Preserving a Central Role for Community Banking

Remarks by

Ben S. Bernanke

Chairman

Board of Governors of the Federal Reserve System

at

Independent Community Bankers of America

Orlando, Florida

March 20, 2010
I’m glad once again to be able to meet with and speak to the Independent Community Bankers of America. I greatly value the chance to hear directly from you about the challenges you are facing today. As everyone in this audience knows, those challenges are daunting indeed, and they go far beyond parochial concerns. Communities all over America are trying to cope with the economic consequences of the most severe financial crisis since the Great Depression--high unemployment, lost incomes and wealth, home foreclosures, strained fiscal budgets, and uncertainty about the future. Because community banks are integral to local economies, you have been on the front line, so to speak, deeply engaged in confronting those problems and uncertainties. Your commitment to your communities, including your willingness to provide credit and services supporting small businesses, home purchases, and commercial development, is reason to be optimistic about our nation’s ability to meet the current challenges and return to economic health.

One of America’s economic strengths is its relatively greater reliance on bottom-up rather than top-down growth and development, in which individual creativity, local knowledge, and the trust born of longstanding relationships help foster economic creativity and progress. Of course, it is precisely the ability to foster bottom-up growth, building on local knowledge and relationships, that sets community banks apart from other financial institutions. It is important for our economic health to maintain a diverse and resilient financial system in which community banks play an important role.

As the crisis has shown, one of the greatest threats to the diversity and efficiency of our financial system is the pernicious problem of financial institutions that are deemed “too big to fail.” I will spend some time today discussing the efforts the Federal Reserve
and other policymakers are making to put an end to the too-big-to-fail problem and thus help foster effective competition in financial services. I also want to speak today about the links between your institutions and mine. The Federal Reserve has always had a special relationship with community banks. As we turn from crisis management to supporting the economic recovery, that relationship will become more important than ever.

**Toward a More Competitive, Efficient, and Innovative Financial System**

The United States has a financial system that is remarkably multifaceted and diverse. Some countries rely heavily on a few large banks to provide credit and financial services; our system, in contrast, includes financial institutions of all sizes, with a wide range of charters and missions. We also rely more than any other country on an array of specialized financial markets to allocate credit and help diversify risks. Our system is complex, but I think that for the most part its variety is an important strength. We have many, many ways to connect borrowers and savers in the United States, and directing saving to the most productive channels is an essential prerequisite to a successful economy.

That said, for the financial system to do its job well, it must be an impartial and efficient arbiter of credit flows. In a market economy, that result is best achieved through open competition on a level playing field, a framework that provides choices to consumers and borrowers and gives the most innovative and efficient firms the chance to succeed and grow. Unfortunately, our financial system today falls substantially short of that competitive ideal.
Among the most serious and most insidious barriers to competition in financial services is the too-big-to-fail problem. Like all of you, I remember well the frightening weeks in the fall of 2008, when the failure or near-failure of several large, complex, and interconnected firms shook the financial markets and our economy to their foundations. Extraordinary efforts by the Federal Reserve, the Treasury, the Federal Deposit Insurance Corporation (FDIC), and other agencies, together with similar actions by our counterparts in other countries, narrowly averted a global financial collapse. Even with those extraordinary actions, the economic costs of the crisis have been very severe; but I have little doubt that, had the global financial system disintegrated, the effects on asset values, credit availability, and confidence would have resulted in a far deeper and longer-lasting economic contraction. It is unconscionable that the fate of the world economy should be so closely tied to the fortunes of a relatively small number of giant financial firms. If we achieve nothing else in the wake of the crisis, we must ensure that we never again face such a situation.

The costs to all of us of having firms deemed too big to fail were stunningly evident during the days in which the financial system teetered near collapse. But the existence of too-big-to-fail firms also imposes heavy costs on our financial system even in more placid times. Perhaps most important, if a firm is publicly perceived as too big, or interconnected, or systemically critical for the authorities to permit its failure, its creditors and counterparties have less incentive to evaluate the quality of the firm’s business model, its management, and its risk-taking behavior. As a result, such firms face limited market discipline, allowing them to obtain funding on better terms than the
quality or riskiness of their business would merit and giving them incentives to take on excessive risks.

Having institutions that are too big to fail also creates competitive inequities that may prevent our most productive and innovative firms from prospering. In an environment of fair competition, smaller firms should have a chance to outperform larger companies. By the same token, firms that do not make the grade should exit, freeing up resources for other uses. Our economy is not static, and our banking system should not be static either.

In short, to have a competitive, vital, and innovative financial system in which market discipline encourages efficiency and controls risk, including risks to the system as a whole, we have to end the too-big-to-fail problem once and for all. But how can that be done? Some proposals have been made to limit the scope and activities of financial institutions, and I think a number of those ideas are worth careful consideration. Certainly, supervisors should be empowered to limit the involvement of firms in inappropriately risky activities. But even if such proposals are implemented, our technologically sophisticated and globalized economy will still need large, complex, and internationally active financial firms to meet the needs of multinational firms, to facilitate international flows of goods and capital, and to take advantage of economies of scale and scope. The unavoidable challenge is to make sure that size, complexity, and interconnectedness do not insulate such firms from market discipline, potentially making them ticking time bombs inside our financial system.

To address the too-big-to-fail problem, the Federal Reserve favors a three-part approach. First, we and our colleagues at other supervisory agencies must continue to
develop and implement significantly tougher rules and oversight that serve to reduce the risks that large, complex firms present to the financial system. Events of the past several years clearly demonstrate that all large, complex financial institutions, not just bank holding companies, must be subject to strong regulation and consolidated supervision. Moreover, the crisis has shown that supervisors must take account of potential risks to the financial system as a whole, and not just those to individual firms in isolation. Implementing supervision in a way that seeks to identify systemic risks as well as risks to individual institutions is a difficult challenge, but the fact is that the traditional approach of focusing narrowly on individual firms did not succeed in preventing this crisis and likely would not succeed in the future. Consequently, we at the Federal Reserve have been working with international colleagues to require that the most systemically critical firms increase their holdings of capital and liquidity and improve their risk management; and we are overhauling our supervisory framework for the largest institutions, both to improve the effectiveness of consolidated supervision and to incorporate in our oversight a more comprehensive, systemic perspective.

The second component of the strategy to end too-big-to-fail is to increase the resilience of the financial system itself, to reduce the potential damage from a systemic event like the failure of a major firm. For example, the Federal Reserve has been leading collaborative efforts to improve the clearing and settlement of credit default swaps and other derivatives and to enhance the stability of markets for repurchase agreements. Limiting the fallout from the failure of a major firm is not only directly beneficial in a crisis, it also helps to reduce the too-big-to-fail problem, because the government has
much less reason to intervene if it believes that the financial system is resilient enough to handle a significant failure without excessive disruption.

Third, because government oversight alone will never be sufficient to anticipate all risks, increasing market discipline is an essential piece of any strategy for combating too-big-to-fail. To create real market discipline for the largest firms, market participants must be convinced that if one of these firms is unable to meet its obligations, its shareholders, creditors, and counterparties will not be protected from losses by government action. To make such a threat credible, we need a new legal framework that will allow the government to wind down a failing, systemically critical firm without doing serious damage to the broader financial system. In other words, we need an alternative for resolving failing firms that is neither a disorderly bankruptcy nor a bailout.

A prototype for such a framework already exists--namely, the rules set forth in the Federal Deposit Insurance Corporation Improvement Act of 1991 for dealing with a failing bank. As the FDIC is now able to do with a failing bank, the government should, under appropriate circumstances and with appropriate safeguards, be able to seize and wind down a failing, systemically critical firm. Institutions should not be permitted to receive assistance while open, but authorities must be empowered to sell, merge, or break up an institution as necessary to avoid a disorderly unraveling that threatens the financial system as a whole. The resolution agency should not be allowed to protect shareholders and other capital providers and it should have clear authority to impose losses on debt holders, override contracts, and replace managers and directors as appropriate. If, in the end, funds must be injected to resolve a systemically critical institution safely, the
ultimate cost must not fall on taxpayers or small financial institutions, but on those institutions that are the source of the too-big-to-fail problem.

I don’t want to understate the difficulties of creating an effective resolution framework for large, interconnected firms. Such firms can be extraordinarily complex, both in terms of their legal structure and in the range and sophistication of their activities. The resolution of large institutions whose operations span many countries poses particular challenges, as legal frameworks vary across countries, and the authorities in each country naturally seek to protect the interests of depositors and creditors in their own jurisdictions. We must also recognize that such resolutions might well take place in the context of a broader crisis, in which the government might be forced to address problems at multiple firms simultaneously. Careful planning is therefore essential. An idea worth exploring is to require firms to develop and maintain a so-called living will, which will help firms and regulators identify ways to simplify and untangle the firm before a crisis occurs.¹

The Federal Reserve and Community Banks

The Federal Reserve and community banks have much in common beyond our mutual concerns about the too-big-to-fail problem. Our interest in community banks has its roots in the founding of the Federal Reserve in 1913, nearly a century ago. President Woodrow Wilson and the other founders of the Fed, taking note of two previous failed attempts to establish a U.S. central bank, intentionally avoided creating a single, monolithic institution located in Washington or New York. Instead, they established a system of 12 Reserve Banks located in major cities around the country. (It was a federal

system--hence the term, “Federal Reserve.”) Why was America’s central bank given this unique structure? The reason was to provide legitimacy and a broad geographic presence across the nation for an institution that often has to make difficult decisions. Over time, this structure has provided the Federal Reserve with grassroots connections, local insights, and diverse perspectives that few other federal institutions enjoy.

We are always looking for opportunities to interact with and learn from community bankers. Events like this one are an important venue for exchanging ideas, as I’ve mentioned, but there are many others. For example, community bankers sit on our Federal Advisory Council, which meets with the Board of Governors for three mornings each year to discuss developments in the economy and in the banking industry. We meet on a similar schedule with a second official council, the Thrift Institutions Advisory Council, which brings together thrifts, saving banks, and a variety of other depository institutions, most of them smaller, from around the country. In addition, community bankers sit on the boards and the advisory councils of the Fed’s 12 regional Reserve Banks and 24 Reserve Bank branches. Both the Board and the Reserve Banks organize regular meetings involving community banks and a range of other participants. For example, the Reserve Banks are meeting with community bankers, community development organizations, and other stakeholders to discuss barriers to and opportunities for extending credit to small businesses.

Of course, many of our regular interactions with community banks arise from our oversight of bank holding companies and state-chartered banks that choose to join the Federal Reserve System. This supervision is guided by the Board, but conducted day-to-day by the Reserve Banks and their examiners, many of whom have lived and worked
within the Districts they serve for many years. We believe this approach ensures that Federal Reserve supervision of community banks is consistent and disciplined but also reflects a local perspective that can take account of differences in regional economic conditions. For example, in the Midwest, where many community banks specialize in agricultural lending, Federal Reserve examiners maintain a special expertise in the agricultural economy and the associated lending practices. They also draw frequently on the expertise of regional and agricultural economists in the Districts to maintain an up-to-date understanding of local conditions. So while many bankers tell us that Federal Reserve examiners are analytical and tough, few tell us that they are unfair or uninformed about what’s going on in the local economy. We believe that this kind of response speaks to the effectiveness of our supervisory program for community banks, and we take pride in the professionalism and quality of our community bank examiners.

