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**FDIC's EXAMINATION OF LIQUIDITY
RISK**

AUDIT REPORT





Federal Deposit Insurance Corporation

FDIC's Examination of Liquidity Risk

Audit Results

The FDIC actively addresses institution liquidity risk through regulatory and supervisory activities. For the 40 financial institutions in our sample, we found that the FDIC examiners complied with applicable examination guidance for assessing an institution's liquidity and associated risk management and reported on those assessments in their work products and examination results. Specifically, we found that:

- Examiners reported on significant liquidity risk management controls, including board and senior management oversight, written policies and procedures, management reporting, internal controls, and CLPs; and sources of funding for each of the 40 financial institutions. Examiners frequently made suggestions and recommendations for improvement.
- Seventeen of the 40 financial institutions were subject to informal or formal enforcement actions, 13 of which included provisions for financial institutions to improve liquidity risk management.

The FDIC's efforts, including examination recommendations and enforcement actions, have provided a means to address liquidity risk and indicate the FDIC's emphasis on controlling such risk.

In addition, the FDIC has issued liquidity guidance to its examiners and FDIC-supervised financial institutions and provided liquidity-related examiner training. The FDIC has recognized that liquidity guidance and training need to be updated and has taken steps to (1) issue a revised examination module on liquidity risk examination procedures, (2) participate in interagency efforts to provide additional examination and institution guidance, and (3) expand examiner training.

We reviewed contingency liquidity planning for 31 of the 40 institutions we sampled and identified variations in the type of information included in the plans. Additionally, we determined that the FDIC's examiner guidance is more extensive than its financial institution guidance. With regard to the Corporation's ongoing efforts to update guidance to institutions on liquidity risk management and CLPs, we identified the following practices, for the FDIC's consideration, that could assist FDIC-supervised financial institutions in identifying, measuring, monitoring, and controlling liquidity risk.

- Providing detailed descriptions of sound liquidity risk management controls, including the content of CLPs.
- Suggesting liquidity reports and identifying red flags that are useful in assessing liquidity and that can be used as leading indicators for liquidity risk.

The FDIC plans to issue updated institution guidance after the international Basel Committee on Banking Supervision has issued final liquidity risk management guidance and related interagency efforts are completed. Because we noted no matters warranting additional management action, we made no recommendation related to the audit objective.

Management Response

DSC provided a written response, stating that the FDIC is committed to assuring that liquidity risk is appropriately assessed and mitigated through its examination and enforcement action procedures. The FDIC also reiterated that the Corporation is involved in various initiatives to update liquidity-related guidance for financial institutions and examiners.

Why We Did The Audit

Liquidity represents the ability of a financial institution to fund assets and meet obligations as they become due. Insured deposits are a common source of liquidity for FDIC-supervised financial institutions. Further, liquidity is critical to the ongoing viability of an institution, and the FDIC considers liquidity management to be among an institution's most important activities.

The audit objective was to assess how the FDIC addresses institution liquidity risk through various regulatory and supervisory activities. We focused our audit on those FDIC-supervised financial institutions for which examinations resulted in lower or less than satisfactory liquidity ratings.

Background

Liquidity risk is the risk of not being able to obtain funds at a reasonable price within a reasonable time to meet financial institution obligations as they become due. Sound liquidity risk management controls include an institution's board of directors' oversight, policies and procedures, management reporting, internal controls, contingency liquidity plans (CLP), and the identification of funding sources. CLPs include strategies for handling events that can impact day-to-day operations and liquidity crises.

The FDIC has issued financial institution and examiner guidance on managing liquidity risk. The other federal financial regulatory agencies and various international and domestic organizations have also issued guidance related to liquidity risk.

As part of the risk management examinations conducted by the FDIC's Division of Supervision and Consumer Protection (DSC), FDIC examiners determine the adequacy of a financial institution's liquidity by analyzing the institution's current liquidity position, asset quality, present and future earnings capacity, and historical and anticipated future funding needs. The FDIC also assesses the adequacy of liquidity risk management controls.

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DATE: July 30, 2008

MEMORANDUM TO: Sandra L. Thompson, Director
Division of Supervision and Consumer Protection

FROM: /Signed/
Russell A. Rau
Assistant Inspector General for Audits

SUBJECT: *FDIC's Examination of Liquidity Risk*
(Report No. AUD-08-012)

This report presents the results of our audit of the FDIC's supervision and examination of liquidity risk at FDIC-supervised institutions. The FDIC's Division of Supervision and Consumer Protection (DSC) is responsible for performing risk management examinations for FDIC-supervised financial institutions.

The audit objective was to assess how the FDIC addresses institution liquidity risk through various regulatory and supervisory activities. Specifically, we reviewed (1) risk management examinations; (2) institution and examination policies, procedures, and guidance; and (3) examiner training. We conducted this performance audit in accordance with generally accepted government auditing standards. Appendix 1 of this report discusses our audit objective, scope, and methodology in detail.

BACKGROUND

Liquidity represents a financial institution's ability to fund assets and meet obligations as they become due and is essential in all banks to compensate for expected and unexpected balance sheet fluctuations and provide funds for growth. Liquidity risk is the risk of not being able to obtain funds at a reasonable price within a reasonable period to meet obligations as they become due. Because liquidity is critical to the ongoing viability of any financial institution, liquidity management is among the most important activities conducted by an institution.

Funds management involves estimating and satisfying liquidity needs in the most cost-effective manner possible and without sacrificing income potential. Effective liquidity management requires financial institutions to measure the liquidity position of the financial institution on an ongoing basis and to determine how funding requirements may

change due to various scenarios, including adverse situations. The formality and sophistication of liquidity management depends on the size and sophistication of the financial institution, as well as the nature and complexity of its activities. Regardless of the institution, adequate management reporting, strong analysis of funding requirements under alternative scenarios, diversification of funding sources, and contingency planning are crucial elements of strong liquidity management.

Examiners' assessment of a financial institution's adequacy of liquidity is based on the Uniform Financial Institutions Rating System (UFIRS), which assigns component ratings, referred to as CAMELS ratings, from "1" to "5" based on a financial institution's financial condition and operations. A "1" indicates the highest rating, strongest performance and risk management practices, and least degree of supervisory concern, while a "5" indicates the lowest rating, weakest performance, inadequate risk management practices, and the highest degree of supervisory concern. The component factors address the adequacy of Capital, quality of Assets, capability of Management, quality and level of Earnings, adequacy of Liquidity, and Sensitivity to market risk. The ability of financial institution management to identify, measure, monitor, and control the risks of its operations is also taken into account when assigning each component rating. Determining an institution's liquidity adequacy requires an analysis of its current liquidity position, present and anticipated asset quality, present and future earnings capacity, historical funding requirements, anticipated future funding needs, and options for reducing funding needs or obtaining additional funds.

In general, a financial institution's funds management practices should ensure that the institution is able to maintain a level of liquidity sufficient to meet its financial obligations in a timely manner and to fulfill the legitimate banking needs of its community. Such practices should reflect the ability of the institution to manage unplanned changes in funding sources, as well as react to changes in market conditions that affect its ability to quickly liquidate assets with minimal loss.

Liquidity-related Guidelines

Liquidity is a key determinant of the soundness of the banking sector. The contraction of liquidity has been a factor in actions taken by international and domestic organizations, such as the Basel Committee on Banking Supervision (BCBS),¹ the Senior Supervisors

¹ The BCBS provides a forum for regular international cooperation among banking supervisory authorities. The objective of the BCBS is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. The BCBS circulates guidance on banking supervisory matters to financial supervisors throughout the world.

