Treasury 2.0: Treasury as a Core of Integrated Financial Resource Management (IFRM)

Accompanying document to keynote speech

MOSCOW, APRIL 2018

Today’s speaker – brief introduction of Dr. Dirk Hollaender

Ph.D., Dipl.-Kfm. born 1974, was educated in Germany, Australia, and the USA, and has been working for zeb since 1999. Dr. Hollaender is a **Partner and Director** at zeb and a **member of the management board**.

For zeb, he has successfully completed a large number of international projects in the Financial Services industry – usually inside global universal institutions. He is focusing on **Finance and Risk topics** as well as **Treasury Management** to support **shareholder value creation,** not only from a conceptual perspective but also with regards to IT, processes, and governance implications.

In Russia, Dr. Hollaender has coordinated a number of **projects for the leading banks** on Treasury / asset liability management, balance sheet management, funds transfer pricing (FTP), top management reporting etc.

Agenda

Introduction to IFRM

IFRM in real life
(sanitized case study)

Way forward

Over the past years, financial resource management in banks has been constantly evolving and now plays a central role in bank management

Evolution of Financial Resource Management (FRM)

BASIC FRM

- **Disintegrated management of financial resources:**
  - Funding
  - Liquidity
  - ALM risks
  - Capital etc.
- Funds Transfer Pricing
- Capital markets trading

CONSTRAINTS MANAGEMENT

- **Management of** a constant flow of new **regulatory requirements**
  - Focus on integrated management of risks
  - FTP 2.0 to separate liquidity and interest rate perspectives
  - Capital constraints etc.

INTEGRATED FRM

- Integrated financial resource management (IFRM[1]) as a **separate function**
- IFRM function becomes a **"trusted advisor" to CFO**
- Responsibility for **improving** the bank's **efficiency** via balance sheet optimization

Evolutionary development

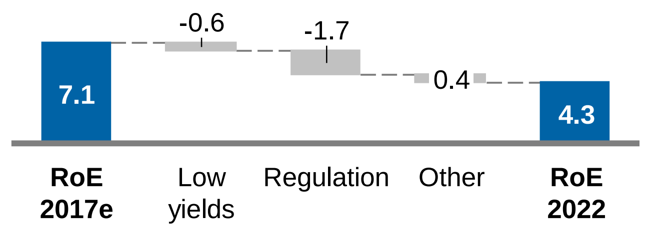
Before financial crisis | **Crisis of 2007/2008** | **Now**

1) Also known as Balance Sheet Management or Total Bank Management

At the same time, pressure from market and regulators now more than ever requires banks to take care of financial resource efficiency

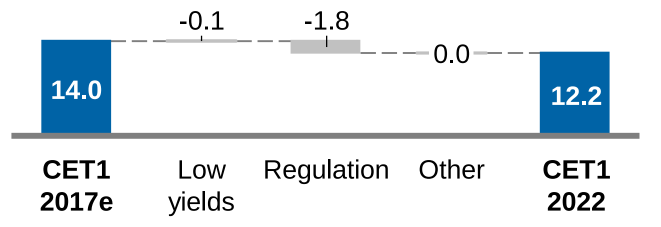
Pressure from market & regulation

Pressure on profitability



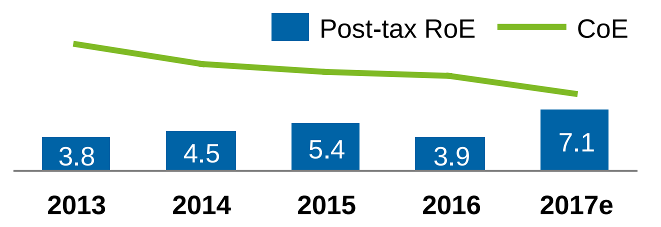
- **Near-zero yields** are expected to put **pressure** on client **margins** and maturity transformation
- New **regulations** impose **additional costs** and also reduce profitability