One particularly valuable aspect of our federal structure is that, over the years, it has provided policymakers in Washington with a way to keep in close touch with the continent-spanning, highly varied economy of the United States. When I attend board of directors meetings at regional Reserve Banks, which I do regularly, one of the most interesting portions is the go-round, during which each director provides his or her perspective on local economic developments. Quite often, the directors who are community bankers provide some of the most valuable contributions. That fact should not be surprising. By their nature, community banks interact with many parts of the area economy--consumers, small businesses, large businesses, real estate developers, even local governments. This breadth of vision, together with a good sense of the underlying economic forces at work in each locality, gives community bankers a unique perspective
on the developments in their part of the country. When the Fed analyzes economic developments, of necessity we rely on official economic data to identify broad national trends. However, the official data often mask the diversity of the U.S. economy; moreover, the data are inherently backward-looking, telling us what happened in the past quarter or year. In contrast, the grass-roots information that we obtain from community bankers and the other community and business leaders who serve as Reserve Bank directors provides a forward-looking perspective on economic developments and concerns, as well as a level of detail and qualitative insight that is often lost in the aggregate numbers.

Our contacts with community bankers also provide critical insights into the state of our nation’s banks. Because of the remarkable diversity of the U.S. financial system, a supervisory agency that focused only on the largest banking institutions, without knowledge of community banks, would get a limited and potentially distorted picture of what was happening in our banking system as a whole. Close connections with community bankers enable the Federal Reserve to better understand the full range of financial concerns and risks facing the country, such as the current difficult problems in commercial real estate lending and the impediments to small business lending. For example, recent patterns in commercial loan growth are very different at large and small banks, and our links to community bankers help us to better understand these trends. The community banking perspective is also critical as we try to assess the burden and effectiveness of financial regulation.

As a group, community banks are also important to the nation’s financial stability, a particular focus and responsibility of the Federal Reserve. Although it was not the case
in the current crisis, instability can be generated by small institutions as well as by large ones—as occurred in the Great Depression or in the thrift crisis, to cite two particularly dramatic examples. Additionally, as a lender through our discount window to community banks and other depository institutions, we rely on information and expertise obtained from our supervisory responsibilities to lend safely, particularly in times of stress.

For all these reasons, our supervisory relationships with the state-chartered banks that have joined the Federal Reserve System are immensely valuable, as is the range of contacts we have with community banks.

Conclusion

I know that community banks, with their special strengths, can flourish in a system that provides fair competition; indeed, many of you have stepped up during a difficult time to provide credit to support the economic recovery. To create a more competitive system, as well as a safer one, we need to end the too-big-to-fail problem once and for all. We will continue to focus on this issue, and we welcome constructive ideas from all quarters.

We at the Federal Reserve look forward to maintaining our long-standing relationships with community bankers. You bring us insights into the banking industry and the economy that we can obtain nowhere else. And as the recovery progresses, we expect that you will continue to aid the nation’s return to prosperity by making good loans to creditworthy borrowers in your communities. We want to continue to work with you to help you play this important role. In doing so, together we will help ensure a bright future both for our economy and for community banking.
Testimony

**Chairman Ben S. Bernanke**

*Regulatory reform*

Before the Committee on Financial Services, U.S. House of Representatives, Washington, D.C.

October 1, 2009

Chairman Frank, Ranking Member Bachus, and other members of the Committee, I appreciate the opportunity to discuss ways of improving the financial regulatory framework to better protect against systemic risks.

In my view, a broad-based agenda for reform should include at least five key elements. First, legislative change is needed to ensure that systemically important financial firms are subject to effective consolidated supervision, whether or not the firm owns a bank.

Second, an oversight council made up of the agencies involved in financial supervision and regulation should be established, with a mandate to monitor and identify emerging risks to financial stability across the entire financial system, to identify regulatory gaps, and to coordinate the agencies' responses to potential systemic risks. To further encourage a more comprehensive and holistic approach to financial oversight, all federal financial supervisors and regulators--not just the Federal Reserve--should be directed and empowered to take account of risks to the broader financial system as part of their normal oversight responsibilities.

Third, a new special resolution process should be created that would allow the government to wind down a failing systemically important financial institution whose disorderly collapse would pose substantial risks to the financial system and the broader economy. Importantly, this regime should allow the government to impose losses on shareholders and creditors of the firm.

Fourth, all systemically important payment, clearing, and settlement arrangements should be subject to consistent and robust oversight and prudential standards.

And fifth, policymakers should ensure that consumers are protected from unfair and deceptive practices in their financial dealings.

Taken together, these changes should significantly improve both the regulatory system's ability to constrain the buildup of systemic risks as well as the financial system's resiliency when serious adverse shocks occur.

**Consolidated Supervision of Systemically Important Financial Institutions**

The current financial crisis has clearly demonstrated that risks to the financial system can arise not only in the banking sector, but also from the activities of other financial firms--such as investment banks or insurance companies--that traditionally have not been subject to the type of regulation and consolidated supervision applicable to bank holding companies. To close this important gap in our regulatory structure, legislative action is needed that would subject all systemically important financial institutions to the same framework for consolidated prudential supervision that currently applies to bank holding companies. Such action would prevent financial firms that do not own a bank, but that nonetheless pose risks to the overall financial system because of the size, risks, or...
interconnectedness of their financial activities, from avoiding comprehensive supervisory oversight.

Besides being supervised on a consolidated basis, systemically important financial institutions should also be subject to enhanced regulation and supervision, including capital, liquidity, and risk-management requirements that reflect those institutions' important roles in the financial sector. Enhanced requirements are needed not only to protect the stability of individual institutions and the financial system as a whole, but also to reduce the incentives for financial firms to become very large in order to be perceived as too big to fail. This perception materially weakens the incentive of creditors of the firm to restrain the firm's risk-taking, and it creates a playing field that is tilted against smaller firms not perceived as having the same degree of government support. Creation of a mechanism for the orderly resolution of systemically important nonbank financial firms, which I will discuss later, is an important additional tool for addressing the too-big-to-fail problem.

The Federal Reserve is already the consolidated supervisor of some of the largest and most complex institutions in the world. I believe that the expertise we have developed in supervising large, diversified, and interconnected banking organizations, together with our broad knowledge of the financial markets in which these organizations operate, makes the Federal Reserve well suited to serve as the consolidated supervisor for those systemically important financial institutions that may not already be subject to the Bank Holding Company Act. In addition, our involvement in supervision is critical for ensuring that we have the necessary expertise, information, and authorities to carry out our essential functions as a central bank of promoting financial stability and making effective monetary policy.

The Federal Reserve has already taken a number of important steps to improve its regulation and supervision of large financial groups, building on lessons from the current crisis. On the regulatory side, we played a key role in developing the recently announced, internationally-agreed improvements to the capital requirements for trading activities and securitization exposures, and we continue to work with other regulators to strengthen the capital requirements for other types of on- and off-balance-sheet exposures. In addition, we are working with our fellow regulatory agencies toward the development of capital standards and other supervisory tools that would be calibrated to the systemic importance of the firm. Options under consideration in this area include requiring systemically important institutions to hold aggregate levels of capital above current regulatory norms or to maintain a greater share of capital in the form of common equity or instruments with similar loss-absorbing attributes, such as "contingent" capital that converts to common equity when necessary to mitigate systemic risk.

The financial crisis also highlighted weaknesses in liquidity risk management at major financial institutions, including an overreliance on short-term funding. To address these issues, the Federal Reserve helped lead the development of revised international principles for sound liquidity risk management, which have been incorporated into new interagency guidance now out for public comment.

In the supervisory arena, the recently completed Supervisory Capital Assessment Program (SCAP), popularly known as the stress test, was quite instructive for our efforts to strengthen our prudential oversight of the largest banking organizations. This unprecedented interagency process, which was led by the Federal Reserve, incorporated forward-looking, cross-firm, aggregate analyses of 19 of the largest bank holding companies, which together control a majority of the assets and loans within the U.S. banking system. Drawing on the SCAP experience, we have increased our emphasis on horizontal examinations, which focus on particular risks or activities across a group of banking organizations, and we have broadened the scope of the resources we bring to bear on these reviews. We also are in the process of creating an enhanced quantitative surveillance program for large, complex organizations that will use supervisory information, firm-specific data analysis, and market-based indicators to identify emerging risks to specific firms as well as to the industry as a whole.
whole. This work will be performed by a multidisciplinary group composed of our economic and market researchers, supervisors, market operations specialists, and other experts within the Federal Reserve System. Periodic scenario analysis will be used to enhance our understanding of the consequences of changes in the economic environment for both individual firms and for the broader system. Finally, to support and complement these initiatives, we are working with the other federal banking agencies to develop more comprehensive information-reporting requirements for the largest firms.

Systemic Risk Oversight
For purposes of both effectiveness and accountability, the consolidated supervision of an individual firm, whether or not it is systemically important, is best vested with a single agency. However, the broader task of monitoring and addressing systemic risks that might arise from the interaction of different types of financial institutions and markets--both regulated and unregulated--may exceed the capacity of any individual supervisor. Instead, we should seek to marshal the collective expertise and information of all financial supervisors to identify and respond to developments that threaten the stability of the system as a whole. This objective can be accomplished by modifying the regulatory architecture in two important ways.

First, an oversight council--composed of representatives of the agencies and departments involved in the oversight of the financial sector--should be established to monitor and identify emerging systemic risks across the full range of financial institutions and markets. Examples of such potential risks include rising and correlated risk exposures across firms and markets; significant increases in leverage that could result in systemic fragility; and gaps in regulatory coverage that arise in the course of financial change and innovation, including the development of new practices, products, and institutions. A council could also play useful roles in coordinating responses by member agencies to mitigate emerging systemic risks, in recommending actions to reduce procyclicality in regulatory and supervisory practices, and in identifying financial firms that may deserve designation as systemically important. To fulfill its responsibilities, a council would need access to a broad range of information from its member agencies regarding the institutions and markets they supervise and, when the necessary information is not available through that source, the authority to collect such information directly from financial institutions and markets.

Second, the Congress should support a reorientation of individual agency mandates to include not only the responsibility to oversee the individual firms or markets within each agency's scope of authority, but also the responsibility to try to identify and respond to the risks those entities may pose, either individually or through their interactions with other firms or markets, to the financial system more broadly. These actions could be taken by financial supervisors on their own initiative or based on a request or recommendation of the oversight council. Importantly, each supervisor's participation in the oversight council would greatly strengthen that supervisor's ability to see and understand emerging risks to financial stability. At the same time, this type of approach would vest the agency that has responsibility and accountability for the relevant firms or markets with the authority for developing and implementing effective and tailored responses to systemic threats arising within their purview. To maximize effectiveness, the oversight council could help coordinate responses when risks cross regulatory boundaries, which often will be the case.

