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Federal Reserve Bank of Philadelphia

Liquidity Risk Management: Are You Prepared? Part II

by Joanne Branigan, Manager

Sound liquidity risk management is an essential function for all financial institutions. Under stressful conditions, the need for sound risk management practices becomes even more critical for operating in a safe and sound manner. Financial institutions need to consistently identify, measure, monitor, and control their liquidity risk. This is the second of a two-part series on liquidity risk management. Last quarter, the elements of financial institution liquidity and sound liquidity risk management practices were discussed. This article will focus on liquidity risk measurement and monitoring and contingency funding plans (CFPs).

Liquidity Risk Measurement and Monitoring

The analysis of liquidity risk should be forward-looking, with the objective of identifying potential future funding mismatches and current imbalances. Effective liquidity risk measures enhance management's understanding of exposures to mismatch, market, and contingent liquidity risks. All financial institutions are expected to manage liquidity risk in an appropriate manner that reflects the institution's risk profile, complexity, and scope of operations—this applies to all aspects of liquidity risk management.

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FEDERAL RESERVE BANK
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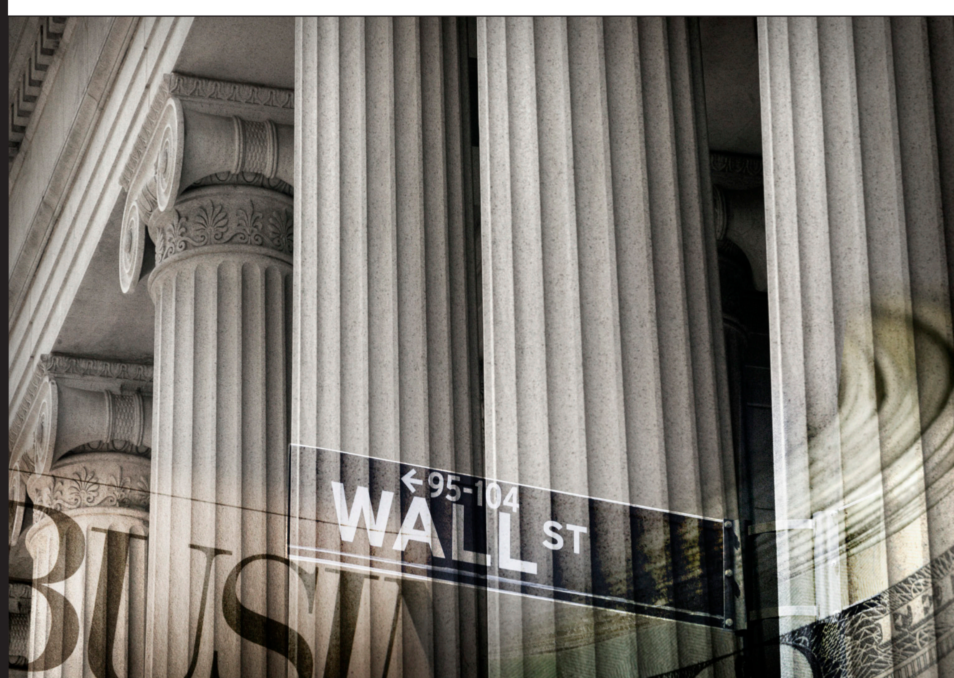
Supervision Spotlight

Restoring Confidence in the Banking System

by Michael E. Collins, Executive Vice President

We are living through a transformative period in our nation's history, and, as in any period of great change, the challenges can seem overwhelming. Confidence in U.S. and global financial institutions has been badly shaken. The combination of mounting losses, falling asset prices, and a deep economic downturn has severely impaired the financial system. The striking loss of confidence at the heart of this crisis has elicited a flood of government-sponsored programs and initiatives extraordinary in their scope, scale, and inventiveness. Consequently, we are seeing public intervention in the financial system on a scale not seen for decades. Policymakers, meanwhile, are debating sweeping changes regarding the way the financial sector will ultimately function and be regulated.

