



SUSTAINING THE KEY PILLARS OF A BANK

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1.0 Banks, the economy and volatility

Banks have always enjoyed a privileged role in society. They are the conduit between the real economy and the financial economy. The financial world tends to revolve significantly around the financial economy ignoring the real economy which produces goods and services resulting in GDP, per capita income which are the measures of the real world. Volatility in markets produces uncertainty which is a challenge to planners of any economy in any country. Volatility is change at a rapid pace in an unexpected manner and direction which requires robust strategies which are flexible and implementable without much deliberations and lead times. Volatility is also the rate at which prices of financial instruments change in a given market, be it global or local. Volatility provides opportunities which must be met with preparation. The preparedness of banks to meet volatility ensures sustainability for banks and its key pillars over a long period of time. What banks are experiencing today is continuing regulatory uncertainty and economic instability in all markets which makes it very challenging for the banks to move forward.

2.0 Key pillars of a bank

The key pillars of a bank are many. However in the order of importance and in the interest of brevity for survival they would be;

- 2.1 Liquidity
- 2.2 Capital
- 2.3 Systems
- 2.4 People

2.1 Liquidity

2.1.1 Liquidity and its role as a sustainer for banks

The lifeblood and raw material of a bank is its liquidity. Managing liquidity for best results is both an art and a science. The art is in building liquidity at the right time so that its costs are minimal and the science lies in the facets of liquidity building such as diversification, tenor and



many technical variants associated with liquidity. In uncertain times liquidity management is always a costly exercise as banks would boost liquidity over and above regulatory and business requirements in order to sustain the business. Liquidity could be used as a tool for increasing a bank's competitiveness. A bank's growth in the medium to long term as well as its profitability will depend on the availability of a ready supply of liquidity for deployment in core assets of the business.

Liquidity costs should be built into any exposure that the bank is planning on taking and the strategies of the bank should be aligned with the liquidity exposure the bank is willing to take. The quantification and attribution of liquidity risk should be made transparent to planners and line managers so that stressed scenarios are better analysed with their input. No plan should be made without looking at the liquidity availability and the ramifications of the scenario on such availability.

The sources of liquidity vary from bank to bank and from market to market. The bank to bank variation is a direct result of the bank's business model.

2.1.2 Bank business model and liquidity

By nature banks are highly leveraged institutions. Recent regulatory directives to dilute the leveraging and strengthen equity capital and the resultant capital adequacy of banks also contribute to sound liquidity management. A bank could decide to follow a traditional model with customer deposits, a few wholesale borrowings balanced with short/medium term customer loans, some investments and cash. A fair amount of fee income would ensure that operational expenses are met while the net interest income and the residual of fee income after operational expenses of distribution and allied services expenses are met would contribute to profitability. A staid model without much chance of super normal profits and surrounded by many entrants would find survival difficult in the long run unless there is sufficient scale or cost leadership. This type of business model could sustain liquidity in volatile conditions better however the franchise and the distribution commanded by such a bank would have a direct correlation to its ability to build liquidity. Large commercial banks fall into this category.

A riskier more diversified model would combine deposits with borrowings and innovative securitisation structures, on and off balance sheet with assets some liquid some illiquid but with attractive returns coupled with derivatives which would make higher profits, could afford a higher level of expenses for product development/ new projects and pursue market innovations. This is preferred by many banks due to the model's ability to let the banks reap super normal profits when volatile conditions provide opportunities. However liquidity management becomes more crucial as the element of illiquid assets and exposure to non- traditional volatile funding results in a higher level of vulnerability to market volatility.

In times of volatility what type of funding is sustainable? The clear answer on the liability side of a bank's balance sheet would be customer deposits and other contractual borrowings where call options on the part of the lender are absent or minimal with adequate time for preparation. On the asset side of a balance sheet of a bank the answer would consist of liquid

assets. Liquid assets in a typical risk/reward scenario would yield low returns and is a conscious decision on the part of the bank to meet its sustainability targets within volatile market conditions. A liquidity cushion should be looked upon as a prerogative during stable times which should be a part of asset allocation decisions.