The Federal Reserve already has begun to incorporate a systemically focused approach into our supervision of large, interconnected firms. Doing so requires that we go beyond considering each institution in isolation and pay careful attention to interlinkages and interdependencies among firms and markets that could threaten the financial system in a crisis. For example, the failure of one firm may lead to runs by wholesale funders of other firms that are seen by investors as similarly situated or that have exposures to the failing firm. These efforts are reflected, for example, in the expansion of horizontal reviews and the quantitative surveillance program I discussed earlier.

Improved Resolution Process

http://www.federalreserve.gov/newsevents/testimony/bernanke20091001a.htm

22/03/2010
Another critical element of the systemic risk agenda is the creation of a new regime that would allow the orderly resolution of failing, systemically important financial firms. In most cases, the federal bankruptcy laws provide an appropriate framework for the resolution of nonbank financial institutions. However, the bankruptcy code does not sufficiently protect the public's strong interest in ensuring the orderly resolution of a nonbank financial firm whose failure would pose substantial risks to the financial system and to the economy. Indeed, after the Lehman Brothers and AIG experiences, there is little doubt that we need a third option between the choices of bankruptcy and bailout for such firms.

A new resolution regime for nonbanks, analogous to the regime currently used by the Federal Deposit Insurance Corporation for banks, would provide the government the tools to restructure or wind down a failing systemically important firm in a way that mitigates the risks to financial stability and the economy and thus protects the public interest. It also would provide the government a mechanism for imposing losses on the shareholders and creditors of the firm. Establishing credible processes for imposing such losses is essential to restoring a meaningful degree of market discipline and addressing the too-big-to-fail problem. The availability of a workable resolution regime also would replace the need for the Federal Reserve to use its emergency lending authority under section 13(3) of the Federal Reserve Act to prevent the failure of specific institutions.

Payment, Clearing, and Settlement Arrangements
Payment, clearing, and settlement arrangements are the foundation of the nation's financial infrastructure. These arrangements include decentralized market utilities for clearing and settling payments, securities, and derivatives transactions, as well as the decentralized activities through which financial institutions clear and settle such transactions bilaterally. While these arrangements can create significant efficiencies and promote transparency in the financial markets, they also may concentrate substantial credit, liquidity, and operational risks, and, absent strong risk controls, may themselves be a source of contagion in times of stress.

Unfortunately, the current regulatory and supervisory framework for systemically important payment, clearing, and settlement arrangements is fragmented, creating the potential for inconsistent standards to be adopted or applied. Under the current system, no single regulator is able to develop a comprehensive understanding of the interdependencies, risks, and risk-management approaches across the full range of arrangements serving the financial markets today. In light of the increasing integration of global financial markets, it is important that systemically critical payment, clearing, and settlement arrangements be viewed from a systemwide perspective and that they be subject to strong and consistent prudential standards and supervisory oversight. We believe that additional authorities are needed to achieve these goals.

Consumer Protection
As the Congress considers financial reform, it is vitally important that consumers be protected from unfair and deceptive practices in their financial dealings. Strong consumer protection helps preserve households' savings, promotes confidence in financial institutions and markets, and adds materially to the strength of the financial system. We have seen in this crisis that flawed or inappropriate financial instruments can lead to bad results for families and for the stability of the financial sector. In addition, the playing field is uneven regarding examination and enforcement of consumer protection laws among banks and nonbank affiliates of bank holding companies on the one hand, and firms not affiliated with banks on the other hand. Addressing this discrepancy is critical both for protecting consumers and for ensuring fair competition in the market for consumer financial products.

Conclusion
Thank you again for the opportunity to testify on these important matters. The Federal Reserve looks forward to working with the Congress and the Administration to enact meaningful regulatory reform that will strengthen the financial system and reduce both the probability and severity of
future crises.

Footnotes


3. For more information about the SCAP, see Ben S. Bernanke (2009), "The Supervisory Capital Assessment Program," speech delivered at the Federal Reserve Bank of Atlanta 2009 Financial Markets Conference, held in Jekyll Island, Ga., May 11. Return to text

▲ Return to top
Financial Regulatory Reform

Remarks by
Daniel K. Tarullo
Member
Board of Governors of the Federal Reserve System
at the
U.S. Monetary Policy Forum
New York, New York

February 26, 2010
It is a pleasure to participate in this year’s U.S. Monetary Policy Forum. To begin the discussion of regulatory reform, I will first explain my view that the imperative for financial regulatory reform has much deeper roots than the imprudent mortgage lending, tightly wound wholesale financing channels, and other factors that were direct contributors to the recent financial crisis. Next, I will summarize the status of the reform proposals to address systemic risk, as well as the changes that are already in train, before ending with a few observations on the relationship between the scope of the systemic risk problem and the reform agenda.

The Roots of the Financial Crisis

It is interesting and important to inquire carefully into the immediate causes of the financial crisis. But an appropriately tailored response must begin by recognizing that the crisis arose following profound changes in both the organization and regulation of financial markets that began in the 1970s.

Starting in 1933, the New Deal established a regulatory system that largely confined commercial banks to traditional lending activities within a circumscribed geographic area, with attendant limits on price competition and a federal deposit insurance backstop meant to forestall bank runs. This approach fostered a commercial banking system that was, for the better part of 40 years, quite stable and reasonably profitable, though not particularly innovative in meeting the needs of depositors and borrowers.

The turbulent macroeconomic developments of the 1970s, along with technological and business innovations, helped produce an increasingly tight squeeze on the traditional commercial banking business model. The squeeze came on both the
liability side of bank balance sheets, in the form of more-attractive savings vehicles such as money market mutual funds, and on the asset side, with the growth of public capital markets and international competition. Large commercial banks reacted, among other ways, by seeking removal or relaxation of the regulations that confined bank activities, affiliations, and geographic reach--a request to which supervisory agencies and legislators were generally sympathetic because of the potential threat to the viability of the traditional commercial banking system.

The period of relative legal and industry stability that followed the New Deal legislation thus gave way in the 1970s to a nearly 30-year period during which many prevailing restrictions on banks were relaxed, both through administrative action by the bank regulatory agencies and through a series of legislative changes culminating in the Gramm-Leach-Bliley Act of 1999. By the turn of the century, the Depression-era cluster of restrictions on commercial banks had been replaced by a regulatory environment in which they could operate nationally, conduct a much broader range of activities, and affiliate with virtually any kind of financial firm.

These changes enabled a series of acquisitions that resulted in a number of very large, highly complex financial holding companies centered on large commercial banks. At the same time, independent investment banks had grown into a group of very large, complex, and highly leveraged firms. Of course, financial engineering had been rapidly changing the character of the financial services sector as a whole. Among other things, securitization and associated derivative instruments were merging capital markets and traditional lending activities, thereby fueling the growth of the shadow banking system.
The regulatory system had also evolved, notably through progressively more
detailed capital requirements and increasing demands that banking organizations enhance
their own risk-management systems. Supervisors counted on capital and risk
management to be supple tools that could ensure stability even as financial activities
changed rapidly. Truthfully, though, there was no wholesale transformation of financial
regulation to match the dramatic changes in the structure and activities of the financial
industry. In particular, the regulatory system did not come close to adequately
accounting for the effects of securitization and other capital market activities on both
traditional banking and systemic risk.

Meanwhile, as shown by the intervention of the government when Bear Stearns
and American International Group were failing, and by the repercussions from the failure
of Lehman Brothers, the universe of financial firms that appeared too big to fail during
periods of stress included more than insured depository institutions and, indeed, reached
beyond the circle of firms subject to mandatory prudential regulation. The extension of
funds by the Treasury Department from the Troubled Asset Relief Program and of
guarantees by the Federal Deposit Insurance Corporation (FDIC) from the Temporary
Liquidity Guarantee Program to each of the nation’s largest institutions revealed the
government’s conclusion in the fall of 2008 that a very real threat to the nation’s entire
financial system was best addressed by shoring up the largest financial firms.

**Regulatory Reform: The Consensus to Date**

The crisis thus arose against the backdrop of a regulatory system that had not
adjusted to the extensive integration of traditional lending with capital market activities,
which had created new sources of systemic risk. The already significant too-big-to-fail
problem was further amplified by the government’s actions in 2008 to prevent a complete
collapse of the financial system. The internal information and risk-management systems
of many financial firms were revealed as inadequate to the task of identifying the scope
of market and credit risks, much less ensuring the soundness of those firms, in a period of
severe stress. Proposed reforms to counteract systemic risk should, both individually and
as a whole, be evaluated by reference to these quite fundamental deficiencies in the
regulatory system.

Despite substantial disagreements over some reform proposals--such as the
creation of an independent consumer financial services protection agency and the
possible reallocation of responsibilities among the regulatory agencies--a fair degree of
consensus has been reached on some elements of a legislative reform package.
Accordingly, and with full recognition that there are still important differences on the
specifics of the legislation, my summary of the reform agenda as it has evolved to this
point will include some proposed legislative elements, as well as various administrative
measures being pursued by the regulatory agencies under existing statutory authority.

It is perhaps instructive to organize this agenda by reference to the “three pillars”
of financial regulation enunciated by the Basel Committee on Banking Supervision--
minimum prudential requirements, supervisory oversight, and market discipline.
Although the Basel Committee formulated the three-pillar approach in the context of the
Basel II arrangement for capital requirements, this frame of reference can also be applied
to the broader set of reform measures.

As to minimum prudential rules, U.S. banking agencies are joining with our
international counterparts in the Basel Committee to modify capital and liquidity
requirements. Increased capital requirements for trading activities and securitization exposures have already been agreed. A consultative paper issued late last year advances additional capital proposals, including improvements in the quality of capital used to satisfy minimum capital rules, with a particular emphasis on the importance of common equity, and a first set of measures designed to reduce the traditional pro-cyclicality of capital requirements.\footnote{Basel Committee on Banking Supervision (2009), \textit{Strengthening the Resilience of the Banking Sector--Consultative Document} (Basel, Switzerland: Bank for International Settlements, December), available at www.bis.org/publ/bcbs164.htm.} Additional work on capital requirements for market risk is also under way. Finally, the bank regulatory agencies are implementing strengthened guidance on liquidity risk management and weighing proposals for quantitative liquidity requirements.

To a considerable extent, these changes strengthen rules that existed prior to the crisis and thus build on existing approaches, even as they underscore the problems with the pre-crisis regulatory regime. Several potential regulatory devices with a more direct systemic focus have also garnered substantial interest, both here and abroad. Prominent among them are proposals to (1) impose special taxes or capital charges on firms based on their systemic importance, (2) require systemically important firms to issue or maintain contingent capital instruments that would convert to common equity in periods of stress, and (3) reduce pro-cyclical tendencies by establishing special capital buffers that would be built up in boom times and drawn down as conditions deteriorate. Each of these ideas has substantial appeal, but, as has become clear, each also presents considerable challenges in the transition from a good idea to a fully elaborated regulatory mechanism.
Many legislative proposals would extend the perimeter of regulation so that rules designed to promote financial stability would apply to firms that currently are not subject to prudential regulation because they do not own a commercial bank. The legislation passed by the House, for example, would subject any firm whose failure could have serious systemic consequences to consolidated supervision, including minimum capital and liquidity requirements.