The crisis has also prompted a debate on the respective roles and costs of capitalism, innovation, and regulation. As a general principle, financial innovation is good for the economy, but, as demonstrated in



the current crisis, the benefits of innovation are usually understood well before the risks come to light. Where some see the bad behavior of individual actors and poor governance at fault, others attribute the current turmoil to serious defects in our economic and financial architecture. As the debate continues, one thing is clear: the American public has lost confidence in the integrity and ethics of our nation's institutional leadership. Questions have arisen around the public and private sectors and the availability and transparency of information, as well as the professional ethics of some who were responsible for managing the business risks that all organizations face.

The financial crisis was triggered by the turn in the U.S. housing market in the spring of 2007. The subprime-related write-downs that led to the collapse and near-collapse of several large and, in some cases, systemically important institutions precipitated the credit freeze that led to the deep economic contraction that continues to have serious repercussions throughout the banking industry. Very few Third District banking organizations, however, participated in those subprime lending practices and exotic products that helped to create the conditions for this crisis.

Several bankers in the Third District have expressed to me their concern and frustration about the damage that has been done to the image of the banking industry due to the questionable choices made by some financial institutions and about the consequent feeling of all banks being painted by the same broad brush. Community and regional banks by and large have consistently engaged in prudent lending practices and have served as a vital source of credit for small businesses and consumers in their communities. Banking organizations across the board, including those that have behaved responsibly before and during the crisis, are facing steep increases in FDIC insurance premiums and will be affected by the profound financial and regulatory reforms that are now being considered.

As regulators and policymakers grapple with the larger issues, banking organizations are struggling in a fundamentally altered landscape with business models that may no longer make sense in some cases. Banking organizations are using this period of change to reevaluate their core missions. Many appear to be returning to banking fundamentals. Meanwhile, locally focused community and regional banks are leveraging their in-depth local knowledge and strong community ties to step in and make loans to creditworthy borrowers where nonbanks and larger banks have stepped back, fulfilling an important need and, in doing so, helping to pave the way to recovery.

For its part, the Federal Reserve has been focusing on a number of areas for reform, some of which may benefit smaller banks, such as the need to regulate institutions with the potential to create systemic risk differently from institutions that do not pose this risk. The regulatory system must also cast a wider net to capture previously unregulated corners of the financial system, often referred to as the shadow banking system. These changes, if formulated and implemented in a thoughtful and prudent way, should lead to a more level playing field for institutions of all sizes and help avoid a repeat of the last crisis, while positioning the U.S. to compete effectively in a global economy.

As we move forward, the emphasis will be on restoring stability to the financial system to repair lending, structuring financial regulations to rebuild trust, and reforming and building strong domestic and global institutions. Banking organizations and other firms will be more cognizant of the need to protect their reputations and add value, rather than to extract value in their interactions with other firms and consumers. Ultimately, these steps should lay the groundwork for reestablishing trust and confidence in the banking system, a key component for economic recovery. □


Michael E. Collins,
Executive Vice President

From the
Examiner's Desk

Overview of the Troubled Asset Relief Program and Its Capital Purchase Program

by Ivy M. Washington, Senior Examiner, and Amy Sill, Supervisory Studies Specialist

The passage of the Emergency Economic Stabilization Act of 2008 (EESA) last October authorized the U.S. Treasury's Troubled Asset Relief Program (TARP), which was intended to stabilize the U.S. financial system and prevent a systemic collapse. Prior to EESA's passage, a series of escalating events triggered by the failures and near failures of some of the world's largest financial institutions through the summer and early fall of 2008 severely eroded confidence in the U.S. financial system, shut down interbank lending and credit markets, and ultimately affected the real economy. These events helped transform the year-long financial crisis into an economic crisis, which set off global shockwaves and gave rise to the fear of a 1930s-style financial and economic meltdown.

