

## Missing the Boat?

*The current tide of Regulatory prescription in the UK focusing on Treasury Risk Management is notable for its lack of detail on the internal Funding 'Frameworks' of Banks.*

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This white paper draws on the convergence of both external and internal drivers behind strengthening liquidity and funding regimes within financial institutions. While noting the irony of timing (vis a vis the economic cycle), it welcomes the increased scrutiny given the genesis of the 'credit crunch' in poor cash management (1). However it observes that the recent UK Financial Services Authority Consultation Papers on Liquidity and Funding (2) do not address the critical issue of how funds are managed internally. It argues that in fact banks can gain competitive advantage if their 'internal funding frameworks' are operated effectively.

## Introduction

It is common to seek to strengthen *external* regulation during a crisis, but this is a time when it is least needed and effective (3). Banks are all too keen to retrench to ultra-conservative lending practices during economic downturn, and this risk aversion exacerbates the impact of the 'credit crunch'. The need for tighter supervision is at its greatest at the top of a bull market when lending and allocation decisions are looser.

Similarly, organizations are less likely to address *internal* processing inefficiencies when funds are flush and revenues growing. While some banks did talk about their businesses from Front-to-Back, the investment and focus was very much at the front, with even revenue-enhancing activities such as funding management suffering from lack of attention.

## Liquidity and Funding

It is in the areas of Liquidity and Funding Risk Management (part of Treasury Risk Management) where an external/ internal dichotomy can be seen to be in play.

The management of Liquidity Risk -defined as the risk of being unable to raise funds to meet payment obligations as they fall due, and to fund increases in assets (4) – and Funding Risk – the risk of being unable to borrow funds in the market – is the current focus of 3 separate Consultation Papers issued in 2008/9 by the UK regulator, the Financial Services Authority.

The move towards prescriptive (rather than principles-based) regulation that characterizes capital adequacy compliance under Basle 2 would appear also to be crystallized in these nascent rulebooks, as is the emphasis not just on searching reporting and disclosure requirements but on the mechanisms in place to compute that data. In adding the methods to produce, collate, aggregate and transform cash flow data, as well as the policies that govern these processes, into the remit of these new regimes, the regulator is setting an Individual Liquidity Adequacy Standard (ILAS) against which organizations are assessed (through an ILAA – Individual Liquidity Adequacy Assessment) which is analogous (in form at least) to the Capital Adequacy assessment of Pillar 2 of the Basel 2 Accord.

Given the way the liquidity crisis unfolded last year, it is natural that the regulators have focused on considerations such as the type, tenor, source and availability of Funding, exercised in both normal and stressed market conditions. The inability of banks such as Northern Rock and Bradford & Bingley to fund themselves had these themes at the root of their demise. However, what has been missing from the analysis and the prescriptions is how *internal* Funding can be optimized – i.e. the internal funding framework, including the price at which cash is internally transferred. Get this right, and the risk/reward measurement of trading activity – such a hot topic today – becomes far easier.

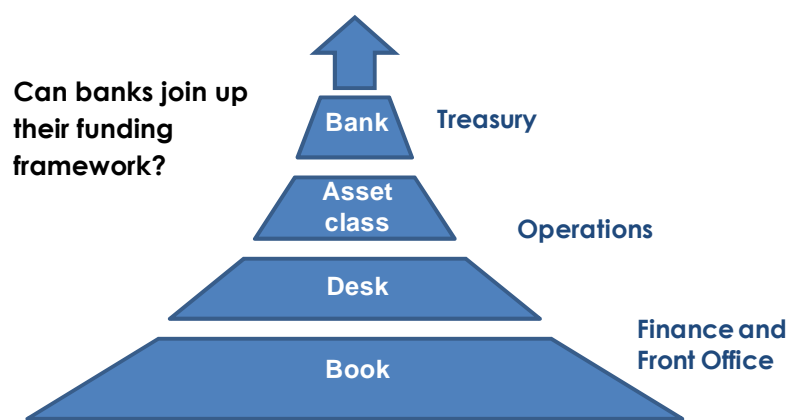
## Internal Funding Framework

While the relevant Consultation Paper (CP 08/22) does touch on banks' internal funding frameworks, this remains peripheral. A consideration of the pricing of funding liquidity in the business decisions driving sales (i.e. asset accumulation, specifically across the 'Product Pricing', 'Approval Process for New Products' and 'Performance Measurement' policies within organizations (5)) albeit 'explicitly and clearly', does not fully address the opportunity for firms to develop a comprehensive framework for internal funding.

Just as capital allocation decisions affecting Front Office business units need to account for the cost of that capital (in terms of return on Regulatory (RWA) and Economic Capital), so Funding decisions exercised by Corporate Treasurers carry significant implications for Sales and Trading teams at the coal face.

It is crucial that the price at which cash is internally transferred within institutions reflects the true economic cost of cash (at each maturity band), thereby aligning commercial propensity to maximize profit with the correct maturity profile of associated funding. Any mismatch after taking into account the 'repo-ability' of each asset class in question, should be highlighted and acted upon as a matter of priority with the objective to reduce recourse to short term, passive funding as much as possible.

There is plenty of evidence suggesting that this was not the case during the credit boom (6). If the cost of funds is set incorrectly, there is a risk that transactions are entered into that



produce an inflated profit. One bank persistently skewed its internal funding model, but did not address this because a more realistic model was viewed as a "constraint on the growth strategy".

Joined up thinking between Controlling and Front Office departments needs to include the view

from Operations as well, where Funding Projection and Cash Management teams work to ensure the institution carries a flat cash position at the end of the trading cycle (7). The need for greater cohesion perhaps even centralization to enforce greater collaboration between these groups becomes compelling given the impact of any disparity between perceived and actual views of the world on lost opportunity and direct interest rate costs.

It is vital that the internal funding framework is transparent to all trading groups, and is supported by effective processes and technology. - For example, timely data transfer between front office and Settlement systems, and from external Correspondent/ Agent banks is critical, and must be underpinned by cash flow information that is sourced from the General Ledger.

With the cost of inter-bank lending still touching record highs, allied to the size (notwithstanding recent disposals and write downs) of the balance sheets of the major banks (that are in excess of USD 1 trillion), a slip of a single basis point in funding efficiency can lead to millions being wiped off the bottom line.

**Conclusion**

As organizations size up the cost of compliance with the current Regulatory soup being served up by the FSA, it may be worth them looking beyond the literal scope of the new supervisory fiat to consider the internal determinants of an efficient, cost effective funding regime. In this way they can move towards the heart of our proposition – to bring funding right into the corporate DNA of financial institutions.

For further information

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