CAIIB PAPER-2

Module-C Unit-1

Bank Financial Management(BFM)

CAIIB Paper 2 (BFM) Module C Unit 1: Introduction to Treasury Management

The Concept

- Conventionally, the **Treasury function was confined to funds management - maintaining adequate cash balances to meet day-to-day requirements, deploying surplus funds generated from operations, and sourcing funds to bridge occasional gaps in cash flow**.
- In the context of a bank, the Treasury is also responsible to meet the reserve requirements, viz. holding minimum cash balances required as per Cash Reserve Ratio (CRR) with Reserve Bank of India, and investing funds in approved securities to the extent required under Statutory Liquidity Ratio (SLR). Thus, the Treasury function was essentially liquidity management, and from an organizational point of view, Treasury was considered as a service centre.

Functions of Integrated Treasury

Integrated Treasury, in a banking set-up, refers to integration of money market, securities market and foreign exchange operations. Integrated Treasury, in the Indian context, is the direct result of reforms in the financial sector, the most important reforms being deregulation of interest rates and partial convertibility of Rupee. Rupee is already freely convertible on current account, and to a large extent, also convertible on capital account, owing to major relaxations allowed by the Reserve Bank, in the area of foreign direct investment (FDI), external commercial borrowings (ECB) and overseas direct investment (ODI) by Indian corporates, and foreign currency operations of resident Indians. Banks have also been allowed large limits, in proportion to their net worth, for overseas borrowing and investment.

We may now restate the driving force of Integrated Treasury as:

- Integrated Cash Flow Management
- Interest Arbitrage
- Access to global resources
- Corporate demand for high-end services, and
- Risk Management

Summarise the functions of Integrated Treasury as:

- Meeting reserve requirements (CRR and SLR)
- Global cash management
- Efficient merchant services, which include foreign exchange (forex) and advisory services
- Optimising profit by exploiting market opportunities in

  i)Forex market

  ii)Money market

  iii)Securities market (debt, equity and credit derivative markets)

- Risk management, i.e., managing the market risk of the bank/entity
- Assisting bank management in ALM

Treasury activity thus encompasses fund management, investment, forex operations, trading and risk management services in a multi-currency environment. To this, we may further add the evolving role of Treasury in managing the balance sheet risks, in coordination with other banking departments.

It is necessary to understand and appreciate the three distinct roles Treasury is expected to play:

- **Liquidity Management:** Treasury is responsible for managing short-term funds across currencies, and also for complying with reserve requirements (CRR and SLR).
- **Proprietary Positions:** Treasury may trade in currencies, securities and other financial instruments, including derivatives, in order to contribute to Bank's profits.
- **Risk Management:** Treasury will aid Management in bridging asset-liability mismatches (ALM), will provide derivative tools to manage risks in client's business, and will also manage risks inherent in its own proprietary positions.

The Process of Globalisation

We mentioned globalisation as a principal factor contributing to integration of treasury activity. **Globalisation refers to interaction between domestic and global markets, and may generally be defined as:**

The process of integrating domestic market with global markets, characterised by free capital flows and minimum regulatory intervention.

Funds flow on capital account may take one or more of the following routes:

- **Portfolio investment**: Foreign investors investing in domestic equity and debt markets
- **Direct investment**: Foreign companies and foreign institutional investors investing long term funds in domestic companies, new projects, manufacturing facilities, business process outsourcing etc.
- External commercial borrowings
- Issue of equity/debt in global markets
- Mergers & acquisitions - involving domestic and foreign entities
- Payment for technology transfer, royalties, financial services etc.

RBI allowed IRFs, deriving value from the following underlying, on the recognised stock exchanges:

- 91-Day Treasury Bills;
- 2-year , 5-year and 10-year coupon bearing notional Government of India security; and
- Coupon bearing Government of India security.

Further relaxations on eligibility for exchange traded IRFs were given by changing the residual maturity in June, 2015.

Evolving Role of Treasury as Profit Centre

- **Foreign Exchange Business:** Buying and selling foreign currency to customers constitutes a major source of other income' for the banks. The difference between 'buy sell rates - known as 'spread' - is the profit for the bank.
- **Money Market Deals:** Conventional banking operation in money market was confined to lending surplus funds and borrowing funds when required. Interest on funds lent in the market is a source of income, but it can hardly be called profit-as such funds come from deposits, where interest cost is higher than the interest earned in money market.

- **Investment Activity:** Banks have always been investing in government securities to satisfy the SLR requirement, but otherwise were not very active in investing in non-government securities. Income from risk-free investments was not considered to be significant. Banks have also been investing in strategic assets such as subsidiary and associate companies -- where returns on investment were only of secondary importance.
- **Profits for Contemporary Treasury:** Buying and selling foreign exchange to customers and interest on investments and money market lending, continues to be the primary source of income for bank treasuries.
- **Interest Arbitrage:** The Treasury operates across the currency and security markets; hence it is in a position to find where the interest differentials are in its favour. The Treasury may borrow in USD and lend in Rupee inter-bank market, or vice versa, depending on the domestic and foreign interest rates. Or, the Treasury may borrow in money market and invest short-term in commercial paper or T-bills.
- **Trading:** Trading is a speculative activity, where profits arise out of favourable price movements during the interval between buying and selling.
- **Treasury Products:** Treasury sells, in addition to foreign exchange services, derivatives and structured products to corporate customers. Large corporates have an appetite for new products in order to hedge their currency and interest rate risks, and at times, also to reduce their interest costs. For instance, a company may buy from the Treasury a Forward Rate Agreement (FRA) to fix interest rate for commercial paper they plan to issue after 3 months.