Group (SSG),² the Financial Stability Forum (FSF),³ the Board of Governors of the Federal Reserve System (Federal Reserve), and the federal financial institutions regulatory agencies⁴ (the “agencies”). Actions taken to enhance liquidity-related guidelines for effective liquidity risk management include the following.

- BCBS issued *Liquidity Risk: Management and Supervisory Challenges*, dated February 2008; and proposed guidance, *Principles for Sound Liquidity Risk Management and Supervision*, dated June 17, 2008.
- SSG issued *Observations on Risk Management Practices during the Recent Market Turbulence*, dated March 6, 2008.
- FSF issued the *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience*, dated April 7, 2008.
- The agencies are taking steps to enhance liquidity risk management guidance. Specifically, the agencies are currently involved in an interagency initiative to issue guidance to supervised institutions, examiners, and other supervisory personnel on sound practices for managing liquidity risk, pending the issuance of final liquidity risk management guidance by the BCBS. The Conference of State Bank Supervisors is also involved in the interagency effort.

During the strained credit market of 2007 and 2008, the Federal Reserve introduced three new lending facilities⁵ to provide liquidity to the financial markets and alleviate funding pressures. Those facilities include the Term Auction Facility, the Term Securities Lending Facility, and the Primary Dealer Credit Facility. Of these three lending facilities, only the Term Auction Facility, announced December 12, 2007, is available to depository financial institutions, and those institutions must be eligible to borrow under the Federal Reserve’s primary credit program.

² Members of the SSG include the French Banking Commission, German Federal Financial Supervisory Authority, Swiss Federal Banking Commission, and United Kingdom Financial Services Authority; and the U.S. Office of the Comptroller of the Currency (OCC), Securities and Exchange Commission, and Board of Governors of the Federal Reserve System.

³ The FSF brings together on a regular basis national authorities responsible for financial stability in significant international financial centers and international financial institutions, including sector-specific international groupings of regulators and supervisors, and committees of central bank experts. The FSF seeks to coordinate the efforts of these various bodies to promote international financial stability, improve the functioning of markets, and reduce systemic risk.

⁴ The OCC, Federal Reserve, FDIC, Office of Thrift Supervision (OTS), and National Credit Union Administration.

⁵ Central banks use lending facilities when lending funds to primary dealers. Primary dealers are banks, broker/dealers, or other financial institutions that meet certain liquidity and quality requirements and make business deals with the Federal Reserve, such as underwriting new government debt.

FDIC Examination Guidance Related to Liquidity Risk Management

DSC has issued liquidity-related guidance to FDIC examiners to assist in evaluating the adequacy of an institution's liquidity position. According to DSC's *Risk Management Manual of Examination Policies* (Examination Manual), examiners should consider the current level and prospective sources of liquidity compared to funding needs, as well as the adequacy of funds management practices relative to an institution's size, complexity, and risk profile. The Examination Manual also states that an examiner's evaluation of a financial institution's funds management practices should ensure that liquidity is not maintained at a high cost or through undue reliance on funding sources that may not be available during times of financial stress or changes that adversely affect market conditions.

The FDIC has also provided examiners the following liquidity-related guidance.

- the *Risk Management Examination Manual of Credit Card Activities*,
- the *Risk Management Credit Card Securitization Manual*,
- the *Case Manager Procedures Manual*,
- the Examination Documentation (ED) Modules (examiner use is optional),
- Regional Directors (RD) memoranda, and
- FDIC Rules and Regulations.

FDIC Enforcement Authority

The *Formal and Informal Action Procedures Manual* (FIAP Manual) provides guidance on the informal actions that the FDIC can accept from financial institutions and formal actions that the FDIC can impose on institutions. Formal actions are notices or orders issued by the FDIC against insured financial institutions and/or individual respondents to correct noted safety and soundness deficiencies, ensure compliance with federal and state banking laws, assess civil money penalties, and/or pursue removal or prohibition proceedings. Informal actions are voluntary commitments made by an insured financial institution's board of directors (BOD) and may include bank board resolutions (BBR) and memoranda of understanding (MOU). Such actions are designed to correct noted safety and soundness deficiencies or ensure compliance with federal and state laws. Section 8 of the Federal Deposit Insurance (FDI) Act provides enforcement authority for formal actions, such as cease and desist (C&D) orders and termination of insurance.

RESULTS OF AUDIT

The FDIC actively addresses institution liquidity risk through regulatory and supervisory activities. For the 40 financial institutions in our sample, the examiners complied with applicable examination guidance for assessing an institution's liquidity and associated risk management and reported on those assessments in their work products and examination results. Specifically, we found that:

- Examiners reported on significant liquidity risk management controls, including BOD and senior management oversight, written policies and procedures, management reporting, internal controls, and contingency liquidity plans (CLP); and sources of funding for each of the 40 financial institutions in our sample, frequently making suggestions and recommendations for improvement.
- Seventeen of the 40 financial institutions were subject to informal or formal enforcement actions, 13 of which included provisions to improve liquidity risk management.

The FDIC's efforts, including examination recommendations and enforcement actions, have provided a means to address liquidity risk and indicate the FDIC's emphasis on controlling such risk (**FDIC Examination of Liquidity Risk**).

In addition, the FDIC has issued liquidity guidance to both examiners and FDIC-supervised financial institutions and provided liquidity-related examiner training. The FDIC has recognized that liquidity guidance and training need to be updated and has taken steps to (1) issue a revised ED module on liquidity risk examination procedures, (2) participate in interagency efforts to provide additional examination and institution guidance, and (3) expand examiner training. Furthermore, we reviewed contingency liquidity planning for 31 of the 40 institutions we sampled and identified variations in the type of information included in those plans. With regard to ongoing efforts to update guidance to institutions on liquidity risk management and CLPs, we compared FDIC institution guidance to other liquidity risk guidance and (1) determined that FDIC examiner guidance is more extensive than the financial institution guidance and (2) identified the following practices that could assist FDIC-supervised financial institutions in identifying, measuring, monitoring, and controlling liquidity risk. These practices are provided for the FDIC's consideration in its update process.

- Providing detailed descriptions of sound liquidity risk management controls, including the content of CLPs.
- Suggesting liquidity reports and identifying red flags that are useful in assessing liquidity and that can be used as leading indicators for liquidity risk.

The FDIC plans to issue updated institution guidance after the international BCBS has issued final liquidity risk management guidance and related interagency efforts are completed (**FDIC Examination and Financial Institution Guidance for Liquidity Risk**).

Because we noted no matters warranting additional management action, we made no recommendation related to the audit objective.

FDIC EXAMINATION OF LIQUIDITY RISK

The FDIC's regulatory and supervisory activities to address liquidity risk include conducting risk management examinations and taking supervisory and enforcement actions to improve financial institutions' liquidity risk management. We sampled 40 FDIC-supervised financial institutions with increased liquidity risk⁶ and determined that the examiners had assessed liquidity and associated risk management during those examinations, reported on liquidity in applicable Reports of Examination (ROE), and frequently made suggestions and recommendations for improvement. In addition, the FDIC included liquidity-related provisions in supervisory and enforcement actions related to 13 of the 17 actions taken for the 40 financial institutions.⁷ Accordingly, we concluded that for the institutions we sampled, examiners complied with current examination policies and procedures to evaluate the adequacy of a financial institution's liquidity position and funds management practices and had taken action to strengthen liquidity risk management controls at FDIC-supervised institutions.

We found that examiners (1) reported on one or more of the liquidity risk management control elements, including BOD and senior management oversight, BOD-approved written policies and procedures, management reporting, internal controls, and CLPs; (2) evaluated sources of funding used by the institutions; and (3) identified issues needing bank management attention and made suggestions or recommendations for improvement for the 40 sampled institutions. The ROEs for these institutions contained examiner comments, suggestions, and recommendations as noted in the following examples.

