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Checks and Balances
The Banking Treasury’s New Role After the Crisis

Peter Neu and Michael Widowitz
May 2011
In order to explore the actions that European banks have taken in response to the shifting financial landscape—and the steps still needed—The Boston Consulting Group conducted a survey of 17 financial institutions, placing special emphasis on the treasury function and its evolving role in the postcrisis era.

**Survey Results: How Banks Are Reacting to the New Playing Field**
As a result of the financial crisis, banks have developed considerable sensitivity to liquidity risk. The pricing of liquidity in internal funds-transfer-pricing systems has become a top agenda item for many institutions. Regional banks tend to favor a market-oriented organization model, in which the strategic treasury function reports to the head of capital markets, whereas global banks typically adopt a CFO-oriented model, in which the strategic treasury function reports to the chief financial officer (or sometimes the chief risk officer).

**What Banks Still Need to Do**
The treasury function of European banks needs to take three critical steps: further improve liquidity risk management, sharpen treasury governance and operating models, and take a strategic approach to balance sheet management.
THE GLOBAL FINANCIAL CRISIS may have peaked, but the banking landscape has shifted significantly. Many critical departments within banks—notably those overseeing treasury and risk functions—must adapt to a new playing field, which reflects the following developments:

- Financial resources, both funding and capital, have become scarcer.
- Liquidity risk and the cost of liquidity have become primary concerns.
- Regulatory changes prompted by the crisis are starting to have a measurable impact.

In order to explore the actions that banks have taken in response to these realities and to identify the actions they still need to take, The Boston Consulting Group recently conducted a survey of European banks. The survey involved 17 financial institutions from Austria, Germany, Italy, Switzerland, and the U.K. In conducting the survey, we placed special emphasis on the treasury function and its evolving role in the postcrisis era.

This report examines in considerable detail how the crisis has changed the banking landscape and how banks are reacting (as indicated by the responses to our survey). We also present further actions that banks need to take in order to gain a competitive edge.

The Crisis: A Wake-Up Call That Is Still Ringing

Prior to the global downturn, the financial landscape was characterized by ample market liquidity (especially in money markets), low volatility, and narrow funding spreads. Short-term funding, which was available at relatively low cost, could be rolled over easily. Capital investors were attracted by promising returns that could be gained from equity shares in banks. Overall, cheap funding, combined with an optimistic assessment of the inherent risks in the system, led to a material increase in both balance sheet size and the structured-product portfolios of banks.

The crisis, of course, prompted a widespread reassessment of risk linked to financial institutions. Growing skepticism over the credit quality and liquidity of structured-product portfolios soon evolved into doubts about the overall integrity of banks’ risk-management functions. Indeed, the interdependence among banks—and the concern that liquidity problems at some would lead to similar problems at others—
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brought the concept of systemic risk to the fore. Not only did the public begin to mistrust banks, but banks also began to mistrust each other. As a result, the inter-bank market virtually dried up. Markets for structured products became illiquid. Private investors stepped back. In order to avoid a meltdown of the entire global banking system, governments were forced to adopt the role of lender and investor of last resort.

In the future, the abundant liquidity provided by central banks will gradually decrease as markets slowly regain confidence and new regulatory measures come into effect. The Basel III measures, published in December 2010, focus strongly on the redefinition of core regulatory capital and adjustments of risk-weighted assets. These measures will force banks to manage their scarce resources more wisely. Basel III also introduced liquidity ratios for both the short term (liquidity coverage ratio, or LCR) and the medium to long term (net stable-funding ratio, or NSFR), as well as a set of monitoring tools. (See the sidebar “The New Regulatory Regime” for a more detailed description of the Basel III measures.)

Yet as regulators and governments continue to search for ways to prevent another systemic crisis, how are banks reacting today to the significant changes in their industry? Our survey indicates a wide range of behaviors.

Survey Results: How Banks Are Reacting to the New Playing Field

Although the new liquidity requirements are soon to take effect—observation of both LCR and NSFR by regulators is to begin on January 1, 2012—the implementation of these measures was still rare within our sample. A majority of our survey participants reported that although they had taken some steps toward meeting the new standards, full implementation had not yet taken place. Also, many expected a relatively high degree of IT complexity to be involved in moving forward.

