Bank Treasury Best Practice

BALANCE SHEET OPTIMISATION IN THE ERA OF BASEL III

How does the regulatory landscape impact banks?

The impact of maintaining regulatory compliance in all the various aspects of Basel III and Basel IV should not be underestimated. It will be expensive to resource, implement and sustain. This makes it imperative to ensure that bank balance sheets are structured to maximise efficiency and minimise regulatory cost, and ensuring this requires a more proactive, integrated approach to product origination. Below are the main areas that need review.

Strategy and business model

Banks face a "three-dimensional" optimisation challenge as they seek to meet simultaneously the competing needs of the regulator, shareholder and customer. Regulatory compliance impacts individual business lines as well as entire bank business models in a way that may render the previous strategy untenable unless it is adapted to operate in the new environment.

Banks need to review their business model and confirm, where specific business lines are negatively impacted by regulation, that they remain value creating, and agree a course for continuing, modifying or ceasing these businesses. The process of originating assets and liabilities on the balance sheet is central to this review, because a sound ALM process is now the vital ingredient in efficient balance sheet management.

Process and organisation

A fit-for-purpose operating model is absolutely vital to achieving efficient balance sheet optimisation. This includes both origination and risk management procedures as well as overall corporate governance infrastructure. The current business environment demands that banks review their operating processes to ensure that these are designed to deliver a balance sheet shape and structure that is arrived at by design rather than well-intentioned accident.

The asset-liability mix in a bank must reflect the bank's risk tolerance capability. Governance infrastructure and organisation effectiveness are paramount, starting from the Board Risk Appetite statement and continuing with the authority and oversight of the bank's ALCO.

Systems and data management

Basel III is as much a technology and data management challenge for banks as it is a regulatory challenge. Risk exposure measurement and reporting create onerous demands on the technology capability at banks, be this in the liquidity, funding, or capital management space or in the customer service and conduct space.

The key focus must be on data accuracy and data analytics. Understanding the balance sheet position and cash flow behavioural characteristics of every single asset, liability and customer is now an urgent requirement at all banks, because without this ability it will be impossible to facilitate realistic risk reporting, let alone balance sheet optimisation. This is a capital and resource intensive challenge for banks to meet.

Calculations

In many cases regulatory reporting requirements allied with capital, liquidity and leverage constraints require banks to review and modify many of their balance sheet calculations processes. Basel IV is another area where the arithmetic of capital calculation may need to be adapted. This is a non-trivial task that should not be undertaken in isolation, because it is closely connected with the risk governance organisation infrastructure and data management capability.

Banks need to address how the process of estimating and reporting balance sheet metrics is best tied in with the overall ALM process so as to help achieve balance sheet optimisation.

What should Treasury be thinking about?

Banks face a three-dimensional challenge in meeting the competing needs of regulator, customer and shareholder. Achieving this and arriving at a balance sheet structure that is robust, sustainable and exhibits the optimum asset-liability mix requires Treasury to develop best-practice solutions to a variety of current questions. These are non-trivial issues, all of which are the current focus of the regulatory authorities.

Key questions for banks

- Is the ICAAP and ILAAP process passing the "use test" effectively?
- Is the liquidity risk MI pack the most relevant for the bank?
- Is the Funds Transfer Pricing policy still fit-for-purpose?
- Is the cost of derivatives usage reflected in the collateral management funding charge to the business?
- Are IRRBB measurement calculations reflective of realistic assumptions and validation?
- Are we optimised for compliance with PRA Pillar 2 liquidity?
- What do Basel IV capital floors mean for individual business line value-added?
- Is the bank's data analytics capability capturing accurately intra-day funding exposure in real time?
- Is the bank's liquidity policy integrated with asset-liability origination processes?
- What is the optimum funding mix for the balance sheet?
- Does the ALCO governance infrastructure enable robust stewardship of the balance sheet?
- What funding structure and asset-liability mix optimises the LCR and NSFR for the bank?
- Should Funding Value Adjustment (FVA) impact the bank's customer pricing for fixed-rate lending?
- Are asset encumbrance levels creating potential issues for liquidity or credit rating?
- What is the most appropriate HQLA policy for the bank?

Treasury solutions scope

Ensuring the balance sheet shape and structure are optimised to meet the needs of all stakeholders requires multi-faceted review of the business model, products and customer base. This reflects the fact that every aspect of the bank's operations is impacted in the current challenging business environment. Banks need solutions across a wide range of disciplines as they implement strategic ALM processes to help achieve balance sheet optimisation.

Liabilities structure, strategy and liquidity coverage ratio (LCR) optimisation.

The LCR metric minimum requirement has a direct cost and opportunity impact on the balance sheet, and its final reported value is a function of a wide range of interconnected customer and product types and stress assumptions. Developing an integrated long-term funding strategy that seeks to maximise the "right" type of liabilities will ensure a more efficient liquid assets buffer policy.