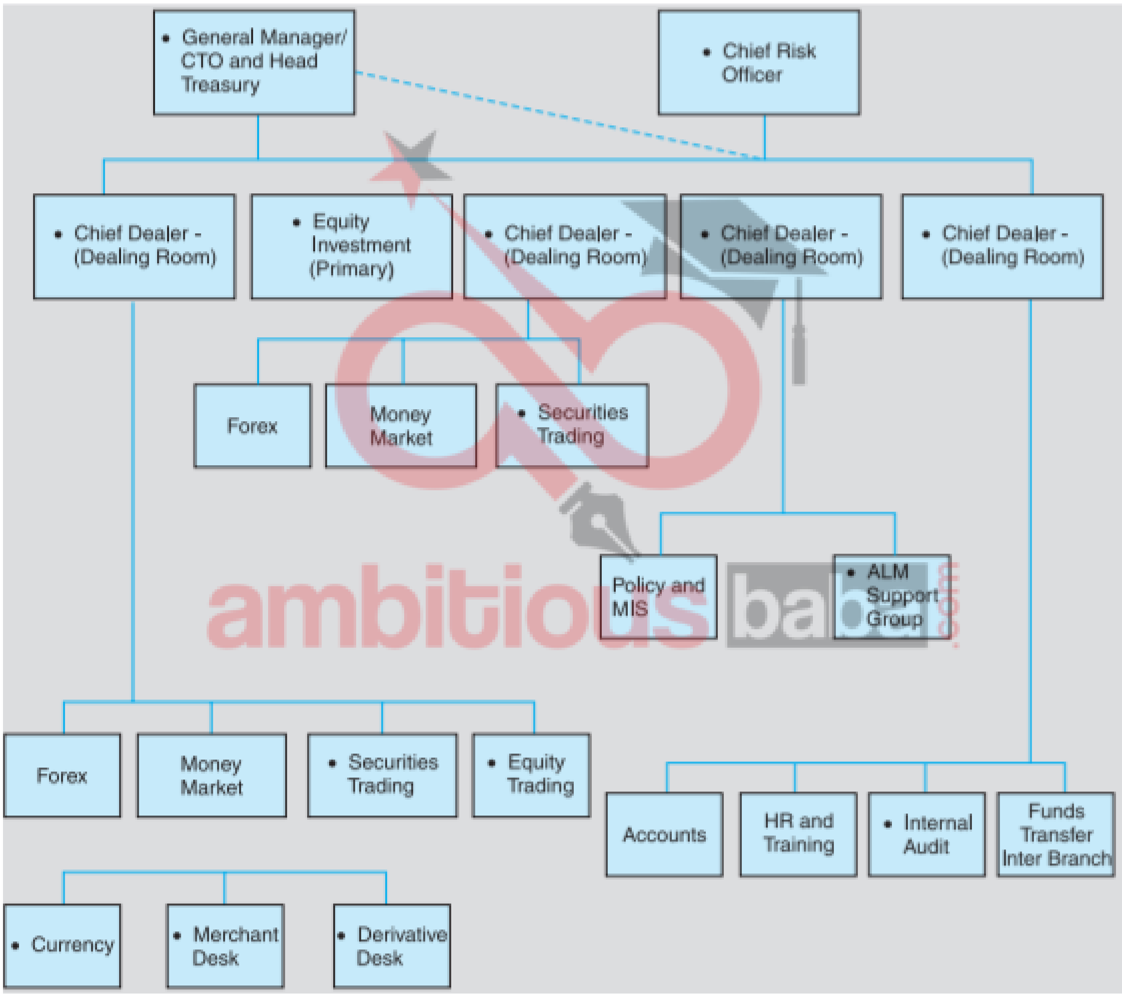
Organisation Of Treasury

The Treasury is organised either as a Department of the bank, or as a Specialised Branch under direct control of the bank's head office. In either case, the Treasury functions with a degree of autonomy, with its own accounting system. The branch status is preferred as the books of accounts of Treasury can be maintained independently (with its own P&L and GL accounts). On the other hand, the departmental form has the advantage of easier coordination with related departments at head office (such as Central Accounts and Planning Departments) in a line management.

The Treasury is segregated into three main divisions:

- The Dealing Room (or, Front Office),
- The Back Office (or, Treasury Administration) and
- The Mid-office (Risk Management).

Treasury will maintain an ALM Book, a Merchant Book and a trading Book, corresponding to its tole in balance sheet management, merchant services and trading, across the currency and security markets.



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