Our survey also provided an assessment of the steering and result reconciliation methodology that the treasury function currently uses, particularly regarding the economic (present value) view compared with the international financial-reporting standards (IFRS) accounting view. Even though the IFRS view shares some similarities with the economic view, there are natural differences that arise from IFRS categorizations and the way that hedging effects are considered within the IFRS rules. Hedging decisions differ significantly depending on which steering view prevails. Usually, the local generally accepted accounting principles (GAAP) view deviates even further from the economic view.

Our survey showed that the IFRS accounting view is the dominant steering metric of most European banks. Yet the clear tendency of many banks to consider both IFRS and the economic impact of steering decisions results in frequent reconciliations between these two views. Reconciliation between the IFRS and local GAAP views is more typical of regional than global banks.

Liquidity Risk. It is safe to say that liquidity risk has long been underestimated or overlooked. The Senior Supervisors Group, in a March 2008 report titled Observa-
In the aftermath of the financial crisis, the Group of Twenty (G-20) countries decided to reform current regulatory standards with the aim of preventing future crises. This was the impetus for a broad range of regulatory initiatives on issues as diverse as remuneration, short selling, and bank resolution. The most important global initiative of the new regulatory landscape is Basel III, which was published in December 2010.

Basel III increases both the quantity and the quality of regulatory capital that banks must hold. Furthermore, additional ratios for liquidity and leverage will be introduced as minimum standards following their respective observation phases. The new requirements for capital, liquidity, and leverage are expressed as ratios. Four of them are critical to understanding Basel III: the capital ratio (core Tier 1 capital to risk-weighted assets, or RWA); two liquidity ratios—the liquidity coverage ratio (LCR) and the net stable-funding ratio (NSFR); and the leverage ratio (Tier 1 capital to an adapted total-assets figure).

Basel III differentiates among three types of capital: core Tier 1, Tier 1, and Tier 2. Under Basel II, banks had to fulfill a minimum capital (core Tier 1) ratio of 2 percent, a minimum Tier 1 ratio of 4 percent, and a total capital ratio of 8 percent. Basel III raised the capital (core Tier 1) ratio to 7 percent of RWA. This 7 percent consists of an absolute-minimum ratio of 4.5 percent and a capital conservation buffer of 2.5 percent. If a bank’s capital ratio falls below the threshold required by the capital conservation buffer, regulators are allowed to intervene in certain corporate-governance decisions, such as the level of dividend distribution. Furthermore, Basel III increases the minimum Tier 1 ratio to 8.5 percent and the total capital ratio to 10.5 percent. Another buffer—the so-called countercyclical buffer, which would tack on up to 2.5 percent of additional core Tier 1 capital in times of above-trend credit growth—is under discussion.

In addition to raising the capital ratios, Basel III also strengthens the quality of capital by requiring common equity as the core constituent of core Tier 1 capital. At the same time, there will be three additional changes: RWA for market risk exposure, counterparty risk, and financial-institution exposure will all increase.

For a sounder approach to managing and supervising liquidity risks, two new ratios are being introduced: the short-term LCR and the NSFR for the medium to long term. While the short-term ratio focuses on cash inflow and outflow in relation to available liquid assets—assets that would provide cash even in a high-stress scenario—the long-term ratio weighs available funds with regard to stability and compares that relationship to the refinancing needs of assets. The intention is to limit maturity transformation to a reasonable level.

The leverage ratio compares Tier 1 capital with total assets and off-balance-sheet (OBS) positions. OBS exposures are recognized with a 10
percent conversion factor. The reported leverage ratio is calculated as the average over the duration of a quarter.

To give banks time, regulatory authorities have provided transition periods during which the new regulatory standards are to be introduced gradually. In a nutshell, the new minimum requirements will be fully implemented by 2015, while regulatory deductions will be fully implemented by 2018. Silent participations will be phased out gradually over a ten-year period starting in 2013. Public-sector capital injections other than common-equity injections made during the financial crisis can be taken into account only until 2018. The new ratios for liquidity and leverage will be introduced after an observation period. For LCR and leverage, the observation period will start in 2012 (this assumes that banks will be able to provide the respective data); likewise for the NSFR. The NSFR and leverage ratio should become effective as minimum requirements in 2018, while the LCR is scheduled for introduction by the beginning of 2015.

Regulations now require banks to deal not only with capital as a minimum standard but also with leverage and liquidity. The technical implementation of liquidity requirements will put resource demands on banks not seen since the introduction of the Basel II internal rating-based approach. Ultimately, liquidity and leverage must be included in bank-wide steering processes and taken into account as part of a bank’s overall strategic planning.

