo) transactions, now come with higher risk-weighted asset (RWA) charges. The combination of leverage constraints and higher RWA charges—along with the corresponding increase in capital that banks must post—makes these low-margin business lines less profitable.

These issues prevent banks from gaining the transparency they need to make critical decisions about risk. Moreover, at a time when macroeconomic forces and other factors are constraining profitability, suboptimal use of treasury guidance is leaving much-needed value on the table.

In facing these challenges, the banks that prove adroit in managing their liquidity, risk, and balance sheets will have a clear advantage over their peers. By adopting a new treasury operating model—one that gives a clearer mandate, centralized governance, and enhanced system and data capabilities—treasuries can improve their collateral, liquidity, and interest-rate maturity transformation. And those changes to the operating model can help treasuries boost net interest income (NII) by 10% to 15% and reduce balance sheet consumption by 10% to 20%.

Improved Governance and Steering Can Unlock Value

Treasury can act as a single point of truth in several areas that are critical to financial governance. Those areas include bank-wide management of liquidity and refinancing risks, market risk positions related to the banking book, and the bank's capital position and composition—under both stress and business-as-usual conditions.

Such enablement starts with centralizing governance and localizing execution under a new operating model. By folding balance sheet management (BSM) under treasury, for instance, banks can gain the integrated oversight they need to optimize capital consumption—helping them meet ratio requirements within the context of liquidity and profitability goals. In addition, by making some structural changes, such as placing treasury under the governance of the asset liability management committee (ALCo), with links to the risk committee and the executive committee, banks can improve resource management and better align strategy with risk appetite and limits. These changes can help treasuries manage their overall contribution more closely and steer the banking book more effectively. The results can include significantly higher NII. BCG research found that the strongest bank treasury departments have the potential to contribute as much as 20% of total NII. (See *A Sisyphean Struggle: Insights from BCG's Treasury Benchmarking Survey 2016,* BCG Focus, November 2016.)

Under this better-aligned operating model, treasuries can become more nimble in applying unused resources—taking advantage of short-term positions that generate value and reduce slack. This capability can make a profound difference in bank performance. Consider, for example, a treasury that manages to meet most of its annual funding targets earlier than expected, just as new asset volumes—per the bank's plan—begin to dip. The countermeasures typically used to put things in better balance include lowering funding targets for the following year and targeting additional asset volumes. But those rebalancing efforts take time to bear fruit. Under the more centralized governance of the new operating model, treasuries learn about such issues earlier, in time to put unused resources to work—by using shorter-dated instruments in the money market and in the repo market.

This revised operating model allows treasuries to improve management and returns in three critical areas: management of liquidity and collateral; management of interest rate risk in the banking book; and balance sheet management, asset liability management, and capital management under ALCo governance.

Management of Liquidity and Collateral.

Under the new operating model, treasuries manage operational and intraday liquidity across all maturities, as opposed to managing liquidity within one-, two-, or three-year bands, as has often been the practice. Using the bank's risk appetite and regulatory limits as a guardrail, treasuries can align risk, return, and capital consumption along the entire liquidity curve. That approach allows treasury to play a more strategic role, optimizing the bank's strategic liquidity gap positions with respect to LCR and NSFR and improving the size and consistency of treasury's contribution to earnings targets. Better liquidity management allowed one bank, for example, to cut its balance sheet consumption by 10%, without hurting profit contribution.

Managing the liquidity buffer also falls within this expanded liquidity management function, as does governing the bank's money market activities, its foreign exchange liquidity management, and its securities financing activities, which include bonds, repos, reverse repos, and securities borrowing and lending, as well as callable bonds and forward bonds.

Active management of the liquidity buffer is essential. To do it well, treasury must help the bank optimize and align its pool of collateral assets (for example, bonds, equities, cash, commodities, and cover-pool-eligible loans) to increase earnings contributions. That takes a treasury management team with the right resources; it may be necessary to bring in talent from capital markets units.

To optimize the bank's position along the entire liquidity curve, short-term activities (money market and repo desks, for example) should support the bank's funds transfer pricing (FTP) setting and be factored into ALCo and asset liability management (ALM) discussions. That broader view represents a significant shift. Money market traders and repo traders must now consider many more variables as they execute short-term positions.