Supervisory oversight is being reoriented in several notable ways. As I mentioned earlier, the crisis revealed the serious shortcomings in the risk-management systems of many large firms. As we found during the Supervisory Capital Assessment Program that the Federal Reserve led early last year, the risk-management prerequisite of good information management was simply lacking at many firms. Accordingly, we are placing increased emphasis on the ability of firms to assess their own capital needs, particularly in periods of stress, both to supplement minimum capital requirements and to ensure that relevant information on firm risks is readily available to supervisors.

More fundamentally, the supervisory perspective of the Federal Reserve has been refocused by modifying the scope of consolidated supervision and by coordinating much more closely the supervision of our largest financial institutions. In the years preceding the crisis, supervision of bank holding companies was principally focused on protecting the commercial banks within a holding company. Too little attention was paid to the risks faced, and created, by the entire holding company, including in affiliates principally involved in trading and other capital market activities. Supervisory attention is now focused on the risks that may develop anywhere within large holding companies, regardless of whether there is an immediate threat to the federally insured bank.
Legislative proposals to remove the Gramm-Leach-Bliley constraints placed on the Federal Reserve’s ability to obtain information from, and address unsafe and unsound practices in, the subsidiaries of bank holding companies would make this supervisory reorientation more effective.

We are also instituting a more closely coordinated system for supervising some of the largest holding companies that will, in effect, establish a cross-firm, horizontal perspective as an ongoing organizing supervisory principle. This new approach will have a macroprudential dimension as well. To advance both macroprudential and microprudential goals, we are instituting a quantitative surveillance mechanism (QSM) for large, complex financial organizations. The QSM will use supervisory information, firm-specific data analysis, and market-based indicators to identify developing strains and imbalances that may affect multiple institutions, as well as emerging risks to specific firms. Periodic scenario analyses across large firms will enhance our understanding of the potential effects of adverse changes in the operating environment on individual firms and on the system as a whole.

*Market discipline* has been an underdeveloped policy tool despite numerous ideas put forth over the years. Yet it is hard to imagine a practical counterstrategy to the undesirable consequences of too-big-to-fail perceptions that does not include a credible alternative to the current Hobson’s choice of bailout or disorderly bankruptcy. Consequently, most regulatory reform proposals have prominently featured a special resolution mechanism that would raise the real prospect of losses for investors and counterparties of even the largest failing institutions. At present, of course, the law provides the FDIC with authority to resolve failed insured depository institutions, but
there is no parallel authority for the holding companies of which these banks are a part or for other systemically important financial firms.

**Regulatory Reform: The Ongoing Debate**

The rough consensus around the reform elements just described has hardly meant an end to the debate for at least three reasons. First, as already noted, there is considerable continuing disagreement over the key features of some of these proposals, even when the basic idea is accepted. The significant differences over the best form of resolution mechanism provide one example. Second, as also mentioned earlier, some ideas that may be promising ideas in concept—such as special charges calibrated to the systemic importance of a firm—are not easy to develop and put into practice effectively. Until more-detailed proposals are generated, judgments on the likely efficacy of these ideas will obviously be difficult to make. Third, many participants in the public policy debate who would agree with some form of this consensus agenda nonetheless believe that it falls short of what is needed to ensure financial stability.

Those who believe that additional regulatory measures are necessary have mostly turned to structural measures, as distinguished from the prudential requirements, supervisory initiatives, and market discipline proposals that constitute the bulk of the consensus reform agenda. One approach is to reverse the 30-year trend that allowed progressively more financial activities within commercial banks and more affiliations with nonbank financial firms. The idea, promoted by former Federal Reserve Chairman Paul Volcker and now endorsed by the Administration, is to insulate insured depository institutions from proprietary trading or similar capital market activities that are thought to
pose unusually high risks for institutions or, more precisely, for the federal safety net provided to insured banks.

A second approach is to directly regulate more financial products and practices, whether or not the firms involved in the transactions are subject to prudential supervision. To an extent, this approach is reflected in the House bill and other proposals that would require standardized over-the-counter derivatives to be cleared through central counterparties or traded on exchanges. Some proponents favor going beyond this market requirement to prohibit or significantly constrain the use of other products or practices.

A third approach is to attack the bigness problem head-on by limiting the size or interconnectedness of financial institutions. The more muscular forms of this approach would break up some existing institutions in a manner somewhat reminiscent of breakups of AT&T in 1982 or Standard Oil in 1911 under the antitrust laws. A somewhat less sweeping variant would prevent firms from growing beyond a certain size or in a way that would significantly increase their systemic importance, including through acquisitions. The Administration’s recent proposals contain an example of the second form, with a cap on the percentage of total financial industry liabilities that could be held by any one firm. The House bill has examples of both forms, as it grants authority to a newly created council of financial regulators to dismantle a firm that poses a “grave threat” to systemic stability and to individual banking regulators to prevent acquisitions that would increase systemic risk.

Regulatory Reform in Perspective

Let me now offer a few observations on the overall effort to revamp our financial regulatory system. First, the reform process cannot be judged a success unless it
substantially reduces systemic risk generally and, in particular, the too-big-to-fail problem. In using the Basel II three-pillar metaphor to classify the consensus reform agenda, I meant to underscore that this agenda is in many respects a program to build out and improve the regulatory approaches that prevailed before the crisis. The important intellectual question is whether the limitations of these approaches that have been revealed in the past can be sufficiently overcome, either within each pillar or through their combination.

The fact that support for reforms of the structural variety has been growing during the past year’s policy debate suggests to me that many thoughtful people have given at least a tentative negative answer to that question. Of course, the specifics of a good number of these proposals have yet to be formulated, and judgment of the merits must await their further development, insofar as the details will determine whether a proposal is likely both to be effective and to have manageable unintended consequences. Speaking personally, however, I think that we should not become unrealistically demanding in seeking specification of such proposals, particularly when a proposal itself provides for ongoing refinement. For example, my sense is that the provision in the House bill that would empower banking regulators to prevent acquisitions that would increase systemic risk could be sensibly and effectively elaborated over time. We should also be thinking more seriously about ensuring that safety and soundness requirements for some types of activities--residential mortgage lending comes to mind--apply throughout the financial system, without regard to the regulated status of the lender.

Second, having just noted the promise of measures beyond what I have termed the consensus agenda, I also want to emphasize the importance of its elements. Without
better capital requirements, a horizontal approach to supervising the largest financial institutions, and a sophisticated macroprudential complement to traditional bank and bank holding company supervision, the regulatory system is unlikely to deliver on a promise of greater financial stability. Similarly, legislative proposals to make a workable resolution mechanism and prudential regulation applicable to all systemically important firms are necessary to achieving the same goal. Indeed, the resolution mechanism is critical to strengthening market discipline sufficiently so that it can truly take its place alongside rules and supervisory oversight as a strong third pillar of the financial regulatory system.

Third, having made the case for extensive change, I want to add a cautionary note. Even as we improve and reorient regulation, we must not lose sight of the ultimate goal. Today we are all mindful of the economic devastation that can ensue when a financial system goes badly awry. But financial stability alone is not the aim of financial regulation. It is instead a stable financial system within which capital is efficiently directed to creditworthy consumers and businesses who need it, as well as a system that offers good savings and investment vehicles for individuals and organizations.

The implications of this caution are several. I will mention two. One, which we regulators have already taken to heart, is that the effect of new capital and liquidity requirements on lending, and thus on economic recovery and growth, must be carefully taken into account. This is why we urged--successfully, I am pleased to say--that the Basel Committee analyze the whole package of capital changes under consideration from a macroeconomic, as well as a microprudential, perspective before those changes are finalized. Another implication is that it will be unnecessary to apply some regulatory
changes to the smaller financial institutions that are far from being able to create systemic risk on their own.

**Conclusion**

In closing, let me say that regulatory reform will not come to a close once we have enacted our new regulations and legislation. The work of containing systemic risk and the too-big-to-fail problem will need to be adaptive. The perspectives, ideas, and criticisms of those outside the regulatory agencies will remain essential to this work, even if they can sometimes cause some discomfort for those of us within.
Speech

Governor Daniel K. Tarullo
At the Money Marketeers of New York University, New York, New York
November 9, 2009

Financial Regulation: Past and Future

Systemic crises typically reveal failures across the financial system. The crisis that unfolded over the past two years is no exception, with fundamental problems apparent in both the private and public sectors. There were massive failures of risk management in many financial firms and serious deficiencies in government regulation of financial institutions and markets. But the breadth and depth of the financial breakdown suggest that it has much deeper roots. In many respects, this crisis was the culmination of changes in both the organization and regulation of financial markets that began in the 1970s. An appropriately directed response must build on an understanding of this history.

In my remarks this evening I will begin by reviewing the origins of the crisis, as a prelude to discussion of the elements of a reform agenda that I believe to be reasonably clearly established. I will close with some thoughts on the very important question of whether additional regulatory methods will be necessary to provide the foundation for a stable and efficient financial system.¹

The Origins of the Crisis
Shortly after President Franklin Roosevelt's inauguration in 1933, Congress enacted sweeping new measures that would define financial regulation for decades. The creation of the Federal Deposit Insurance Corporation (FDIC) countered the problem of bank runs and panics by insuring the bank accounts of the vast majority of Americans. Along with preexisting restrictions in the National Banking Act and state laws, the Glass-Steagall Act established a regulatory system that largely confined commercial banks to traditional lending activities within a circumscribed geographic area. At the same time, the Securities Act of 1933 and the Securities Exchange Act of 1934 brought increased transparency and accountability to the trading and other capital market activities that were now essentially separated from commercial banking.

This regulatory approach fostered a commercial banking system that was, for the better part of 40 years, quite stable and reasonably profitable, though not particularly innovative in meeting the needs of depositors and borrowers. The new FDIC insurance, the 1933 statutory prohibition of interest payments on demand deposits, and the Fed's Regulation Q upper limit on interest rates paid on savings deposits had together suppressed competition for deposits among banks and made retail deposits a highly stable source of relatively attractive financing.

The turbulent macroeconomic developments of the 1970s, along with technological and business innovations, helped produce an increasingly tight squeeze on the traditional commercial banking business model. The squeeze came from both the liability side, in the form of more attractive savings vehicles such as money market funds, and from the asset side, with the growth of public capital markets and international competition. The large commercial banking industry that saw its lending to large and medium-sized corporations threatened by their increasing access to public capital markets sought removal or relaxation of the regulations that confined bank activities.
affiliations, and geographic reach. While supervisors differed with banks on some important particulars, they were sympathetic to this industry request, in part because of the potential threat to the viability of the traditional commercial banking system.