This article will provide an overview of TARP, including legislative changes made to TARP as of this writing, as well as ongoing oversight of TARP. It will also cover details of participation in the TARP Capital Purchase Program (CPP) and CPP redemption criteria and explain TARP within in the context of the Treasury's overarching Financial Stability Plan.

TARP Overview

Under EESA, the Treasury was allotted up to $700 billion in three installments to fund TARP—$250 billion initially, with an additional $100 billion to be released contingent upon the approval of the U.S. President, and a third installment of $350 billion contingent upon the approval of both the U.S. President and U.S. Congress. The first two installments, totaling $350 billion, were released to the Treasury in the latter half of 2008. The third installment of $350 billion was released to the Treasury on February 13, 2009, with the passage of the American Recovery and Reinvestment Act (ARRA).

Legislative changes to TARP. TARP and the Treasury's various programs falling under the TARP umbrella have undergone changes since the passage of EESA. Legislatively, the ARRA (2009) retroactively established significant conditions and restrictions around executive compensation, incentive pay, and severance pay for firms receiving TARP funds. The ARRA also authorized the extension of TARP funds to the auto industry and enhanced reporting and recordkeeping requirements for institutions receiving TARP funds.

In addition to legislative changes introduced under the ARRA, the Treasury has continued to refine and develop various programs through its TARP authority and to administer these and other programs that aim to stabilize financial markets and prevent further home foreclosures through the adoption of an overarching Financial Stability Plan framework. The Treasury has described the Financial Stability Plan, which it announced in February 2009, as a broad-based effort that will reach across government agencies to implement a series of financial initiatives alongside the ARRA to help lay the foundation for economic recovery.

Under the plan, the Treasury is administering the following TARP programs:

- Capital Assistance Program
- Consumer and Business Lending Initiative
- Making Home Affordable Program
- Public-Private Investment Program

- Regulatory Reform
- Capital Purchase Program (CPP)
- Asset Guarantee Program (AGP)
- Targeted Investment Program (TIP)
- Automotive Industry Financing Program

For information on these initiatives and the Financial Stability Program, go to <www.financialstability.gov/>.

TARP Oversight

EESA created an oversight board, the Financial Stability Oversight Board (FSOB), for TARP. The FSOB meets monthly to review and discuss TARP-related programs, policies, and financial commitments and other key objectives of EESA. The FSOB is composed of the Secretary of the Treasury, Chairman of the Board of Governors of the Federal Reserve System (chair), Secretary of the Department of Housing and Urban Development, Chairman of the Securities and Exchange Commission, and Director of the Federal Housing Finance Agency. Minutes of the FSOB meetings are made public at <www.financialstability.gov/about/oversight.html>.

The original provisions of TARP under EESA focused on a Treasury asset purchase program to buy the illiquid mortgage-backed assets that many believed were clogging up the balance sheets of financial institutions and hindering their ability to lend and raise private capital.

EESA also established a special inspector general (SIGTARP) to conduct, supervise, and coordinate audits and investigations of the purchase, management, and sale of assets under TARP. The goal of the SIGTARP, who has authority to issue subpoenas, is to protect the interest of the American taxpayers by providing effective oversight for TARP and robust criminal and civil enforcement against those who waste, steal, or abuse TARP funds.

CPP Program

The original provisions of TARP under EESA focused on a Treasury asset purchase program to buy the illiquid mortgage-backed assets that many believed were clogging up the balance sheets of financial institutions and hindering their ability to lend and raise private capital. When it became clear that an asset purchase program was too complicated to implement quickly enough to calm the markets and forestall an economic meltdown, the Treasury implemented the CPP.

This move was found by some to be controversial, as the CPP enabled the Treasury to inject capital directly into the financial system by purchasing equity stakes in sound financial institutions. Nine of the largest U.S. financial institutions subsequently accepted between $2 billion and $25 billion each under the CPP, and numerous institutions applied for and voluntarily accepted CPP funds thereafter.