Pressure on capitalization



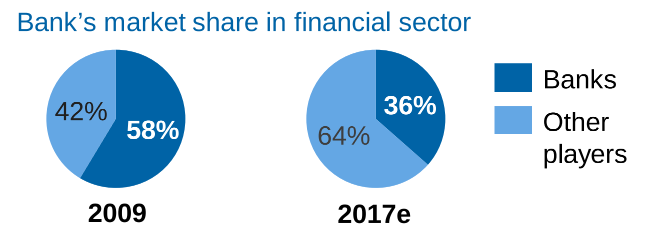
- Infinite flow of **new regulations** are expected to result in a **pressure on CET-1** and other capital ratios if no actions are taken

Investor expectations



- Banks' **RoE is below the cost of equity** required by the shareholders
- As a result, **no significant capital injections** are **possible** in the short run

Pressure from competitors



- **FinTechs** and other financial sector players are **taking over parts of the banking business**
- **Banks are loosing market share** to competitors and thus part of their revenues

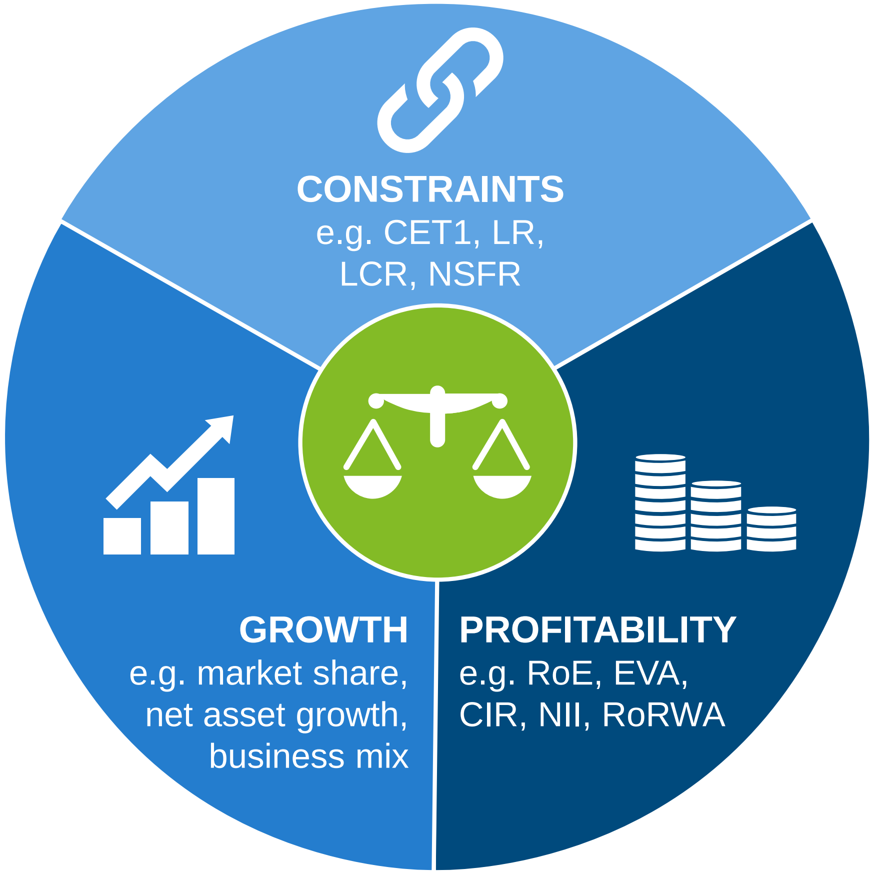
- **Financial resources are scarce**—their efficient and effective use/ management becomes the main challenge
- **Pressure** on banks **in Russia** is **not yet as strong** as in EU…
- …but the **negative trend is observable** and is getting on the agenda of the leading market players

Source: European Banking Study 2018 by zeb

Integrated financial resource management is aimed increasing efficiency via pursuing balance between profitability, growth and constraints, thus facilitating trade-off decisions

Objectives of Integrated Financial Resource Management (IFRM)

IFRM PURSUES BALANCE BETWEEN PROFITABILITY, GROWTH AND CONSTRAINS



EXEMPLARY TRADE-OFFS

Expansion into new markets **vs. limitation of balance sheet size** to comply with leverage ratio

Higher **dividend payouts** for shareholders **vs. retained earnings** to fortify capital position

Cost of funding optimization vs. HQLA in order to enhance LCR / NSFR ratios

Excess capital to safeguard compliance with capital ratios **vs. investments** to increase market share

