

# Treasury: Back to Basics

## View Point

Bank treasuries are seeking to surmount the hurdles posed by the turmoil in the world's financial markets, triggered by the sub-prime meltdown. The need of the hour is for banks to rewind and reapply the first lessons of the business: simplicity, risk-sensitivity and cost-consciousness.

Finacle from Infosys provides bank treasuries the solutions to manage robust yet lean operations, strengthen risk management and rationalize costs. It also empowers treasury operations with the technology backbone to stand up to the challenges of changing business dynamics.



# Staying Profitable in the Face of Pressure

The operating environment for bank treasuries has changed dramatically in recent months. The US sub-prime crises, that originated in the Americas in the summer of 2007, has now spread through the world giving a hard knock to several assumptions premised on which treasuries transacted business. Postulates like a benign interest rate environment, easy credit conditions, expanding volumes, growing complexity of financial instruments (financial engineering), and tolerance for risk-taking, have been turned upside down.

News from the market has only served to exert greater pressure on the profitability of bank treasuries, as inflation and interest rates are poised to scale northward. Financial markets are grappling with the possibility of job losses of the magnitude comparable with that of the post 9/11 era.

Prevention of increasingly sophisticated fraud is a burgeoning concern. Consider this recent occurrence at a leading European bank. A junior futures trader, authorized only to enter into the simplest of trades, single-handedly wiped out almost the entire profit at the bank. While demarcation between the front and mid office was apparently in place, the trader is said to have used his knowledge of the bank's control procedures to hack into its computers and erase all traces of his alleged fraud. This clearly illustrates that additional controls put in place to segregate front and mid office operations does not always prevent the occurrence of fraud.

Risk aversion is reaching phobic magnitude as treasurers focus on hitherto neglected operational and concentration risks. Complex instruments with their attendant multifaceted pricing attributes and model risks, have lost most of their sheen.

Awake to a new reality, banks are also aggressively seeking to cut back the splurge, as they struggle to manage their cost structures.

So, just how can bank treasuries respond to the dynamics of this changing business world, to seize the opportunities it holds and emerge not just unscathed but successful? The answer lies in harnessing the potentials of 3 key fundamental but truly powerful enablers.

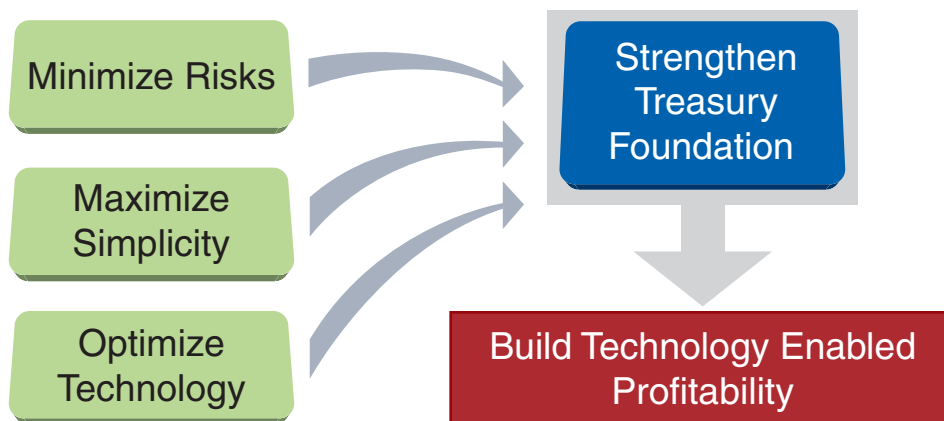
# The Fundamental Enablers

Winning in this downturn entails a smart and calculated consolidation of strengths before leapfrogging to redraw the competitive landscape.

In our view, three fundamental enablers set the direction for bank treasuries to tide the difficult times as they gather force to restart their march to scale new heights:

- Minimize Risks
- Maximize Simplicity
- Optimize Technology

## TREASURY: BACK TO BASICS



## Minimize Risks

A quick recap of recent banking history clearly showcases the fact that banks have had to raise large sums to re-capitalize themselves – raising serious questions about the adequacy of their risk management practices. Though a majority of these banks have invested substantially in risk management systems, what is clearly lacking is ‘prudent management of risks’.

We, at Finacle, believe that bank treasuries will do well to map, track and manage the following risks, increasingly assuming prominence in the shifting landscape of today’s business:

### Liquidity Risk

As Bear Sterns exemplifies, this primary risk can bring a once mighty institution to its knees. Liquidity risk, barely something to contend with when markets are operating in order, turns into primary risks determining the very fate of an institution, when markets are in turmoil.

## Concentration Risk

This risk has assumed importance as banks exposed more to the sub-prime or US housing assets have been punished substantially compared to other institutions with a lesser concentration of these assets. Bank treasuries have to balance their pursuit of higher returns with concentration risk.

## Counterparty Risk

Given the uncertain nature of markets in recent times, bank treasuries are re-evaluating their credit lines with counter parties in accordance with their disclosures. Re-balancing of credit lines in alignment with the market situation is a strongly recommended risk management practice.

## Model Risk

Bank treasuries have learnt to manage model risks only after taking some hard hits through this downturn. Models are stress tested during rough market patches and often fail to perform. Markets tend to overshoot or undershoot in extreme situations and the prices available are typically significantly lower, when compared to the model. Treasurers must question their hitherto unchallenged reliance on these models, and actively consider adaptations to reframe these models to meet the rigors of changing times.