- Management had not devoted sufficient time and attention to the oversight of the institution and had not provided clear guidance for acceptable risk exposure levels or ensured that appropriate policies, procedures, and practices had been established. The CLP was inadequate given the bank's size and complexity. Management also did not employ stress testing techniques, although the bank heavily relied on potentially volatile liabilities to fund operations. The institution was rated "3" for liquidity.
- The institution should formally adopt a comprehensive, BOD-approved CLP and identify the types of events for which the institution should be prepared, including

⁶ The OIG's determination of financial institutions with increased liquidity risk was based on those institutions with a liquidity risk rating that had been either lowered from a "1" to a "2" for liquidity or that were rated "3," "4," or "5" for liquidity based on the most recent examination results, as of December 31, 2007.

⁷ The OIG reviewed the circumstances surrounding the four institutions for which enforcement actions did not include liquidity-related provisions. Those actions were taken for (1) safety and soundness concerns for other than liquidity for institutions with a "2" rating for liquidity or (2) noncompliance with the Bank Secrecy Act. The OIG agreed with the examiners' decisions not to include liquidity provisions in those actions.

systemic events that would have a significant impact on the institution's liquidity. The CLP should provide for realistic action plans to address liquidity needs for differing levels of stress. For each potential event identified, the CLP should: (1) evaluate funding needs and funding capacities, (2) specify progressive actions and procedures to be implemented, (3) identify alternative contingency funding sources, and (4) measure the institution's ability to fund operations over an extended period of liquidity stress. The institution was rated "2" for liquidity.

- The bank's adopted investment policy did not address all the required areas, and current practice did not comply with the institution's stated policy. Guidelines for the types of investments, maturities, ratings, internal controls, and liquidity risks were not defined. The examiner recommended that the institution revise the investment policy, increase reporting to the BOD, and develop strategies on available funding sources. The institution was rated "2" for liquidity.

In addition, supervisory or enforcement actions were in place for 17 of the 40 financial institutions, of which 13 actions—BBRs, MOUs, and C&Ds—included liquidity-related provisions to assist bank management in improving liquidity risk management. Those actions applied to 1 institution rated "2" for liquidity and 12 institutions rated "3," "4," or "5" for liquidity. Those liquidity-related provisions included, but were not limited to, (1) developing, revising, and implementing a written liquidity and funds management plan; (2) restricting the use of brokered deposits;⁸ and (3) restoring all aspects of the financial institution to a safe and sound condition, including asset quality, capital adequacy, earnings, management effectiveness, and liquidity.

FDIC EXAMINATION AND FINANCIAL INSTITUTION GUIDANCE FOR LIQUIDITY RISK

DSC has issued liquidity-related guidance to FDIC examiners and FDIC-supervised financial institutions and provided liquidity-related examiner training. These actions help the FDIC in ensuring that examiners have guidance to determine whether financial institutions have liquidity risk management controls to identify, measure, monitor, and control liquidity risk. The FDIC's financial institution guidance helps institutions to implement CLPs for Federal Reserve discount window programs⁹ and addresses the

⁸ Brokered deposits are solicited by a third-party broker and are usually, but not always, for amounts less than \$100,000 so that all interest, as well as principal, is covered by deposit insurance. Brokers are typically paid a fee by the depository bank.

⁹ Discount window programs are credit facilities that financial institutions use to borrow funds from the Federal Reserve. The discount window helps to reduce liquidity problems for banks and assists in assuring the basic stability of financial markets.

eligibility of asset-backed commercial paper (ABCP) liquidity facilities.¹⁰ In addition, the FDIC is participating in ongoing interagency efforts to strengthen guidance to provide greater assurance that institutions needing to develop or strengthen their liquidity risk management controls will have more detailed guidance to assist in those efforts.

DSC Risk Management Manual of Examination Policies

FDIC examiners for the 40 FDIC-supervised financial institutions we sampled complied with examination guidance to evaluate the adequacy of the institutions' liquidity position and funds management practices. During risk management examinations, according to the Examination Manual, examiners should consider the current level and prospective sources of liquidity compared to funding needs, as well as the adequacy of funds management practices relative to the institution's size, complexity, and risk profile. Those practices should:

- ensure that an institution is able to maintain a level of liquidity sufficient to meet its financial obligations in a timely manner and to fulfill the legitimate banking needs of its community;
- reflect the ability of the institution to manage unplanned changes in funding sources, as well as react to changes in market conditions that affect the ability to quickly liquidate assets with minimal loss; and
- ensure that liquidity is not maintained at a high cost or through undue reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

Section 1.1 of the Examination Manual also provides information to examiners (detailed in Table 1 on the next page) to assist in evaluating liquidity and determining the appropriate rating for the "L" component in CAMELS.

¹⁰ ABCP conduits issue short-term notes backed by trade receivables, credit card receivables, or medium-term financial assets with an original maturity of 270 days or fewer. A specific pool of assets collateralizes the paper, which is repaid by the cash flow generated by the underlying assets and the issuance of new commercial paper.

Table 1: Liquidity Rating Description According to DSC’s Examination Manual

A rating of **1** indicates strong liquidity levels and well-developed funds management practices. The institution has reliable access to sufficient sources of funds on favorable terms to meet present and anticipated liquidity needs.

A rating of **2** indicates satisfactory liquidity levels and funds management practices. The institution has access to sufficient sources of funds on acceptable terms to meet present and anticipated liquidity needs. Modest weaknesses may be evident in funds management practices.

A rating of **3** indicates liquidity levels or funds management practices in need of improvement. Institutions rated 3 may lack ready access to funds on reasonable terms or may evidence significant weaknesses in funds management practices.

A rating of **4** indicates deficient liquidity levels or inadequate funds management practices. Institutions rated 4 may not have or be able to obtain a sufficient volume of funds on reasonable terms to meet liquidity needs.

A rating of **5** indicates liquidity levels or funds management practices so critically deficient that the continued viability of the institution is threatened. Institutions rated 5 require immediate external financial assistance to meet maturing obligations or other liquidity needs.

Source: Examination Manual, Section 1.1.

For institutions that present increased risk for liquidity, examiners are to consider whether the institution should be rated a “3,” “4,” or “5” for the “L” component of the CAMELS ratings. These ratings indicate that a financial institution’s liquidity risk and funds management practices need improvement, are deficient/inadequate, or are critically deficient and threaten the viability of the institution.

Section 6.1 of the Examination Manual states that the formality and sophistication of liquidity management depends on the size and sophistication of the financial institution as well as the nature and complexity of the institution’s activities. In addition, Section 6.1 states that a financial institution should have a BOD that understands the nature and level of the institution’s liquidity risk, establishes the institution’s tolerance for liquidity risk, and approves significant policies related to liquidity management. Further, Section 6.1 states that financial institutions should have liquidity risk management control elements that include:

- BOD-approved written policies and procedures for the day-to-day management of liquidity and that should be communicated throughout the institution;
- management reporting systems adequate to measure, monitor, and control liquidity risk and that provide regular reports to the BOD and senior management;
- adequate internal controls to ensure the integrity of the institution’s liquidity risk management process; and

- a CLP that (1) addresses alternative funding if initial projections of funding sources and uses of those funds are incorrect or if a liquidity crisis arises and (2) is updated regularly.

Section 6.1 also provides information on mechanisms to monitor various internal and market indicators of liquidity problems at the institution. In addition, the Examination Manual provides specific information on retail funding sources such as core deposits¹¹ and wholesale funding sources, such as federal funds, public funds, Federal Home Loan Bank (FHLB) advances,¹² foreign deposits, brokered deposits, and deposits obtained through the Internet or certificate of deposit listing services.