The period of relative legal and industry stability that had followed the 1933 legislation thus gave way in the 1970s to a nearly 30-year period during which many prevailing restrictions on banks were relaxed. A good number were loosened through administrative action by the banking agencies, but regular and important statutory measures headed in the same direction. This legislative trend culminated in the Gramm-Leach-Bliley Act of 1999, which consolidated and extended the administrative changes that had allowed more extensive affiliations of commercial banks with investment banks, broker-dealers, merchant banks, and other financial firms. By the turn of the century, the Depression-era cluster of restrictions on commercial banks had given way to a regulatory environment in which they could operate nationally, conduct a much broader range of activities within their own operations, and affiliate with virtually any kind of financial firm.

These changes enabled a series of acquisitions that resulted in a number of very large, highly complex financial holding companies centered on a large commercial bank. At the same time, independent investment banks had grown into a group of very large, complex, and highly leveraged firms. Of course, financial engineering had been rapidly changing the character of the financial services sector as a whole. Securitization and associated derivative instruments were merging capital markets and traditional lending activities, fueling the growth of what has become known as the shadow banking system. Financial institutions relied for a significant portion of their financing on short-term capital market sources that were often poorly matched with the maturity structure of the firm's assets. As a result, both the asset mix and sources of funding of many financial firms had shifted dramatically.

The regulatory system had also evolved, notably through progressively more detailed capital requirements and increasing demands that banking organizations enhance their own risk-management systems. Supervisors counted on capital and risk management to be supplie tools that could ensure stability even as financial activities changed rapidly. Truthfully, though, there was no wholesale transformation of financial regulation to match the dramatic changes in the structure and activities of the financial industry. In particular, the regulatory system did not come close to adequately accounting for the impact of trading, securitization, and some other capital market activities on both traditional banking and systemic risk.

The consequences of this neglect were dramatic. When questions arose about the quality of the assets on which the shadow banking system was based--notably poorly underwritten subprime mortgages--a classic adverse feedback loop ensued. With lenders increasingly unwilling to extend credit against these assets, liquidity-strained institutions made increasingly distressed asset sales, which placed additional downward pressure on asset prices, thereby accelerating margin calls for leveraged actors and amplifying mark-to-market losses for all holders of the assets. The margin calls and booked losses would start another round in the adverse feedback loop.

Meanwhile, as shown by the intervention of the government when Bear Stearns and AIG were failing, and by the repercussions from the failure of Lehman Brothers, the universe of financial firms that appeared too-big-to-fail during periods of stress included more than insured depository institutions and extended beyond the perimeter of traditional safety and soundness regulation. The extension of funds by the Treasury Department from the Troubled Asset Relief Program (TARP) and guarantees by the FDIC from the Temporary Liquidity Guarantee Program to each of the nation's largest institutions in the fall of 2008 revealed the government's view that a very real threat to the nation's entire financial system was best addressed by shoring up the nation's largest financial firms.

The Agenda for Reform
The need for a thorough overhaul of the financial regulatory system is thus borne out not only by our frighteningly close brush with financial collapse in the fall of 2008, but also by the degree to which too-big-to-fail perceptions and capital-market sources of systemic risk had been permitted—if not encouraged—by regulatory developments in the preceding decades. A post-crisis reform program will ultimately be judged adequate only if it addresses these problems head-on. A reform agenda aimed at these problems has, in fact, taken shape this year, although important components remain the subject of active debate. Let me take a few minutes to set forth the outlines of that agenda, which includes both changes by financial regulatory agencies acting under their existing authority and new legislation.

The first important item on the reform agenda is to extend the perimeter of regulation so that any firm whose failure could have serious systemic consequences will be subject to consolidated supervision, including minimum capital and liquidity requirements. As last year's events showed, systemic problems can arise from the activities of non-banking firms but, under present law, these requirements apply only to firms owning a commercial bank. Indeed, there is an incentive to shift riskier activities into unregulated firms.

A second item is to strengthen the prudential rules applicable to supervised institutions. This component of a reform program has manifold elements. There is little doubt that capital levels prior to the crisis were insufficient to serve as an adequate buffer against loss and constraint on leverage, particularly in some of the largest financial institutions. Working with our counterparts in the Basel Committee on Banking Supervision, U.S. supervisory agencies have already increased capital requirements for trading activities and securitization exposures, two of the areas in which losses were especially high. We are moving toward agreement on modifying existing rules to improve the quality of capital used to satisfy minimum capital rules, with a particular emphasis on the importance of common equity.

Liquidity issues have rightly garnered considerable attention in the aftermath of the crisis. It has always been recognized that a solvent financial institution can be brought down by liquidity problems. That, of course, is one traditional justification for reserve requirements. But the tightly wound, often complex channels of financing characteristic of the shadow banking system, including the wholesale funding practices of many regulated institutions, simply outpaced conventional liquidity risk management assumptions. The bank regulatory agencies are implementing strengthened guidance on liquidity risk management and weighing proposals for quantitatively based requirements.

A third part of the reform agenda is to use market discipline more effectively as a regulatory and supervisory tool. Too-big-to-fail perceptions weaken normal market disciplinary forces by producing a distorted set of incentives in which counterparties of a large institution may not price into their extensions of credit the full risks assumed by the institution. The management and shareholders of the too-big-to-fail institution may regard themselves as holding a put option and may, accordingly, be motivated to take greater risks with the cheaper funds now available to them. The assumption, of course, is that the government will bail out a large firm encountering severe distress, to preclude potential contagion from the direct or indirect effects of a disorderly bankruptcy. The enormous concerns with this moral hazard effect explain the focus in current reform proposals on a special resolution procedure that raises the real prospect of losses for shareholders and creditors of even the largest financial firms.

The fourth item on the current reform agenda is to increase the effectiveness of the consolidated supervisory process, particularly for the largest institutions. In the years preceding the crisis, bank holding company supervision was principally focused on protecting the commercial banks within a holding company. Too little attention was paid to the risks faced, and created, by the entire holding company, including affiliates principally involved in trading and other capital market activities. This weakness may be partially explained by the supervisory approach embedded in the Gramm-Leach-
Bliley Act, with its emphasis on the functional supervision of affiliates in a holding company. But it was also the case that not enough supervisory scrutiny was given to the risks associated with securitization, the common exposures of different affiliates, and the implications of the explosion of off-balance-sheet assets.

This is an especially appropriate moment to describe what the Federal Reserve is doing to reorient the supervision of large institutions, since today we announced results of the implementation of the capital plans formulated last spring as part of the special Supervisory Capital Assessment Program (SCAP). As you will recall, the unprecedented SCAP process was begun last February, during one of the darkest periods of the financial crisis. Led by the Federal Reserve, a multidisciplinary team from the bank regulatory agencies assessed the amount of capital that would be needed by the 19 largest bank holding companies to withstand losses in an adverse stress scenario through 2010, and still remain sufficiently capitalized to meet the needs of their creditworthy borrowers.

In May we publicly released the results of that assessment. Ten of the firms needed additional capital. By early June they had each submitted plans for realizing the specified capital buffers. Today was the deadline for implementing these plans. As we announced earlier in the day, nine of the 10 bank holding companies that were determined to need the raise, or improve the quality of, their capital have met or exceeded their required capital buffers. The tenth firm, GMAC, is expected to meet its buffer by accessing the TARP Automotive Industry Financing Program administered by the U.S. Treasury. These institutions have increased common equity by more than $75 billion, mostly through issuance of new shares, conversions of preferred to common stock, and sales of businesses and assets.

The immediate effect of the completion of the assessment phase of SCAP was to provide important information about the condition of the 19 institutions at a time of substantial stress and uncertainty in financial markets. The SCAP clearly helped to restore public confidence in the banking system. Through its demonstration of the importance of individual assessments of firms' capital needs, improved management information systems in complex firms, and horizontal reviews of large institutions, SCAP will also have longer-lasting effects on the supervision of large institutions.

One particularly important byproduct of the SCAP was a renewed supervisory focus on institutions' ability to assess their own capital adequacy--specifically their ability to estimate capital needs and identify available capital resources during very stressful periods. The uncertainty associated with capital needs in such periods is one among numerous reasons for firms to maintain substantial capital buffers. However, to the degree that firms cannot demonstrate their capacity to conduct rigorous internal capital assessments, supervisors will demand even higher capital cushions. SCAP revealed significant deficiencies in the information and quantitative risk assessment capabilities of some firms. Currently, we are conducting a horizontal assessment of internal processes that evaluate capital adequacy at the largest U.S. banking organizations, focusing in particular on how shortcomings in fundamental risk management and governance impair firms' abilities to estimate capital needs for their specific exposures and activities.

The Federal Reserve is also putting in place a permanent quantitative surveillance mechanism for the large, complex financial organizations we supervise. This mechanism will incorporate supervisory information, firm-specific data analysis, and market-based indicators to identify developing strains and imbalances that may affect multiple institutions, as well as emerging risks to specific firms. The work will be performed by a multidisciplinary group composed of economic and market researchers, supervisors, market operations specialists, and accounting and legal experts. Periodic scenario analyses will be used to evaluate the potential impact of adverse changes in the operating environment on individual firms and on the system as a whole. This program will be distinct from the activities of on-site examination teams, so as to provide an independent supervisory perspective, as well as to complement the work of those teams. It will provide both improved microprudential supervision of the largest institutions and a foundation for a
Supplementing the Reform Agenda
The administrative and proposed legislative measures I have discussed present a strong set of reforms around which a consensus seems to be developing, at least in general terms. But many participants in the public policy debate on regulatory reform believe that more will need to be done to ensure the safety and soundness of financial institutions, guard against systemic risk, and substantially contain the too-big-to-fail problem.

Some additional potential regulatory devices are already under active consideration, both among U.S. bank supervisors and in international forums. These include proposals to create special charges on firms based on their systemic importance, to require contingent capital that would be available in periods of stress, and to counter pro-cyclical tendencies by establishing special capital buffers that would be built up in boom times and drawn down as conditions deteriorate. Each of these ideas has substantial appeal. A number of thoughtful proposals are being discussed, though each idea presents considerable challenges in the transition from good idea to fully elaborated regulatory mechanism.

Yet to gain traction are proposals for what might be termed structural measures—that is, steps that would directly affect the nature and organization of the financial services industry. But discussion of such concepts is clearly increasing.

One suggested approach is to reverse the 30-year trend that allowed progressively more financial activities within commercial banks and more affiliations with non-bank financial firms. The idea is presumably to insulate insured depository institutions from trading or other capital market activities that are thought riskier than traditional lending functions, although separating trading from hedging and other prudent practices associated directly with lending is not an altogether straightforward proposition.

In any case, this strategy would seem unlikely to limit the too-big-to-fail problem to a significant degree. For one thing, some very large institutions have in the past encountered serious difficulties through risky lending alone. Moreover, as shown by Bear Stearns and Lehman, firms without commercial banking operations can now also pose a too-big-to-fail threat. Still, imposition of higher capital and liquidity requirements for riskier trading and other capital market activities can, if well devised and implemented, achieve some of what proponents of this approach seem to have in mind.