2.1.3 Market to market variation

Assessment of market liquidity calls for an assessment of fiscal liquidity. Any market which is in a country facing fiscal deficits in the medium to long term would face liquidity shortfalls and surpluses as all markets do, but much more volatility than other markets. This is a direct result of procyclicality in markets as opposed to countercyclicality. Bank's asset allocation should include planning taking into account market liquidity cycles. Predictive approach is always fraught with so many unknowns it is prudent to adopt historical methods and stress testing taking into consideration market liquidity.

2.1.4 Liquidity Risk

There are three types of liquidity risks faced by a bank, viz Mismatch Risk, Market Liquidity Risk and Liquidity Contingency Risk.

Mismatch Risk

Banks core business revolves around maturity formalisation of assets and liabilities. Therefore Liquidity Gaps and resultant mismatches are very much a part and parcel of making money for the bank. The banks usually address the risks by setting duration gap limits which when subjected to sensitivity analysis will yield results the bank would study as an impact on profitability.

Market Liquidity Risk

This risk is discussed under market to market variation where a liquid asset upon realisation will result in losses due to lack of market depth and liquidity. This is a systemic risk and cannot be hedged but monitored closely for any triggers for management action.

Liquidity Contingency Risk

Unforeseen contingencies may require larger than usual liquidity. This risk culminates in the crystallising of bank's and market's liquidity risk. Contingency Funding Plans are a stop gap solution until more concrete steps are taken in the event of a contingency.

2.1.5 Liquidity for sustainability-Regulatory perspective

The acid test for liquidity is a bank's ability to meet its obligations when required. Hence when is a wide term the Committee for Basle III has proposed a 30 day horizon as the most



Thirty days is perceived as a pragmatic period for a bank to put in place mechanisms to meet its immediate obligations. The two ratios which are proposed by Basle III for the sustaining of liquidity are as follows;

$$\text{Liquidity Coverage Ratio} = \frac{\text{High quality liquid assets}}{\text{Payments falling due within the next 30 days}}$$

$$\text{Net Stable Funding Ratio} = \frac{\text{Available amount of Stable Funding (ASF)}}{\text{Required Amount of Stable Funding (RSF)}}$$

These two ratios are a good indication about the sustainability of the bank's key pillar of liquidity in times of volatility. It is a known fact that many global banks reach only 98% in the first ratio and many banks meet less than 90% in the second ratio. The requirement for both is a minimum 100%. During major volatile periods such as the financial crisis and the sovereign debt crisis banks who have met the two ratios above are definitely better able to sustain the key pillars of a bank. This calls for constant calibration of liquid asset characteristics, the payments due as well as categorisation of funding. Every funding source should be tested at suitable frequencies (ideally weekly, practically monthly) for its stability and volatility. This is a process which should be religiously followed by treasury, risk and asset and liability management for accurate ratio calculation and thereby establish contingency plans where necessary.

Basle III has taken a 30 day horizon due to the fact contractual liabilities falling due in 30 days are very important to be met while anything beyond 30 days has more time. The Net Stable Funding Ratio is concerned with stable funding that is required for the next 365 days which is a vital planning tool for liquidity.

Liquidity Gaps measured by accurate cashflow forecasting and scenario analysis is the key, not historic ratios

2.1.6 Liquidity Planning

Timing and innovation are key facets in the art of liquidity management. There should be sufficient investment in information technology and analysis to spot trends and understand their implications in the context of an adverse market which may not be the present. When a liquidity



crisis occurs it may be market wide as discussed above or it may be due to the institution's Volatile liquidity changes status frequently. One is posed with the question is there any permanent stable/volatile funding. The answer is that anything is stable as long as the features which make it stable are present meaning anything could be volatile or stable based on the situation.

There are three simple questions every bank should attempt to answer;

<i>Liquidity Question</i>	<i>Probable Answer</i>
<i>When do we need it?</i>	<i>Cashflow metrics and predictive tools</i>
<i>Will there be enough money?</i>	<i>Liquid assets at a minimum required with scenario analysis</i>
<i>Are there approved contingency plans?</i>	<i>Subject to stress testing</i>

Cashflow metrics

Be honest about cashflows to prepare a base case. History is a good starting point aided by the annual plan of the bank

Prepare adverse case based on the three types of liquidity risk stated above. Ensure funding concentration issues are addressed in the adverse scenario assumptions. A multiplicity of assumptions are required. However experience and value judgement are an imperative for decision making.