Enhanced efficiency of the resource usage

Whilst IFRM should be at the core of a finance and risk steering, banks often suffer from a lack of integrated view on financial resources

Current status and pain points in many banks

STATUS QUO IN MANY BANKS

Banks **manage individual resources** and risks separately (in a “silo manner”) - **no integrated and holistic view**

- CAPITAL MANAGEMENT ✓
- LIQUIDITY MANAGEMENT ✓
- FUNDS MANAGEMENT ✓
- RISK MANAGEMENT ✓
- FULLY INTEGRATED AND HOLISTIC VIEW

MAJOR PAIN POINTS

INEFFICIENT USE ON FINANCIAL RESOURCES

- …due to their decentralized management and control.

NO VALUE-CREATING RESOURCE ALLOCATION

- …due to isolated views and missing link between value creation and internal KPI systems.

NON-OPTIMAL BALANCE SHEET STRUCTURE

- …due to lack of holistic view on the bank’s balance sheet, as well as simulation and optimization capabilities.

WRONG STEERING IMPULSES

- …due to ambiguous performance evaluation and weaknesses in reporting, resulting in a lack of transparency

MISSING COOPERATION BETWEEN FUNCTIONS

- …since different organizational units work “in silos”, often leading to the double work

Someone in the bank has to take care of IFRM – no market standard yet as the function has just recently started to evolve but Treasury is a candidate to undertake it

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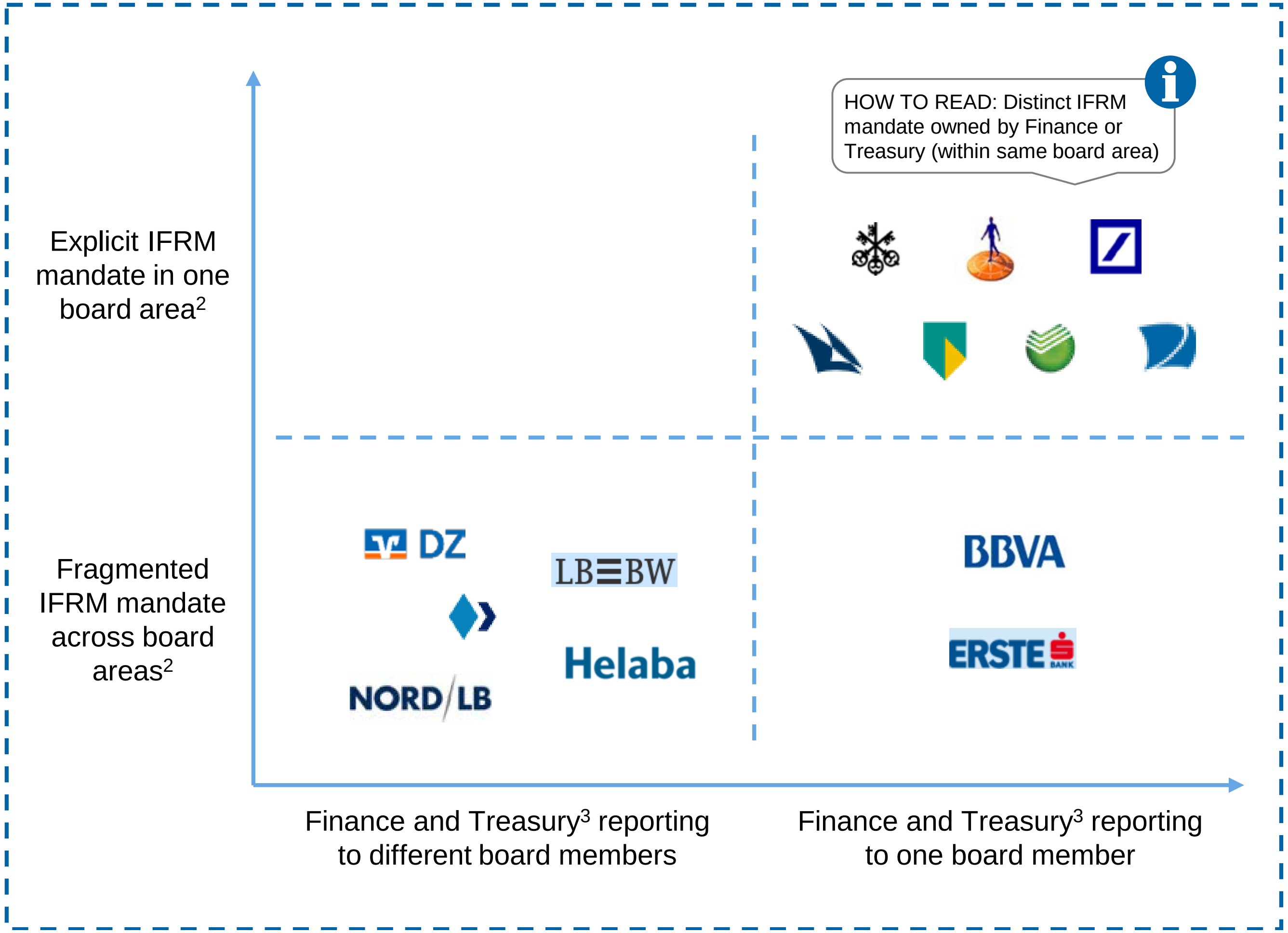
Different IFRM models – high level/ outside in analysis by zeb