The Treasury created the CPP to address the severe strains affecting the financial markets and obstructing the free flow of credit essential to a well-functioning economy. Under the CPP, which is voluntary, the Treasury is providing capital to viable financial institutions through the purchase of up to $25 billion of a financial institution's preferred shares. These investments enable participating financial institutions to build their capital base, thereby increasing their capacity to lend to households and businesses and support the economy. As of March 31, 2009, the Treasury has invested approximately $198.8 billion in 532 financial institutions under the CPP.[1]

Provisions built into the Treasury's CPP agreements are meant to protect the interests of the taxpayers and generate a return on the Treasury's investment. Publicly-held participating financial institutions, for

[1] <www.financialstability.gov/latest/reportsanddocs.html>.

example, pay the Treasury a five percent dividend on senior preferred shares for the first five years following the Treasury's investment and nine percent per year thereafter. To protect the taxpayers, participating financial institutions must adhere to executive compensation and dividend and stock repurchase agreements. They must also provide the Treasury with warrants as specified under EESA, the CPP program rules, and the terms of their purchase agreements.

Institutions that qualified for the CPP include U.S.-controlled banks, savings associations, security brokers or dealers, and insurance companies. Additionally, financial institutions that filed a bank or thrift holding company application on or before December 8, 2008, and were approved on or before January 15, 2009, were also permitted to apply for CPP funds. Any bank or thrift holding company that has CPP funds must maintain its status as a bank or thrift holding company until those funds are repaid.

While the original application deadlines for the CPP have closed, the Treasury recently announced that the CPP application window for all term sheets—public and private corporations, Subchapter S corporations, and mutual institutions—will be reopened for institutions with total assets under $500 million. The terms of the program will also be revised to raise the amount for which qualifying institutions can apply from three percent of risk-weighted assets to five percent. Current CPP participants will be allowed to reapply with an expedited approval process.

The Treasury also indicated that it will extend the deadline for small banks to form a holding company for the purposes of the CPP. The window to form a holding company and the window to apply or reapply for the CPP will be open for six months.

The Treasury's capital injections under the CPP are intended to restore the credit markets and encourage financial institutions to resume lending at more normal pre-crisis levels to businesses and consumers, a prerequisite to stabilizing the financial sector and improving investor confidence in financial institutions and the markets. Financial recovery has been a slow process, however, and although short-term credit markets are functioning better and bank and nonbank lending has picked up considerably since last fall, the amount of financing extended to consumers and businesses remains somewhat restricted.

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Redeeming CPP Funds

The changes implemented by the ARRA, especially those surrounding executive compensation and incentive pay, have prompted many institutions to evaluate the costs and benefits associated with CPP funds. For some institutions, the perceived stigma associated with TARP has been a determining factor in their decision to pull their applications for Treasury investments under CPP or, for those that have already accepted funds, to pay back those funds early.

The original CPP placed a number of conditions on repaying funds. The ARRA, however, revised the terms of CPP to permit financial institutions to redeem CPP funds prior to any contractual waiting period specified in their purchase agreements with the Treasury and permits them to redeem CPP funds with funds obtained from any source.

Institutions that are interested in redeeming their CPP funds are advised to notify their primary regulator and to notify the Treasury at CPPRedemption@do.treas.gov. After receiving an institution's notice, the Treasury will consult with the institution's primary regulator.

Following are FAQ links for institutions interested in paying back TARP funds:

- <www.financialstability.gov/docs/FAQ_CPP-CAP.pdf>
- <www.financialstability.gov/docs/CPP/CPP-FAQs.pdf>

The Impact of the CPP

Some observers have compared the government's intervention under TARP to the 1930s, with the chartering of the Reconstruction Finance Corporation Act, which made loans to various state and local governments, as well as distressed financial institutions. Supporters of EESA today argue that government intervention has prevented a catastrophic collapse of the financial system and has had some effect in restoring short-term lending markets and improving the flow of credit to businesses and consumers. These supporters also believe that there is the possibility that the government may recoup a portion—potentially all—of its investment, although critics have objected to the enormous cost of the intervention and the uncertainty of the outcome.

