Impact of recent market events on Banks’ Treasury

March 2023

Considerations for Treasury

In light of recent market events, combined with the cycle of rising interest rates, we've outlined below the immediate considerations for Banks' Treasury and Treasury Risk functions

Background

March 2023 saw the collapse of several banks following significant deposit outflows triggered by a loss of confidence and the following **contributing factors**:

- Funding mismatch (fixed vs floating rate) and duration gap risk (long-term vs short-term)
- Concentrated funding and deposit outflows in excess of regulatory and stress scenarios
- Minimal hedging against rising interest rates and negative impact on valuations of investments
- Inadequate risk and control framework particularly for liquidity and interest rate risks

Despite injections of liquidity, market confidence continued to erode amid concerns across the banking sector.

Potential regulatory responses

- Review of existing and proposed **regulatory requirements** applicable to small to medium institutions, with additional regulatory requirements and actions (such as level of insured deposits guaranteed) across the industry
- Enhanced **supervisory scrutiny** over duration profile for investments, funding profile (including deposits not covered by guarantee schemes), funding concentration, and hedging of duration mismatch
- Increased frequency of capital and liquidity **regulatory reporting** and ad-hoc requests for further information (such as unrealised gains/losses and impact on capital and liquidity ratios)
- Review of existing **accounting rules** and requirements for investments held at amortised cost rather than at fair value (FVOCI or FVTPL), which resulted in material unrealised losses
- Increased regulatory focus on potential impact of group risk on **UK subsidiaries** of overseas Banks

Immediate considerations

- **Continue to monitor** the fair value of investments for further deterioration and review all unhedged positions
- Review the **investments** (which are not measured at fair value and marked-to-market) and monitor the available capital against any unrealised losses to P&L
- Monitor the liquidity risk drivers, assumptions and liquidity stress testing **outflow** factors applied due to deposit withdrawals, collateral outflows, etc.
- Assess any funding requirements and strategy with associated higher cost of **funding** and potential further impacts on P&L
- Identify **exposures** to any bank(s) experiencing idiosyncratic risk and immediate potential impact on liquidity, funding & capital

Further considerations

- Once Banks have taken immediate actions, Treasury and Treasury Risk functions need to **shift focus** to the core areas of Asset Liability Management, Liquidity Management, and Capital Management

Considerations for Treasury

In addition, below are the short-term and longer-term considerations for Banks' Treasury and Treasury Risk functions, covering the core areas of Asset Liability Management, Liquidity Management and Capital Management

Short-term – Asset Liability Management

- Assess stability of **funding** profile, identify concentrations, short term funding strategy and identify deposits not covered by guarantee schemes
- Assess overall **funding** mismatch (long-term assets funded by short-term liabilities) and duration profile of investments
- Assess **funding** impacts (including any increase in funding costs) and impact to other lending portfolios
- Identify potential impact of **capital and liquidity** positions in the event of higher than normal outflows of deposits
- Identify and pre-position high-quality, unencumbered and central bank eligible **collateral** that could be utilised for funding

Short-term – Liquidity Management

- Review liquidity assumptions for cash inflows and **outflows** in line with regulatory guidance, considering actual realisation in current market conditions and potential further adverse impacts
- Assess **liquidity metrics** (e.g., LCR, NSFR, internal EWIs) against regulatory and internal limits and thresholds
- Conduct **internal stress test** with identified idiosyncratic risk and market scenario for impact on metrics, buffer & survival period
- Test the **monetisation** period for HQLA based on current market conditions to estimate impact on prices and applicable haircuts
- Identify proportion of **illiquid investments** in the portfolio and apply severe haircuts for actual realisation in current market

Short-term – Capital Management

- Assess **capital metrics** across different risk types (e.g., CET1, RWA, Leverage) against the Risk Appetite and Limit Framework
- Review any **capital deterioration** due to current market conditions against the bank's internal and regulatory minima, and potential further impacts
- Conduct **internal stress test** with identified idiosyncratic risk and current stress market scenario for impact on risk and capital metrics against regulatory and internal limits
- Review the **Interest Rate Risk in Banking Book** (IRRBB) through regulatory metrics (i.e., EVE and NII) and conduct further EVE assessment with market value of the investments held

Longer-term considerations

In the longer-term banks should review and enhance:

- **ALM framework** and diversify funding base to reduce concentration risk and balance short-term/ long-term mix
- **Interest rate risk** management (across duration/gap risk, basis risk, option risk and credit spread risk)
- **Liquidity risk** management (specifically for duration profile of investments and short-term liquid assets)
- Controls and **metrics** for investments (including risk appetite and limit framework)
- Monitoring **unrealised losses** on investments and potential impact on liquidity, funding & capital
- **Hedging** policy, strategy and framework for managing interest rate risk and longer-term investments

Further considerations

- Banks' Treasury and Treasury Risk functions need to consider the above **relative to** the bank's size (systemically important or regionally focused), risk (exposure to certain markets, concentrations), and product profile (retail vs investment banking)
- In light of this, banks should **perform reviews** across the core areas of the Treasury framework – Asset Liability Management, Liquidity Management and Capital Management

How we can support

Our Deloitte Treasury team has deep technical understanding, wide-ranging level of experience and industry insights. We can support with reviews across all components of the Treasury framework as represented below

Our areas of expertise

Forecasting and Stress Testing

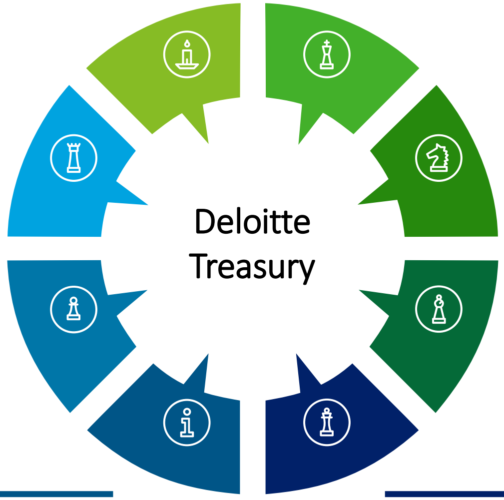
Cash, liquidity, capital and funding forecasting, stress testing and reviews of assumptions under idiosyncratic, market and combined scenarios inc. development of internal stress and link to RST

Liquidity Management

Liquidity optimisation, forecasting and stress testing, intraday liquidity, collateral management, ILAAP reviews, regulatory reporting, and contingent liquidity plan

Funding Management

Funding strategy, funding plan, funds transfer pricing, funding execution, debt and equity issuance, funding in resolution, and integrated capital, liquidity and funding framework



Capital Management

Capital optimisation, forecasting (RWAs and leverage) and stress testing, Pillar 2, ICAAP reviews, regulatory reporting, and integrated capital, liquidity and funding framework

Asset and Liability Management

Balance sheet optimisation, management of duration/ gap risk, hedging strategy, framework, and implementation, and structural FX management

Interest Rate Risk Management

Assessment for duration/gap risk, basis risk, option risk and credit spread risk, regulatory (EVE, NII) and internal metrics, and hedging framework and implementation

Regulatory Reporting

Definition of regulatory requirements, regulatory interpretations, methodologies and calculations, policies and frameworks, and governance and controls

Treasury Management

Transformation and operating models, 1st and 2nd line roles and responsibilities, trading mandates, cash management, and payments and settlements

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