Best Practices in Developing a Liquidity Policy and Contingency Funding Plan

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Objectives

• Review of Regulatory Focus and Expectations for Managing Liquidity Risk

• Relationship of Liquidity Risk to Other Risks

• Liquidity Risk Management – Concepts and Metrics

• Liquidity Policies and Contingency Funding Plans
Regulatory Expectations

Failure to maintain an adequate liquidity risk management process will be considered an unsafe and unsound practice.

Interagency Policy Statement on Funding and Liquidity Risk Management, March 17, 2010
Liquidity – The next crisis?

Warning to banks: It’s not too early to worry about a liquidity crunch
By Andy Peters
*American Banker*, April 10, 2018

Regulators are quietly warning banks that the overly aggressive pursuit of brokered and other high-priced deposits to fuel loan growth poses a long-term threat to liquidity.

What will the next crisis look like?
By Marko Kolanovic, PhD, and Bram Kaplan
*www.equities.com*, October 3, 2017

We think the main attribute of the next crisis will be severe liquidity disruptions resulting from market developments since the last crisis.
Total Loans to Total Assets – Banks Under $10 Billion

Source: Call Report Data
Liquid Assets to Total Assets – Banks Under $10 Billion

Source: Call Report Data

Liquid Asset Proxy: Cash, Federal Funds Sold, Reverse Repos, and Unpledged Held-to-Maturity (HTM) and Available-for-Sale (AFS) Securities
Techniques and regulatory focus have changed.

1998
- Asset-Based Liquidity Management
- Static Balance Sheet Ratios (Liquidity Ratio)
- Securities Assumed Liquid and Loans Considered Illiquid
- Wholesale Lines and Pledging Limited

2018
- Balanced Funds Management Approach
- Forward-Looking Cash Flow Analysis and Stress Testing
- Less Liquid Securities and More Liquid Loans
- Wholesale Lines and Pledging Expanded

FDIC: New York Region Regulatory Teleconference, June 15, 2017
Regulatory Expectations – Interagency Policy Statement

• Effective corporate governance
• Appropriate strategies, policies, procedures, and limits
• Comprehensive liquidity risk measurement and monitoring systems
• Active management of intraday liquidity and collateral
• An appropriately diverse mix of funding sources
• Adequate levels of highly liquid marketable securities
• Comprehensive contingency funding plans (CFPs)
• Internal controls and internal audit processes

Source: Interagency Policy Statement on Funding and Liquidity Risk Management, March 17, 2010
Basel Committee Principles

• 17 Principles for sound liquidity management

• Most integrated into the Interagency Policy Statement

• Address:
  • Governance
  • Measurement and management
  • Public disclosure
  • Role of supervisors (regulators)

Basel Committee on Banking Supervision’s *Principles for Sound Liquidity Risk Management and Supervision*,
September 2008
Basel Governance Principles

1) A bank is responsible for the **sound management** of liquidity risk.  
2) A bank should clearly articulate a liquidity **risk tolerance** that is appropriate for its business strategy and its role in the financial system.
3) Senior management should develop a **strategy, policies and practices** to manage liquidity risk in accordance with the risk tolerance.
4) A bank should incorporate **liquidity costs, benefits and risks** in the internal pricing, performance measurement and new product approval process for all significant business activities.

Basel Committee on Banking Supervision’s *Principles for Sound Liquidity Risk Management and Supervision*, September 2008
Interdependency of Risks

- Strategic Risk
- Market Risk
- Reputation Risk
- Credit Risk
- Operational Risk
- Compliance / Legal Risk

Liquidity Risk cannot be looked at in a vacuum. It impacts, and is impacted by, the other risks faced by the financial institution.
What is liquidity?

- **Liquidity** is a financial institution’s capacity to meet its cash and collateral obligations at a reasonable cost. Maintaining an adequate level of liquidity depends on the institution’s ability to efficiently meet both expected and unexpected cash flows and collateral needs without adversely affecting either daily operations or the financial condition of the institution.

