

Liquidity Optimisation

ABI Supervision, Risks & Profitability

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The EY logo is positioned in the bottom right corner of the slide. It consists of the letters 'EY' in a bold, white, sans-serif font. A yellow triangle is located to the right of the 'Y', pointing towards the left. The background of the slide is a photograph of a modern office meeting room with large windows and people seated around a table.

Building a better
working world

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1 | Setting the scene: recent market developments

Deposit growth has outpaced loan growth, largely due to Covid-19, and contraction of QE programs will tighten money supply from record levels which reduces liquidity. **Banks should be profiling how their structural liquidity and funding risk profile have shifted.**

Europe has reached some of the highest levels of inflation within the last 40 years leading European Authorities to raise rates by >350bps in the last 12 months and banks to assess their models, assumptions, strategies and reporting capabilities to manage this environment effectively.

Banks' existing structural hedging strategies have generally sought to exploit the lower-for-longer interest rate environment. **Banks should be adjusting their hedging strategies to mitigate IRRBB and protect their balance sheet.**

Rising rates have seen customers switch into higher-yielding products like term deposits or money market funds, leading to out-flows or the terming-out of bank liability profiles. **Banks need to be monitoring the rapidly-changing shape of their balance sheets for interest rate purposes.**

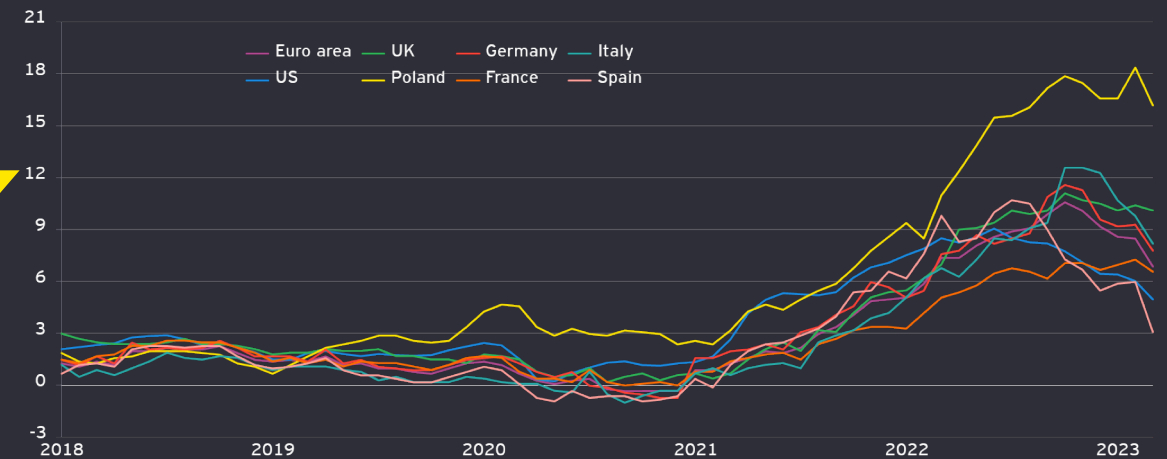
Increased inflation is putting pressure on business and retail customer current account balances, reducing access to stable, sticky funding. **Banks should be monitoring the development of the rates cycle and the possibility that central banks could be forced to cut rates rather than raise them if inflation falls more quickly than anticipated.**

In the digitalized world, social media news coverage spilled over the panic, accelerating the pace of deposit withdrawals. For SVB, high sector concentration in corporate deposits further increased the liquidity stress. **Banks should set up controls to monitor reputational risks, revisit sector concentration risk in funding and apply these to liquidity risk analyses.**