In the wake of the crisis, however, banks have developed considerable sensitivity to liquidity risk. According to our survey results, banks typically have a large number of liquidity risk metrics in place, the two most common being liquidity gap and liquidity reserve. (See Exhibit 1.)

Obviously, when it is managing liquidity across a large number of regions, regulatory climates, currencies, and legal entities, a bank treasury needs both to monitor the group’s overall liquidity position and ensure sufficient liquidity in each local market. Abundant liquidity in one region or currency may not be enough to prevent default in another, since liquidity is not always readily transferable. Time delays, currency exchange issues, and national regulations mandating that certain
funds stay within specific countries are a few of the reasons why liquidity should be managed “from the bottom up.”

In addition to carrying out analyses to determine the potential for liquidity gaps, a majority of the banks in our survey employ the concept of a liquidity reserve. This reserve consists of high-quality and highly liquid assets that allow institutions to raise liquidity within a very short time frame. Because holding such assets imposes additional costs on banks, a key task of the treasury function is to define both the adequate size and the composition of the liquidity reserve. In order to do this, banks typically consider the size of their undrawn commitments, the impact of unforeseen deposit drawdowns, and other potential cash outflows. They also look more at behavioral maturity—customers’ tendencies to consider withdrawal of their financial assets during periods of stress—than at contractual maturity. (See Exhibit 2.)

For defining the composition of the liquidity reserve, central-bank eligibility is the main criterion. This leads to increased dependence on central banks, especially during periods of stress. Some global players seek additional quality criteria, such as repurchase collateral eligibility. Most banks fund their liquidity reserve for at least 12 months. (See Exhibit 3.)

Moreover, effective management of liquidity risk involves creating “what if?” stress scenarios, as well as forging clearly defined contingency plans in the case of an extreme event. Most banks in our survey run regularly scheduled scenario analyses,
considering idiosyncratic institution-specific behaviors, systemic behaviors, and combinations of both. Scenarios that integrate the effects of an extreme event across different risk types are less common, suggesting that there is ample room for improvement. One of the principal challenges is overcoming cross-functional boundaries within a bank’s risk and treasury organization.

The key elements of contingency plans are carefully planned actions, effective governance, and clear communication. In general, global players focus on measures that have an impact on the size of the balance sheet (such as the level of asset sales and the collection of liabilities). The emphasis is on being able to survive a crisis through the bank’s own actions. The contingency plans of regional banks are less elaborate. In particular, the triggers for putting key measures into action are frequently unclear, and potential measures are less clearly defined.

**Liquidity Cost.** Ultimately, ensuring sufficient liquidity for stress scenarios is a goal that most large banks can meet if they are willing to make the necessary investment. Banks need to make sure that they consider the two drivers of liquidity cost—the cost of business-as-usual liquidity and the cost of contingent liquidity in

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**EXHIBIT 2 | The Size of the Liquidity Reserve Is Determined Mainly by Undrawn Commitments and Deposit Drawdowns**

<table>
<thead>
<tr>
<th>Components considered in determining the size of the liquidity reserve</th>
<th>% of respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Undrawn commitments and liquidity facilities</td>
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</tr>
<tr>
<td>Deposit drawdowns</td>
<td>0</td>
</tr>
<tr>
<td>Guarantees</td>
<td>0</td>
</tr>
<tr>
<td>Margin payments and collateral agreements</td>
<td>0</td>
</tr>
<tr>
<td>Payment and settlement requirements</td>
<td>0</td>
</tr>
<tr>
<td>Other specific contingent outflows</td>
<td>0</td>
</tr>
<tr>
<td>Working capital</td>
<td>0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Maturity considered for reserve calculation</th>
<th>% of respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contractual maturity</td>
<td>0</td>
</tr>
<tr>
<td>Behavioral maturity in times of stress</td>
<td>100</td>
</tr>
</tbody>
</table>

stress scenarios—in their day-to-day business decisions. An effective way to accomplish this is by incorporating liquidity cost into internal funds-transfer-pricing (FTP) schemes.

Our survey shows that nearly all banks have FTP schemes that consider both assets and liabilities, use asset- and currency-specific funding curves, and apply behavioral adjustments. Marginal funding costs are more frequently employed than actual funding costs.