- **Liquidity risk** is the risk that an institution’s financial condition or overall safety and soundness is adversely affected by an inability (or perceived inability) to meet its obligations.

Interagency Policy Statement on Funding and Liquidity Risk Management, March 17, 2010
At a fundamental level, LIQUIDITY is the product of entity-wide net cash flows.
Liquidity Management

Liquidity management then becomes a process of measuring, monitoring, and projecting cash flows.
Liquidity Risk Management

Two basic questions:

1) Is your liquidity adequate today?

2) Will your liquidity be adequate tomorrow?

You don’t know until you look.
Liquidity Risk Management

- Contingency Funding Plans
- Stress Testing
- Measurement Systems
- Liquidity Risk Management

Source: FDIC
Common Liquidity Measurement Metrics/Data

1) Asset Liquidity Ratio
   Liquid Assets/Total Assets

2) Total Liquidity Ratio
   Liquid Assets plus Available Capacity/Total Assets

3) Liquidity Coverage Ratio
   Both Asset Liquidity and Total Liquidity

4) Concentration Data
   Customers, Products, Geographic, Demographic

5) Non-Core Funding Dependence
   Borrowings, Broked Deposits, Large Depositors, Listing Service Deposits

6) Trend Analysis
Liquidity Risk Management Policy – Contents

• Governance Framework
  • Board and Committee Responsibilities
  • Management Responsibilities
  • Risk Tolerances

• Liquidity Measuring, Monitoring, and Reporting Requirements
  • Monitoring Metrics
  • Monitoring Procedures
  • Reporting Types and Frequencies

• Stress Testing Requirements

• Process and Model Validation
Liquidity Risk Management Policy

• Governance Framework

  • Established lines of authority and responsibilities
  • Articulation of liquidity strategy
  • Established liquidity risk tolerances
  • Regular communication between management and the Board
  • Broad representation from major operational areas of the bank on liquidity committee (ALCO)
Liquidity Risk Management Policy

• Liquidity Measurement and Monitoring Requirements

  • Measure both current and projected liquidity (base case)
  • Prepare and back-test cash flow projections
  • Assumptions – reasonable, appropriate, documented
  • Identify both primary and secondary (contingent) liquidity sources
  • Regular assessment of collateral position
  • Timely reporting (monthly/quarterly)
Liquidity Risk Management Policy

• Stress Testing
  • Require stress testing of current position
    • Institution-specific issues
    • Industry-wide issues
    • Multiple time horizons
  • Require stress assumptions to be documented, reviewed, and approved
  • Foundation for contingency funding planning

• Model/Process Validation
  • Require process and model validation
    • Independence (can be internal)
Liquidity Risk Management Policy

• Other Issues
  • Intraday liquidity
  • Transfers between related entities (Regulation W – Affiliate Issues)
Contingency Funding Plan
Contingency Funding Plan – Expectations

• Adequate Governance and Oversight
• Identify Stress Events
• Assess Levels of Severity and Timing
• Assess Normal Funding Sources and Needs
• Identify Contingent Funding Sources
• Establish Liquidity Event Management Processes
• Establish a Monitoring Framework for Contingent Events

SR letter 10-6, “Interagency Policy Statement on Funding and Liquidity Risk Management”
CFP – Adequate Governance and Oversight

• Board has **ultimate responsibility** for establishing, reviewing, and approving CFP
• Review and approve CFP at least annually
• Establish CFP **framework** – Board, committee, and management roles
• Develop detailed **action plans** for specific events identified in CFP

CFP – Identify Stress Events

- Identify market-wide and institution-specific scenarios
- Consider multiple time horizons
- Assess severity and likelihood (impact and probability)
- Develop assumptions regarding “what might happen”
- Model assumptions with pro forma cash flow analysis and compare to risk limits and base case scenario

CFP – Stress Event Example Scenarios

• Base Case Scenario
  • Management’s most likely scenario. Used to compare stress results. Base case assumptions.

