Liquidity Risk Management Practices

Community Bankers Forum

August 7, 2008

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Objectives

- Reasons for new guidance
- Major Differences (vs. old guidance)
- Key elements of sound liquidity risk management practices
- Examination Expectations

Why new guidance?

- **Enhance supervision of liquidity risk management**
- Old guidance was in need of improvement
- Increasing trend of liquidity risk

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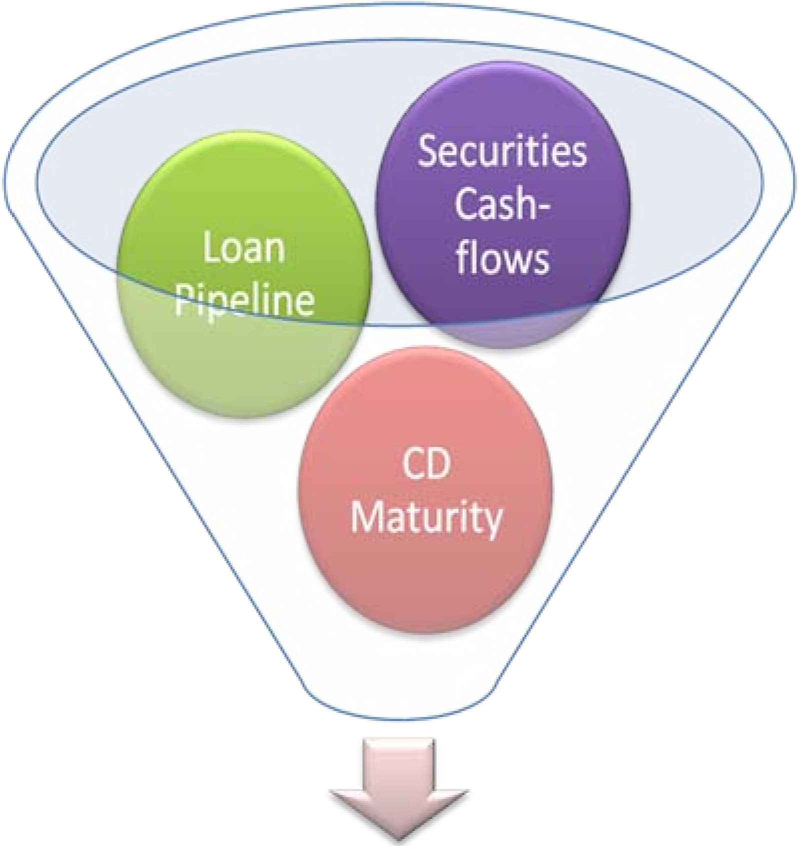
Major Differences in Guidance

- Formally defines 3 elements of Liquidity risk (Mismatch risk, Market Liquidity risk, and Contingent Liquidity risk)
- Emphasizes more robust forward-looking cash flow projections to supplement "static" measures (i.e., UBPR ratios)
- Promotes the analysis of underlying characteristics of "stable" and "volatile" funds; warns against using defined "core" and "non-core" terminology
- Discusses CFP Requirements in-depth (including measurement tools)
- Independent Review
- **Greater emphasis on liquidity risk management processes**



Pro-Forma Cash-Flow

Emergency Liquidity Planning

- Test ability to sell loans
- Establish multiple Federal funds lines of credit
- Establish repurchase agreements
- Understand FHLB capacity
- Diversify funding sources / alternative funding vehicles
- Accessibility to Discount Window and Term Auction Facility
- Retail promotional programs
- Public Relations

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Contingency Funding Plan

Key Components: Narrative and Quantitative requirements

Narrative Section / Administrative Matters

- Contact information for critical team members
- Assignment of responsibility to initiate external communication
- Required communication flow between lines of business
- Reporting requirements: what, when, how
- Description of stress scenarios
- Declaring a crisis, trigger events
- When plan should be revised and frequency

Contingency Funding Plan

<u>Quantitative Section / Adverse Scenario Analysis</u>

- Start with "business-as-usual" forward-looking cash flow report
  - Incorporate potential adverse events
  - Crisis should hit where bank is vulnerable, with scenario severe enough to cause substantial funding disruption
  - Evaluate estimates for reasonableness
    - Fed Fund Lines - Will they be available?
    - FHLB Borrowings – Haircuts? Additional collateral requirements?
    - Brokered Deposits – PCA restrictions?
    - Securitization – How long will it reasonably take?
    - Discount Window – Is documentation and collateral in place?
  - Is there over-reliance upon any one source?

Independent Review

Assess the adequacy of liquidity risk management relative to the risk profile

- Verify compliance with policy / procedure for accuracy
- Assess reasonableness of assumptions
- Identify material risk profile changes

Examination Expectations

- Greater emphasis on liquidity risk management processes (the qualitative aspect)
- Guidance should be disseminated through the examination process; educational process
- Institutions should be looking to diversify funding sources as well as increase potential funding vehicles
- Examiners are expected to encourage institutions to move towards cash flow modeling over time (to complement static ratio analysis) and utilize scenario analysis for contingency funding purposes
- Lack of appropriate liquidity risk management practices may result in a downgrade of the liquidity rating and/or result in matters requiring attention (or immediate attention)

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