OBSERVATIONS

- Current market practices show **link between board responsibilities** for Finance / Treasury and **IFRM mandate**
- In banks, where both functions are allocated within same board, a **primary unit owning mandate to challenge the bank** on IFRM basis and value generation is often observable
- Location of holistic IFRM mandate **outside Finance or Treasury** (e.g. CEO, CRO, …) currently **rarely observable**
- Decision b/w Finance and Treasury for location of IFRM dependent upon bank's setup – external benchmarking only partly helpful[1]

HOLISTIC IFRM MODELS – SOME MARKET PRACTICE

illustrative



TREASURY AS THE CORE OF IFRM

- **Treasury already has a lot of** traditional **tasks** to perform on a daily basis…
- …and it could also take a **broader view on the Treasury function**
- **Treasury** can take care of IFRM if it…
  - …is **not a profit center**, hence has no conflict of interests
  - …has a **compre-hensive view on the bank** and all the available resources
  - …is able to **manage the entire B/S**

1) Different semantics to be harmonized, survey-based approaches sometime lacking reliable feedback, situation evolves over time, 2) Explicit IFRM mandate means that primary unit is owning mandate to challenge bank holistically on financial resources usage; fragmented mandate means that IFRM mandate is spread across different units; 3) Focus here on strategic Treasury functions, execution/ trading functions sometimes sitting separately.
Source: annual reports, disclosure reports, other public information; zeb.research

Agenda

Introduction to IFRM

IFRM in real life (sanitized case study)

Way forward

To ensure an efficient and effective management of financial resources, IFRM components need to be embedded into a comprehensive framework