It is still too early to have a good understanding of the impact of the CPP on the U.S. economy. Demand for credit typically falls during economic downturns, as lenders and borrowers react to the uncertain economic environment. It is also difficult to isolate the effect of the CPP from the host of other governmental economic recovery efforts implemented during the same timeframe. The Treasury has recently developed tools to better measure the lending and disintermediation activities of institutions receiving CPP funds. These tools should eventually provide more insight into the impact of the CPP and the role it is playing, as the industry continues to progress toward financial and economic recovery.

For more information on the CPP, please visit <www.financialstability.gov/roadtostability/capitalpurchaseprogram.html>. □

The following is an update to the article, "Emerging Issues Regarding Trust Preferred Securities," published in the First Quarter 2009 issue of *SRC Insights*.

On March 17, 2009, the Federal Reserve Board announced the adoption of a final rule that delays until March 31, 2011, the effective date of new limits on the inclusion of trust preferred securities and other restricted core capital elements in tier 1 capital of bank holding companies (BHCs). This action is being taken in light of continued stress in financial markets and the efforts of BHCs to increase their overall capital levels. These new limits were scheduled to take effect on March 31, 2009, pursuant to a final rule adopted by the Board on March 10, 2005 (70 Federal Register 11827). As a result of delaying implementation of the new limits and until the new effective date in 2011, all BHCs may include cumulative perpetual preferred stock and trust preferred securities in tier 1 capital up to 25 percent of total core capital elements.

Liquidity Risk Management: Are You Prepared? Part II

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A sound practice for measuring liquidity risk includes establishing a comprehensive method for cash flow forecasting. Cash flow from assets, liabilities, and off-balance-sheet items should be forecasted considering vulnerability to events, activities, and strategies that can significantly strain an institution's ability to generate internal cash flow using an appropriate set of time horizons. Forecasts can range from a simple spreadsheet to very intricate, detailed reports.

Time horizons. Selected time horizons should be meaningful and relate to the current and potential vulnerability to changing liquidity needs under both normal and stressed conditions. All forecasting processes should involve both short-term and long-term time horizons. Common horizons include: intraday, day-to-day, short-term weekly, monthly, and longer-term of up to one year and beyond.

Assumptions. Cash flow forecasting includes the use of assumptions. Institutions should carefully select and regularly review their assumptions to ensure that they are reasonable and appropriate. The board of directors should effectively document and approve assumptions, and management should additionally scrutinize assumptions that are used to assess the liquidity risk of complex assets, liabilities, and off-balance-sheet positions. Assumptions about the stability or volatility of retail deposits, brokered deposits, wholesale borrowings, and other funding sources are especially important, particularly if the related assumptions are used to evaluate contingent liquidity sources.

MIS reporting. As with other elements of sound liquidity risk management, the complexity and sophistication of management reporting and MIS should be consistent with the size and liquidity profile of the institution. For example, larger institutions that use wholesale funds as a funding source may incorporate daily reports of funding source usage, maturities of various instruments, and rollover rates. A smaller institution may need only a simple maturity gap or cash flow report that depicts rollovers and mismatch risks, combined with pertinent liquidity ratios, to adequately manage its risk.

Reports should be customized to the intended audience and level of responsibility. This includes those associated with day-to-day management, regular senior management and ALCO review and decisionmaking, as well as periodic reporting to the board of directors. Liquidity risk reports to senior management should provide aggregate information in sufficient supporting detail to enable management to assess the institution's sensitivity to changes in market conditions or its own financial performance and other important risk factors.

Stress test results assist financial institutions with identifying, quantifying, and analyzing sources of liquidity strain and the potential impact to cash flow.