DSC Financial Institution Guidance

The FDIC has issued financial institution letters (FIL),¹³ specifically, FIL-59-2003 and FIL-74-2005 that provide liquidity-related guidance to FDIC-supervised financial institutions. The FILs are to be used by financial institutions as the basis for the development of a CLP that incorporates the Federal Reserve's discount window programs, as well as other viable sources of liquidity funds, and as clarification on applying of the asset quality test for liquidity facilities.

- *FIL-59-2003, Use of the Federal Reserve's Primary Credit Program in Effective Liquidity Management*, dated July 23, 2003, presents information on these programs and provides directors, management, examiners, and supervisors of depository institutions guidance on the appropriate use of primary and secondary credit in effective liquidity management, with particular focus on the primary credit program.¹⁴

In addition, FIL-59-2003 states that the agencies have advised financial institutions that sound liquidity risk management requires well-established strategies, policies and procedures, liquidity risk measurement systems, adequate internal controls, and contingency liquidity planning. Adequate contingency liquidity planning is critical to the ongoing maintenance of the safety and soundness of any depository institution. Such planning starts with an assessment of the possible liquidity events that an institution might encounter. A

¹¹ Core deposits include deposits that (1) have an indefinite maturity—such as checking accounts and interest-bearing checking accounts, money market deposit accounts, and savings accounts; (2) are stable; and (3) are under \$100,000 each.

¹² FHLB advances are a popular source of funding for financial institutions. To obtain FHLB advances, an institution must be a member of an FHLB and, for most advances, must pledge collateral. Access to advance funding can increase an institution's liquidity by affording an institution the ability to pledge otherwise illiquid assets as collateral.

¹³ FILs, issued to FDIC-supervised financial institutions by the Corporation, may announce new regulations and policies, new FDIC publications, and a variety of other matters of principal interest to those responsible for operating a bank or savings association.

¹⁴ For this program, the primary credit rate is a short-term rate charged for the most financially secure financial institutions. The secondary credit rate is a short-term rate charged for financial institutions that do not qualify for the primary rate.

fundamental principle in designing contingency plans is to ensure adequate diversification in the potential sources of funds to be utilized.

- FIL-74-2005, *Capital Standards, Supervisory Guidance on the Eligibility of Asset-Backed Commercial Paper Liquidity Facilities and the Resulting Risk-Based Capital Treatment*, dated August 4, 2005, addresses the eligibility of ABCP liquidity facilities.

During our audit, we noted: (1) variations in the type and extent of information included in financial institutions’ CLPs, (2) examiner guidance that is more extensive than financial institution guidance, and (3) variations in the type and extent of guidance issued by the FDIC as compared to the other agencies. These areas are described in detail in the following paragraphs.

Contingency Liquidity Planning. DSC officials provided CLPs and related documentation for 31 of the 40 financial institutions included in our sample. Of those 31 financial institutions, 15 were rated “2” for liquidity, and 16 were rated “3,” “4,” or “5” for liquidity. According to the Examination Manual, CLPs help management to monitor liquidity risk, ensure that an appropriate amount of liquid assets is maintained, measure and project funding requirements during various scenarios, and manage access to funding sources. Based on our analysis of the contingency liquidity planning for those 31 financial institutions and our review of the 13 plan elements listed in the Examination Manual (as stated in Appendix 2 of this report), we determined that the institutions’ contingency planning actions widely varied as noted in Table 2 below.

Table 2: OIG Review of Contingency Planning Actions for 31 Sampled Financial Institutions

CLP Element	Number of Financial Institutions that Included the Element in Contingency Planning Actions
Define responsibilities and decision-making authority	27
Identify and assess the adequacy of contingent funding sources	23
Include an assessment of the possible liquidity events that an institution might encounter, ranging from high-probability/low-impact events that can occur in day-to-day operations to low-probability/high-impact events that can arise through institution-specific, systemic market, or operational circumstances	10
Match potential sources and uses of funds	13
Identify the sequence in which sources of funds will be used for contingent needs	9
Assess the potential liquidity risk posed by other activities such as asset sales and securitization programs	4

Source: Examination Manual, Section 6.1, and OIG review of CLPs for 31 of the 40 sampled financial institutions.

Our review of the actions to address contingency planning for 31 financial institutions determined that some of the 13 CLP elements included in the Examination Manual were not always specifically covered in the contingency planning actions. However, we also determined that financial institutions included other elements to assist the institutions in managing liquidity risk. Those elements included, but are not limited to:

- identifying new customers or funding sources and maximizing current customer deposit business,
- monitoring demand deposit and time deposit activities of the largest customers,
- selling all unpledged securities that are at break-even or at a profit and investing proceeds in federal funds,
- limiting lending facilities if liquidity risk increases at the financial institution and directing the institution to take action in the following order:
 - temporarily cease commercial lending,
 - discontinue loans to new customers, and
 - refuse short-term, working capital loans to existing commercial customers or short-term loans to consumer customers.

Extent of Examiner Guidance Compared to Financial Institution Guidance. The FDIC has provided liquidity-related guidance to its examiners. However, the FDIC's institution guidance provides limited information on liquidity risk management controls that institutions should use to identify, measure, monitor, and control liquidity risk. In contrast, FDIC examiner guidance contains comprehensive information to assist in the evaluation of FDIC-supervised financial institutions' liquidity risk and outlines specific liquidity risk management controls that examiners should consider during risk management examinations.

FIL-59-2003 discusses the use of the Federal Reserve's discount window and provides guidance, to some degree, on liquidity risk management controls, including CLPs. Specifically, the FIL (1) provides interagency guidance on the need for financial institutions to develop CLPs that incorporate the Federal Reserve's discount window programs, as well as other viable sources of liquidity funds, and (2) informs depository institutions that sound liquidity risk management requires the four elements listed in Table 3 on the next page.

Table 3: Elements of Sound Liquidity Risk Management Based on Institution Guidance in FIL-59-2003

Well-established strategies, policies, and procedures for managing both the sources and uses of an institution's funds across various tenors or time frames. This includes assessing and planning for short-term, intermediate-term, and long-term liquidity needs.

Liquidity risk measurement systems that are appropriate for the size and complexity of the institution. Depending upon the institution, such measurement systems can range from simple cash flow measures to very sophisticated cash flow simulation models.

Adequate internal controls and internal audit processes. Internal controls and internal audit reviews are needed to ensure compliance with internal liquidity management policies and procedures.

Comprehensive contingency liquidity planning. Contingency plans need to be well designed and should span a broad range of potential liquidity events that are tailored to an institution's specific business lines and liquidity risk profile.

Source: FIL-59-2003.

The majority of the guidance on CLPs in FIL-59-2003 relates to the Federal Reserve's discount window, in general, and the primary and secondary credit programs, in particular. More specifically, FIL-59-2003 does not provide detailed guidance on:

- BOD and senior management oversight,
- policies and procedures,
- management reports,
- internal controls, and
- warning indicators.

In contrast to the FIL, examiner guidance in the Examination Manual stresses the importance of financial institutions' policies and procedures established by a sound liquidity and funds management policy and provides detailed information on the types of institution policies and procedures needed (see Figure 1). The Examination Manual also provides detailed examiner guidance related to other liquidity risk management controls, including internal controls and management reporting.

Figure 1: Examples of Policies and Procedures Included in Examiner Guidance But Not in Financial Institution Guidance

- Establishment of an asset/liability committee.
- Periodic review of the bank's deposit structure.
- Policies and procedures that address funding concentration in, or excessive reliance on, any single source or type of funding, such as brokered deposits, Internet deposits, and other similar rate sensitive or credit sensitive deposits.
- Method of computing the bank's cost of funds.

Source: Examination Manual, Section 6.1.

Appendix 3 provides additional information on our comparison of the FDIC's examiner and financial institution guidance.

