How to Use This Manual

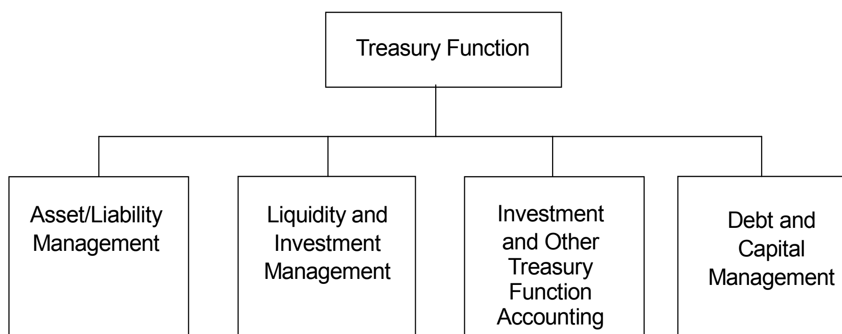
All banks — large and small — confront the same key issues. Banks are financial intermediaries. That is your business. Some in-flows and out-flows of funds are driven by customer choices, some are driven by bank choices. The sum of these cash flows creates both profit opportunities and risks.

The risks of financial intermediation cannot be avoided. You accept liquidity risk whenever you take demand deposits or short-term liabilities and invest those funds. You accept credit risk whenever you choose to hold any assets more risky than cash or direct obligations of the U.S. Treasury. You accept interest rate risk when the rates that you agree to pay for deposits and borrowings do not change in the same way and at the same time as the rates that you receive from your loans and deposits. Of course you face many other risks, such as operations risk, strategic risk, reputation risk, and compliance risks. However, those risks can be considered secondary in the sense that they mainly arise from the core activities that create liquidity, credit, and rate risk.

If you avoid all of those risks, you provide no financial intermediation services and therefore have no opportunity to earn profits from traditional bank functions. Yet if you fail to control those risks, your profits will be volatile at best.

Two of the three core risks incurred by banks — rate risk and liquidity risk — are managed by financial or treasury personnel. In many small- and medium-sized banks, this responsibility is handled by a chief financial officer. Larger banks often have a treasury function for these tasks. In this book we generally use the term "treasurer" to refer to responsible individuals and the terms "treasury department" or "treasury function" to refer to the bank areas that manage these risks.

The exact scope of the treasury functions differs from bank to bank. It depends in part on the range of activities that the bank undertakes. For example, a bank that sells deposit notes or other capital market debt instruments to obtain some of its funding has treasury functions that other banks do not have. In general, we might depict a typical treasury function like this:



The asset/liability management (ALM) function is responsible for interest rate risk management. In a very small bank, this might be the part-time job of the CFO — or even the CEO. In very large banks, this is a large department that specializes in ALM.

Liquidity risk management is shown with investment portfolio management because investment assets play a key role in liquidity management. However, responsibility managing liquidity risk may be handled in the ALM area or in a stand-alone department; it does not have to be the responsibility of the investment portfolio managers.

Treasury-related accounting functions obviously include investment accounting. They often include a host of other internal information systems, such as net interest income margin analysis. In some banks, a funds transfer pricing system is also administered by the treasury area.

Debt and capital management, including all nondeposit funding, is usually managed in this area as well. All of these tasks are discussed in detail in this manual.

Two other observations about the scope of the treasury function are important. First, the operational risks that are inherent in the management of rate risk, liquidity, and bank investments are very important. We discuss these at length in this manual. Second, the management of both rate risk and liquidity risk is inseparable from credit risk. Most financial instruments from money market investments to interest rate swaps have at least some credit risk. Even though these credit risk exposures are typically far smaller than the credit risk exposures in the loan portfolios, they are not insignificant. The management of credit risk is usually outside the scope of the treasury function, but we address it from time to time in applicable portions of this manual.

WHO SHOULD USE THIS MANUAL?

The objectives of the *Treasurer's Manual* are to propose a systematic approach to treasury management that results in greater coordination of efforts and higher profits and to serve as a reference source for areas that are critical to the treasury function.

Larger banks typically have a treasurer and a controller, both of whom report to the chief financial officer. As we noted above, smaller banks are less specialized and often combine responsibility for those functions. Only the funds management, rate risk, and liquidity functions are included in the scope of this manual. The accounting functions that are normally associated with a controller are only addressed in the context of investment portfolio management.

Regardless of the organization or the functional titles in your bank, you should find that this manual works well for the following three types of readers:

- Experienced bankers with direct responsibility for treasury functions will find many sections of this manual to be helpful guides whenever they want to improve, expand, revise or just review the management of funding, investments, interest rate risk management, liquidity management, and related responsibilities.

- Trainees and staff members with new responsibilities in funding, investments, rate risk management, and liquidity management will find sections of this manual applicable to their new duties. The manual should be both a training guide and a reference source for these readers.

- Senior managers and auditors with oversight functions related to funding, investments, interest rate risk management, and liquidity management should use this book as a reference source. Sections of this manual can be used to answer questions, provide a guide to best practices or merely as an information "refresher" when needed.

STRUCTURE OF THE MANUAL

This manual is divided into six sections that address different groups of treasury functions and responsibilities. The organization of the six sections, as well as the chapters within those sections, is designed to serve two functions. First, the material is grouped in a way that will facilitate research into specific areas. Second, the order of the topics is designed to make it easy for students to grasp the key issues and the interrelationships between those issues.

The six sections cover the following subjects:

- Part I provides an overview of the treasury function.

- Part II covers assets managed in a typical treasury function. These are mainly cash and investment assets. This part also covers liquidity management.

- Part III provides a comprehensive discussion of interest rate risk and asset/liability management issues. The chapters in this section discuss management strategies and tools, not just risk measurement and analysis.

- Part IV addresses critical earnings and capital management topics. Key issues such as managing the net interest margin are supplemented with chapters covering often under-emphasized topics, such as funding strategies, and chapters covering advanced tools such as funds transfer pricing and risk- adjusted returns on capital.

- Part V focuses on operational responsibilities in the treasury function. These include investment accounting, reporting, and the management of operations risk.

- Finally, Part VI provides sample bank policies and procedures for every major treasury function.