AuditOne Regulatory Advisory

From Bud Genovese, Chairman

Understanding the New Statement on Funding and Liquidity Risk

By Jeremy D. Taylor, President of AuditOne

The federal banking agencies together with state supervisors recently released an "Interagency Policy Statement on Funding and Liquidity Risk Management" (http://www.fdic.gov/news/news/press/2010/pr10055a.pdf). Like January's IRR release, it's a clarification and consolidation of previous statements, with some areas of elaboration such as in regard to the Contingency Funding Plan (CFP). But mostly it serves as a refresher/reminder of the importance they attach to sound practice – at any time… but especially now.

It starts by recognizing common deficiencies such as insufficient liquid assets, weak cash flow projections and CFPs, and the funding of high-risk and/or illiquid assets with volatile, shorter-term liabilities. To tighten liquidity management practices, there's an emphasis on need to improve the following:

- Standard Board governance, including an ALCO with broad representation (taking in the investment, lending and deposit functions) and sufficiently detailed ALCO and Board reporting that includes clear presentation of limit compliance. (On pg. 31 of the Statement, there's a list of possible reports to consider.)

- Liquidity has both on- and off-balance sheet components. While they need to be looked at together, don't underestimate the importance of the former – i.e., the adequacy of available liquid assets.

- Get the right mix of limits, starting with liquid asset coverage and the volatile liability ratio. Pg. 26 has other suggestions. But liquidity is an area where we sometimes see too many limits in place – often overlapping and even conflicting.

- Cash flow projections that reflect both expected and adverse outcomes, with appropriate time horizons; we recommend at least weekly out to three months, then monthly out to six months. The Statement talks about need for documentation and periodic review and approval of the assumptions (e.g., the stability of deposit balances, the realizability of asset values) underlying the projections.

- As part of this process, understand your contingent liabilities – most importantly, your unfunded loan commitments. This means typical utilization patterns across the portfolio broadly, but also anticipated draw downs on larger individual loans.

- They emphasize diversification in funding sources. This ties in with last fall's proposed guidance (still not issued in final form) on correspondent concentration risks (http://www.fdic.gov/news/news/press/2009/pr09202.html).

- Collateral position management: Be able to calculate, monitor and report on assets pledged and assets available. Tie it in to the stress-testing (see below) – e.g., increased margin requirements under stress.

- Holding companies: Look at liquidity adequacy at both the consolidated and operating level, including any restrictions on intra-company transfers.

As mentioned above, the CFP and associated stress-testing gets particular attention, probably because it's where regulators see the biggest deficiencies. A few observations:

- As the Statement elaborates, and as confirmed by examiner criticisms we see, the CFP needs to be more than just a list of adverse scenarios and another list of contingent funding sources. Rather, each scenario needs to be spelled out separately:
  - Its early warning signals (e.g., rising charge-offs, or eroding deposits);
  - Its triggers (e.g., lower PCA capital category, lower CAMELS, lower agency rating, negative press);
  - The escalation of events; and
  - How the institution would respond at each stage.
- Stress events can be institution-specific (per the bullets above) or market-wide (such as the fall 2008 market upheaval, or a disruption to payments systems). The PCA capital scenario gets particular attention given the deposit restrictions that kick in if a bank falls below Well-Capitalized.
- There's need for regular testing of the CFP: testing to confirm availability of back-up sources, updating of roles and responsibilities, ability to access and move cash around as needed.
- An interesting aspect: planning how to handle press inquiries (especially for smaller institutions not used to that interaction).
- Stress-testing is of course an integral part of all this. Look at how each internal and external event/scenario would impact key liquidity measures/ratios across multiple time horizons. Assess not just the impact but also the likelihood of each scenario, then judge the appropriateness of your risk exposure and the adequacy of your liquidity cushion (including back-up sources).

While liquidity and solvency may be distinct concepts, weakness in the former can clearly aggravate, if not overwhelm, the latter. So liquidity is getting its share of examiner scrutiny. We're happy to talk with you about any of the Statement's provisions – including its requirement for regular independent review of the liquidity management process. AuditOne performs many of these every year, often as part of an IRR audit, though it can certainly be done as a separate exercise. If you would like further information or a proposal for such an engagement, please contact Kevin Watson (kevin.watson@audit-one.com) or Jeremy Taylor (jeremy.taylor@audit-one.com) at 562-802-3581.

Bud Genovese is Chairman of AuditOne LLC, a California-based internal audit firm that focuses only on banks and their service providers. Mr. Genovese pioneered the concept of providing comprehensive, affordable, independent internal audit and credit review services by gathering wide-ranging, extraordinary expertise within one firm. AuditOne now serves over 160 clients throughout the Western United States, and ***nationally.*** *Contact Bud Genovese at 408-980-8099 or bud. genovese@audit-one.com*