IFRM framework

3 GOVERNANCE

1 METHODS

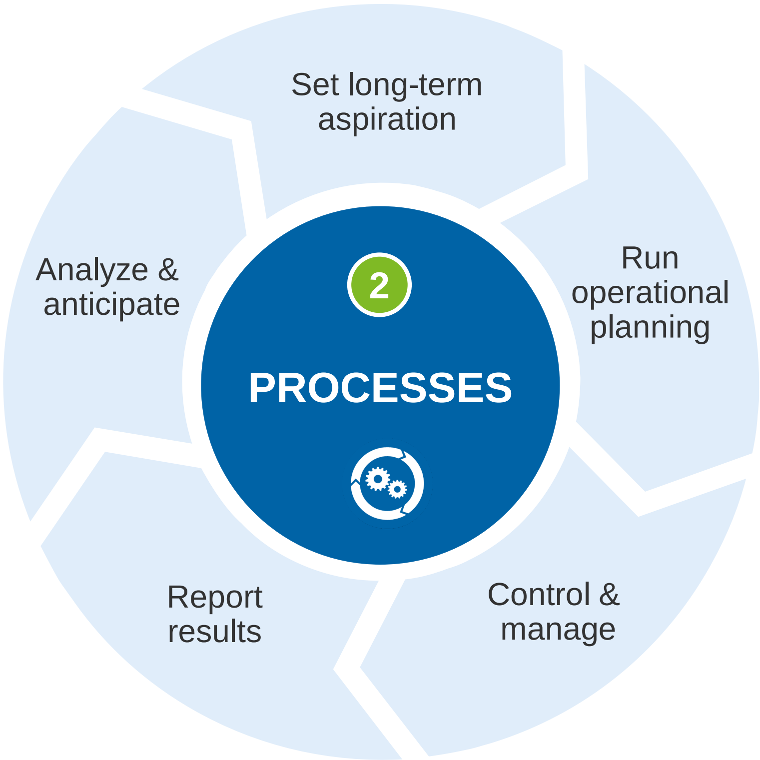
WHAT

- Capital allocation
- Product portfolio optimization[1]
- FTP
- Funding mix optimization

HOW

- Scenario analysis
- Automated optimization algorithms

2 PROCESSES



DATA & IT

Not in focus today

FIT-FOR-PURPOSE DATA

Data to exhibit properties such as granularity, timeliness, quality, etc. for a comprehensive IFRM reporting and implementation

SCENARIO IT INFRASTRUCTURE

Software supporting scenario simulation incl. implementation efforts

SKILLS AND PEOPLE MANAGEMENT

1) Various approaches exist, e.g. NII immunization

1 IFRM benefits from a variety of methods available for implementation – all aimed at increasing efficiency and optimizing financial resource consumption

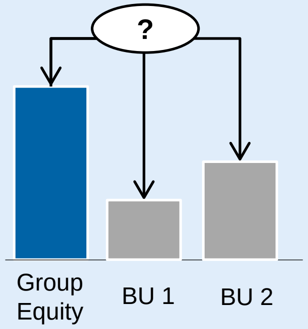
IFRM methods

Selected methods

CAPITAL ALLOCATION

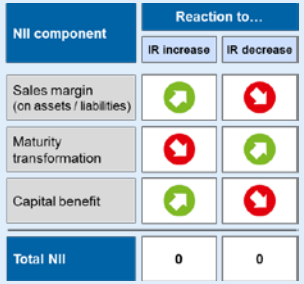
- Capital allocation…
  - types
  - methods
  - principles

  …must ensure a **value-creating allocation of capital** and an optimal risk/return profile



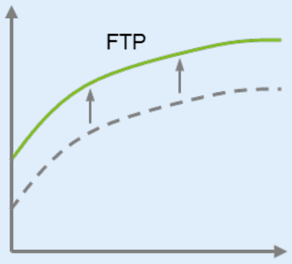
PRODUCT PORTFOLIO OPTIMIZATION

- NII components react differently to interest rate changes
- Thus, an **optimal risk-return profile** can be found via **extensive balance sheet simulations**



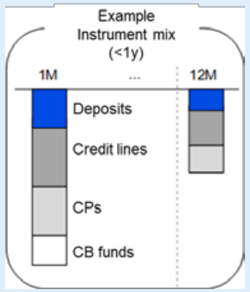
FTP

- Attributing the **correct cost of financial resources** via FTP…
  - creates **right incentives** for business
  - steers the **balance sheet** towards an **optimal structure**



FUNDING MIX OPTIMIZATION

- **Cost-optimized selection of funding instruments** considering existing constraints allows to
  - **reduce funding costs**
  - thus enhance performance



Increasing efficiency and optimizing resource consumption

1 Efficient allocation and intra-year management of financial resources must be supported by comprehensive scenario simulation capabilities

Scenario analysis

INPUT

- Current **B/S, P&L**
- **Current business** portfolio (incl. term structure)
- Assumptions on the **new business**
- **Set of scenarios**, incl.:
  - Storyboard
  - Macro parameters

METHODOLOGY

PARAMETRIZATION

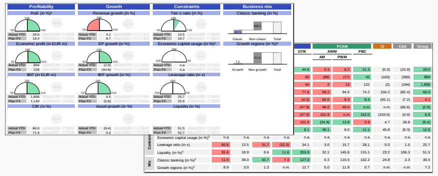
Translation / **connection of macro parameters with the internal parameters** (B/S, P&L line items, portfolios etc.)

