

Liquidity Risk Management

This guidance describes the FDIC's expectations for insured institutions that have shifted from asset-based liquidity strategies (i.e., maintaining pools of highly liquid and marketable securities to meet unexpected funding needs) to liability-based or off-balance sheet strategies (i.e., funding partly through securitization, brokered/Internet deposits, or borrowings). Increased use of liability-based and off-balance sheet strategies has elevated the liquidity risk profile of some insured institutions and highlights the importance of a forward-looking approach to liquidity planning.¹

For banks using liability-based or off-balance sheet liquidity strategies, traditional measures of liquidity, such as the ratio of loans to deposits or non-core funding dependency, may not provide an accurate view of the institution's true liquidity position. Such institutions should augment traditional liquidity risk measures with pro forma cash flow and scenario analysis, and should have realistic contingency funding plans that are responsive to changes in liquidity risk exposure. The FDIC expects institutions to use liquidity measurement tools that match their funds management strategies and that provide a comprehensive view of an institution's liquidity risk. Risk limits should be approved by an institution's Board of Directors and should be consistent with the measurement tools used.

Some institutions have underestimated the difficulty of obtaining or retaining funding sources during times of financial stress. The terms associated with wholesale borrowings (both secured and unsecured) can become more restrictive when an institution faces either real or perceived financial difficulties. Institutions that become less than well capitalized² may face limits on the ability to accept, renew, or roll over brokered or high-cost deposits.³ Institutions using securitization can face early amortization events resulting from market disturbances, deterioration in the institution's financial condition, or the performance of securitized assets. These risks are more pronounced for institutions that have concentrated business lines or funding sources.

Pro forma Cash Flows

Institutions using liability-based or off-balance sheet funding strategies, that hold significant amounts of assets with cash flows that depend on choices borrowers can make to prepay or extend their obligations, or that have off-balance sheet funding commitments should use pro forma cash flow statements as part of their liquidity analysis. Other institutions may also benefit from the use of pro forma cash flow statements when managing liquidity risk. Pro forma cash flow analysis shows the institution's projected sources and uses of funds under various liquidity scenarios, identifying potential funding shortfalls or gaps. Institutions should work to limit these

¹ Institutions should refer to the FDIC's existing supervisory guidance and examination procedures regarding sound liquidity risk management found in the FDIC's Risk Management Manual of Examination Policies, Section 6.1 – Liquidity (February 21, 2005). The evaluation factors for rating liquidity are described in the Uniform Financial Institutions Rating System (UFIRS) (December 19, 1996).

² For purposes of these restrictions (established under part § 337.6, of the FDIC's Rules and Regulations) the terms *Well Capitalized*, *Adequately Capitalized*, and *Undercapitalized* [shall have the same meaning as to each insured depository institution as provided under regulations implementing Section 38 of the Federal Deposit Insurance Act.](#)

³ The *Joint Agency Advisory on Brokered and Rate-Sensitive Deposits*, May 11, 2001, reminds institutions that risk management systems must be commensurate in complexity to the liquidity and funding risks faced by an institution.

exposures, should report the exposures to the Board of Directors, and should have plans established to address significant potential funding shortfalls. Such analysis and reporting should be commensurate with the complexity of the institution's liquidity risk profile. Management's pro forma cash flow analysis should incorporate multiple scenarios that consider the general and unique risks faced by an institution.

Assumptions used in pro forma cash flow projections should be reasonable and appropriate. Assumptions should consider a wide range of potential outcomes with regard to the stability of both retail and larger deposits, brokered deposits, public funds, borrowings, Internet deposits, and the retention rate of funds obtained through deposit specials. Institutions that rely on securitization should perform sensitivity tests to measure the effects that material changes to assumptions would have on related accounts.

Contingency Funding Plan (CFP)

Funding decisions can be influenced by unplanned events. Such events include, but are not limited to, the inability to fund asset growth; difficulty renewing or replacing funding as it matures; the exercise of options by customers to withdraw deposits or to draw down lines of credit; legal or operational risks; the demise of a business line; and market disruptions. Funding and investment strategies that are concentrated in one business line or relationship typically are at greater risk of being disrupted by adverse events. Institutions should examine contracts and arrangements associated with major lines of business and funding sources to identify low-probability/high-impact events that could adversely affect liquidity. Institutions should work to minimize exposure to such events and should have plans in place that incorporate practical solutions that can be adopted quickly to address such contingencies should they arise.

The CFP should be customized to the liquidity risk profile of the institution and identify the types of stress events which may be faced. Possible stress events may include a change in credit rating, a deterioration in asset quality, becoming less than well capitalized, funding unplanned asset growth, the loss of access to market funding sources, recognizing operating losses, suffering negative press coverage, or other events that may call into question an institution's ability to meet its obligations. The overall impact of a given stress event should be considered, including both direct and indirect effects.

Institutions that rely on liability-based and off-balance sheet liquidity strategies should ensure that their CFP includes the following:

- Defines responsibilities and decision-making authority so that all personnel understand their role during a problem-funding situation.
- Includes an assessment of the possible liquidity events that an institution might encounter.
- Details how management will monitor for liquidity events, typically through stress testing of various scenarios in a pro forma cash flow format.
- Assesses the potential for triggering restrictions on the bank's access to brokered and high-cost deposits and the effect on the bank's liability structure.
- Identifies and assesses the adequacy of contingent funding sources. The plan should identify any back-up facilities (lines of credit), the conditions and limitations to their use,

and the circumstances where the institution might use such facilities. Management should understand the various legal, financial, and logistical constraints, such as notice periods, collateral requirements, or net worth covenants that could affect the institution's ability to use back-up facilities.