Other Agencies' Liquidity Risk Management Guidance. The FDIC and the other agencies have addressed liquidity risk in various ways. More specifically, all of the agencies have issued joint and individual liquidity-related guidance to the respective institutions they supervise. For example, the agencies jointly issued guidance related to the use of the Federal Reserve's discount window, ABCP liquidity facilities, and a *Joint Agency Advisory on Brokered and Rate Sensitive Deposits*, dated May 11, 2001,¹⁵ which supplements each agency's existing supervisory and examination guidance on funding and liquidity issues.¹⁶

However, unlike the FDIC, the other federal regulatory agencies have issued more extensive liquidity-related institution guidance that provides detailed information on liquidity risk management controls. For example, other agency guidance includes detailed information on sound practices for liquidity management, suggested liquidity reports, and red flags (see Figure 2) that may be used as leading indicators of liquidity-related problems.

¹⁵ Our audit did not include a detailed review of those types of deposits, except to identify the type and extent of related guidance.

¹⁶ In this advisory, the agencies warned that excessive reliance on these types of funding products without proper risk management safeguards could weaken an institution's financial condition. Financial institutions that make use of significant amounts of brokered and rate-sensitive deposits (such as those obtained through the Internet, certificate of deposit listing services, and similar advertising services) should ensure that proper risk management practices are in place. Such practices include control structures to limit concentrations in this type of funding, due diligence in assessing deposit brokers and the risk to earnings and capital, and appropriate management reporting. The advisory lists potential red flags that may indicate the need for closer supervisory review, including newly chartered institutions with an aggressive growth strategy and few relationship deposits, high on- or off-balance sheet growth rates, and inadequate systems or controls.



Figure 2: Red Flags That May Indicate Problems Related to Liquidity Risk Management

- Exceeding liquidity risk limits established by the financial institution's BOD.
- Changes in significant funding sources.
- Rapid asset growth funded by rate and/or credit sensitive funding, such as brokered deposits or deposits obtained through certificate of deposit listing services.
- Eliminated or decreased credit line availability from lenders.
- Ineffective CLPs that are not current and commensurate with the complexity of the financial institution's funding activities.

Source: OCC financial institution guidance, *Detecting Red Flags in Board Reports—A Guide for Directors*.

Appendix 4 of this report contains additional information on guidance provided by the other federal regulatory agencies.

Conclusion

The FDIC has initiatives underway to review and enhance financial institution and examiner liquidity-related guidance based on forthcoming BCBS guidance. The FDIC plans to issue updated institution guidance after the BCBS has issued final liquidity risk management guidance and related interagency efforts are completed. Because we noted no matters warranting additional management action, we made no recommendation related to the audit objective.

CORPORATION COMMENTS

On July 23, 2008, the Director, DSC, provided a written response to the draft report. DSC's response is provided in its entirety as Appendix 5 of this report. In its response, DSC acknowledged the FDIC's role in the BCBS' Working Group on Liquidity, which is in the process of developing updated guidance expected to be issued later in 2008 and is planning to issue domestic interagency guidance shortly after the BCBS guidance is finalized. DSC also stated that the FDIC:

- is involved with international and interagency partners in providing industry guidance as well as training to examiners; and
- plans to issue updated financial institution guidance shortly that provides detailed descriptions of sound liquidity risk management controls and suggests key liquidity reports and typical red flags that are useful in assessing liquidity and that can be used as leading indicators for liquidity risk.

OBJECTIVE, SCOPE, AND METHODOLOGY

Objective and Scope

The audit objective was to assess how the FDIC addresses institution liquidity risk through various regulatory and supervisory activities. Specifically, we reviewed (1) risk management examinations; (2) institution and examination policies, procedures, and guidance; and (3) examiner training. We conducted this performance audit from November 2007 through May 2008 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our significant findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Methodology

To obtain an understanding of DSC guidance for liquidity risk, we interviewed DSC officials in Washington, D.C., and reviewed the following FDIC financial institution and examiner guidance related to liquidity:

- two FILs issued to financial institutions,
- the *Risk Management Examination Manual of Credit Card Activities*,
- the *Risk Management Credit Card Securitization Manual*,
- the *Case Manager Procedures Manual*,
- ED Modules,
- RD memoranda, and
- Parts 325 and 337 of the FDIC Rules and Regulations.

In addition, we reviewed a non-statistical sample¹⁷ of 40 FDIC-supervised financial institutions, which consisted of 20 institutions for which the liquidity rating had been lowered from “1” to “2” at the most recent examination and 20 institutions with a liquidity rating of “3,” “4,” or “5.” The sample was selected as of December 31, 2007 and included the 10 largest institutions rated “2” in liquidity and the 10 largest institutions rated “3,” “4,” or “5” based on total asset size. The sample also included 10 randomly-selected institutions from each of those two categories. For those 40 financial institutions, we obtained supervisory documentation from the FDIC’s Virtual Supervisory Information on the Net (ViSION)¹⁸ System that included:

¹⁷ The results of a non-statistical sample cannot be projected to the intended population by standard statistical methods.

¹⁸ DSC uses ViSION to capture data from the ROEs and other supervisory information.

- ROEs and visitation reports;
- state regulatory agencies' examination results;
- supervisory documentation that included pre-examination planning data; liquidity ratios; targeted risk areas; supervisory plans; FDIC supervisory comments on various supervisory issues, including enforcement actions, progress reports, correspondence, and offsite reviews; problem bank memoranda; and supervisory and enforcement actions; and
- supervisory comments on large insured depository institutions,¹⁹ if applicable.

We limited our review to information readily obtainable from ViSION and did not review any examination work papers or regional or field office correspondence except information related to CLPs for 31 of the 40 sampled financial institutions.

We developed a data collection instrument focusing on broad categories of liquidity and management controls described in examiner guidance included in DSC's Examination Manual. Those categories included:

- BOD and senior management oversight,
- written policies and procedures,
- management reporting to the institution's BOD and senior management,
- internal controls,
- CLPs, and
- sources of funding.

Internal Control

To obtain an understanding of relevant internal controls, we interviewed DSC officials and reviewed FDIC policies and procedures provided to financial institutions and examiners in the following:

- FILs—issued by the FDIC to the institutions it supervises, address issues such as the use of the Federal Reserve's primary credit program (FIL-59-2003, dated July 23, 2003) and the eligibility of ABCP liquidity facilities (FIL-74-2005, dated August 4, 2005).
- DSC's Examination Manual—provides guidance to assist examiners in evaluating the adequacy of a financial institution's liquidity position, taking into consideration the institution's current level and prospective sources of liquidity compared to funding needs, as well as the adequacy of funds management practices relative to the institution's size, complexity, and risk profile.
- *Risk Management Examination Manual of Credit Card Activities*—provides guidance to assist the examiner's review of the credit card activities process,

¹⁹ The FDIC's Large Insured Depository Institution program assesses the risk that financial institutions with consolidated banking assets that exceed \$10 billion present to the Deposit Insurance Fund.

including its relationship to liquidity. The manual addresses various areas that examiners should consider during examinations, including but not limited to, funds management policies, CLPs, cash flows for credit card lending, brokered and rate-sensitive deposits, securitization, asset management, and funding concentrations.

- *Risk Management Credit Card Securitization Manual*—serves as guidance for examiners in their review of the credit card securitization process, including its relationship to liquidity. The manual discusses the principals involved in the credit card securitization process such as ABCP conduits and their roles and liquidity facilities. According to the manual, examiners should review the liquidity implications of the institution’s securitization activities in relation to the bank’s normal liquidity management process, including contingency planning.
- ED Module, *Liquidity*—is designed to assist examiners in providing consistency and standardized procedures and decision factors during risk management examinations. The ED module provides core, expanded, and impact examination procedures. Examiner use of the module is discretionary.
- RD Memoranda—address the following liquidity-related topics.
 - *Federal Home Loan Bank Advances*, Transmittal Number 2000-046, dated August 22, 2000.
 - *Revised Examination Guidance for Liquidity and Funds Management*, Transmittal Number 2002-01, dated November 19, 2001.
 - *Wholesale Funding*, Transmittal Number 02-039, dated August 28, 2002.