## Operational Risk

Systems managing operational risk are notoriously difficult to program and implement. However, what has come to the fore is not 'operational risk' from the Basel II perspective but of systems ensuring proper controls and procedures. The need of the hour is for systems to ensure that all deals go through a controlled deal lifecycle and admit action only from permitted users.

Banks have invested in several complex risk management systems in the past. They have also spent colossal amounts trying to get an integrated view of their risks. However, this random maze of 'risk management systems' has, albeit inadvertently, only served to lead their focus astray, and away from basics like liquidity and counterparty risks. It is high time treasurers pulled out their operating instructions manual and studiously strived for compliance with all the injunctions therein. In addition, treasurers must enable themselves with risk management systems that manage basic risks prudently, while allowing for model modifications and accommodation of stress scenarios. Focus must also shift to management of credit risk against market risk. From the operational risks perspective, a system that can mould itself to the lines of operational procedures within the bank, will stand the treasury in good stead.

## Maximize Simplicity

One of the hallmarks of the current crises has been that of investors investing in products that they did not really understand. Some of these structured finance products were so complex that even their designers probably did not grasp the essence of the risks embedded in them. Financial institutions holding these instruments have experienced significant difficulties in marking them to market because there is no liquid market for them. Instead, they have been frequently 'marked-to-model', using models with complex mathematical and computational features, mastered neither by the institution's risk managers nor the supervisors and regulators.

The need to make a shift towards simpler products is unmistakably evident. This is not to say that structured products are to be avoided. Post sub-prime, exotic structured products are falling from grace, even as standard structured products see some sustained growth. Many standard structured products like mortgage-backed securities have their roots in genuine market demand. However, over time, the "rocket scientists" among our financial engineers have created a plethora of products that are likely to fade into oblivion for at least the next couple of years. The demand for structured products, in general, is likely to slow down in the near term.

Treasuries and treasury customers must clearly identify risks before they select products that suitably address those risks. Going forward, these risks will drive the creation or purchase of products and not vice versa where a complex product created is sold to meet 'suitable' risk taking. Products such as structured MBS and CDO, along with exotic options, must be dropped in favour of products catering to credit risk such as credit derivatives and new asset classes like commodities. In addition, the general complexity levels of OTC trades must come down.

Banks' increasing risk aversion means that they are unlikely to trade in derivative products unless they have supporting pricing and risk management systems. Treasuries must leverage systems which are able to break risks into different categories such as credit risk, market risk and sub-categories thereon. Additionally, treasuries will benefit from easy to use 'dashboards' providing the treasurer or trader a consolidated view of risks they are exposed to. A facility wherein the risk breakup of a complex product like 'dual currency deposit' is clearly exhibited across different risk categories, will be greatly empowering.

We recommend that the treasury's hedging strategy must also change. Typical hedging must be done using a group of standardized products rather than buying one big opaque structured product. Systems will need to link a basket of trades together and then provide combined risk assessment.

Bank treasuries must look for products in relation to their underlying exposures and risk. Components and sub-components of different individual risks must first be understood before treasuries buy and recommend risk products, accordingly.

# Optimize Technology

Undisputedly, banks are increasingly looking at technology to drive their costs down. While the agenda for technology was volume-growth till recently, that focus must shift to one that centers around improved cost control and risk management. The move from “best of breed” systems to “swiss knife” systems – those with comprehensive functionality in a single integrated platform – is recommended.

This can take the following routes:

## Cross Asset Platforms

Over time, banks have invested in different systems for different asset classes. For example, it is quite common to find a bank using one system for its foreign exchange business and another for its money markets business. The same bank is likely to use another specialist system for its complex derivatives business. Banks must now look towards centralizing their operations in one single system which reasonably meets its requirements for different asset classes. This, in addition to brightening the costs side, will help centralize risk management.

## Combined Front, Mid and Back Office Operations

Banks must focus on increasing integration between front, mid and back office operations. This is important from the risk perspective and vital from the costs perspective. In addition to investing in different specialist systems to handle front, mid and back office operations banks continue to spend large sums on their integration. A cost banks can ill afford in these rough times.

## SaaS

One of the initiatives at the forefront of discussions to lower operating costs and ensure a higher return on investment is the Software as a Service (SaaS) model. SaaS is a software distribution model in which applications are hosted by a vendor or service provider and made available to customers over a network, typically the Internet. Banks must invest in systems which can be delivered through the SaaS route.

## Multi-entity Operations

Another area where system vendors can help banks reduce the cost of operations is by centralizing operations for different legal entities or different geographies on an integrated platform. For example, consider a bank using three different systems – one in the Americas, another in Europe and a third one in Asia. The bank can shift to a multi-entity system wherein the same instance supports operations on a global basis. This helps centralize risk management as well as back office operations, significantly reducing costs.

## Build Basics. Build Profitability.

In summary, these difficult times are also opportune moments for introspection and making fundamental changes in the way business is managed. In a year or two, a lot of froth would have swept past, operations would be leaner, risk management stronger, and costs rationalized. Then bank treasuries can take that next leap – on a much stronger, surer turf.

Banks must take that ‘flight to simplicity’, and manage risks prudently. Technology will play an important role in the treasurer’s journey ‘back to the basics’.