• Economic Recovery Scenario – (long term)
  • Results in increased loan demand. Customer cash flow issues. Specific assumptions.

• Deposit Disruption Scenario – (short term)
  • Local disaster or system outage causing problems with collecting and processing deposits. Specific assumptions.

• Market Disruption Scenario – (medium term)
  • Aggressive competitor enters market and takes deposits. Specific assumptions.

• Economic Downturn Scenario – (long term)
  • Economic downturn and lax credit underwriting. Causes credit deterioration and bank to become “less than well capitalized.” Draw on outstanding unfunded commitments. Specific assumptions.
CFP – Brokered and High Rate Deposit Restrictions

- Part 337 of the FDIC Rules and Regulations
  - “Well Capitalized”: No restriction on brokered deposit use or rates paid on all deposits
  - “Adequately Capitalized”: Waiver required to solicit/renew/roll over brokered deposits. Restriction on rates paid for all deposits
  - Less than “Adequately Capitalized”: Prohibited from brokered deposit use. Restriction on rates paid for all deposits
CFP – Identify Funding Sources and Needs

• Maintain appropriate “liquidity buffer” (highly liquid assets)
• Maintain diversified sources
• Consider availability of off-balance sheet sources in stress scenarios
• Monitor availability of collateral (for borrowing as well as sale)
• Assess market values of collateral and any possible “haircuts”
• Regularly test contingent sources
CFP – Establish Event Management Process

- Describe roles and responsibilities
- Identify crisis management team
- Describe specific actions to be taken by management
- Describe communication channels for both internal and external stakeholders
- Should be detailed enough to provide actionable guidance (specific action plans)

CFP – Establish Monitoring Framework

- Identify “early warning” indicators (i.e., decline in deposits)
- Specify “event triggers” for the indicators (i.e., > 10%)
- Choose triggers that are appropriate for the bank’s risk profile
- Maintain comprehensive set of effective liquidity measures on an ongoing basis
- Complexity of monitoring depends on the risk profile of the bank

Summary Best Practices – Liquidity Management

- Measure
- Execute
- Strategize
- Correlate
- Monitor
- Stress
- Communicate
Regulatory Guidance

Interagency Policy Statement on Funding and Liquidity Risk Management, March 17, 2010

Basel Committee on Banking Supervision’s *Principles for Sound Liquidity Risk Management and Supervision*, September 2008

Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools, January 2013

OCC Bulletin 2014-51 – Liquidity Coverage Ratio

Regulatory examination manuals (OCC, FDIC, FRB, NCUA)

Regulation W Limits – Affiliates – Section 23A of the Federal Reserve Act (12 USC 371c)

NCUA Regulation §741.12 Liquidity and Contingency Funding Plans

“Community Bank Liquidity Risk: Trends and Observations from Recent Examinations,” FDIC Supervisory Insights, Vol. 14, Issue 1, Summer 2017

John has over 35 years of bank management and consulting experience. He has held various bank executive management positions including CEO of a community bank in Pittsburgh and CEO of a credit union with a national field of membership. John has also held the positions of Chief Auditor and Chief Financial Officer in community banks in Pennsylvania and West Virginia. In addition to his experience in bank management, John spent four years in public accounting where he audited financial institutions and served five years as an Assistant Professor of Accounting at a local college.

John is a Certified Public Accountant and holds a master of business administration from Waynesburg University. He earned his doctorate (Ed.D.) in administration and leadership from Indiana University of Pennsylvania in 2014. His dissertation research explored the relationship between job satisfaction and financial performance in community banks. John was involved in the design of our proprietary enterprise risk management process. He provides ERM and strategic planning services for our clients and assists on audits of unique, higher-risk areas. John is also involved in our training program for new staff members covering financial and operational topics impacting the banking industry and conducts an ongoing forum for bank CFOs addressing current accounting and operational issues.