Stress testing. Regular stress testing should be conducted and include a variety of both institution-specific and marketwide events across short- and long-term time horizons. Stress test results assist financial institutions with identifying, quantifying, and analyzing sources of liquidity strain and the potential impact to cash flow. Management should review stress test results and develop and implement risk mitigants, when needed. Management also needs to ensure that any potential exposures are in line with its approved liquidity risk tolerance and to make any necessary adjustments to its liquidity profile. Stress tests also help institutions to develop CFPs.

Ongoing monitoring. Monitoring of liquidity risk should be done on a flow basis and should assess cost trends for both existing and contingent funds providers, funding source concentrations, the adequacy of liquidity reserves, and the sensitivity of funds providers to market events and institution-specific trends and events.

Contingency Funding Plans

A CFP is a combination of policies, procedures, and action plans for responding to contingent liquidity events. Events are unexpected situations or business conditions that may increase liquidity risk, given an institution's balance sheet structure, organizational structure, business activities, and other institution-specific characteristics.

Events can result from:

- The inability to fund asset growth
- The inability to renew or replace maturing funding liabilities
- Unexpected deposit withdrawals or off-balance-sheet commitment activity

- Change in economic conditions, market perception, or dislocations in the financial markets
- Disturbances in payment and settlement systems due to operational or local disasters

A CFP's primary purpose is to assist management with considering potential events and scenarios that may result in a liquidity shortfall, in order to ensure that liquidity sources are sufficient to fund normal operating requirements without incurring undue expense or causing business disruptions. The CFP provides the institution with a plan for responding to a liquidity crisis.

Events can affect any institution, regardless of size or complexity, and can be institution-specific or result from external factors. Institution-specific events are typically related to internal operational and strategic risks, whereas external events may be related to systemic financial market conditions, like securities price volatility resulting from market events, economic conditions, or financial market disruption.

Events can be high-probability/low-impact or low-probability/high-impact, and institutions need to plan for both. The risk from the former can be addressed in an institution's daily management of its sources and uses of funds using variations in expected cash-flow projections and provisions for adequate liquidity reserves. The risk from the latter should be addressed in the CFP.

Key elements of a CFP include:

- **Identifying reasonably plausible events**—An institution should conduct regular monitoring for potential events and establish early-warning indicators and event triggers that are specific to its liquidity risk profile.
- **Evaluating those events under different levels of severity**—The various severity levels of each event should be defined and an associated response plan established. This includes temporary liquidity disruptions, as well as intermediate- or longer-term disruptions.
- **Conducting quantitative projections and assessments of funding needs and funding ca-**

pacity—This is a crucial element of a CFP. Analysis should be realistic, include all material on- and off-balance-sheet cash flows, and assess potential funding erosion at the various severity levels of the event and potential cash flow mismatches that may occur. Institutions also need to determine and document the sequence of steps for responding to an event and sources of funds. Two common quantitative reports that are developed are pro forma cash flow reports that estimate funding surpluses or shortfalls over selected future timeframes and under various liquidity event scenarios.

- **Identifying potential funding sources**—Alternative sources should be identified, and administrative procedures and agreements should be created and established well in advance of any potential liquidity event. These sources are rarely utilized in the normal course of business, yet any steps necessary to ensure that an institution is ready to activate alternative funding sources should be defined and detailed in the CFP.
- **Providing for commensurate management processes, reporting, external communication**—A crisis management team should be identified, and appropriate action plans for each event severity level should be established. Communication and reporting among crisis team members and between the team and the board of directors and other business line management are essential. In addition, communication and reporting should be ramped up with each increasing level of event severity.

In the process of establishing a CFP, management may become aware of certain funding positions that are outside its current risk tolerance, providing an opportunity to reduce risk in a normal operating environment. Another benefit of implementing a CFP is that it allows management to develop strategies for managing specific scenarios, thereby reducing response time and financial impact to the institution if the event actually occurs. Also, separate CFPs may be necessary for the parent company and the consolidated banks in a multibank holding company or for separate nonbank subsidiaries.

