February 17, 2010

MEMORANDUM TO: The Board of Directors

FROM: Sandra L. Thompson
Director
Division of Supervision and Consumer Protection

SUBJECT: Final Interagency Statement of Policy on Funding and Liquidity Risk Management

Proposal: That the Board of Directors of the Federal Deposit Insurance Corporation (FDIC) approves the publication of the attached final interagency statement of policy titled, *Funding and Liquidity Risk Management* (Final Policy Statement). The Final Policy Statement summarizes the principles of sound liquidity risk management the FDIC has issued in the past and, where appropriate, harmonizes them with the liquidity risk management principles issued by the Basel Committee on Banking Supervision (BCBS) in a September 2008 release titled, *Principles for Sound Liquidity Risk Management and Supervision* (Liquidity Risk Management Document). The Final Policy Statement document would provide the supervisory expectations regarding funding and liquidity risk management for all domestic depository institutions, including banks, thrifts, and credit unions. The guidance is also broadly applicable to bank and thrift holding companies and non-insured subsidiaries of holding companies. If approved by the Board, the Final Policy Statement would be published in the *Federal Register* by the FDIC, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the National Credit Union Administration (together, the agencies).

Recommendation: That the Board adopt the attached Final Policy Statement document for publication in the *Federal Register*.

Concur:

Michael Bradfield
General Counsel

Introduction

The FDIC Board of Directors is being asked to adopt for publication in the *Federal Register* the attached Final Policy Statement. This document restates the principles of sound liquidity risk management that the agencies have issued in the past and, where appropriate, harmonizes such principles with those provided in the BCBS Liquidity Risk Management Document.

Background

In response to the recent economic crisis, in September 2008, the BCBS issued the Liquidity Risk Management Document, which provides 17 principles for sound liquidity risk management. The Liquidity Risk Management Document was released to facilitate the correction of system-wide deficiencies in liquidity risk management that became apparent in the wake of the economic crisis, for example, the maintenance of insufficient holdings of liquid assets and the funding of risky or illiquid asset portfolios with volatile short-term liabilities.

On July 6, 2009, the agencies published in the *Federal Register* a proposed interagency guidance document titled, *Funding and Liquidity Risk Management* (Proposed Guidance Document). The Proposed Guidance Document requested public comment on all aspects of the proposal, and provided a 60-day comment period that closed on September 4, 2009.

The agencies received 22 comments on the Proposed Guidance Document.[1] Generally, the commenters supported the agencies' efforts to consolidate existing supervisory expectations for liquidity risk management and harmonize them to the Liquidity Risk Management Document. However, commenters did object to certain provisions in the proposed guidance. A number of commenters objected to the proposed supervisory expectation that affiliated institutions maintain liquidity commensurate with their individual liquidity risk profiles on a deconsolidated basis. These commenters were concerned that this effectively would require the maintenance of a separate liquidity buffer for each regulated legal entity, restrict the movement of liquidity within an organization in times of stress, and discourage the use of operating subsidiaries.

[1] This memorandum does not provide a discussion of the comments specific to credit unions.

Commenters also objected to proposed supervisory expectations regarding the asset composition of an institution's liquidity buffer. These commenters were of the view that restricting the composition of a liquidity buffer to high-quality, liquid assets such as U.S. Treasury bonds would impair an institution's ability to diversify its funding sources.

Some commenters expressed concerns regarding the proposed supervisory expectations for contingency funding plans (CFPs). Specifically, these commenters supported more flexibility in the design of CFPs to allow institutions to respond quickly to unanticipated liquidity events. Other commenters sought clarification as to whether institutions would be expected to use certain funding sources, such as brokered deposits or Federal Home Loan Bank advances, to demonstrate that a CFP is sufficiently diversified. A number of commenters also requested clarification regarding the supervisory expectations for testing the components of a CFP to recognize situations where testing certain elements of the CFP may be impractical, for example, where the sale of assets may have unintended market consequences.

Final Policy Statement

The Final Policy Statement is generally consistent with the Proposed Guidance Document; however, the document incorporates certain modifications to address some of the concerns raised by the commenters. With regard to scope, the Final Policy Statement clarifies the maintenance of liquidity on a legal entity basis. Specifically, the policy statement indicates that the agencies expect depository institutions to maintain adequate liquidity both at the consolidated level and at significant legal entities. As an overarching principle, depository institutions should maintain sufficient liquidity to ensure compliance during economically stressed periods with applicable legal and regulatory restrictions on the transfer of liquidity among regulated entities. The agencies have modified the language in the policy statement to reflect this view.

The principles of liquidity risk management articulated in this policy statement are broadly applicable to bank and thrift holding companies, and non-insured subsidiaries of holding companies. However, because such institutions may face unique liquidity risk profiles and liquidity management challenges, the Federal Reserve and Office of Thrift Supervision are articulating the applicability of the policy statement's principles to these institutions in transmittal letters of the policy statement to their regulated institutions. As a result, the guidance for holding companies contained in the original proposal issued for comment has been omitted from this final policy statement.

The Final Policy Statement clarifies the agencies' expectations regarding the asset composition of the liquidity buffer. Specifically, the Final Policy Statement would provide the agencies' supervisory expectation regarding the maintenance of a liquidity buffer comprised of high-quality assets that can be converted into cash at little or no loss to the institution. In addition, the example of liquid assets provided in the proposal would be expanded to include government-guaranteed debt, excess reserves maintained within the Federal Reserve System, and securities issued by Government-Sponsored Enterprise (GSEs).

With respect to supervisory expectations regarding CFP testing, the agencies recognize that there may be a situation where it is impractical to test certain elements of the CFP. Accordingly, the Final Policy Statement would clarify that institutions should test only the operational components of the CFP, for example, by reviewing the appropriateness of existing roles, responsibilities, and legal documentation; and ensuring the ability of the institution to transfer cash and collateral and access contingent liquidity lines as appropriate.