Another approach is to attack the bigness problem head-on by limiting the size of financial institutions. It is notable that current law provides very little in the way of structural means to limit systemic risk and the too-big-to-fail problem. The statutory prohibition on interstate acquisitions that would result in a commercial bank and its affiliates holding more than 10 percent of insured deposits nationwide is the closest thing to such an instrument. Policy commentators might usefully attempt to develop similarly discrete mechanisms that could be beneficial in containing the too-big-to-fail problem.

This exercise would, at a minimum, require development of valid and administrable standards for judging when systemic risk or too-big-to-fail problems would be materially increased, as well as a more complete understanding of what efficiencies attach to very large or complex financial institutions, and thus what social benefits might be lost by limiting or reducing their size. Thus considerable work would need to be done before evaluating the promise of these ideas. But, as I have said before, further elaboration of these ideas could be very useful in advancing our understanding of the dimensions of the too-big-to-fail problem.

Conclusion
In closing, let me reiterate the importance both of moving ahead with the administrative and legislative reform agenda that I described earlier and of continuing investigations of complementary
or alternative regulatory approaches. These inquiries into possible alternatives should not be used as an excuse to delay consideration of current legislative proposals. But the justifiable focus of policymakers on achieving these administrative and legislative changes should not crowd out open-minded consideration of additional measures.

1. The views expressed are my own and not necessarily those of other members of the Board of Governors. Return to text

Return to top
Interagency Policy Statement on Funding and Liquidity Risk Management

AGENCIES: Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (FRB); Federal Deposit Insurance Corporation (FDIC); Office of Thrift Supervision, Treasury (OTS); and National Credit Union Administration (NCUA).

ACTION: Final Policy Statement
SUMMARY: The OCC, FRB, FDIC, OTS, and NCUA (the agencies) in conjunction with the Conference of State Bank Supervisors (CSBS), are adopting this policy statement. The policy statement summarizes the principles of sound liquidity risk management that the agencies have issued in the past and, when appropriate, supplements them with the “Principles for Sound Liquidity Risk Management and Supervision” issued by the Basel Committee on Banking Supervision (BCBS) in September 2008\(^1\). This policy statement emphasizes supervisory expectations for all depository institutions including banks, thrifts, and credit unions.

DATES: This policy statement is effective on [INSERT DATE 60 DAYS FROM DATE OF PUBLICATION IN FEDERAL REGISTER]. Comments on the Paperwork Reduction Act burden estimates only may be submitted on or before [INSERT DATE 30 DAYS FROM DATE OF PUBLICATION IN FEDERAL REGISTER].

FOR FURTHER INFORMATION CONTACT:


FRB: James Embersit, Deputy Associate Director, Market and Liquidity Risk, 202-452-5249 or Mary Arnett, Supervisory Financial Analyst, Market and Liquidity Risk, 202-721-4534 or Brendan Burke, Supervisory Financial Analyst, Supervisory Policy and Guidance, 202-452-2987


\(^1\) NCUA is not a member of the Basel Committee on Banking Supervision and federally insured credit unions are not directly referenced in the principles issued by the Committee
SUPPLEMENTARY INFORMATION:

I. Background

The recent turmoil in the financial markets clearly demonstrated the importance of good liquidity risk management to the safety and soundness of financial institutions. In light of this experience, supervisors worked on an international and national level through various groups to assess the lessons learned on individual institutions’ management of liquidity risk and inform future supervisory efforts on this topic. As one result of these efforts, the Basel Committee on Banking Supervision issued in September 2008, *Principles for Sound Liquidity Risk Management and Supervision*, which contains 17 principles detailing international supervisory guidance for sound liquidity risk management.

II. Comments on the Proposed Policy Statement

On July 6, 2009, the agencies requested public comment on all aspects of a proposed interagency policy statement on funding and liquidity risk management. The comment period closed on September 4, 2009. The agencies received 22 letters from financial institutions, bank consultants, industry trade groups, and individuals. Overall, the commenters generally supported the agencies’ efforts to consolidate and supplement supervisory expectations for liquidity risk management.

2 Significant international groups addressing these issues include the Basel Committee on Banking Supervision (BCBS), Senior Supervisors Group, and the Financial Stability Board.

3 74 FR 32035, (July 9, 2009).
Many commenters expressed concern regarding the proposed policy statement’s articulation of the principle that separately regulated entities would be expected to maintain liquidity commensurate with their own profiles on a stand-alone basis. These commenters indicated that the language in the proposed statement suggested that each regulated entity affiliated with a parent financial institution would be required to maintain its own cushion of liquid assets. This could result in restrictions on the movement of liquidity within an organization in a time of stress. Such restrictions are commonly referred to as “trapped pools of liquidity”. These commenters assert that there are advantages to maintaining liquidity on a centralized basis that were evident during the current market disruption. Further, they assert that requiring separate pools of liquidity may discourage the use of operating subsidiaries.

The agencies recognize the need for clarification of the principles surrounding the management of liquidity with respect to the circumstances and responsibilities of various types of legal entities and supervisory interests pertaining to them, and, therefore, have clarified the scope of application of the policy statement with regard to the maintenance of liquidity on a legal entity basis. Specifically, the policy statement indicates that the agencies expect depository institutions to maintain adequate liquidity both at the consolidated level and at significant legal entities. The agencies recognize that a depository institution’s approach to liquidity risk management will depend on the scope of its business operations, business mix, and other legal or operational constraints. As an overarching principle, depository institutions should maintain sufficient liquidity to ensure compliance during economically stressed periods with applicable
legal and regulatory restrictions on the transfer of liquidity among regulated entities. The agencies have modified the language in the policy statement to reflect this view.

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

Many commenters expressed concern over whether the agencies were being too prescriptive in the policy statement regarding expectations for contingency funding plans (CFPs). These commenters asserted that there needs to be flexibility in the design of CFPs such that institutions can respond quickly to rapidly moving events that may not have been anticipated during the design of the CFP. Other commenters asked whether the policy statement requires institutions to use certain funding sources (e.g., FHLB advances or brokered deposits) in order to show diversification of funding within their CFP.

The agencies believe that the policy statement provides adequate flexibility in supervisory expectations for the development and use of CFPs. In fact the policy statement provides a basic framework that allows for compliance across a broad range of business models.
whether financial institutions are large or small. While the policy statement addresses the need
to diversify an institution’s funding sources, there is no requirement to use a particular funding
source. The agencies believe that a diversification of funding sources strengthens an institution’s
ability to withstand idiosyncratic and market wide liquidity shocks.

Many commenters representing financial institution trade organizations (both domestic
and international) and special-purpose organizations such as banker’s banks and clearing house
organizations expressed concern over the treatment of federal funds purchased as a concentration
of funding. As of this writing, under a separate issuance, the agencies issued for public
comment, “Correspondent Concentrations Risks.”4 That guidance covers supervisory
expectations for the risks that can occur in correspondent relationships. The draft guidance can

Some commenters expressed concern over limiting the high-quality liquid assets used in
the liquidity buffer to securities such as U.S. Treasuries. These commenters assert that limiting
the liquidity buffer to these instruments would limit diversification of funding sources and
potentially harm market liquidity.

The agencies agree with some comments on the need for a liquidity buffer of
unencumbered high-quality assets sized to cover an institution’s risk given an appropriate stress
test. The agencies believe that such buffers form an essential part of an effective liquidity risk
management system. The question centers on the composition of assets that make up an
institution’s liquidity buffer. This is an issue that not only resonates with this domestic policy

4 NCUA did not participate in this proposed guidance.
statement but with the Basel Committee on Banking Supervision’s (BCBS) “Principles for Sound Liquidity Risk Management and Supervision.” It is the intention of the agencies for institutions to maintain a buffer of liquid assets that are of such high quality that they can be easily and immediately converted into cash. Additionally, these assets should have little or no loss in value when converted into cash. In addition to the example used in the policy statement, other examples of high-quality liquid assets may include government guaranteed debt, excess reserves at the Federal Reserve, and securities issued by U.S. government sponsored agencies. The policy statement was amended to include additional examples.

Some commenters expressed concern over supervisory expectations for CFP testing. These commenters assert that the agencies need to clarify their expectations for testing of components of the CFP.

The agencies agreed with the commenters and have amended the policy statement to include a recognition that testing of certain elements of the CFP may be impractical. For example, this may include the sale of assets in which the sale of such assets may have unintended market consequences. However, other components of the CFP can and should be tested (e.g., operational components such as ensuring that roles and responsibilities are up-to-date and appropriate; ensuring that legal and operational documents are current and appropriate; and ensuring that cash collateral can be moved where and when needed and back-up liquidity lines can be drawn).
Two credit union commenters questioned the need for NCUA to adopt the proposed policy statement in light of existing guidance in NCUA’s Examiner’s Guide. The commenters questioned the appropriateness of imposing new requirements on credit unions. The purpose of the policy statement is to reiterate the process and liquidity risk management measures that depository institutions, including federally insured credit unions, should follow to appropriately manage related risks. The policy statement does not impose requirements and contemplates flexibility in its application. The policy statement is also not intended to replace the NCUA’s Examiner’s Guide but provides a uniform set of sound business practices, with the expectation that each institution will scale the guidance to its complexity and risk profile. The policy statement, when issued by NCUA, will likely be an attachment to an NCUA Letter to Credit Unions. The letter will provide additional guidance to federally insured credit unions on NCUA’s expectations. The two credit union commenters also characterized the policy statement as imposing additional burden on federally insured credit unions, specifically as it relates to stress testing and overall liquidity management reporting. Depending on a credit union’s risk profile, such testing and reporting is already expected. NCUA “Letter to Credit Unions 02-CU-05, Examination Program Liquidity Questionnaire”, issued in March of 2002, includes examiner review of stress testing performed as well as an overall assessment of the adequacy of management reporting. The policy statement does not add to a credit union’s current burden in this regard but rather clarifies NCUA’s expectation for those credit unions with risk profiles warranting a higher degree of liquidity risk management.

Lastly, the two credit union commenters encouraged NCUA to not include corporate credit unions within the scope of this policy statement as the corporate credit union network may

---

5 The letter can be found at NCUA’s website at www.ncua.gov/letters/2002/02-CU-05.html
be restructured. NCUA’s intent is for the policy statement to apply only to federally insured, natural person credit unions, not corporate credit unions and the policy statement has been modified to clarify that point.

Accordingly, for all the reasons discussed above, the agencies have determined that it is appropriate to adopt as final the proposed policy statement as amended.

III. Paperwork Reduction Act

In accordance with section 3512 of the Paperwork Reduction Act of 1995, 44 U.S.C. 3501-3521 (PRA), the Agencies may not conduct or sponsor, and the respondent is not required to respond to, an information collection unless it displays a currently valid Office of Management and Budget (OMB) control number. The information collection requirements contained in this guidance have been submitted to OMB for approval.

On July 6, 2009, the agencies sought comment on the burden estimates for this information collection. The comments are summarized below.

