Interagency Community Bank Teleconference - Liquidity and Funding Risk Management

November 6, 2017
2:00 pm ET

Operator: Welcome and thank you for standing by. At this time all participants are in a listen-only mode. During the question and answer session please press Star 1. Today's conference is being recorded. If you have any objections you may disconnect at this time. Now I'd like to turn the meeting over to Mr. Daniel Bean. Thank you. You may begin.

Daniel Bean: Thank you. Good afternoon everyone and welcome to today's Risk Analysis Center Conference Call entitled Interagency Community Bank Teleconference on Liquidity and Funds Management. There will be a discussion by our presenters followed by a question and answer session at the end.

The operator will come back on at that time and provide instructions for any in the queue to ask your questions. If you would like to submit a question during the presentation via email please email your question to rac@fdic.gov. That's R-A-C@F-D-I-C.gov.

I would like now to turn this call over to Suzanne Clair, Chief Exam Support, Division of Risk Management Supervision.

Suzanne Clair: Thank you Dan. Good afternoon everyone. I wanted to introduce my colleagues from the other agencies that will be participating in this afternoon's call. I'm joined this afternoon by Anthony Cain who serves as the Federal Reserve Board's Manager for Community Banking Organizations, Kelly Rutz who is a Risk Specialist of Treasury and Market Risk with the Office of the Comptroller of the Currency and Kyle Thomas who is President of Accreditation and Supervisory Processes with the Conference of State Bank Supervisors. Thank you all for joining us.

We'd like to provide a warm welcome to bankers from across the country who are participating with us today and appreciate you taking the time out of your busy schedules to listen in. We recognize the concerted efforts financial institutions have made this decade to improve their asset liability management programs and hope this event can provide some good information to enhance your processes going forward.

I'd also like to note that bank examiners and other supervisory personnel are listening to this teleconference from both federal and state agencies so welcome to everyone. To make a quick disclaimer the comments we'll make on today's call are the views of CSBS, FRB and FDIC staff have not been approved by any participating agency and do not necessarily represent the official position of any participating agency.

As Mr. Bean mentioned today's call will be recorded and we will post a replay on fdic.gov with a transcript later.

The purpose of today's call is to discuss a number of liquidity and funds' management issues relevant to community banks that the federal banking agencies and state supervisors have observed over the past year. And we would like to share this experience and our perspectives. The target audience for our comments is institutions with less than $10 billion in total assets.

Most banks have seen positive trends in new loan growth and profitability since the crisis which is expected in a recovery period. During the past few years some institutions are using sources other than traditional local retail deposits to fund loan growth.

Overall liquid assets are declining and wholesale funding reliance is rising at community banks. These trends have not manifested into systemic issues as most institutions maintain adequate liquidity and prudent funds' management practices.

However we have recently observed instances of concentrated use of wholesale funding sources that prove problematic when asset quality or other difficulties surface.

This afternoon we'll flag some of the potential pitfalls and risks we've seen while emphasizing the importance of a strong liquid asset cushion, diversified funding strategies and robust risk management and contingent funding practices.

While we currently believe these risks are not widespread there are common weaknesses and trends we're seeing in liquidity risk management in certain institutions and we agreed that a reminder about prudent asset and liability management practices through an outreach call would be helpful to our community financial institutions.

Although we will point out some important risk characteristics in certain wholesale funding sources the agencies do not discourage the use of the sources by well performing institutions with effective funds' management practices.

The agenda for our teleconference today is straightforward. I'll begin with a brief overview of existing supervisory resources for liquidity and fund's management then describe the types of potentially volatile funding sources that we have seen some banks use in concentrated volumes that led to or exacerbated liquidity stress including broker deposits and high rate deposits that may be restricted by the Federal Deposit Insurance Act and the FDIC's rules and regulations.

Next Kyle will discuss specific concerns with a few additional funding sources and prudent risk management practices. Then Anthony will conclude with contingency funding planning and the benefits of cash flow scenario analyses in managing liquidity.