CALCULATION

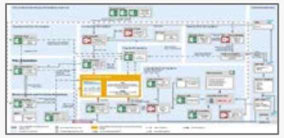
Modeling of B/S, P&L and relevant KPIs **using the identified connections and** set of **macro parameters** in different scenarios

OUTPUT

- **Reports** of financial resource development in the future **given different scenarios**



**Relevant for both regulators and top management*



Target architecture

Software platform

TECHNICAL FOUNDATION

1 Advanced balance sheet optimization allows to maximize performance of the bank given the desired ambition level

Automated optimization algorithm

THE IDEA: AUTOMATED BALANCE SHEET OPTIMIZATION

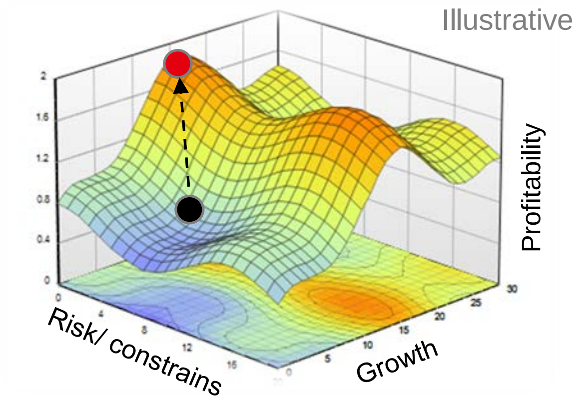
Two approaches to the holistic optimization

High-level holistic optimization

Advanced holistic optimization

Not an industry standard yet

Balance Sheet optimization



- Maximize profitability, while staying within desired level of risk and growth
- **Empowered by:**
  - Non-linear optimization algorithms
  - State-of-the-art technology such as Big Data, Artificial Intelligence and Machine Learning

Specific actions

Sell / buy client or product portfolio	*Adjust FTP rates*	*Hedge FX risk*	*[…]*

WHAT IT DOES

- Conducts **holistic optimization** that takes all major value components & restrictions into account
- Identifies **non-obvious performance potential** or risk mitigation potential
- Supports **technological break-through** via use of **cutting edge technology**, i.e. Big Data, AI, Machine Learning
- Ensures that all units work together in a cooperation mode – **avoidance of “silo” mentality**

2 IFRM processes cover an entire cycle from setting long-term aspirations to the analysis of current resource usage & allocation

Core IFRM processes

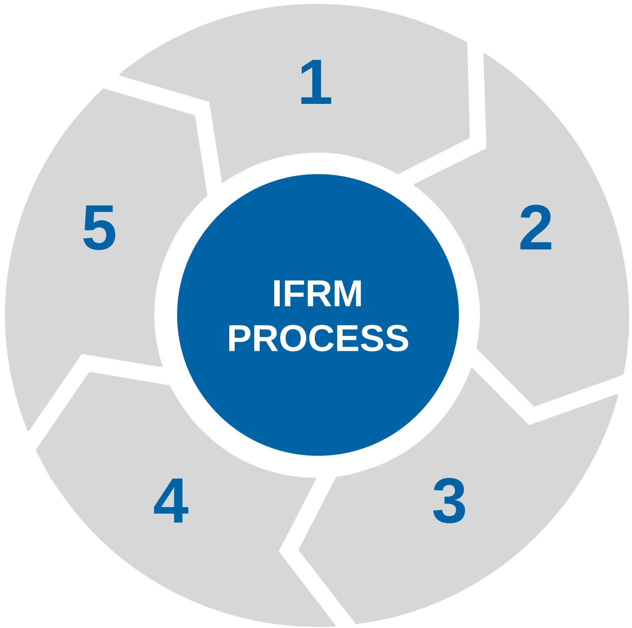
1. SET LONG-TERM ASPIRATION

- **Definition of main constraints** (CET-1, LCR, NSFR, …)
- **Derivation** of **long-term target levels** for constraints
- **Support** of **strategic financial planning**

Cornerstones in many banks

5. ANALYZE AND ANTICIPATE

- Support of **ad-hoc** strategic **analyses** and **stress testing** processes
- **Forecasting** for financial resource usage & development of constraints
- On-going **review of constraints**



2. RUN BUSINESS PLANNING

- **Definition** of yearly **targets** for relevant **constraints**
- Support and challenge of **bottom-up and top-down plan** from the resource perspective