Finally, judging from our survey, it can be considered standard practice to apply “behavioralization”—reviewing contractual maturities through a behavioral lens so that they more accurately reflect the true liquidity of various assets—to FTP modeling. But the specifics of the applied models are subject to heated debate. Although there is a tendency in the market to fund new assets on the basis of marginal funding costs, a number of players, especially global banks, also use actual funding costs or a blended model. Their rationale is that the true costs of funding need to be matched and allocated to specific businesses to ensure efficient steering decisions.
Governance. To work as intended, any given FTP scheme should be embedded in an appropriate governance structure that considers two dimensions: the organization model and the operating model (including cross-functional governance) of the bank’s treasury function.

Our survey revealed two basic organization models among European banks. The market-oriented model, in which the strategic treasury function reports to the head of capital markets, is found mainly in regional banks. The CFO-oriented model, in which the strategic treasury function reports to the chief financial officer (or sometimes the chief risk officer, or CRO), is typically adopted by global banks. In this model, the money- and capital-market treasury activities are linked more closely to the head of capital markets. Of course, no bank’s organization model exactly matches either of these prototypes. Variations occur according to company-specific characteristics. (See Exhibit 4.)

The advantages of the market-oriented model include closeness to markets (for example, access to trading and product knowledge), as well as optimal matching of policy setting and policy execution (operational activities). Shorter decision-making processes are an added benefit.

There are also advantages to the CFO-oriented model. These include the ability to concentrate all policy-setting and operational measures for overall bank management at the CFO level, clear prioritization of organization-wide targets over business unit targets, and the combining of strategic and funding priorities (with a focus on overall bank management).

In addition to choosing the right organization model for the treasury function, banks must forge an adequate operating model. The tasks and goals of each unit that performs treasury-related functions (as well as the interfaces among units)
need to be clearly defined. Roles must be differentiated, risk transfers agreed upon, and market access standardized. Finally, a coherent approach that links the defined tasks with an incentive structure (cost center versus profit center, economic P&L versus accounting P&L) is required.

About half the banks in our survey run asset and liability management and liquidity management as profit centers. Many regional banks run overall bank-management units as profit centers if they are assigned to the head of capital markets. At global banks, profits from balance-sheet structure management (for example, maturity mismatches) are usually attributed to the corporate center and not booked to profit centers.

Furthermore, global players typically establish their secondary-market units as profit centers. Direct market access is usually given to syndication and securitization units. Capital-market units (such as money-market, derivatives-market, and swap desks) are usually, by their nature, run as profit centers. In most cases, desks that are run as profit centers have market access. A swap desk for the trading book has greater relevance for global players, as it is frequently the unit that manages interest risks. A swap desk for the banking book is more important for regional banks, because the relevance of the banking book is higher for these banks.

In our view, banks need to set up cross-functional governance and establish strong asset-liability committees (ALCOs) that conduct frequent meetings with representatives of both business and steering functions. ALCOs need clear agendas that cover resources, risks, and business strategies—as well as liquidity and funding. The goal is to position the ALCO as the central forum for managing all financial resources (capital and funding) on the basis of a given risk profile (RWA and economic capital) and liquidity needs (short-term and structural). The ALCO should serve as an information and decision forum for planning and controlling, resource needs and allocation, and transfer pricing and portfolio management.

In the majority of the banks in our survey, especially the global players, most treasury and risk topics are discussed in the ALCO. (See Exhibit 5.) Treasury topics are also discussed in some risk committees (RICOs). What’s more, global players tend to use the ALCO for integrated discussions of treasury topics—such as balance sheet size and composition, FTP, and interest-rate risk management—while regional banks often manage these topics without committee discussion. Regional banks have fewer discussions on liquidity, balance sheets, and capital in their RICOs than do global banks, meaning that the CRO function has less relevance for overall bank management.

Our survey shows that almost all players have an ALCO that meets once a month, usually involving the participation of the entire top-management team: CEO, CFO, CRO, and the heads of capital markets, corporate and investment banking, and the various other business divisions.

**Information Technology.** It is important to note that the most sophisticated treasury operating model will be fruitless if it cannot rely on an IT infrastructure that provides transparent, timely, and comprehensive data on the bank’s overall
liquidity, currency, and interest positions. Roughly 70 to 80 percent of our survey participants were able to provide a clear view of such data on a daily basis, and those that were not yet able were working hard to get there. However, the picture gets foggier when it comes to some other types of data. Although most banks are able to generate an overview of collateral-eligible assets, only global players are, in general, able to pull available eligible assets out of their systems and provide IT-supported transparency. Some regional banks can reach these standards, but they do so with considerably less ease.