CFPs are particularly important in institutions that rely on securitization or other originate-to-distribute business models. Particular attention should be directed to scenarios where securitization or asset sales become rapidly unavailable. Securitizing institutions should also have plans in place to address:

- Disruptions in the capital markets that would result in delayed sales of receivables/loans.
- Increased volume of putbacks. The monitoring of this risk should be commensurate with the nature of assets sold or securitized.
- Required increases in retained interests and other credit enhancements.
- Early amortization events.

Restrictions on the Use of Brokered and High-Rate Deposits

CFPs should account for the limitations set forth in Part 337.6 of the FDIC's Rules and Regulations for both brokered and high-rate deposits, specifically that these limits can result in deposit run-off. In particular, institutions falling to adequately capitalized⁴ must obtain a waiver from the FDIC in order to use a deposit broker, and institutions that become less than adequately capitalized are precluded from using a deposit broker. In addition, all institutions that are less than well capitalized are precluded from offering deposit interest rates that are significantly higher than the prevailing rates in the institution's normal market area or the national rate, as may be appropriate.

Individuals responsible for managing a bank's liquidity should be familiar with all aspects of the applicable restrictions and limitations set forth in the FDIC's rules and regulations. If a bank uses a deposit broker or pays above normal interest rates to attract deposits, or plausibly could become less than well capitalized, it is important for management to be aware of whether the Part 337.6 brokered deposit restrictions and interest rate limits could constrain its ability to attract deposits and plan accordingly. CFPs should address the potential ramifications that reduced capital levels could have on the institution's ability to use brokered and high-cost deposits.

The FDIC's criteria for deciding waiver applications are described in Part 337.6: The FDIC may, on a case-by-case basis and upon application by an adequately capitalized insured depository institution, waive the prohibition on the acceptance, renewal, or rollover of brokered deposits upon a finding that such acceptance, renewal, or rollover does not constitute an unsafe or unsound practice with respect to such institution. The FDIC may conclude that it is not unsafe or unsound and may grant a waiver when the acceptance, renewal, or rollover of brokered deposits is determined to pose no undue risk to the institution. Any waiver granted may be revoked at any time by written notice to the institution.

⁴ Including those reclassified as adequately capitalized for being subject to a written agreement, order to cease and desist, capital directive, or prompt corrective action directive which includes a capital maintenance provision.

A CFP should not assume that the FDIC will grant a waiver in the event the institution becomes adequately capitalized and should establish plans under such a scenario to replace or offset the need for such funding as it comes due. In many cases, approval of a waiver request is conditioned on an institution's credible plan to limit growth, reduce its risk exposure, and return to a well-capitalized position. Institutions also should note that an undercapitalized insured depository institution may not accept, renew, or roll over any brokered deposit and is not eligible for a waiver.

Even if an adequately capitalized institution obtains a waiver, interest rate restrictions apply. In addition to brokered deposit restrictions, Part 337.6 of the FDIC's Rules and Regulations also limits the deposit rates that can be paid by institutions that are less than well capitalized. In general, any insured depository institution that is less than well capitalized may not pay an effective yield on any deposit that exceeds 75 basis points of either of the following rates, depending on its circumstances:

1. the effective yield paid on comparable deposits within its normal market area; or
2. 120 percent of the current yield on similar maturity U.S. Treasury obligations.⁵

Additional rate restrictions apply for undercapitalized institutions. CFPs should include a description of the institution's normal market area and should set forth how effective yields in the normal market area will be calculated for the purposes of compliance with Part 337.6.

Liquidity Risk Limits and Guidelines

Liquidity risk tolerances or limits should be appropriate for the complexity and liquidity risk profile of the institution and should employ both quantitative targets and qualitative guidelines. These limits, tolerances, and guidelines may include items such as:

- Discrete or cumulative cash flow mismatches or gaps (sources and uses of funds) over specified future short- and long-term time horizons under both expected and adverse business conditions. Often, these are expressed as cash flow coverage ratios or as specific aggregate amounts.
- Target amounts of unpledged liquid asset reserves expressed as aggregate amounts or as ratios.
- Asset concentrations, especially with respect to more complex exposures that are illiquid or difficult to value.
- Funding concentrations that address diversification issues, such as dependency on a few large depositors or sources of borrowed funds.
- Contingent liability metrics, such as amounts of unfunded loan commitments and lines of credit relative to available funding. The potential funding of contingent liabilities, such as credit card lines and commercial back-stop lending agreements, should also be appropriately modeled and compared to policy limits.

Institutions may use other risk indicators in specifying risk tolerances. These may include, for example, ratios such as loans to deposits, loans to equity capital, purchased funds to total

⁵ In the case of any deposit at least half of which is uninsured, 130 percent of such applicable yield.

assets, and other common measures and ratios. However, in developing and using such measures, management should be fully aware that some measures may not appropriately assess the time dimension and specific characteristics of the institution's liquidity risk profile. Static balance sheet measures may not reveal significant liquidity risk that may exist under either normal or adverse business conditions and generally should not be the sole measures institutions use to monitor and manage liquidity.

The scope and frequency of a bank's internal liquidity risk management reports will vary according to the complexity of the institution's operations and risk profile. Reportable items may include, but are not limited to:

- Cash flow gaps
- Asset and funding concentrations
- Critical assumptions used in cash flow projections
- Key early warning or risk indicators
- Funding availability
- Status of contingent funding sources
- Collateral usage.