4. REPORT RESULTS

- Comprehensive **reporting covering all relevant financial resources**
- **Integration into** top management and ad-hoc **reporting**

3. CONTROL AND MANAGE

- Regular **analysis of resource usage / allocation efficiency**
- Support of **performance dialogue**
- **Resource (re-)allocation** throughout the year

2 IFRM report needs to be embedded in regular management reporting and focus specifically on capital, balance sheet and liquidity

Integration of IFRM into management reporting

TOP MANAGEMENT REPORTING PACKAGE

- KEY MESSAGES
- FINANCIAL PERFORMANCE
- **FINANCIAL RESOURCES**
- RISK ANALYSIS
- IT, OPERATIONS AND HR
- NEXT STEPS & ACTION POINTS

IFRM REPORT – EXEMPLARY STRUCTURE AND CONTENTS

1	**DASHBOARD**	• Overview of key IFRM metrics on Group level • Breakdown of key metrics on LoB[1] level • Comparison plan vs. YTD vs. forecast
2	**CAPITAL**	• Capital ratios on Group and LoB level • Capital adjusted performance of individual LoBs • Analysis of capital consumption drivers
3	**BALANCE SHEET**	• B/S-related ratios (asset growth, leverage ratio etc.) • B/S figures on Group and LoB levels • Main change drivers of the balance sheet
4	**LIQUIDITY**	• Liquidity ratios on group and LoB level • Analysis of liquidity drivers

FEATURES

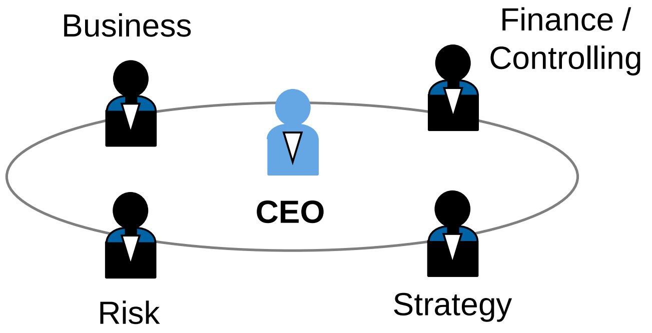
- **Clear visualization and color coding** to ensure easy understanding
- **Inclusion of peer benchmarking** to support better decision-making and outperform the competitors
- Graphs and figures supported by **concise comments and observations**

1) Line of business

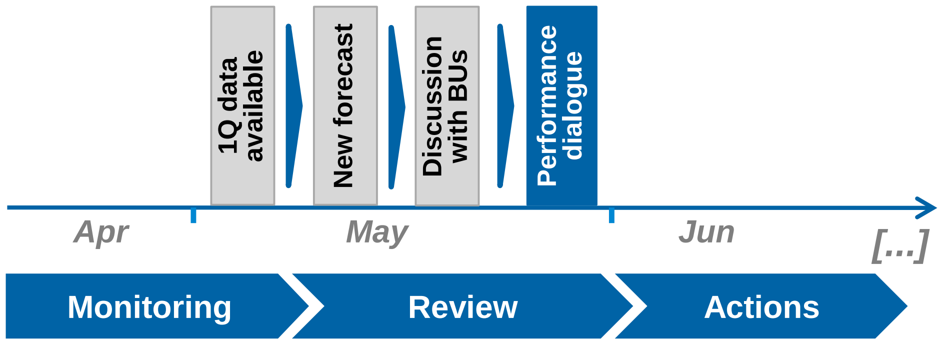
2 IFRM reports and overall plan fulfillment should be regularly analyzed within the quarterly performance dialogue sessions

Performance dialogue sessions

PARTICIPANTS



REVIEW AND ANALYSES PROCESS



PERFORMANCE DIALOGUE

Performance dialogue (PD) is the central process to regularly **review the plan** and **take actions** based on the updated forecast for the year to go

MAIN CONTENT FOR DISCUSSION

- All **relevant perspectives**, i.e.:
  - P&L,
  - Balance Sheet,
  - Capital and liquidity
  - Risk, etc.