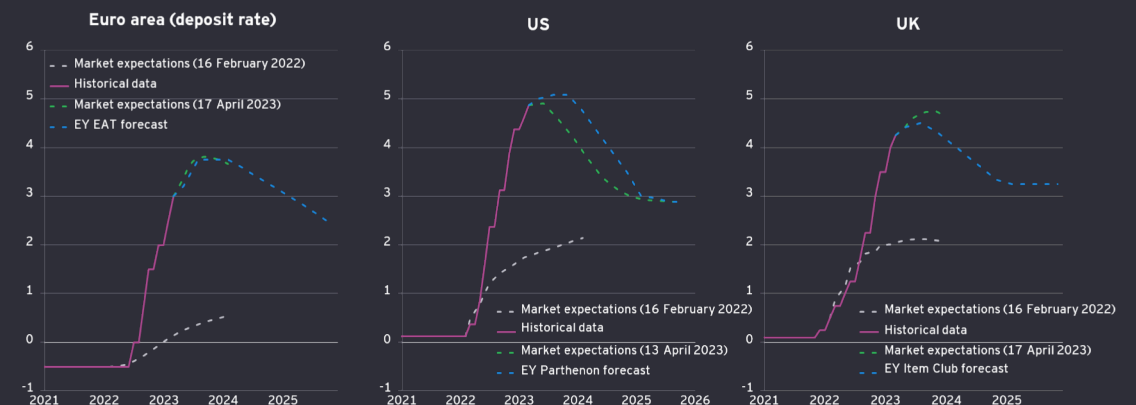
Changes to liability profiles and increased liquid asset requirements impact net interest margins. Banks should be considering the knock-on impact on cash generation and capitalization.

Banks facing material IRRBB (due to unrealised HtM security losses, changes in deposit duration, etc.) create a risk at the intersection of IRRBB and Liquidity Risk. **Banks should be stressing IRRBB modelling assumptions with liquidity considerations to reduce the compounding effect of realising each risk type.**

Inflation (YoY Percentage)



Historical and expected central bank interest rates (in percentage)



2 | Key capabilities that banks should enhance

In the rising interest rate environment, banks should re-assess the maturity of their Treasury function. The maturity evaluation should cover their models, assumptions, reporting and reaction capabilities to have effective liquidity risk management in the digitalised world. Structural risks are now more explicit with banks re-evaluating the appropriateness of risk appetite, tolerances and monitoring capabilities in the evolution of stress events.



Steering the on/off balance sheet and income statement

- Treasury operating model on liquidity portfolio and related IRR, hedging, forecasting, planning and stress testing
- Optimizing liquidity buffer composition and the cost of funding with liquidity constraints
- Cash flow mismatch for different currencies
- Liquidity Planning



Governance

- Effectively operating LoD model
- Liquidity risk LoD capabilities in line with the size and complexity of the business
- Recalibration and revalidation of Balance Sheet risk limits and revisiting subsidiary/group limits
- Communication plans to deal with a contemporary bank run



Stress testing capabilities

- Liquidity Stress test assumptions on deposit run-off
- Recalibration of liquidity stress testing models in the rising interest rate environment
- Reputational risk from both operational and liquidity risk perspectives



Data quality and technology architecture

- Data and IT system infrastructure to capture liquidity developments on demand
- Flexible Treasury Risk Dashboard capturing liquidity, interest rate, FX and solvency risks
- Integrated TMS, Risk and Payment Systems

3 | Short term actions

We have crafted a series of recommendations about how banks can approach liquidity risk management within the wider construct of a maturity assessment.

In summary, they are:



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Steering the on/off balance sheet and income statement

The key issue

Market uncertainties and higher rate environments necessitate a reassessment of IRR and Liquidity management, models, assumptions and balance sheet strategies to manage this environment effectively. Banks should manage actively their regulatory requirements. All liquidity and funding processes should be oriented to the Risk/Return profile optimization; in addition, the FTP framework must be coherent with business strategies to allocate the correct financial cost.

Key questions for banks

- **Investment portfolio:** What are the key drivers for the constitution of the investment portfolio? Is the constitution of the Liquidity Buffer an endogenous process within the investment portfolio? Is the liquidity portfolio considered within the Funding Plan process? Is sensitivity considered in the constitution of the liquidity portfolio? How are hedging strategies managed in the liquidity portfolio? Is there a process for optimizing the liquidity portfolio management? Is the current treatment of the investment portfolio managed consistently with the buffer and accounting methodology?
- **Funding:** Is the TLTRO replacement strategy defined? Is in place a process between Treasury and the Commercial Department aimed at drafting new funding products to be allocated? Does the institution have a cost of funding optimization process in place to impacts on P&L considering regulatory requirements (e.g.: MREL, NSFR, etc.)? Is the current Asset management process effective in secured funding and Collateral management?
- **Active Balance-Sheet Management:** Does treasury have a forward-looking view of operative and structural liquidity? Is there an integrated management between CBC and HQLA? Does Treasury have an efficient methodology to assess the impact of its business operations on Liquidity ratios forecasting? Do you set KPIs for the return on the liquidity buffer? Does the Treasury actively monitor the NMD instruments?
- **Liquidity planning:** How well does your Funding Plan reflect the actual performance? How frequently is it reviewed? Does your Funding Plan reflect TLTRO maturity impact on your liquidity and performance indicators (LCR, NSFR, AER, etc.)? How frequently do you run liquidity tests on the assets in your liquidity buffer?