Once we complete our respective presentations we'll open up the teleconference for a question and answer session so that we can respond to your specific questions about the issues covered during the call. And as Mr. Bean mentioned you can email the RAC site or we will be taking questions over the phone and the operator will prompt.

So let's just jump right into our presentation. I'll start by providing a quick overview of the 2010 Interagency Policy Statement on Funding and Liquidity Risk Management. We'll be referring to this document throughout the teleconference. We thought it was important to provide a short overview as it presents a supervisory perspective on liquidity and fund's management based on safety and soundness principles.

As you know the 2010 Interagency Liquidity Policy Statement provides information about the policies and practices that should be in place at a well-managed financial institution. In particular the Policy Statement lays out certain fundamental characteristics of a sound liquidity and fund's management program.

It encourages financial institutions to manage funding and liquidity risk commensurate with their complexity, risk profile and scope of operation.

The Policy Statement emphasizes the importance of a prudent cushion of liquid assets, diversified funding sources, projecting cash flows, scenario stress testing and a well-developed contingency funding plan as primary tools for measuring and managing liquidity risk.

In the spirit of the 2010 Policy Statement I'd like to share some of the FDIC's observations over the past year when several financial institutions encountered unexpected liquidity constraints when asset quality deficiencies emerged.

The specific liquidity constraints that we observed include an insufficient stock of on balance liquid assets free of encumbrance, over reliance on potentially less stable or wholesale funding sources such as certain broker deposits, Internet deposits and listing service deposits, funding and interest rate caps when the institutional was reclassified as less than well capitalized for prompt corrective action purposes, runoff of uninsured deposits and insufficient collateral to support secured borrowing needs.

Insured financial institutions are likely well aware of our concern for these issues given the principals outlined in the 2010 Policy Statement as well as discussions we have about liquidity during examination and the banking industry's own experience dealing with such liquidity issues during the financial crisis.

Given the liquidity problems that several banks experienced in the past year we continue to believe the first line of defense for responding to a liquidity event is a cushion of unencumbered liquid assets. This means assets that are free from legal, regulatory or operational impediments.

In a stress scenario it's likely easier for an institution to pledge or sell a readily marketable security or withdraw a federal reserve district bank deposit than to request an advance from a funds provider who may be aware of an institution's financial problems.

The most marketable and liquid assets are usually U.S. Treasury and agency securities and federal reserve or correspondent deposits. These on balance sheet resources or liquid asset buffer can be pledged or sold at little or no discount and often serve as the institution's lifeblood in a crisis situation.

In terms of funds management most community banks still use retail deposits as their primary funding source. The agency's experience shows that local retail deposits are generally stable, lower cost and tend to reprice more favorably than other instruments when institution specific or market conditions worsen.

However in circumstances when local retail deposits are unavailable or not preferred in a funds management strategy financial institutions may turn to other potentially less stable sources including wholesale funding to supplement liquidity.

Generally speaking potentially volatile or wholesale funding sources include deposits or borrowing that can be less stable than a typical retail customer with an established relationship with the institution.

High interest rate on uninsured deposit accounts are also potentially less stable as these customers can be credit and rate sensitive sometimes showing cost, runoff and other characteristics similar to wholesale sources.

Based on our experience potentially volatile funding sources may increase liquidity, interest rate and other risks especially when used to facilitate rapid asset growth. Importantly we do not discourage the use of potentially less stable or wholesale funding when incorporated into an effective asset liability management process that promotes a sound balance sheet.

Generally speaking potentially volatile and wholesale funding is readily accessible by well performing institutions under normal market conditions but can become more costly and prone to runoff if an institution's financial condition weakens.

In past and recent problem bank situations we have observed that institutions with asset quality and capital problems also frequently experience liquidity issues. These issues can involve deposit runoff, statutory broker deposit restrictions, legal restrictions on interest rates paid for all deposit accounts, higher collateral requirements from wholesale funding providers or counterparties or an insufficient volume of assets that could be quickly monetized or used as collateral to obtain contingent funding.