  …are **made transparent** for each business area
- Suggested **measures / actions** to return the bank to the right track (in case of deviations of forecast from the plan)

MAIN ORGANIZATIONAL ASPECTS

- PD is carried out **for each relevant business area**
- **Senior participants:** Board and Board-1 only
- **Uniform information basis:** discussion should be based on the standardized reports
- **Regular process:** performance dialogue conducted in the 2nd month of each quarter

3 Committee structure should be adjusted in order to promote more efficient financial resource management

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Committee structure

Client example

COMMITTEE	OBJECTIVE	RESPONSIBILITY	MEMBERS
ASSET / LIABILITY COMMITTEE	**Holistic financial resource management on Group level**	• Utilization/allocation of resources • Maturity transformation result • Decisions regarding IFRM methods (e.g. FTP) • …	• CEO, CFO, CRO and heads of business • Chair: CFO
PERFORMANCE REVIEWS	**Optimization of resource utilization on business unit level**	• Review of segment performance and forecast • Reallocation decisions • …	• CEO, CFO, CRO and respective business head • Chair: CEO or CFO
INVESTMENT REVIEW	**Oversight regarding investment portfolio/ excess capital management**	• Review of investment portfolio activities and results • Decisions on investment portfolio strategy/universe • …	• CFO (chair) • CRO • GT/Chief Investment Officer

3 Group Treasury can play an important role in IFRM processes – it is paramount that setup ensures clear responsibilities and an unbiased view

Key players within IFRM process (simplified)

Client example

	Long-term aspiration	Targets, plans, budgets	Facilitate execution	Control & report	Analyze & anticipate	Manage & re-allocate
Group Finance	I	R	I	R	I	I
Group Treasury	R	I	R	I	R	R
Group Risk Mgmt.	I	I	R	I	I	I
Business Segments	I	I	I	I	I	I
ALCO			D			D
Performance Review						D
Investment Review						D
Executive Board	D	D				

R Responsible I Involved D Decision

Agenda

Introduction to IFRM

IFRM in real life
(sanitized case study)

Way forward

Establishing a state-of-the-art IFRM should be based on a stepwise approach rather than a “big bang solution”

Stepwise approach to IFRM implementation

Illustrative

STEP 1

Create the basis

- Clear view on current situation and “white” spots with regards to IFRM (baselining)
- Prioritization and roadmap for next 1-2 years
- First tangible results with special focus on highly visible topics, e.g.
  – Revised capital allocation framework
  – New/ adjusted IFRM reporting

STEP 2

Implement IFRM TOM

- Upgrade of IFRM toolbox
- Anchoring of IFRM in relevant Treasury and Finance processes, including new governance structures
- Full integration of IFRM in the annual planning and performance management processes
- Global roll-out and communication

STEP 3

Make it stick

- Expanding and training of the IFRM team, securing organizational anchorage
- Continuous training of Finance, Risk and Business people regarding principles of IFRM to create common view
- Further refinement of IFRM processes and strategic data sourcing

Increasing degree of implementation

zeb project experience shows that there are six success factors crucial for a successful implementation of IFRM

Key success factors

CLEAR MANDATE	**Clear mandate** to be defined for **IFRM function**, mandate to be reflected in **governance** to bring it to life and avoid shadow IFRM functions on business level
INTEGRATION INTO FINANCE & RISK	IFRM to be **integrated** in the **main Finance and Risk processes** as an **active challenger**, e.g. IFRM report to be integrated into top management reporting
STATE-OF-THE-ART METHODS	IFRM team needs to **own state-of-the art methods** to drive the resource allocation – for all relevant constraints right methods to be incorporated in the **IFRM framework**
AVAILABILITY OF RIGHT-PROPERTY DATA	Data of the right properties has to be available – **granularity, timeliness and overall quality** to be considered as requirements for driving resource (re-) allocation
CLOSE ALIGNMENT & COMMUNICATION	Close **alignment between involved teams**, clearly defined **ownership of methods** and either direct control over decentral resources or indirect synchronization via SLAs
STRONG & SKILLED TEAM	IFRM team must have a very **broad skillset,** i.e. comprehensive and holistic thinking combined with **technical knowledge** in finance & risk and **excellent analytical skills**

Dr. Dirk Hollaender
Director / Partner

E-mail: dhollaender@zeb.de
Phone: +44.2077.968.698
Mobile: +49.151.12.054.016

London office
107 Cheapside
UK-EC2V 6DN London

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