An aerial photograph of a city skyline at sunset, with buildings and streets illuminated by the warm, golden light of the setting sun. The image is positioned on the left side of the slide, partially overlapping the dark background.

1

Steering the on/off balance sheet and income statement

Our recommendations

- Assess whether the treasury operating model on liquidity portfolio and related IRR hedging is fit for purpose
- Revisit optimization methodologies and tools to optimize liquidity buffer returns and cost of funding within liquidity constraints in line with the profitability targets of the business plan
- Enhance and optimize the link with Commercial department to strengthen the funding strategy
- Assess and refine Liquidity Transfer Pricing (LTP) to transfer the cost of liquidity buffer and related cost of funding that aligns with the Bank's business model and incentivises the right behaviours
- Optimization tool driven by Managerial and Regulatory KPIs
- Regulatory methodological enhancement on specific instruments
- Treasury support on defining and structuring LCR/NSFR friendly instruments

1

Focus on Optimization Process



Minimize the impacts on the Profit and Loss Account considering the regulatory and strategic requirements set out within the R.A.F.

Calculation Methodology Assessment:

Assessment on:

- Current regulatory interpretation adopted for specific instruments as follows:
 - ✓ Contingency outflows
 - ✓ Operational deposit
 - ✓ Credit lines, Collateral
 - ✓
- KRI's currently used within the RAF framework as a driver for Treasury & Liquidity Management

HQLA Portfolio Optimization:

- Framework design aimed at optimizing the trade-off between the risk and return of assets considering:
 - ✓ Liquidity portfolio sizing
 - ✓ Liquidity Buffer selection criteria and governance
 - ✓ Accounting rules treatment
 - ✓ Hedging strategies
 - ✓ Optimization rules considering market volatility, associated returns and Liquidity Buffer computability

Liquidity Optimization

New Funding structure:

- Assessment on Funding structure and related regulatory mapping
- Client segment enhancement including commercial data
- Client behavioral analysis and related synergies with IR Framework
- Treasury support on defining and structuring LCR/NSFR friendly instruments

Forecasting:

- Forecasting methodology accuracy assessment considering:
 - ✓ Scenario analysis and Assumption
 - ✓ Integration of Planning data Forecasting
 - ✓ Link with IR and related impact on NII

An optimized liquidity buffer can provide Banks with the flexibility to take advantage of new opportunities or invest in growth initiatives. Optimizing liquidity is a key task, however, the optimization can be challenging and Banks need to carefully consider their cash flow projections, risk tolerance, and regulatory requirements when making decisions about their liquidity buffer and strategic target.





2 Governance

The key issue

The new market environment characterized by a restrictive monetary policy increasingly require management to retrain Liquidity Risk Management within the bank; not merely aimed at maintaining regulatory requirements, but increasingly embedded in all decision-making processes. Governance, rather than calculation and data processing rules, will be the main focus of the regulator's future agendas.

Key questions for banks

- **Risk Culture:** How do you balance prudential responsibilities with optimizing commercial outcomes? How effective are you in assessing the yield/liquidity trade-off? Do liquidity and interest rate risk metrics have sufficient prominence in decision making?
- **Controls:** Are controls set up to manage risks in the context of digital era and social media platforms? i.e., fast pace of depositor withdrawal, prompt recovery action triggers.
- **Liquidity Transfer Pricing:** Is your current LTP methodology designed to give right incentives to Treasury and business lines? Are the cost of LCR/NSFR requirements correctly attributed to business units?
- **Capability of Liquidity Management Teams:** Do you have the right capabilities within your line of defense to effectively challenge the business? Are these capabilities growing commensurately with the size and complexity of your business?
- **Risk Appetite Statement - Contingency Funding Plan & Recovery Plan integration:** Are risk appetite statements, early warning indicators, triggers and tolerances appropriate for the business model? As part of the Recovery Plan, do you have a communication plan for internal and external stakeholders that allows making decisions in times of stress?
- **Liquidity Transfer Pricing:** Is your current LTP methodology designed to give right incentives to Treasury and business lines? Are the cost of LCR/NSFR requirements correctly attributed to business units?