Comments continue to be invited on:

(a) Whether the collection of information is necessary for the proper performance of the Federal banking agencies’ functions, including whether the information has practical utility;

(b) The accuracy of the estimates of the burden of the information collection, including the validity of the methodology and assumptions used;

(c) Ways to enhance the quality, utility, and clarity of the information to be collected;

(d) Ways to minimize the burden of the information collection on respondents, including through the use of automated collection techniques or other forms of information technology;

6 74 FR 32035.
and

(e) Estimates of capital or start up costs and costs of operation, maintenance, and purchase of services to provide information.

Comments on these questions should be directed to:

OCC: Communications Division, Office of the Comptroller of the Currency, Mailstop 2-3, Attention 1557-NEW, 250 E Street, SW., Washington, DC 20219. In addition comments may be sent by fax to (202) 874-5274, or by electronic mail to regs.comments@occ.treas.gov. You may personally inspect and photocopy comments at the OCC, 250 E Street, SW., Washington, DC. For security reasons, the OCC requires that visitors make an appointment to inspect comments. You may do so by calling (202) 874-4700. Upon arrival, visitors will be required to present valid government-issued photo identification and to submit to security screening in order to inspect and photocopy comments.

FRB: You may submit comments, identified by Docket No. OP-1362, by any of the following methods:

- E-mail: regs.comments@federalreserve.gov. Include the docket number in the subject line of the message.
- FAX: 202/452-3819 or 202/452-3102.
- Mail: Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551.
All public comments are available from the FRB’s Web site at www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm as submitted, unless modified for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information. Public comments may also be viewed in electronic or paper form in Room MP-500 of the FRB’s Martin Building (20th and C Streets, NW) between 9 a.m. and 5 p.m. on weekdays.

FDIC: Interested parties are invited to submit written comments. All comments should refer to the name of the collection, “Liquidity Risk Management.” Comments may be submitted by any of the following methods:

- **E-mail:** comments@fdic.gov.
- **Mail:** Leneta G. Gregorie (202.898.3719), Counsel, Federal Deposit Insurance Corporation, PA1730-3000, 550 17th Street, NW., Washington, DC 20429.
- **Hand Delivery:** Comments may be hand-delivered to the guard station at the rear of the 550 17th Street Building (located on F Street), on business days between 7:00 a.m. and 5:00 p.m.

OTS: Send comments, referring to the collection by title of the proposal or by OMB approval number, to OMB and OTS at these addresses: Office of Information and Regulatory Affairs, Attention: Desk Officer for OTS, U.S. Office of Management and Budget, 725 – 17th Street, NW., Room 10235, Washington, DC 20503, or by fax to (202) 395-6974; and Information Collection Comments, Chief Counsel's Office, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552, by fax to (202) 906-6518, or by e-mail to
infocollection.comments@ots.treas.gov. OTS will post comments and the related index on the OTS Internet Site at www.ots.treas.gov. In addition, interested persons may inspect comments at the Public Reading Room, 1700 G Street, NW., by appointment. To make an appointment, call (202) 906-5922, send an e-mail to public.info@ots.treas.gov, or send a facsimile transmission to (202) 906-7755.

NCUA: You may submit comments by any of the following methods (Please send comments by one method only):


NCUA Web Site:

http://www.ncua.gov/Resources/RegulationsOpinionsLaws/ProposedRegulations.aspx Follow the instructions for submitting comments.

- E-mail: Address to regcomments@ncua.gov. Include "[Your name] Comments on Proposed Interagency Guidance – Funding and Liquidity Risk Management," in the e-mail subject line.

- Fax: (703) 518-6319. Use the subject line described above for e-mail.

- Mail: Address to Mary F. Rupp, Secretary of the Board, National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314-3428.

- Hand Delivery/Courier: Same as mail address.

Public inspection: All public comments are available on the agency’s website at http://www.ncua.gov/Resources/RegulationsOpinionsLaws/ProposedRegulations.aspx as submitted, except as may not be possible for technical reasons. Public comments will not be edited to remove any identifying or contact information. Paper copies of comments may be inspected in NCUA’s law library, at 1775 Duke Street, Alexandria, Virginia 22314, by
appointment weekdays between 9:00 a.m. and 3:00 p.m. To make an appointment, call (703) 518-6546 or send an e-mail to OGC Mail @ncua.gov.

You should send a copy of your comments to the OMB Desk Officer for the agencies, by mail to U.S. Office of Management and Budget, 725 17th Street, NW., #10235, Washington, DC 20503, or by fax to (202) 395-6974.

Title of Information Collection: Funding and Liquidity Risk Management.

OMB Control Numbers: New collection; to be assigned by OMB.

Abstract: Section 14 states that institutions should consider liquidity costs, benefits, and risks in strategic planning and budgeting processes. Significant business activities should be evaluated for liquidity risk exposure as well as profitability. More complex and sophisticated institutions should incorporate liquidity costs, benefits, and risks in the internal product pricing, performance measurement, and new product approval process for all material business lines, products and activities. Incorporating the cost of liquidity into these functions should align the risk-taking incentives of individual business lines with the liquidity risk exposure their activities create for the institution as a whole. The quantification and attribution of liquidity risks should be explicit and transparent at the line management level and should include consideration of how liquidity would be affected under stressed conditions.

Section 20 would require that liquidity risk reports provide aggregate information with sufficient supporting detail to enable management to assess the sensitivity of the institution to changes in market conditions, its own financial performance, and other important risk factors. Institutions should also report on the use of and availability of government support, such as
lending and guarantee programs, and implications on liquidity positions, particularly since these programs are generally temporary or reserved as a source for contingent funding.

Comment Summary:

The OCC, FRB, and OTS received one comment regarding its burden estimates under the Paperwork Reduction Act. The comment, which was from a trade association, stated that some community banks with less than $10 billion in assets reported to them that the estimate of 80 burden hours for small respondents is accurate. Other community banks estimated that it would take significantly longer, especially in the first year of implementation. The agencies have determined that, on average, the burden estimate is accurate and, therefore they have not changed the burden estimates in the final policy statement.

The NCUA received two comments from trade organizations regarding the Paperwork Reduction Act, section III, items (a) through (e). One commenter stated that no additional information should be required of credit unions if they are following current procedures addressed in NCUA’s Examiner’s Guide. Sections 14 and 20 of the proposed guidance include specific analysis and reporting expectations based on the complexity of the credit union and risk profile. The time estimates provided by NCUA reflect the estimated amount of time if credit unions complied with those expectations. The time burden estimate is not in addition to complying with NCUA Examiner’s Guide and such analysis and reporting are existing expectations for complex, higher risk credit unions (refer to Letter to Credit Unions 02-CU-05). It is difficult to accurately estimate how many credit unions would have an implementation burden for Sections 14 and 20 under the proposed guidance and the extent of that additional burden. It is largely dependent upon
the structure of the credit union and the inherent risks present, which will fluctuate over time. The initial comment period for the guidance solicited comments on time burden estimates. No specific responses were provided from credit unions to support or challenge the time estimates provided. The time estimates provided are an average per credit union based on asset size alone and may not accurately reflect the time necessary for a particular credit union to comply with the expectations of Sections 14 and 20.

Affected Public:

   OCC: National banks, their subsidiaries, and federal branches or agencies of foreign banks.

   FRB: Bank holding companies, state member banks, state-licensed branches and agencies of foreign banks (other than insured branches), and corporations organized or operating under sections 25 or 25A of the Federal Reserve Act (Agreement corporations and Edge corporations).

   FDIC: Insured state nonmember banks.

   OTS: Federal savings associations and their affiliated holding companies.

   NCUA: Federally-insured credit unions.

Type of Review: Regular.

Estimated Burden:

   OCC:

   Number of respondents: 1,560 total (13 large (over $100 billion in assets), 29 mid-size ($10 - $100 billion), 1,518 small (less than $10 billion)).

   Burden under Section 14: 720 hours per large respondent, 240 hours per mid-size respondent, and 80 hours per small respondent.
Burden under Section 20: 4 hours per month.

Total estimated annual burden: 212,640 hours.
FRB:

Number of respondents: 6,156 total (29 large (over $100 billion in assets); 117 mid-size ($10--$100 billion); and 6,010 small (less than $10 billion).

Burden under Section 14: 720 hours per large respondent, 240 hours per mid-size respondent, and 80 hours per small respondent.

Burden under Section 20: 4 hours per month.

Total estimated annual burden: 825,248 hours.

FDIC:

Number of respondents: 5,076 total (10 large (over $20 billion in assets), 309 mid-size ($1 - $20 billion), 4,757 small (less than $1 billion)).

Burden under Section 14: 720 hours per large respondent, 240 hours per mid-size respondent, and 80 hours per small respondent.

Burden under Section 20: 4 hours per month.

Total estimated annual burden: 705,564.

OTS:

Number of respondents: 801 total (14 large (over $100 billion in assets), 104 mid-size ($10 - $100 billion), 683 small (less than $10 billion)).

Burden under Section 14: 720 hours per large respondent, 240 hours per mid-size respondent, and 80 hours per small respondent.

Burden under Section 20: 4 hours per month.

Total estimated annual burden: 128,128.
NCUA:

Number of respondents: 7,736 total (153 large (over $1 billion in assets), 501 mid-size ($250 million to $1 billion), and 7,082 small (less than $250 million)).

Burden under Section 14: 240 hours per large respondent, 80 hours per mid-size respondent, and 20 hours per small respondent.

Burden under Section 20: 2 hours per month.

Total estimated annual burden: 404,104.
IV. Guidance

The text of the Interagency Policy Statement on Funding and Liquidity Risk Management is as follows:

INTERAGENCY POLICY STATEMENT ON FUNDING AND LIQUIDITY RISK MANAGEMENT

1. The Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (FRB), Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA) (collectively, the agencies) in conjunction with the Conference of State Bank Supervisors (CSBS)7 are issuing this guidance to provide consistent interagency expectations on sound practices for managing funding and liquidity risk. The guidance summarizes the principles of sound liquidity risk management that the agencies have issued in the past8 and, where appropriate, harmonizes these principles with the international statement recently issued by the Basel Committee on Banking Supervision titled “Principles for Sound Liquidity Risk Management and Supervision.”9

---

7 The various state banking supervisors may implement this policy statement through their individual supervisory process.
2. Recent events illustrate that liquidity risk management at many financial institutions is in need of improvement. Deficiencies include insufficient holdings of liquid assets, funding risky or illiquid asset portfolios with potentially volatile short-term liabilities, and a lack of meaningful cash flow projections and liquidity contingency plans.

3. The following guidance reiterates the process that institutions should follow to appropriately identify, measure, monitor, and control their funding and liquidity risk. In particular, the guidance re-emphasizes the importance of cash flow projections, diversified funding sources, stress testing, a cushion of liquid assets, and a formal well-developed contingency funding plan (CFP) as primary tools for measuring and managing liquidity risk. The agencies expect every depository financial institution\(^\text{10}\) to manage liquidity risk using processes and systems that are commensurate with the institution’s complexity, risk profile, and scope of operations. Liquidity risk management processes and plans should be well documented and available for supervisory review. Failure to maintain an adequate liquidity risk management process will be considered an unsafe and unsound practice.