To ensure prudent liquidity in funds management we encourage directors and senior management to remain attentive to their institutions' funding profile. I will discuss a few of the key funding issues that bear close monitoring based on our recent experience. The first issue is deposit interest rates that are well above prevailing market rates to fund asset growth or address competitive and local market consideration.

Financial institutions that offer well above average interest rates on deposits should remain keenly aware of the potential deposit runoff and the difficulty of locating replacement funding if their financial condition deteriorates or they are unable to continue offering competitive interest rates.

Furthermore institutions that are not well capitalized for prog corrective action purposes generally may not offer deposit interest rates more than 75 basis points above the national rate for deposits of similar size and maturity. Section 337.6 of the FDIC Rules and Regulations define the national rate as a simple average of rates paid by all insured depository institutions and branches for which data are available.

Please note that the FDIC posts national average deposit rates on its Web site at www.fdic.gov/regulations/resources/rates.

Also note that if a bank believes that the posted national rates do not represent the actual rates in the bank's local market area the institution may seek a determination from the FDIC that the bank is operating in a high rate area. In accepting deposits from outside its local market area such as through a national listing service for example the bank must use the national rate.

In our recent experience funding issues have stemmed from deposits gathered via deposit brokers, the Internet and listing services which in large part are related to the high rate deposit issues I just described. We won't get into the technical aspects of whether deposits should be classified as brokered on this call and refer you to the frequently asked questions on broker deposits that the FDIC updated last year should you have any question.

In the normal course of business these three sources of deposits are generally available to well performing institutions but are potentially more expensive and less stable than insured retail deposits.

If market conditions change or more attractive returns become available these customers may transfer their funds to other institutions or investments. Subsequent to withdrawal these deposits may be difficult or more costly to replace especially when market rates are rising or broker deposit restrictions are triggered by a prompt corrective action capital category reclassification.

Less than well capitalized insured depository institutions are subject to certain broker deposit restrictions. However a well-capitalized institution is not restricted from accepting or renewing broker deposits and is not restricted as to rates of interest.

Note that an institution can fall below well capitalized for prompt corrective action purposes because it is subject to a capital maintenance provision and a formal enforcement action.

As provided in the FDIC's 2011 study on core and broker deposits the risks associated with using broker deposits to fund rapid asset growth which contributed to weak financial and liquidity position over successive economic cycles have been well documented.

Furthermore Internet and listing service deposits can have cost and runoff characteristics similar to brokered funds. Both often involve gathering deposits from customers who typically have no other relationship with the institution and are seeking the highest possible return on their deposit.

The agencies do not discourage prudent brokered deposit programs or other Internet or listing service deposit gathering efforts when used as part of a diversified comprehensive asset liability management strategy.

We do suggest however that banks using these deposits should be vigilant in their monitoring and oversight given the funding risks associated with high rate deposits including the potential interest rate cap on all the deposits.

The third funding issue we have observed is uninsured deposits. Wholesale, retail and public depositors may place funds in financial institutions that exceed federal deposit insurance limits for a variety of business or economic reasons. When an institution is profitable with strong asset quality, liquidity and market presence uninsured deposits may behave similarly to those covered by federal deposit insurance.

Conversely if an institution encounters financial or reputational difficulty uninsured depositors may be among the first to run off. Such unanticipated withdrawals can be disruptive for an institution if other funding sources or committed back-up lines of credit are not readily available.

Accordingly we suggest that financial institutions with moderate to high volumes of uninsured deposits quantify the volume of these funds, monitor their runoff potential and have contingency funding resources available to bolster liquidity if fees on insured depositors withdrawal their funds unexpectedly.

Next Kyle Thomas of the Conference of State Bank Supervisors will discuss some additional funding issues and associated funds management considerations.

Kyle Thomas: Thank you Suzanne. In the case of certain public deposits state or federal law may prescribe collateral requirements. For these deposits an institution typically pledges liquid assets or in other situations obtains a standby credit facility to support uninsured balances.

Institutions should be mindful of liquidity and contingency funding plan considerations when using standby credit facilities to support uninsured deposits because such borrowing lines can encumber assets that could otherwise be sold or pledged in a stress event.