Finally, it is also important to note that the majority of the global players in our survey rely on in-house IT solutions for their treasury management. Regional banks, by contrast, often use one or several of currently available commercial systems.

**What Banks Still Need to Do**

Given the significant changes to the overall financial landscape, what are the primary implications for a bank’s treasury function? In our view, the treasury function needs to act on three critical imperatives:

- Further improve liquidity risk management.
- Sharpen treasury governance and operating models.
- Take a strategic approach to balance sheet management.

**Further improve liquidity risk management.** Despite progress in recent years, there is still ample room for improvement among many banks. For example,
structural liquidity-management metrics are just starting to make their way into the CEO suite. Such metrics should be more widely used in order to actively influence business decisions that will ultimately have liquidity implications.

Moreover, all banks should conduct deeper analysis of stress scenarios, integrating the effects of contagion. Smaller and regional banks need to advance their FTP systems and contingency planning in order to prepare for the possibility of another liquidity crisis.

**Sharpen treasury governance and operating models.** The increased complexity of today’s banking and financial landscape makes it harder than ever to clearly separate responsibilities across large organizations. Banks need to establish units that coherently manage all financial resources (capital and funding) more from a balance-sheet and less from a P&L perspective. Banks also need to enhance their cross-functional capabilities by increasing the scope and mandate of committees such as the ALCO.

**Take a strategic approach to balance sheet management.** In the strategic business-planning process, the primary focus should not be on the development of assets alone. There should be clear links between assets and liabilities, the uses and sources of funding, and all implied maturities. The treasury function should step up to the strategic-planning process, since certain elements that are heavily influenced by treasury—such as funding, liquidity, and balance sheet size—have gained a higher profile since the crisis.

Indeed, it is now clear that banks must involve the treasury function much earlier in the process of mapping out overall strategic direction. Treasury should come to see itself as a more active business partner that can help determine which terms and currencies are favorable from a funding point of view and which assets are required. Furthermore, treasury can lend its voice to the continuous monitoring of the business, helping to decide when and where action is required.

In summary, the global financial crisis has brought the role of the bank’s treasury function increasingly into the limelight. Scarce resources, increased liquidity risk, high complexity, and the need for integrated management of banking assets and liabilities are shaping today’s decision-making processes in major financial institutions. As BCG’s Treasury Survey 2010 has shown, enterprise-wide steering responsibilities are more prominent on the agendas of banking treasuries than ever before. And evolving regulatory standards will drive complexity for years to come.

As a result, banks must review their treasury function thoroughly, revisiting strategic-planning methods, reevaluating collaboration mechanisms, and retooling organization and operating models. They should adjust their risk- and performance-management metrics, stress-testing techniques, transfer-pricing systems, and decision-making processes. Technological and data quality hurdles will also have to be overcome. Only those banks that recognize the need for improvement and take decisive action will be able to adapt and optimize their treasury function for the new environment.
For Further Reading
The Boston Consulting Group has produced a number of White Papers and Discussion Papers on risk management, including the following:

Liquidity Risk Management: Managing Liquidity Risk in a New Funding Environment, May 2009, revised October 2010


Impact of Regulatory Headwind, January 2010

Operational Risk Management: Too Important to Fail, February 2009

New Risk Regime, December 2008

All Dried Up: The Impact of the Subprime Crisis on Liquidity Risk Management, April 2008


The Subprime Crisis: Do Not Ignore the Risks, September 2007

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Acknowledgments
This report and the underlying BCG Treasury Survey would not have been possible without the cooperation of the participating banks, as well as the support of BCG’s Financial Institutions practice. The authors would especially like to thank Benjamin Friedrich, Achim Glaser, Hans Knoth, Sonja Meierl, Kai-Oliver Müller, Oliver Pauly, and Patrick Uhlmann, for their support in preparing and evaluating the survey, as well as Duncan Martin and Pascal Vogt for their overall contribution on treasury-related topics. The authors would also like to thank Philip Crawford for his editorial direction, as well as other members of the editorial and production staffs, including Gary Callahan, Elyse Friedman, Kim Friedman, and Kirsten Leshko.

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