Reliance on Computer-processed Information

For purposes of the audit, we did not rely on computer-processed information to support our findings, conclusions, and recommendations. Our assessment centered on the review of:

- The FDIC’s ROEs and visitation reports and state regulatory agencies’ examination results for the most recent examination conducted as of December 31, 2007;
- supervisory documentation that included pre-examination planning data and liquidity ratios, targeted risk areas, supervisory action plans, FDIC supervisory comments, and problem bank memoranda;
- supervisory and enforcement actions; and

- supervisory comments on large insured depository institutions, if applicable.

We determined that information system controls were not significant to our audit objectives. Accordingly, we did not consider it necessary to develop procedures to assess those controls. In addition, the FDIC OIG is currently conducting an audit entitled, *ViSION System's Data Reliability and Security Controls*. The objective of that audit is to assess the reliability of key supervisory information in the FDIC's ViSION system.

Compliance with Laws and Regulations

We coordinated with the Counsel to the Inspector General to identify the laws and FDIC regulations related to liquidity risk and to determine specific requirements that would apply to FDIC-supervised institutions, in general, and DSC examinations, in particular. We determined that there are no laws and regulations applicable to liquidity risk, in general. However, there are specific laws and regulations that relate to restrictions placed on financial institutions based on capital level categories established by Section 38 of the FDI Act, the use of funding sources such as brokered deposits in compliance with Section 29 of the FDI Act, and borrowings from the Federal Reserve Banks in compliance with Section 10B of the Federal Reserve Act and Section 41 of the FDI Act. During the course of the audit, no instances of noncompliance come to our attention.

We assessed the risk of fraud and abuse related to the audit objective in the course of evaluating audit evidence.

Performance Measurement

The Government Performance and Results Act of 1993 directs Executive Branch agencies to develop a strategic plan that sets performance goals and objectives for agency management. We reviewed the FDIC's *2005-2010 Strategic Plan*, the *2008 Annual Performance Plan*, and DSC's divisional performance objectives to determine whether the Corporation and/or DSC had performance goals, objectives, and indicators or targets that specifically relate to the examination of financial institutions for liquidity risk.

We did not identify any specific performance goals related to liquidity risk. However, according to the FDIC's *2008 Annual Performance Plan*, the FDIC has established the following strategic goal, objective, performance goals, and indicators and targets related to the risk management components of the FDIC's Supervision Program, which relates to the examination and supervision of financial institutions' liquidity risk management.

Table 4: The FDIC’s Activities to Address the Government Performance and Results Act

Strategic Goal	Strategic Objective	Annual Performance Goals	Indicators And Targets
FDIC-supervised institutions are safe and sound.	FDIC-supervised institutions appropriately manage risk.	Conduct on-site risk management examinations to assess the overall financial condition, management practices and policies, and compliance with applicable laws and regulations of FDIC-supervised depository institutions.	<p>Indicator: Percentage of required examinations conducted in accordance with statutory requirements and FDIC policy.</p> <p>Target: 100 percent of required risk management examinations are conducted on schedule.</p>
		Take prompt and effective supervisory action to address issues identified during the FDIC examination of FDIC-supervised institutions that receive a composite uniform financial institutions rating of “4” or “5” (problem institution). Monitor FDIC-supervised insured depository institutions’ compliance with formal and informal enforcement actions.	<p>Indicator: Percentage of follow-up examinations of problem institutions conducted within required time frames.</p> <p>Target: 100 percent of follow-up examinations are conducted within 12 months of completion of the prior examination.</p>

Source: The FDIC’s 2008 Annual Performance Plan.

Prior Coverage

In an August 1996 audit report entitled, *Audit of the Effectiveness of Deposit Restrictions on Institutions That Are Not Well Capitalized* (Audit Report No. 96-083), the FDIC OIG reported on the effectiveness of deposit restrictions on institutions that were not well capitalized, as defined in Section 29 and 11(a)(1)(D)(ii) of the FDI Act. Section 29, *Brokered Deposits*, restricts the acquisition of brokered and high-rate deposits by all but well-capitalized financial institutions. Section 11, *Insurance Funds*, reduces the amount of deposit insurance coverage available for retirement and other employee benefit plan deposits when an institution is restricted from accepting brokered deposits. Both of these provisions were designed to contribute to the reduction of losses to the Deposit Insurance Funds by limiting problem institutions’ access to certain sources of volatile deposits that may allow weak institutions to continue funding operations. The OIG concluded that Section 29 and Section 11 had not always been effective in restricting less than well-capitalized banks’ access to volatile deposits and reducing insurance fund losses, respectively. In addition, the OIG concluded that interest rate restrictions in Section 29 were so complex that implementation of this restriction was difficult and burdensome to administer. The report made several recommendations to address identified deficiencies.

GUIDANCE IN DSC'S EXAMINATION MANUAL ON CLPS

DSC's Examination Manual presents information on CLPs and 13 elements that the plans should include. The Examination Manual states that a CLP helps ensure that a financial institution can prudently and efficiently manage routine and extraordinary fluctuations in liquidity. The Examination Manual also states that each institution's liquidity policy should have a CLP that addresses alternative funding if initial projections of funding sources and uses are incorrect or if a liquidity crisis arises. Such a plan also helps management to monitor liquidity risk, ensure that an appropriate amount of liquid assets is maintained, measure and project funding requirements during various scenarios, and manage access to funding sources. As specifically stated in the manual:

The contingency plan should be updated on a regular basis and:

- Define responsibilities and decision-making authority so that all personnel understand their role during a problem-funding situation.
- Include an assessment of the possible liquidity events that an institution might encounter. The types of potential liquidity events considered should range from high-probability/low-impact events that can occur in day-to-day operations, to low-probability/high-impact events that can arise through institution-specific, systemic market, or operational circumstances.
- Assess the potential for erosion (magnitude and rate of outflow) by funding sources under optimistic, pessimistic, and status quo scenarios.
- Assess the potential liquidity risk posed by other activities such as asset sales and securitization programs.
- Analyze and make quantitative projections of all significant on- and off-balance sheet fund flows and their related effects.
- Match potential sources and uses of funds.
- Establish indicators that alert management to a predetermined level of potential risks.
- Identify and assess the adequacy of contingent funding sources. The plan should identify any back-up facilities (lines of credit), the conditions related to their use, and the circumstances where the institution might use them. Management should understand the various conditions, such as notice periods, that could affect access to [the] back-up line and test the institution's ability to borrow from established back-up [line] facilities.
- Identify the sequence in which sources of funds will be used for contingent funding needs. The uncertainty of the magnitude and timing of available resources may call for different priorities in different situations.
- Assess the potential for triggering legal restrictions on the bank's access to brokered deposits under PCA [prompt corrective action] standards and the effect on the bank's liability structure.
- Accelerate the timeframes for reporting, such as daily cash flow schedules, in a problem liquidity situation.
- Address procedures to ensure funds will meet the overnight cash letter.²⁰
- Include an asset tracking system that monitors which assets are immediately available for pledging or sale and how much a cash sale of these assets will generate.

²⁰ Cash letters are sent to a bank for transmittal to other banks for the purpose of clearing checks drawn on other banks.