Business line value-add and Basel IV

The forthcoming capital floors and standardisation approach impacts different business lines to a greater or lesser extent. How is the bank preparing to assess and remodel business lines that are effected in a material way? Adopting a more integrated asset-liability product origination approach will help to preserve shareholder value for customer franchises that may otherwise be impacted negatively.

Liquidity risk metrics suite

Liquidity risk exposure is measured using a number of proxies, and it is vital to select and calculate the appropriate suite of metrics for the bank's business model and balance sheet structure. Ensuring the most realistically representative set of metrics will ensure optimum liquidity risk planning.

Centralised clearing and collateral management

Banks using derivatives for structural balance sheet hedging face higher costs arising from higher collateral margins in centralised and bilateral clearing. Putting in place an effective collateral management framework will enable banks to 'flex' the balance sheet for optimum collateral usage and deployment, and generate greater returns.

Intra-day liquidity risk management

Meeting Basel standards on intra-day liquidity risk management goes beyond a straight reporting requirement. It sets challenges on real-time data analytics capability and stress testing output. Calculating the intra-day exposure as accurately as possible will enable a bank to optimise the intraday liquidity buffer as well as maintain a robust balance sheet position.

PRA Pillar 2 Liquidity compliance

Pillar 2 liquidity demands further reporting and potentially larger HQLA buffer size. Ensuring the balance sheet is as robust as possible from a liquidity and ALM perspective will assist the bank in optimising its Pillar 2 add-on. This requires an effective set of assumptions and validation of the process.

Internal funds pricing and allocation methodology

The regulator focuses closely on banks' funds transfer pricing (FTP) policy due to its key position within the liquidity risk management framework. A fit-for-purpose FTP regime can move beyond this role and assist robust customer pricing and more accurate returns allocation.

Interest-rate risk in the Banking Book (IRRBB)

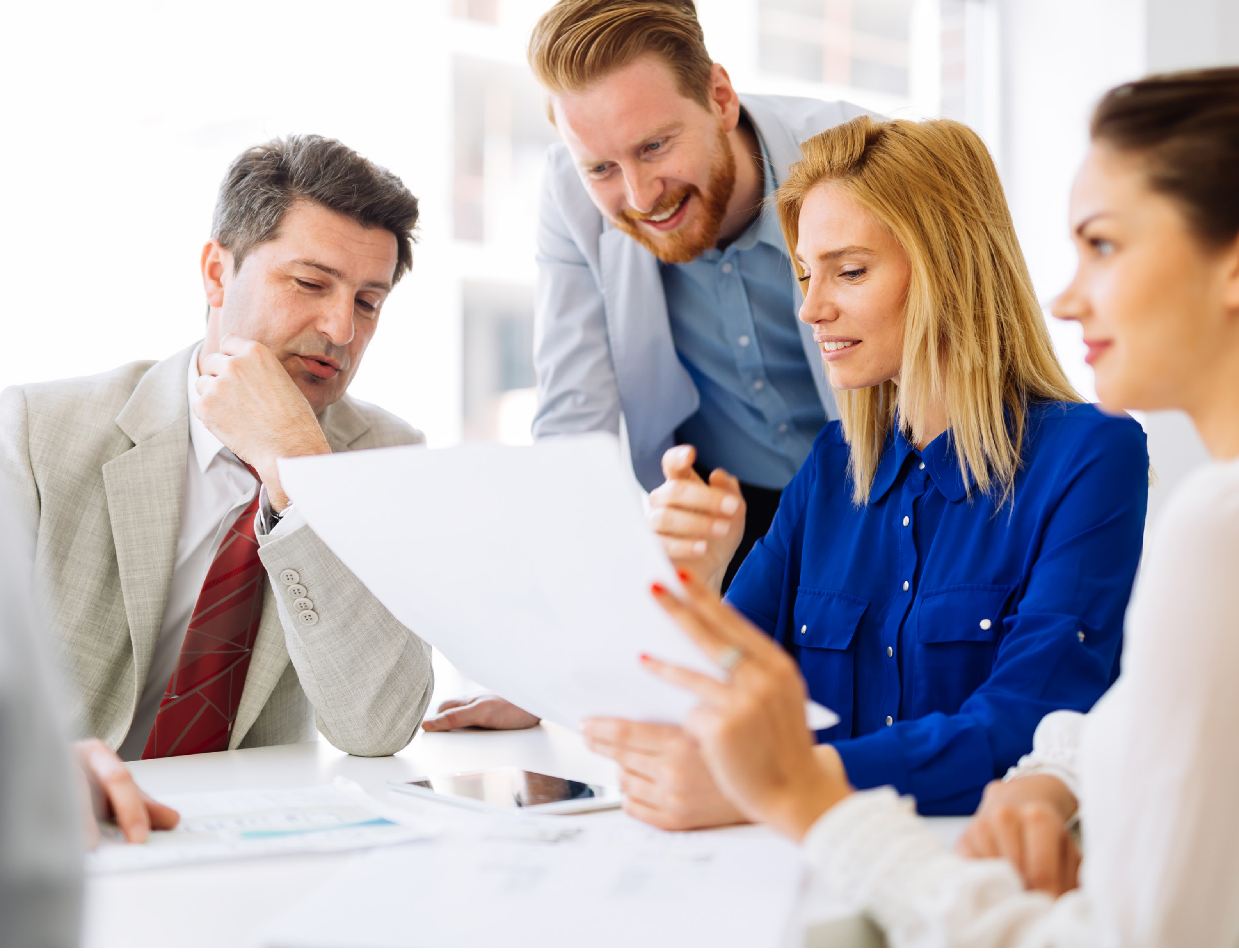
Compliance with Basel standards on IRRBB is the first order requirement of all banks, but beyond this banks will want to ensure minimum Pillar 2 add-on for IRRBB, which demands an efficient and effective hedging approach, and one that maximises application of "natural" cash hedges available on the balance sheet.