The final funding issue we'd like to address today is the use of borrowed funds. Financial institutions regularly use borrowings to supplement deposit gathering efforts. These products can include federal funds purchases, Federal Home Loan Bank advances, repurchase agreements and other borrowings.

Borrowings can be an appropriate funding source as part of an effective asset liability management process that promotes a sound balance sheet. Nonetheless some financial institutions have encountered problems using borrowings when costs, budgeting requirements and refinancing risk impaired liquidity as credit quality issues arose and persisted.

It is also important to understand the collateral acceptance criteria used by funds' providers. For instance does the creditor only accept wet signatures on original loan documents? The agencies have seen institutions that move to electronic mortgages or imaging that had their lines reduced because the documents failed to meet collateral acceptance standards. We do not discourage financial institution's prudent use of borrowings but recommend risk limits and careful consideration of the term, structure, refinancing risk and deployment of these funds.

From a big picture perspective strategies that increase less stable or wholesale funding reliance should fully consider the stability and sensitivity of an institutions' deposits. There have been several trends over the past decade that may make it difficult to predict depositor behavior as the deposit mix for all institutions has shifted considerably to non-maturity deposits. Shifts in this mix including moves from non-maturity deposits to time deposits could increase the cost of deposit funding.

The banking system has also seen a substantial overall increase in deposits. It is important for bank management to consider various depositor behavior scenarios because these recent trends may create uncertainty about future stability. This analysis is especially important for institutions that have experienced above average deposit growth in recent years.

A period of protracted historically low rates contributed in part to these shifts in bank deposit bases and rate increases even if rates do not change significantly may impact stability and cost of funds. Moreover new technologies may introduce competitive pressures that should be considered when evaluating the stability of existing deposits.

As appropriate bank management should maintain a thorough understanding of their deposit base before materially engaging in a potentially volatile or wholesale funding strategy. Depending on an institution's size and complexity this understanding can be facilitated using quantitative and qualitative sources to analyze deposit behavior. Quantitative measures can include financial analysis, interest rate modeling results that incorporate behavioral assumptions and deposit studies. Qualitative sources may include discussions by the board of directors, ALCO or other committees where strategic deposit, marketing or pricing decision are made.

Given recent trends these committees should consider the stability of their existing liability and structure, pricing strategies and should fully consider all potential sources of competition for deposits. Institutions relying on potentially less stable and wholesale funding should consider appropriate governance and risk mitigation processes as described in the 2010 Interagency Policy Statement including a cushion of liquid assets to address unforeseen stress events.

A robust policy and risk limit framework, funds management process on balance sheet liquidity position, alternative liquidity sources and contingency funding plans are increasingly important when an institution meaningfully relies on potentially volatile or wholesale funding sources.

As appropriate our examiners will discuss safety and soundness concerns related to these sources with senior management during the supervisory process. Our district, regional, state and field staff are available to help banks enhance their liquidity risk management programs. And we are happy to provide our perspectives with you as you review and refine these processes.

And with that I will let Anthony Cain from the Federal Reserve make some remarks about contingency funding planning and liquidity cash flow analyses.

Anthony Cain: Thank you Kyle. Before I begin discussing some of the key elements of a contingency funding plan I want to quickly remind everyone what a contingency funding plan is. Ultimately a contingency funding plan is a guide for managing unexpected liquidity situations. A good plan will help bank management execute a controlled response to unforeseen stress events. All regulated financial institutions regardless of size and complexity should have a formal contingency funding plan.

Now what should a contingency funding plan include? The interagency liquidity policy statement outlines several high-level elements that the bank should include in its plan. According to the guidance a plan should at a minimum establish a liquidity event management process that outlines the roles and responsibilities of key personnel during a liquidity event. Establish a system that monitors for potential liquidity stress events by using early warning indicators and event triggers. Assess possible funding needs by understanding the potential erosion of liquidity resulting from various stress scenarios of differing magnitudes across several time horizons. And lastly, identify potential liquidity sources and discuss the order at which these sources will be used.