Contingent liabilities should be brought into the cashflow under adverse scenario

Have target liquid assets which are unencumbered and sufficient to cover volatile liabilities based on both scenarios of normal and adverse

Quantification and scenario analysis

Liquidity based Funds Transfer Pricing

Business units must clearly understand the cost of building and maintaining liquidity which is required as a result of the exposures they create for the bank.

2.1.7 Best Practices: Liquidity Risk Measurement & Management

In order that the key pillar is sustained a bank should have the following policies;



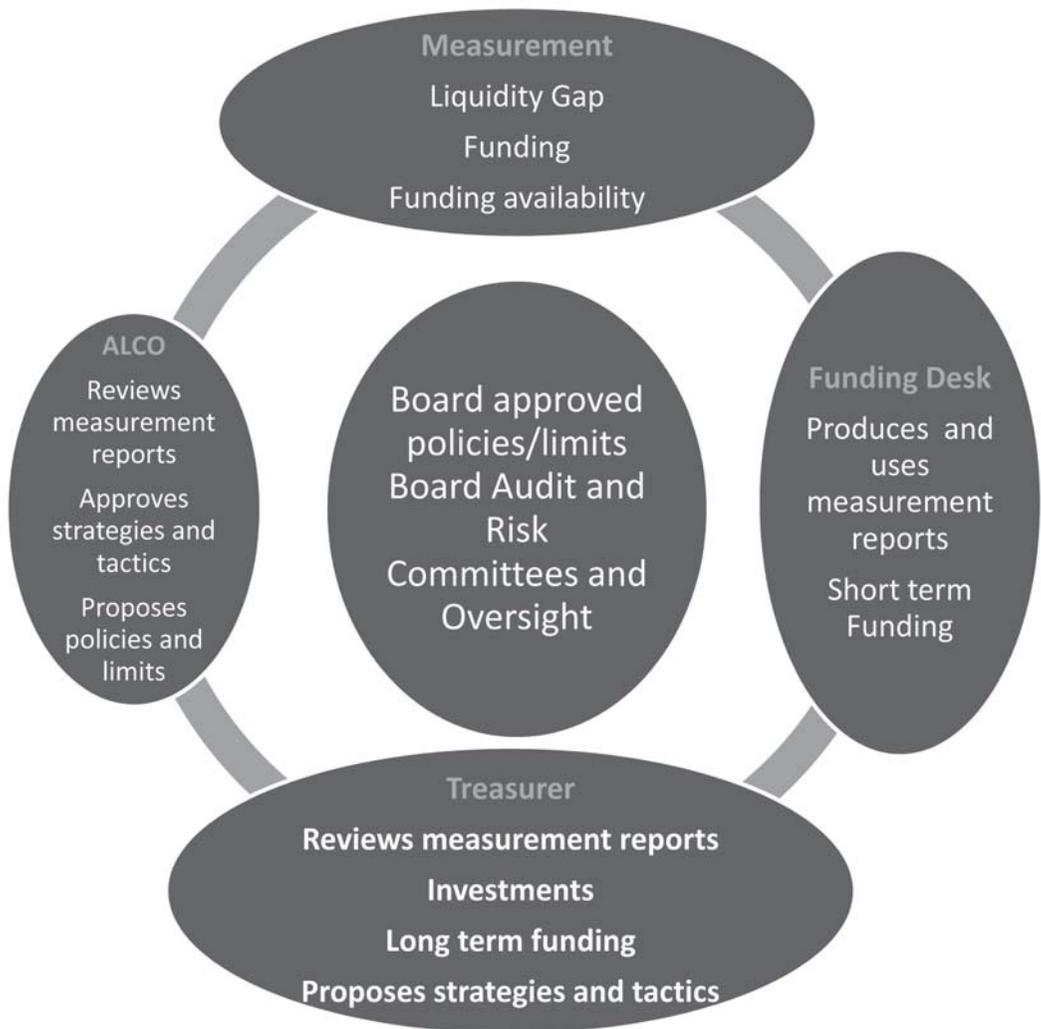
Scenarios & Stress tests

Contingency Funding Plans

Indicators & Risk Limits

Oversight, internal controls and audit

2.1.8 Liquidity Measurement and Management Responsibilities





2.1.9 Contingency Funding Plans (CFPs)

It is a regulatory requirement for banks to have a CFP in place. CFP has become important given the market conditions we have experienced locally and globally. Whilst funding arrangements under a CFP should be given pride of place what is most important is the Key Risk Indicators (KRIs) which are bank specific and market related. To this end the dissemination of internal and external information is relevant and ongoing in the context of what the CFP contains.