ALCO governance framework

The PRA's 'Dear CEO' letter from the immediate post-crash era made clear the regulator's preferences with regard to bank's ALCO process and its effectiveness as the guardian of the balance sheet. It is important for banks to benchmark their ALCO governance framework with market best-practice, to ensure regulator satisfaction.

ICAAP and ILAAP process effectiveness and bestpractice

The regulatory requirements for the submission of the ICAAP and ILAAP results in a resource-intensive and process-intensive workload for all banks, which also have to demonstrate that they are passing the "use test". Having in place a best-practice and effective framework for the process will ensure that resource application is used efficiently.



Banks need to strengthen capabilities across the following areas:

- Strategy and business model
- Capital calculations and implications
- Project management and business analysis
- Organisational structures
- Executive awareness and training
- Infrastructure (data computational and documentation)
- Governance and reporting
- Gap analysis
- Embedding understanding and cultural change

What are the key challenges facing banks today?

Achieving regulatory compliance under the myriad different strands of Basel III/CRDIV and Basel IV makes onerous demands on a bank's balance sheet structure, sustainability and asset-liability management (ALM) discipline. Every aspect of the balance sheet is impacted, and constraints on capital, liquidity, leverage and encumbrance mean that efficient ALM processes are now an imperative. Further challenges arise in maintaining effective compliance in regulatory reporting and data analytics.

The importance of balance sheet optimisation, and meeting effectively the competing demands of all bank stakeholders, should not be underestimated. Many banks will need to review their strategy and balance sheet origination processes. A critical task in achieving this objective is to assess the interaction of individual business lines and how this benefits from an integrated ALM approach.

Of course maintaining compliance with the supervision authority does not take place in isolation from the demands of other stakeholders. The competitive landscape for banks is as significant a challenge as the regulatory one – in the UK 14 new banks have been authorised by the PRA since 2010, with 23 more license applications in the pipeline. Outstanding customer service is essential, as is supplying the demand from the customer franchise for the right product type. And ultimately, the shareholder desires a stable and sustainable return on capital.

Why is this so significant for Treasury?

Meeting the requirements of three different stakeholders makes conflicting demands on the balance sheet and by definition on the practice of ALM discipline. Treasury now needs to implement an integrated approach to balance sheet origination and risk management. Here are just some of the challenges:

Basel III liquidity requirements act indirectly to penalise certain asset types that customers desire, and demand certain liability types that banks deem expensive: what is the optimum asset-liability mix that meets the needs of regulators and customers alike?

IRRBB Pillar 2 regulatory capital compliance together with centralised clearing and higher bilateral margin requirements makes derivatives use more expensive: what is the best value approach when using derivatives for structural balance sheet hedging?

Asset encumbrance levels are closely monitored by regulators and credit rating agencies, but a high balance sheet share of secured funding is a characteristic feature of a wide range of business lines. What levels of encumbrance should a bank be tolerating, and how can this be tied into the overall liabilities strategy?

Banks need to implement an optimum target operating model and risk oversight infrastructure that enables effective governance of the balance sheet by ALCO, reflecting industry best-practice

In the current macroeconomic environment, it's important for Treasury to adapt ALM processes to remain fit-for-purpose where markets are exhibiting low or negative interest rates, to preserve NII/NIM.

Who's affected?

All banks face balance sheet management challenges, regardless of their size or business model. Typically it is the Treasury department that is responsible for ALM control and oversight, working closely with Risk and Finance. Together these three departments form the risk management "triumvirate" that is now tasked with delivering a balance sheet shape and structure optimised to meet the requirements of all stakeholders.

To meet these challenges requires a Treasury department that follows a more proactive, integrated ALM approach, what we term Strategic ALM, that maximises the efficiency of the balance sheet origination process. Some of the issues that Treasury faces are shown below.

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