In addition to these key elements we expect that an institution's contingency funding plan be consistent with the institution's overall liquidity risk profile. For example if an institution uses brokered or higher cost deposits, management is expected to thoroughly understand the consequences of a PCA capital category reclassification under the FDIC's broker deposit regulation including the associated waiver application process and deposit rate restriction.

We expect these institutions to incorporate PCA related downgrade triggers into their contingency funding plan since a change in PCA status could have a material impact on the availability of these funding sources. In short the contingency funding plan should be tailored to an institution's risk profile and management should review the plan periodically to make sure it is still appropriate.

Each element of the contingency funding plan contributes to an effective liquidity risk management program. However establishing a crisis management team and formalizing in writing a step-by-step plan of the roles and responsibilities of each member of the team during a liquidity event may be the most critical component of an institution's contingency plan.

A crisis management team may involve personnel from all levels of the organization including members of the board of directors, senior management and staff. Members of the crisis team should understand their responsibility and have authority to execute on their portion of the action plan.

At a minimum the plan should identify a person or a team who is responsible for the following. Making any public statements and responding to the media, concerned customers, employees and/or shareholders. Indicating with wholesale funding and equity providers to secure additional funding. Determining and executing on the sale of assets. Maintaining contact with contingent funding sources such as the Federal Home Loan Bank and the Federal Reserve Discount Window. And answering questions from federal and state regulators and any rating agencies.

During a liquidity event communication among the crisis team should be frequent to ensure business decisions are coordinated in order to reduce the impact on the institution's liquidity position. When should the crisis team enact the contingency funding plan? When early warning indicators are triggered.

Early warning indicators alert management to a potential and/or approaching liquidity issue. Early recognition of a potential event allows the institution to ready for an impending liquidity crisis seeking timely and appropriate action.

Early warning indicators should be progressive and prompt the crisis team to take mitigating actions. As liquidity events worsen more severe indicators which trigger a crisis team to take even more aggressive mitigating actions. Early warning indicators should also be comprehensive and include triggers for a mix of internal and external events.

For example institutions may establish indicators for unexpected loan growth from draws on unfunded lines of credit, increased potential for deterioration in the institution's financial condition, negative publicity, widening credit spreads and large deposit withdrawals.

A common issue we have noticed while reviewing institutions contingency funding plans is that the early warning indicators do not directly tie to any coordinated response. As I just mentioned when an early warning indicator is set off the plan should trigger the crisis team to take timely and appropriate actions.

For example an unexpected decline in deposit account balances may trigger additional liquidity monitoring. Communication with account holders or even tapping longer-term alternative funding sources. The prescribed actions taken should correspond with the severity of the threat.

Other common issues we have seen include the lack of support for setting the early warning indicator level and institutions selecting after event triggers such as a trigger based on a ratings downgrade. Early warning indicators and associated triggers should be meaningful and provide management time to respond in advance of an event.

Before meaningful early warning indicators and triggers can be set management needs to understand the potential funding needs from a stress event. The 2010 Interagency Liquidity Policy Statement highlights the importance of performing stress testing or scenario analysis in developing a contingency funding plan.

In order to adequately plan for a liquidity event management first needs to identify and quantify the possible impact of a liquidity strain on an institution's cash flow, profitability and solvency. Without testing management cannot establish appropriate trigger levels for early warning indicators or understand potential funding needs.

Testing does not have to be complex. For many community banks testing can be completed using a simple spreadsheet that estimates funding surpluses or shortfalls under stress at various time horizons.

No matter what approach is used management should ensure that the test is tailored to the institution taking into consideration the institution's balance sheet structure, risk profile and scope of operations.

For example a community bank that originates loans for sale in the secondary market may want to understand the impact of liquidity from a market dislocation.

In order for results of the test to be useful management should test the impact of liquidity from extreme but plausible stress scenarios. Stress scenarios may include a natural disaster, unexpected deposit account withdrawals, higher interest rates, deterioration in asset quality or a downgrade in the institution's PCA capital category.