Our recommendations

- Perform a holistic review of risk management frameworks to ensure LoD model is operating effectively and keeping the board apprised of key information in a timely manner
- Review of liquidity risk policies to gain comfort that capabilities are commensurate to the size and complexity of the business
- Recalibration and revalidation of Balance Sheet risk limits and revisiting subsidiary/group limits
- Reimagine communication plans to be fit for purpose to deal with a contemporary bank run
- Assess and refine Liquidity Transfer Pricing Model to charge the Liquidity Buffer Funding Cost aligned with the Bank's business Model incentives and strategies



3 Stress testing capabilities

The key issue

Stress tests measure banks' resilience against hypothetical stress scenarios and are a key part of banks' risk management framework. With the banks facing rising rates after a prolonged low-rate environment their stress tests need to consider the following:

- Speed of policy rates changes and the impact it is having on product offerings and customer behaviors.
- Impact of increased digitalization, and how stress tests scenarios consider social media's impact on spreading panic and starting a deposit withdrawal chain.
- Impact of potential changes in government policy if inflation targets are achieved sooner than expected and/or other global/local themes emerge which could impact the rate environment i.e., material change in the course of the Ukraine war.

Key questions for banks

- **Scenario Identification & Analysis:** Are the current processes to identify and design scenarios up to date and able to respond to emerging issues?
- **Data:** Is the data being used in the liquidity stress testing process complete, accurate and readily available?
- **Customer behaviours:** Are deposit modelling capabilities fully capturing customer behaviours in times of high volatility and stress in the market? Do liquidity stress testing models capture differences in retail deposit clients' behaviour for different demographics?
- **Sector concentration risk:** How well sector concentration risk in wholesale funding is incorporated in liquidity stress scenarios?
- **Modelling:** Have you recalibrated your liquidity stress testing models considering the ongoing rising interest rate environment?

Our recommendations

- Review current regulatory and stress testing methodology assumptions used for the purpose of determining liquidity reserves and required stable funding
- Consider new stress test assumptions for deposits run-off and buffer eligible assets (e.g. segment sensitivity and stickiness, sector concentration, hedging and accounting rules)
- Consider reputational risk from both operational and liquidity risk perspectives

4

Data quality and technology architecture

The key issue

As the world has become increasingly connected and digitalized, pace of moving funds has increased considerably. Banks should have the capability to monitor liquidity key risk indicators and metrics on demand to be proactive in times of stress.

Key questions for banks

- **IT system integration:** How integrated is the analysis on market, liquidity risk and IRR on the Treasury daily run? Is front-end data being effectively incorporated into Treasury/Risk & Performance Management Systems? How effective is the current Payment system/monitoring set-up?
- **Availability of data:** Does the IT architecture provide accurate, timely and complete data from various systems as well as market data and reference data to support the production and monitoring of liquidity indicators on demand? Is the IT architecture able to generate reliable risk data to meet both normal and stress reporting accuracy requirements? Is it inclusive of all on/off Balance-sheet items? Are commercial analytics integrated within the liquidity risk management framework?
- **Close to real-time reporting:** Does the stress testing framework generate rapid results? Is the trade-off between granularity and timeliness appropriate?

Our recommendations

- Ensure availability of data and IT system architecture to capture liquidity developments and metrics on demand (intraday/daily/weekly etc.)
- Use a flexible Treasury Dashboard of limits and utilizations that captures all sources of liquidity, interest rate, FX and solvency risk insights and market indicators timely
- Integrate TMS, Risk and Payment System in order to simulate immediate specific deal impact on limit metrics (e.g., repo, Securitization, Covered Bond, etc.)

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