Supervision of Liquidity Risk Management

U.S. Regulatory Issues

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Discussion Topics

- Overview of U.S. approach to supervision
- Current regulatory developments
  - Issuance of new supervisory materials
  - Training for both examiners and bankers
  - Revision of surveillance tools
- Issues, challenges and ideas for change
Mission Statement

- Conducting the nation’s monetary policy by influencing the monetary and credit conditions in the economy in pursuit of maximum employment, stable prices, and moderate long-term interest rates
- Supervising and regulating banking institutions to ensure the safety and soundness of the nation’s banking and financial system and to protect the credit rights of consumers
- Maintaining the stability of the financial system and containing systemic risk that may arise in financial markets
- Providing financial services to depository institutions, the U.S. government, and foreign official institutions, including playing a major role in operating the nation’s payments system
Bank Supervision

- Agencies adopted Uniform Financial Institutions Ratings System (UFIRS) in 1979
- Principles based, qualitative in nature
- Focus on “Sound Practices” not quantitative standards
- Utilize CAMELS rating system
- Require numerous reports to gather data, monitor activities and compare against peers for the more than 7,000 depository institutions, BHCs and branches of FBOs
Sound Practices for Liquidity Risk Management

- Strategy for the Management of Liquidity
- Effective Management Structure
- Determine and Monitor Limits
- Acceptable System of Internal Controls
- Adequate MIS and Reporting System
- Scenario Analysis
- Liquidity Risk Measurement
Sound liquidity risk management requires the following four elements:

- Well-established strategies, policies, and procedures for managing both the sources and uses...
- Liquidity-risk measurement systems that are appropriate...can range from simple gap-derived cash-flow measures to very sophisticated cash-flow simulation models.
- Adequate internal controls and internal audit processes.
- Comprehensive liquidity contingency planning. (Contingency plans...should span a broad range of potential liquidity events that are tailored to an institution’s specific business lines and liquidity-risk profile.)
What Have the Agencies Seen?

Reviews of banks have found:

- Lack of cash flow / liquidity gap analysis at some institutions,
- Need for enhanced contingency planning at some institutions,
- Need for better coordination of strategic planning, tactical execution and liquidity management at some institutions,
- Overdependence on outdated static liquidity ratios,
- Less than robust analysis of liquidity risk profiles and management practices.

Suggests Need for Enhanced Examiner Guidance
Liquidity Has Also Changed

Traditional concepts and measures no longer valid due to:

- **Changing asset liquidity**
  - Reduced or potentially less liquid securities portfolios
  - Increased liquidity of loans (pledging & securitization)
  - Loan products with increased optionality
  - Increasing concentrations in particular loan types

- **Changing liability liquidity**
  - Traditional definitions of core/non-core are less valid
  - More options and increase use of “alternative” funding
  - Increasing competition for retail deposits

- **Changing funding sources and uses** challenge traditional LRM concepts and liquidity risk measures
Agencies Reviewed Liquidity Ratings

Reviews of banks with satisfactory “L” ratings but low “A” or “S” ratings have found:

- Little correlation between conditions that could lead to liquidity problems and the “L” rating,
- Lack of cash flow / liquidity gap analysis at some institutions,
- Need for enhanced contingency planning at some institutions,
- Need for better coordination of strategic planning, tactical execution and liquidity management at some institutions.

Reviews of banks with 3 & 4 “L” ratings have found:

- Inadequate support for rating,
- Overdependence on outdated static liquidity ratios,
- Less than robust analysis of liquidity risk profiles and management practices.

Reviews suggested the need for enhanced examiner guidance and training on LRM.
New Chapter on Funding Liquidity Risk

- Three year effort to consolidate and enhance existing guidance to provide a better tool for examiners and bankers
  - Includes a comprehensive discussion of all liquidity components, exhibits, and references
  - Samples of cash flow statements under normal and stress scenarios
What is Different?

- Begins with an overview that discusses the elements of effective liquidity risk management
- Identifies and describes the various sources of funds
- A description of external factors and other risk exposures
- Also describes three broad types of risk that banking organizations face
Benefits/Improvements

Extensive Discussion on Sound Practices
- Appropriate Corporate Governance & Oversight
- Appropriate Strategies, Policies, Procedures & Limits
- Liquidity Risk Measurement & Monitoring Systems
- Comprehensive Contingency Funding Plans
- Adequate Internal Controls
Benefits/Improvements

- Revised Exam Objectives & Procedures
- Appendix with Educational Materials
- Fundamentals of Liquidity Risk Measurement
  - Cash-flow analysis and worksheets
  - Characteristics of Assets, Liabilities & Off-balance sheet items
- Extensive Discussion on Summary Measures of Liquidity
Implementation Efforts

- Will update the Commercial Bank Exam Manual this year
- Conducting examiner training across the System
- Improved discussion with banks and encouraging change through the exam process
- Plans to update liquidity risk surveillance screens
New Section Emphasizes...

**Funding mismatches and cash flow analysis**
- Emphasis on cash flow forecasting to manage both day-to-day and contingent liquidity needs while considering the over reliance of static measures by banks

**Market liquidity constraints and contingent liquidity events**
- Comprehensive contingency funding plans
- Assessment of contingency funding under normal and stressed business conditions
- Coordination of LRM with strategic planning and business continuity planning as well as with the execution of business tactics

**Characteristics of “stable” and “volatile” funds**
- Minimizes discussion of “core” and “non-core” terminology
- “Right sizes” the use of “static” measures, such as UBPR ratios

**Incorporating “all” banking activities in LRM process**
Issues & Challenges

- Are Banks Managing Circumstances or Events?
  - Contingent liquidity events and stress scenarios
    - Incorporating roll-over, re-pricing and credit risk elements
    - From high probability / low impact to low probability / high Impact
  - Are they identifying funding mismatches – mismatch of cash inflows & outflows? Short-term / Long-term
  - Constraints on market sensitive sources of liquidity
    - Access to secondary market funding
    - Availability of wholesale borrowings
    - Availability of brokered and internet deposits
    - Market liquidity of assets
  - Testing operational elements of funding sources
Common Recommendations

- **Contingency Funding Plans**
  - Board approved
  - Include action steps
  - Establish crisis lines of authority
  - Define required stress testing

- **Improve Stress Testing**
  - Unexpected Loan growth
  - Covenant compliance / early amortization triggers
  - Increased haircuts / pledging requirements
  - Run more than just worse case

- **Incorporate ALCO in Liquidity Risk Management Process**
  - Monitor internal and external early warning indicators for:
    - Loan and receivable growth
    - Asset quality
    - Covenant compliance / early amortization triggers
    - Capital levels
Liquidity Risk Red Flags for Examiners

- Use of structured funding products without understanding risks
- Increasing concentration of one liquidity source
- Little or no asset liquidity (investment securities)
- All liquid collateral pledged to one source – all asset blanket lien
- FHLB increases haircut on collateral reducing availability or takes custody of collateral
- No or few risk limits for liquidity
- Inadequate Contingency Funding Plan
- Static ratio driven risk measurement system that is not based on forward looking projected sources and uses of funds
- Credit lines terminated or reduced by counterparty