OIG COMPARISON OF LIQUIDITY GUIDANCE FOR EXAMINERS AND FINANCIAL INSTITUTIONS

Description of Guidance on Liquidity	FDIC Examiner Guidance	FDIC Financial Institution Letter (FIL 59-2003)
	✓ = Yes ✗ = No	✓ = Yes ✗ = No
Liquidity Management—General Liquidity Management Risk Control Elements:		
BOD and senior management oversight.	✓	✗
Policies and procedures.	✓	✓
Internal controls.	✓	✓
Management reporting.	✓	✗
Warning indicators.	✓	✗
CLPs.	✓	✓
Liquidity Management—Specific Guidance on General Liquidity Management Risk Control Elements:		
BOD and Senior Management Oversight		
Establishing procedures, guidelines, internal controls, and limits for managing and monitoring liquidity.	✓	✗
Preparing CLPs.	✓	✗
Reviewing the institution's liquidity position on a regular basis and monitoring internal and external factors and events that could affect the institution's liquidity.	✓	✗
Reviewing liquidity strategies, policies, and procedures.	✓	✗
Policies and Procedures		
Provides for the establishment of an asset/liability committee.	✓	✗
Provides for the periodic review of the bank's deposit structure.	✓	✗
Provides policies and procedures that address funding concentration in, or excessive reliance on, any single source or type of funding, such as brokered deposits, Internet deposits, and other similar rate-sensitive or credit-sensitive deposits.	✓	✗
Provides a method of computing the bank's cost of funds.	✓	✗
Determines which types of investments are permitted, the desired mix, the maturity distribution, and the amount of funds that will be available.	✓	✓
Conveys the BOD's risk tolerance and establishes target liquidity ratios such as loan-to-deposit ratio, longer-term assets funded by less stable funding sources, individual and aggregate limits on borrowed funds by type and source, or a minimum limit on the amount of short-term investments.	✓	✗
Provides an adequate system of internal controls that ensures the independent and periodic review of the liquidity management process and compliance policies and procedures.	✓	✓

Description of Guidance on Liquidity	Examiner Guidance	Financial Institution Letter (FIL 59-2003)
	✓ = Yes ✗ = No	✓ = Yes ✗ = No
Ensures that the BOD and senior management are given the means to periodically review compliance with policy guidelines, such as compliance with established limits and legal reserves requirements, and to verify that duties are properly segregated.	✓	✗
Includes a CLP that addresses alternative sources of funds if initial projections of funding sources and uses are incorrect or if a liquidity crisis arises. Establishes bank lines and periodically tests their use.	✓	✓
Establishes a process for measuring and monitoring liquidity, such as generating proforma cash flow projections or using models.	✓	✓
Defines approval procedures for exceptions to policies, limits, and authorizations.	✓	✗
Provides for tax planning.	✓	✗
Provides authority and procedures to access wholesale funding sources and includes guidelines for the types and terms of each wholesale funding source permitted. Defines and establishes a process for measuring and monitoring unused borrowing capacity.	✓	✗
Management Reports		
Identifies liquidity needs and the sources of funds available to meet these needs over various scenarios. The maturity distribution of assets and liabilities and expected funding of commitments would be useful in preparing the management report.	✓	✗
Provides a list of large funds providers.	✓	✗
Generates reports on asset yields, liability costs, net interest margins and variations from the prior month and budget. Reports should be sufficiently detailed to permit an analysis of causes of interest margin variations.	✓	✗
Identifies longer-term interest margin trends.	✓	✗
Generates reports on any exceptions to policy guidelines.	✓	✗
Generates reports on economic conditions in the bank's trade area, interest rate projections, and any anticipated deviations from the original plan or budget.	✓	✗
Provides information concerning non-relationship or higher-cost funding programs. At a minimum, this information should include a listing of public funds obtained through each significant program and the rates paid.	✓	✗
Internal Controls		
Ensures the integrity of the liquidity risk management process.	✓	✓
Should promote effective operations, reliable financial and regulatory reporting and compliance with laws.	✓	✗
Should promote compliance with institutional policies.	✓	✓
Internal control systems should provide appropriate approval processes and limits and ensure regular and independent evaluation and review of the liquidity risk management process.	✓	✓
Internal control reviews should address any significant changes in the nature of the instruments acquired, limits, and controls since the last review.	✓	✗
Instrument positions that exceed established limits should receive prompt management attention.	✓	✗

Description of Guidance on Liquidity	Examiner Guidance	Financial Institution Letter (FIL 59-2003)
	✓ = Yes ✗ = No	✓ = Yes ✗ = No
Warning Indicators		
Monitor various internal and market indicators of liquidity problems at the institution.	✓	✗
Indicators serve as early warning signals of a potential problem or as later-stage indicators that the institution has a serious liquidity problem. Examples of indicators may include: rapid asset growth funded by potentially volatile liabilities; real or perceived negative publicity; decline in asset quality; decline in earnings performance or projections; correspondent banks decrease or eliminate credit line availability; and counterparties and brokers are unwilling to deal in unsecured or longer-term transactions.	✓	✗
Indicators that the institution may have a serious liquidity problem include: volume of turndowns in the brokered markets is unusually large; certain providers, such as money managers and public entities, abandon the bank; the institution receives requests from depositors for early withdrawal of their funds; transaction sizes decrease; and an increasing spread paid on deposits relative to competitors.	✓	✗
CLP		
Should address alternative funding if initial projections of funding sources and uses are incorrect or if a liquidity crisis arises.	✓	✓
Helps to ensure that a bank or consolidated company can prudently and efficiently manage routine and extraordinary fluctuations in liquidity. The CLP also helps management monitor liquidity risk to ensure that an appropriate amount of liquidity assets is maintained, measure and project funding requirements during various scenarios, and manage access to funding sources.	✓	✓
A CLP is even more critical for banks that have an increasing reliance on alternative funding sources.	✓	✓
Should be updated on a regular basis and include the 13 CLP elements. (Refer to report Appendix 2.)	✓	✗

Source: OIG Analysis of guidance in DSC's Examination Manual and FDIC FIL-59-2003.

OTHER FEDERAL REGULATORY AGENCIES' LIQUIDITY-RELATED GUIDANCE

This appendix contains detailed information related to actions taken by the OTS, OCC, and Federal Reserve to address institution liquidity risk, discussed in our report section entitled, *FDIC Examination and Financial Institution Guidance for Liquidity Risk*. Those actions include guidance that each agency has issued individually, as discussed below.²¹

OTS Guidance

The OTS has issued *Sound Practices for Liquidity Management at Savings Associations-Thrift Bulletin 77*, which includes specific guidance for management and the BOD of thrift institutions on liquidity management and states that:

- Each institution should have a written strategy for the day-to-day management of liquidity.
- The liquidity strategy should define the institution's general approach to managing liquidity, including various quantitative and qualitative targets.
- The liquidity strategy should cover specific policies on the composition of assets and liabilities, the use of wholesale funding, and strategies for addressing temporary and long-term liquidity disruptions.

In addition, Bulletin 77 provides detailed information, including suggested sound liquidity practices, on each of the components of liquidity risk management, including, but not limited to:

- BOD and senior management oversight,
- policies and procedures,
- management reporting to the institution's BOD and senior management,
- measuring and monitoring liquidity,
- scenario analysis,
- contingency planning, and
- managing access for funding sources.

²¹ In addition to the liquidity-related guidance provided to financial institutions, each of the agencies has issued liquidity-related guidance to their respective examination staffs. More specifically,

- OCC has issued examiner guidance in its *Comptroller's Handbook, Liquidity*.
- FRB has issued examiner guidance in its *Commercial Bank Examination Manual, Bank Holding Company Supervision Manual and Trading and Capital Markets Activities Manual*.
- OTS has issued examiner guidance in its *Examination Handbook*.