2.2 Capital

Capital is a scarce resource for many banks. Banks leverage much more than other organisations hence the desire to obtain equity capital is high through rights issues and other forms. However all banks should be keenly conscious at all times of the Return On Equity to ensure that scarce capital has been invested in profitable ventures which may result in long term returns. Growth plans should be based on capital availability to ensure that risks are taken commensurate with capital availability. The regulatory ratios ensure minimum capital levels. However in times of volatility probabilities of default and losses given default compel the requirement for a capital buffer to rise. The regulatory minimum should only be a guideline and internal capital adequacy assessment process should ensure robustness of capital to sustain this key pillar of the bank. In times of volatility there is opportunity and banks based on their business models should exploit them. Although Basle II and III have both being criticised for adding to procyclical effects to a market the discipline brought about by planning far outweighs the negative impact. Capital is boosted with high retention of profits and consistent reinvestment of profits in the core business which calls for a disciplined approach to dividends, investments and managing costs.

2.2.1 Capital Planning

In the planning process the required capital should suffice for annual dividend payments, adequate buffer for planned risks and a percentage for unforeseen emergencies. A bank which is well capitalised should also concentrate on where the capital is invested. The first pillar of sound liquidity management and capital go hand in hand as higher capital is ineffective in times of market volatility and low liquidity if coupled with a lack of liquidity as the bank is unable to book risks. Banks should increasingly concentrate on fee based businesses to complement its fund based activity so that income would boost profits without being balance sheet intensive. Banks should endeavour to build balance sheet light businesses such as wealth management and treasury services. In other words capital consumption should be permitted for businesses which are profitable after costing for capital.

However a bank needs to sustain its core business which is essentially fund based. In times of volatility the many banks' core business of lending would experience stress which requires additional capital to absorb losses in the loan book. Hence sustaining capital of a bank in good times would ensure adequate capital but not high capital during volatile market conditions.



2.2.2 Capital Metrics and their use

Since sustaining capital is of paramount importance and the sustenance of such depends on the dividend and investment policy of the bank it is prudent to have a business model which at least partly supports dividend payments with dividend income from bank's own investments. Pursuant to this strategy the core income of the bank could be retained which is ploughed back into existing capital as reserves. Return On Equity (ROE) is always an important measurement, However in times of volatility preceded by regulatory uncertainty capital metrics become important along with performance indicators. The core income should be a result of clear segregation of revenue streams a targeted total return where pricing plays a pivotal role .The market should reward banks which may have lower ROE but better capital metrics. However this may not be the actual case. If all banks adopt a risk/reward matrix which correctly prices products strong capital metrics will be clearly better recognised. Capital is a resource to be utilised intelligently. Banks should pursue disciplined innovation and good capital metrics rather than risk aversion and strong capital.

$$\text{RAROC} = \frac{\text{Expected Profit}}{\text{Economic Capital}}$$

$$\text{RAROC} = \frac{\text{Return} - \text{Expected Losses} - \text{Expenses}}{\text{Economic Capital}}$$

Economic Value Added (EVA)

This is less popular than RAROC which has wide appeal and use as a measure to compare investments and most analysts and bank managers are comfortable in its use. EVA is a relative concept which gives an absolute measure of profit over cost of capital. EVA by itself would be meaningless. Generally it is interpreted in association with RAROC.

The danger in over zealous use of capital metrics is its loss of relevance specially in South Asian markets where competition is murky due to information asymmetry and regulatory arbitrage. Most banks do not adhere to RAROC and EVA in pricing loans due to loss of business due to competition. If users ignore capital metrics the risk management function's objectives of building discipline in pricing and aligning strategies with capital and liquidity management are under achieved.



The challenges are in implementation, information management and deciding at what varying levels the Economic Capital model will be used to price products. An immediately possible model for Sri Lankan banks to ensure sustenance of capital in the long term would be to adopt the Economic Capital model at business unit level and within business units at very large client relationship level. A very micro level of granularity would not be relevant for Sri Lankan banks with lesser complex operations and small geographical presence.