Conclusion

All financial institutions are expected to appropriately manage liquidity risk, given their risk profile, complexity, and scope of operations. Any liquidity risk analysis should expose current funding mismatches and evaluate contingent liquidity risks. Management and the board of directors should evaluate and understand the institution's liquidity risk profile. If you have any questions on liquidity or liquidity risk management, please contact Avi Peled (Avi.Peled@phil.frb.org) at (215) 574-6268 or Andrea Anastasio (Andrea.Anastasio@phil.frb.org) at (215) 574-6524. ☐

Enforcement Unit Purpose and Practices

In addition to its primary responsibility of drafting and issuing supervisory actions, the Enforcement Unit also plays a key role in fulfilling the broader mission of Supervision, Regulation and Credit. Detailed descriptions of the unit's various roles and responsibilities, definitions of the different types of supervisory actions, and an explanation of the process for issuing supervisory actions are included in the publication *Enforcement Unit Purpose and Practices*, which is now available online at <www.philadelphiafed.org/publications/supervision-and-regulation/>. ☐

What Is an Excess Balance Account? *by Gail Todd, Credit Officer*

On May 20, 2009, the Board of Governors approved an amendment to Regulation D authorizing the establishment of limited-purpose accounts at Federal Reserve Banks for the purpose of maintaining excess reserve balances. Available beginning July 2, 2009, these accounts are known as excess balance accounts (EBAs).

Some institutions may not be aware of what a limited-purpose account is and why the Federal Reserve offers them. An EBA is an account at a Federal Reserve Bank established for the benefit of one or more depository institutions (referred to as participants), which are eligible to earn interest on the account's balance. The EBA is managed by an agent on behalf of the participants. It is anticipated that agents will be institutions that offer correspondent services.

EBAs are intended to allow eligible institutions to earn interest on their excess balances in an account relationship directly with a Federal Reserve Bank without significantly disrupting established business relationships with their correspondents. EBAs permit the correspondent to serve as agent when placing the respondent's excess balances at the Federal Reserve Bank. Balances in the EBA are an asset of the participants in the account, not the agent that manages the account. The Federal Reserve Bank pays interest on the average balance in the EBA over the reserve maintenance period, and the agent disburses that interest to each participant in accordance with the instructions of the participant. Only excess balances may be placed in an EBA; the account balance cannot be used to satisfy reserve balance or contractual clearing balance requirements.

An EBA will be set up by the institution intending to perform the role of EBA agent. The agent must have its own account at a Federal Reserve Bank and must agree to comply with the terms and conditions of operating an EBA. It should be noted that the agent does not have to be eligible to earn interest on its own balance maintained at a Federal Reserve Bank.

Each participant must authorize the agent to manage the EBA on its behalf pursuant to an Excess Balance Account Agreement. Participants in an EBA must be eligible to earn interest on the balance they hold at the Federal Reserve Bank. Each participant can participate in only one EBA, and the EBA may be located in a different District than the participant. The agent will coordinate the execution of agreements and forward all agreements to the Federal Reserve Bank.

If you have any questions regarding these new accounts, please contact Donna Wilson (donna.wilson@phil.frb.org) at 215-574-6595 or go to <www.frbservices.org>. ☐

Is Something Missing?

With each issue of *SRC Insights*, we aim to highlight the supervisory, regulatory, and consumer compliance issues that affect you and your banking institution the most. But we recognize that your institution may be interested in topics that we have not covered, and we want to ensure that your voice is heard. What issues arise in your daily operations? What questions concern you in the course of business? What else would you like to see in an upcoming issue of *SRC Insights*?

We encourage you to contact us with any topic ideas, concerns, or questions. Please direct any comments and suggestions to Joanne M. Branigan (joanne.branigan@phil.frb.org) at (215) 574-3769.

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