When testing management may want to combine scenarios. Often scenarios cascade into one another. For example during the most recent financial crisis and even today some community banks experienced deteriorating asset quality which has led to regulatory capital ratios falling below the PCA well capitalized category, the institution's CAMELS ratings being downgraded and eventually the institutions being placed under a public enforcement action.

In these cases the community bank's first encounter cash flow issues due to the elevated level of low problem loans. Then the community banks face funding challenges from higher haircut supply to assets pledged for borrowing purposes.

Lastly funding challenges grew more severe when the community banks ran into interest rate restrictions when trying to replace deposit runoffs as a result of the negative news.

When testing management should also ensure that the testing duration matches the stress scenario. Depending on the event or series of cascading events, the time horizon that liquidity is under stress can range from a few days or weeks to months or even over a year.

For instance a liquidity scenario stemming from negative publicity in general will have a short stress time horizon and the impact will likely be analyzed over days and not months. In a reputational risk scenario if an institution chooses to review runoff assumptions or cash flow results monthly rather than daily the institution may not understand the full extent of the liquidity event. In scenarios where liquidity events can cascade into one another cash flows may need to be projected on a monthly basis up to one year. Doing so will provide management with the most realistic assessment about what could potentially take place.

Assumptions used in testing need to be sufficiently severe. Management needs to identify and quantify the magnitude of a liquidity strain before a crisis ever ensues.

A common conversation we have with management centers around the severity of assumptions used in testing, particularly deposit runoff assumptions. Ideally deposit runoff assumptions would be based on an institution's historical performance.

However many institutions have not experienced a deposit runoff situation before especially under the scenarios being tested. In these cases management should use peer data from troubled or even possible failed institutions. The support or the rationale for the deposit runoff assumption should be well documented.

Results from performing scenario stress testing should play a pivotal role in shaping the contingency funding plan. Management should use the results to help determine what constitutes a comfortable amount of liquidity risk. If testing results show the institution becoming illiquid management should take mitigating actions to reduce the institution's exposure such as building up a liquidity cushion and/or increasing borrowing availability.

All institutions will likely need to access to alternative funding sources during a liquidity event. Ready access to alternative funding sources strengthens an institution's capacity to withstand a liquidity event. That's why we expect management to identify alternative funding sources in the contingency funding plan and ask management to ensure ready access to them. During the liquidity event alternative funding may come from raising capital, issuing debt, selling assets, and/or pledging assets to access secure borrowings or unsecured borrowings.

Alternate funding sources are not all created equal. Depending on the nature, severity and duration of the liquidity event management may make different choices on which alternative funding sources to access.

Management should identify and document in the contingency funding plan the sequence in which funding sources will be used and take into consideration that different situations may call for a different response.

For instance in what situation will the bank drawn down an existing borrowing line versus liquidate assets? In situations where the answer is both the next question is in what order? When making these decisions management should take into consideration how long it will take and at what cost will it take to obtain funding.

Of course the best laid plans will be meaningless if the institution cannot access identified funding sources in a timely manner. Periodically management should test the operational components of the plan. At a minimum, management should ensure that contractual arrangements with fund providers are up to date.

Management should also ensure that key personnel understand collateral requirements and who to contact for accessing borrowing lines and liquidating assets. Also management should confirm via correspondence the availability of committed borrowing lines and management may actually want to test access to unsecured lines by drawing on them.

To wrap up, a Contingency Funding Plan is an institution’s emergency preparedness guide. For the guide to be successful in case of an emergency management needs to understand the institution’s vulnerability, develop strategies to mitigate them and identify key personnel to take action once the sirens are set off.

This concludes the prepared discussion for today’s call. I think we are now ready to open up the telephone conference for any questions related to the issues covered during the call or anything else that you may have on your mind.

Operator: Thank you. We will now begin the question and answer session. If you’d like to ask a question please press Star 1. You’ll be prompted to record your name. To withdraw your request please press Star 2. One moment please to see if we have any questions or comments.

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