2.2.3 Factors in using and interpreting Capital Metrics

The biggest concern when Economic Capital model is adopted at business unit level is the underpricing of riskier transactions as they are bundled with safer transactions and therefore seemingly less capital use overall.

2.3 Systems

The following aspects are imperatives for any business model in the area of systems. Any bank which invests in flexible IT and operating platforms toward the same goal more and better information is in the right direction. Systems will determine how banks they manage their financial performance, and risk and capital positions of their organizations and build capabilities across their organisations. This is specially relevant in an era where banks grow inorganically through acquisitions of different businesses.

- § Capacity to do scenario analysis and perform a reasonable level of analytics
- § Data mining

§ Capacity to do scenario analysis and perform a reasonable level of analytics

Scenario Analysis should be done with experienced business managers and risk managers to evaluate plausible severe losses based on scenarios, The assumptions are made by a team of experienced experts representing diverse areas of the bank. Systems in the bank should support this requirement. Important fact is to measure actual against predictions once a scenario has occurred to understand the efficiency of assumptions and accuracy and the predictive capability of systems.

§ Data Mining

Data mining is the process employed in information technology to find the needles in hay stacks. In other words assist the bank to discover the profit from a customer, but also with regard to capital usage, leverage and liquidity. As a result data mining allows the bank to plan for better customer relationship management. Data mining has been successfully used in the medical world such as patient data and their medical diagnosis. However it could also provide very valuable information on your customers which are hidden to you and with such information your competitor may be supplying him with products. Data mining in customer relationship management applications



can contribute significantly to the bottom line. Rather than randomly contacting a prospect or customer through a call center or sending mail, a company can concentrate its efforts on prospects that are predicted to have a high likelihood of responding to an offer. The investment made in data mining is touted to be more than justified. However caution should be exercised with the models used in terms of their relevance and reliability.

2.4 People

People have become a key force despite an enhanced degree of automation. The tasks of banks have become more intelligent requiring intervention whilst repetitive lower level jobs have been largely automated. Customer Relationship Management, Data Mining, Wealth Management and Treasury services all rely very highly on people and people. In fact the success of investment banking, treasury and corporate banking is based on the skills of the workforce. The tools the human resources department of a bank would use range from compensation (rules governing pay and pay raises to pay levels, and wage and benefit structures), training, staffing (including workforce levels, the mix of full-time, part-time and contingent employees), hiring and selection, systems of workplace governance (including schemes for employee involvement and representation), and job design and work organization. Gender equality, policies on harassment at work would all require new thinking and the bank to understand legal ramifications and the potential reputational risk a bank would run with disgruntled employees or ex employees.

Banks have long regarded their organisations as specialised and hence operated a closed service. However increasingly the skill set required by a bank employee reflects an employee of a FMCG company on top of his/her financial, analytical skills. Today's bank employees need to be global citizens, well informed, cosmopolitan, exposed and well trained to cater to demanding clientele specially in the areas of wealth management and treasury.

A further challenge to banks which are normally well established organisations counting a minimum of 25- 50 years in existence would be the generational gaps existing within the organisation. HR should facilitate intergenerational harmony as much as possible blending experience with enthusiasm to benefit the organisation. In recruitment Competency mapping Frameworks and Key Performance Indicators would indicate fairly accurately the traits and tasks expected of and from a prospective employee. This is painstaking work at every level of the organisation. The key to remember is that a disgruntled employee is a threat to the organisation and could potentially harm most of its key initiatives.

3.0 Conclusion

In terms of sustaining the key pillars of a bank banks need to innovate doing the same business. It is very likely that it will not happen through revolutionarily different product offerings but through improvements and innovations to how you offer the products. Decide what you are good at. The competencies that a bank has built over a period through its products, services, people, systems, processes and financial performance all tell a story about what the bank is good



at doing. Very simply what you are good at doing should be continued. What you should be doing should be commenced immediately. It is also very prudent to study others mistakes and attempt to learn. All strategies should contribute to sustaining the key pillars of the bank and if there is no relationship such strategies ought to be changed. Early investments in IT which will save costs give added advantages in information analysis and knowledge although a drain on a bank's resources is well worth the money spent provided it is utilised constantly in decision making. A continuous monitoring of staff is also important to retain a highly focused, motivated happy team of employees who work with a passion. In the final analysis the key driver for banks is the customer experience which could never be complete without the right employee delivering the service.

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