Management of Interest Rate Risk in the Banking Book. In the target operating model, treasury assumes management of the interest rate risk stemming from its retail and commercial banking activities. That management role includes oversight of the interest rate risk coming from treasury's own issuances (including domestic and foreign currencies) across all maturity bands (from overnight through the longest-dated asset maturities) within the bank's Interest Rate Risk in the Banking Book (IRRBB) limits.

Given the proposed changes to FRTB and IRRBB, treasury's role in guiding interest rate risk management (IRRM) will become increasingly important. The transition may also require IT system changes; most front-office systems cannot simulate NII on their own. By taking on greater responsibility for IRRM, treasury can do more to help banks realize set earnings targets and improve their overall strategic position.

Balance Sheet Management, Asset Liability Management, and Capital Management Under ALCo Governance. Under the target operating model, BSM and ALM functions remain largely unchanged, since both already encompass areas such as liquidity risk monitoring and reporting, liquidity risk analytics and modeling, funding planning, liquidity stress testing, crisis management, and resolution planning. ALM also serves as a check on treasury's role in shaping liquidity and interest rate management strategy and decision making.

Given the new regulatory ratios, which link balance sheet size and structure to capital position and composition (leverage ratio, bail-in regulations, and asset encumbrance, for example), it is especially important that BSM and capital management be closely integrated. Treasury must be able to run scenarios that look at balance sheet performance in ways that link profitability with key economic and regulatory ratios. Such ex-ante simulations are the primary basis for any optimization.

With respect to FTP, treasuries must factor in the following considerations:

- **Trading Assets.** Treasuries need to assess the liquidity and marketability of trading assets and ensure that the liquidity spreads charged are commensurate with actual (rather than hypothetical) consumption.

- **Regulatory Ratios.** To support proactive management, the FTP system should factor in the effects of regulatory ratios. This is especially important because LCR and NSFR are binding regulatory ratios.

- **Collateral Value.** The simple differentiation of funding as either secured or unsecured doesn't work in the context of collateral optimization. Banks must implement a cost-allocation approach that defines the liquidity cost or benefit of each collateral.

Enabling the Future

Working under the new operating model, the treasury function is in a good position to take advantage of important new technologies. Big data and advanced machine learning, for instance, could allow treasury teams to pull in data from many sources, run scenario models, and model customer behavior and deposit activity with much greater accuracy and granularity. Similarly, robotic process automation could open up new opportunities in treasury. For instance, treasuries could employ trading robots, which are already used in other areas of the financial services industry, to improve IRRBB management and hedging and support collateral optimization, payments programs, FTP-quoting for individual transactions, and documentation of simple contracts. These technologies can improve cycle times, reduce cost, and provide richer, data-backed insights.

The changing payments landscape presents other opportunities. Distributed ledger solutions, such as blockchain, could give treasuries alternative sources of settlement. Leading treasury functions won't wait on the sidelines. They'll scan the market to see how intraday trading and other events impact liquidity management and whether "overnight," given the increasingly real-time transaction environment, remains the shortest maturity band.

Digitization has introduced an array of platforms, expanded the functionality available on those platforms, and opened the market to nontraditional competitors. BCG's Fintech Control Tower data reveals that the number of fintech companies has mushroomed over the past several years, from 4,400 in 2010 to roughly 10,500 in 2017. Although they don't pose a direct threat to banks in the near term, fintechs' specialized value propositions and customer-friendly interfaces are raising the bar. In time, bank treasuries could partner with relevant fintechs in order to access sleek payments platforms, powerful analytical engines, and other financial services innovations.

Getting Started

How fast and how far banks transform will depend on the relative maturity of their current treasury operating models and on their overall strategy and business objectives.

To succeed, treasury must partner with business units and IT, align on a unified strategy, and determine which opportunities stand to deliver the greatest near-term impact. Peer benchmarking can help treasury leaders compare different operating models and flag specific areas for improvement to help the bank design the new operating model. As part of that process, banks should develop a comprehensive business case, factoring in hard numbers, such as the expected NII contribution and investment cost, as well as qualitative elements, such as organizational benefits. In mapping the implementation, the planning team should include quick wins that build momentum and generate savings to fund the longer-term transformation effort.

In the current environment—with profitability still trailing precrisis levels, macroeconomic challenges holding interest rates in check, and regulatory requirements continuing to add cost and complexity—banks that reform their treasury operating models will be better able to manage their liquidity, risk, and balance sheet performance and gain an advantage over their peers.

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