OCC Guidance

The OCC has provided the following extensive liquidity-related guidance to its financial institutions to assist in identifying, measuring, monitoring, and controlling liquidity risk.

The Director's Book—The Role of the National Bank Director. The handbook (1) contains general concepts and standards for the safe and sound operation of a bank; and (2) outlines the responsibilities of the BOD, highlighting areas of particular concern, and addresses, in broad terms, the duties and liabilities of the individual director. Examples from the handbook follow:

- The BOD must make certain that the bank's liquidity risk position is reasonable and does not compromise the bank's ability to maintain earnings and protect capital.
- Such risks must be commensurate with management's expertise and the bank's balance sheet flexibility, especially since rapidly changing market conditions can have a substantial impact on the bank's position.
- Management should provide regular reports to the BOD on all off-balance sheet activity. These reports should explain the types and amount of risk involved and indicate which internal controls and audit and monitoring functions are in place to manage risks.
- Management should provide the BOD with relevant and appropriate financial information. Useful reports are likely to include the following information: budgeted compared to actual performance; portfolio activity, including classified asset trends, significant loans, past dues, and renewals; liquidity trends; off-balance sheet exposures, including derivatives activities; large depositor listings to determine volatile liabilities; and interest rate sensitivity reports.

Detecting Red Flags in Board Reports—A Guide for Directors. The OCC issued this guide to assist the BOD of a financial institution in assessing risk prospectively. This guide identifies various leading indicators of increasing credit risk, liquidity risk, and interest rate risk that should be a part of ongoing BOD reports.

Additionally, the guide states that the BOD should regularly receive reports on liquidity risk. To effectively use financial information, directors should review the trend and level of individual measures and the interrelationships among capital, asset quality, earnings, liquidity, market risk, and balance sheet growth. The BOD and institution management should ensure that the institution has a realistic CLP in case of market disruptions.

The guide includes the following suggested reports that should assist the directors in assessing the bank's liquidity risk:

- Liquidity risk report—shows the level and trend of the financial institution’s liquidity risk by a variety of appropriate measures. The report should indicate how much liquidity risk the institution is assuming, whether management is complying with risk limits, and whether management’s strategies are consistent with the BOD’s expressed risk tolerance.
- Funds provider report—lists large funds providers and identifies funding concentrations.
- Projected needs and sources report—projects future liquidity needs for a prescribed timeframe and compares these projections to available sources of funds.
- Funds availability report—states the amount of borrowing capacity based on established lines of credit and indicates the amount of funding the financial institution can obtain based on its financial condition and qualifying collateral.
- Cash flow or funding gap report—reflects the quantity of cash available compared to the quantity of cash required within the same periods. The difference between the available and required amounts is the cash flow or funding “gap.” The report may also include growth projections and the impact of rate changes on cash flows.
- Funding concentration report—reflects significant funding from a single source or from multiple sources that have common credit or rate sensitivity. A funding concentration occurs when a single decision or factor might cause a significant and sudden withdrawal of funds.
- CLP—may incorporate the funding gap report or may be an outgrowth of that report. The CLP forecasts funding needs and funding sources under varying market scenarios resulting in rapid liability erosion.

The OCC guide also provides a list of liquidity ratios and red flags the institution’s BOD can use as leading indicators of problems related to liquidity risk. The red flags include the following:

- Exceeding liquidity risk limits established by the financial institution’s BOD.
- Frequent exceptions to the financial institution’s liquidity risk policy.
- Change in significant funding sources.
- Funding concentration from a single source or multiple sources with a common credit or rate sensitivity.
- Rapid asset growth funded by rate and/or credit-sensitive funding, such as brokered deposits, or deposits obtained through certificate of deposit listing services.
- Large purchases in the brokered funds or other potentially volatile markets.
- Eliminated or decreased credit line availability from lenders.
- Mismatching funds by funding long-term assets with short-term liabilities.

- Ineffective CLPs that are not current and commensurate with the complexity of the financial institution's funding activities.

Federal Reserve Guidance

The Federal Reserve has provided liquidity-related guidance to the financial institutions it supervises in various Supervision and Regulation (SR) Letters.²² For example, the SR Letter entitled, *Bank Holding Company Funding and Liquidity* (SR-90-20), dated June 22, 1990, provides information on (1) the avoidance of funding strategies or practices that could undermine public confidence in liquidity or stability and (2) prudent financial practices for bank holding companies, including establishing and maintaining reliable funding and contingency plans. An excerpt from the guidance follows:

- Bank holding companies should establish and maintain reliable CLPs to meet ongoing liquidity needs and to address any unexpected funding mismatches that could develop over time. Such plans could include reduced reliance on short-term purchased funds, greater use of longer-term financing, appropriate internal limitations on parent company funding of long-term assets, and reliable alternate sources of liquidity.
- Prudent internal liquidity policies and practices should include specifying limits for, and monitoring the degree of reliance on, particular maturity ranges and types of short-term funding. Special attention should be given to the use of overnight money since a loss of confidence in the issuing organization could lead to an immediate funding problem.

²² FRB has issued various SR Letters that provide guidance related to liquidity risk including, but not limited to, SR-90-20, dated June 22, 1990, entitled, *Bank Holding Company Funding and Liquidity*; SR-93-69, dated December 20, 1993, entitled, *Examining Risk Management and Internal Controls for Trading Activities of Banking Organizations*; and SR-97-21, dated July 11, 1997, entitled, *Risk Management and Capital Adequacy of Exposures Arising from Secondary Market Credit Activities*.

CORPORATION COMMENTS



Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990

Division of Supervision and Consumer Protection

July 23, 2008

TO: Russell A. Rau
Assistant Inspector General for Audits

FROM: Sandra L. Thompson
Director

SUBJECT: Response to Draft Report Entitled: *FDIC's Examination of Liquidity Risk*
(Assignment No. 2008-004)

The Division of Supervision and Consumer Protection (DSC) appreciates that you found effective performance and management controls over the assessment of Liquidity Risk.

We are committed to assuring that Liquidity Risk is appropriately assessed and mitigated through our examination and enforcement action procedures. As you noted, we are constantly involved with our international and interagency partners in providing industry guidance as well as training to our examiners. We are currently playing an active role in the Basel Committee on Bank Supervision's (BCBS) Working Group on Liquidity, which is in the process of developing updated guidance that we expect to be issued later this year. We are also planning to issue U.S. interagency guidance through the Federal Financial Institutions Examination Council shortly after the BCBS guidance is finalized. Moreover, DSC plans to issue updated institution guidance shortly that provides detailed descriptions of sound liquidity risk management controls, and suggests key liquidity reports and typical red flags that are useful in assessing liquidity and that can be used as leading indicators for liquidity risk.

ACRONYMS USED IN THE REPORT

ABCP	Asset-Backed Commercial Paper
BBR	Bank Board Resolution
BCBS	Basel Committee on Banking Supervision
BOD	Board of Directors
C&D	Cease and Desist Order
CAMELS	Capital, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk
CLP	Contingency Liquidity Plan
DSC	Division of Supervision and Consumer Protection
ED	Examination Documentation
FDI	Federal Deposit Insurance
FHLB	Federal Home Loan Bank
FIAP	Formal and Informal Action Procedures
FIL	Financial Institution Letter
FSF	Financial Stability Forum
GAO	U.S. Government Accountability Office
MOU	Memorandum of Understanding
NCUA	National Credit Union Administration
OCC	Office of the Comptroller of the Currency
OTS	Office of Thrift Supervision
RD	Regional Directors
ROE	Report of Examination
SR	Supervision and Regulation
SSG	Senior Supervisors Group
UFIRS	Uniform Financial Institutions Rating System
ViSION	Virtual Supervisory Information on the Net