### Liquidity and Liquidity Risk

4. *Liquidity* is a financial institution’s capacity to meet its cash and collateral obligations at a reasonable cost. Maintaining an adequate level of liquidity depends on the institution’s ability to

---

\(^{10}\)Unless otherwise indicated, this interagency guidance uses the term “depository financial institutions” or “institutions” to include banks, saving associations, and federally insured natural person credit unions. Federally insured credit unions (FICUs) do not have holding company affiliations, and, therefore, references to holding companies contained within this guidance are not applicable to FICUs.
efficiently meet both expected and unexpected cash flows and collateral needs without adversely affecting either daily operations or the financial condition of the institution.

5. **Liquidity risk** is the risk that an institution’s financial condition or overall safety and soundness is adversely affected by an inability (or perceived inability) to meet its obligations. An institution’s obligations, and the funding sources used to meet them, depend significantly on its business mix, balance-sheet structure, and the cash flow profiles of its on- and off-balance-sheet obligations. In managing their cash flows, institutions confront various situations that can give rise to increased liquidity risk. These include funding mismatches, market constraints on the ability to convert assets into cash or in accessing sources of funds (i.e., market liquidity), and contingent liquidity events. Changes in economic conditions or exposure to credit, market, operation, legal, and reputation risks also can affect an institution’s liquidity risk profile and should be considered in the assessment of liquidity and asset/liability management.

**Sound Practices of Liquidity Risk Management**

6. An institution’s liquidity management process should be sufficient to meet its daily funding needs and cover both expected and unexpected deviations from normal operations. Accordingly, institutions should have a comprehensive management process for identifying, measuring, monitoring, and controlling liquidity risk. Because of the critical importance to the viability of the institution, liquidity risk management should be fully integrated into the institution’s risk management processes. Critical elements of sound liquidity risk management include:
• Effective corporate governance consisting of oversight by the board of directors and active involvement by management in an institution’s control of liquidity risk.

• Appropriate strategies, policies, procedures, and limits used to manage and mitigate liquidity risk.

• Comprehensive liquidity risk measurement and monitoring systems (including assessments of the current and prospective cash flows or sources and uses of funds) that are commensurate with the complexity and business activities of the institution.

• Active management of intraday liquidity and collateral.

• An appropriately diverse mix of existing and potential future funding sources.

• Adequate levels of highly liquid marketable securities free of legal, regulatory, or operational impediments, that can be used to meet liquidity needs in stressful situations.

• Comprehensive contingency funding plans (CFPs) that sufficiently address potential adverse liquidity events and emergency cash flow requirements.

• Internal controls and internal audit processes sufficient to determine the adequacy of the institution’s liquidity risk management process.

_Supervisors will assess these critical elements in their reviews of an institution’s liquidity risk management process in relation to its size, complexity, and scope of operations._

_Corporate Governance_

7. The board of directors is ultimately responsible for the liquidity risk assumed by the institution. As a result, the board should ensure that the institution’s liquidity risk tolerance is
established and communicated in such a manner that all levels of management clearly understand
the institution’s approach to managing the trade-offs between liquidity risk and short-term
profits. The board of directors or its delegated committee of board members should oversee the
establishment and approval of liquidity management strategies, policies and procedures, and
review them at least annually. In addition, the board should ensure that it:

- Understands the nature of the liquidity risks of its institution and periodically reviews
  information necessary to maintain this understanding.
- Establishes executive-level lines of authority and responsibility for managing the institution’s
  liquidity risk.
- Enforces management’s duties to identify, measure, monitor, and control liquidity risk.
- Understands and periodically reviews the institution’s CFPs for handling potential adverse
  liquidity events.
- Understands the liquidity risk profiles of important subsidiaries and affiliates as appropriate.

8. Senior management is responsible for ensuring that board-approved strategies, policies, and
procedures for managing liquidity (on both a long-term and day-to-day basis) are appropriately
executed within the lines of authority and responsibility designated for managing and controlling
liquidity risk. This includes overseeing the development and implementation of appropriate risk
measurement and reporting systems, liquid buffers (e.g., cash, unencumbered marketable
securities, and market instruments), CFPs, and an adequate internal control infrastructure. Senior
management is also responsible for regularly reporting to the board of directors on the liquidity
risk profile of the institution.
9. Senior management should determine the structure, responsibilities, and controls for managing liquidity risk and for overseeing the liquidity positions of the institution. These elements should be clearly documented in liquidity risk policies and procedures. For institutions comprised of multiple entities, such elements should be fully specified and documented in policies for each material legal entity and subsidiary. Senior management should be able to monitor liquidity risks for each entity across the institution on an ongoing basis. Processes should be in place to ensure that the group’s senior management is actively monitoring and quickly responding to all material developments and reporting to the boards of directors as appropriate.

10. Institutions should clearly identify the individuals or committees responsible for implementing and making liquidity risk decisions. When an institution uses an asset/liability committee (ALCO) or other similar senior management committee, the committee should actively monitor the institution’s liquidity profile and should have sufficiently broad representation across major institutional functions that can directly or indirectly influence the institution’s liquidity risk profile (e.g., lending, investment securities, wholesale and retail funding). Committee members should include senior managers with authority over the units responsible for executing liquidity-related transactions and other activities within the liquidity risk management process. In addition, the committee should ensure that the risk measurement system adequately identifies and quantifies risk exposure. The committee also should ensure that the reporting process communicates accurate, timely, and relevant information about the level and sources of risk exposure.
Strategies, Policies, Procedures, and Risk Tolerances

11. Institutions should have documented strategies for managing liquidity risk and clear policies and procedures for limiting and controlling risk exposures that appropriately reflect the institution’s risk tolerances. Strategies should identify primary sources of funding for meeting daily operating cash outflows, as well as seasonal and cyclical cash flow fluctuations. Strategies should also address alternative responses to various adverse business scenarios. Policies and procedures should provide for the formulation of plans and courses of actions for dealing with potential temporary, intermediate-term, and long-term liquidity disruptions. Policies, procedures, and limits also should address liquidity separately for individual currencies, legal entities, and business lines, when appropriate and material, and should allow for legal, regulatory, and operational limits for the transferability of liquidity as well. Senior management should coordinate the institution’s liquidity risk management with disaster, contingency, and strategic planning efforts, as well as with business line and risk management objectives, strategies, and tactics.

12. Policies should clearly articulate a liquidity risk tolerance that is appropriate for the business strategy of the institution considering its complexity, business mix, liquidity risk profile, and its role in the financial system. Policies should also contain provisions for documenting and periodically reviewing assumptions used in liquidity projections. Policy guidelines should

---

11 In formulating liquidity management strategies, members of complex banking groups should take into consideration their legal structures (e.g., branches versus separate legal entities and operating subsidiaries), key business lines, markets, products, and jurisdictions in which they operate.
employ both quantitative targets and qualitative guidelines. For example, these measurements, limits, and guidelines may be specified in terms of the following measures and conditions, as applicable:

- Cash flow projections that include discrete and cumulative cash flow mismatches or gaps over specified future time horizons under both expected and adverse business conditions.
- Target amounts of unencumbered liquid asset reserves.
- Measures used to identify unstable liabilities and liquid asset coverage ratios. For example, these may include ratios of wholesale funding to total liabilities, potentially volatile retail (e.g., high-cost or out-of-market) deposits to total deposits, and other liability dependency measures, such as short-term borrowings as a percent of total funding.
- Asset concentrations that could increase liquidity risk through a limited ability to convert to cash (e.g., complex financial instruments,\textsuperscript{12} bank-owned (corporate-owned) life insurance, and less marketable loan portfolios).
- Funding concentrations that address diversification of funding sources and types, such as large liability and borrowed funds dependency, secured versus unsecured funding sources, exposures to single providers of funds, exposures to funds providers by market segments, and different types of brokered deposits or wholesale funding.
- Funding concentrations that address the term, re-pricing, and market characteristics of funding sources with consideration given to the nature of the assets they fund. This may include diversification targets for short-, medium-, and long-term funding; instrument type

\textsuperscript{12} Financial instruments that are illiquid, difficult to value, or marked by the presence of cash flows that are irregular, uncertain, or difficult to model.
and securitization vehicles; and guidance on concentrations for currencies and geographical markets.

- Contingent liability exposures such as unfunded loan commitments, lines of credit supporting asset sales or securitizations, and collateral requirements for derivatives transactions and various types of secured lending.

- Exposures of material activities, such as securitization, derivatives, trading, transaction processing, and international activities, to broad systemic and adverse financial market events. This is most applicable to institutions with complex and sophisticated liquidity risk profiles.

- Alternative measures and conditions may be appropriate for certain institutions.

13. Policies also should specify the nature and frequency of management reporting. In normal business environments, senior managers should receive liquidity risk reports at least monthly, while the board of directors should receive liquidity risk reports at least quarterly. Depending upon the complexity of the institution’s business mix and liquidity risk profile, management reporting may need to be more frequent. Regardless of an institution’s complexity, it should have the ability to increase the frequency of reporting on short notice, if the need arises. Liquidity risk reports should impart to senior management and the board a clear understanding of the institution’s liquidity risk exposure, compliance with risk limits, consistency between management’s strategies and tactics, and consistency between these strategies and the board's expressed risk tolerance.
14. Institutions should consider liquidity costs, benefits, and risks in strategic planning and budgeting processes. Significant business activities should be evaluated for both liquidity risk exposure and profitability. More complex and sophisticated institutions should incorporate liquidity costs, benefits, and risks in the internal product pricing, performance measurement, and new product approval process for all material business lines, products, and activities. Incorporating the cost of liquidity into these functions should align the risk-taking incentives of individual business lines with the liquidity risk exposure their activities create for the institution as a whole. The quantification and attribution of liquidity risks should be explicit and transparent at the line management level and should include consideration of how liquidity would be affected under stressed conditions.

**Liquidity Risk Measurement, Monitoring, and Reporting**

15. The process of measuring liquidity risk should include robust methods for comprehensively projecting cash flows arising from assets, liabilities, and off-balance-sheet items over an appropriate set of time horizons. For example, time buckets may be daily for very short timeframes out to weekly, monthly, and quarterly for longer time frames. Pro forma cash flow statements are a critical tool for adequately managing liquidity risk. Cash flow projections can range from simple spreadsheets to very detailed reports depending upon the complexity and sophistication of the institution and its liquidity risk profile under alternative scenarios. Given the critical importance that assumptions play in constructing measures of liquidity risk and projections of cash flows, institutions should ensure that the assumptions used are reasonable, appropriate, and adequately documented. Institutions should periodically review and formally
approve these assumptions. Institutions should focus particular attention on the assumptions used in assessing the liquidity risk of complex assets, liabilities, and off-balance-sheet positions. Assumptions applied to positions with uncertain cash flows, including the stability of retail and brokered deposits and secondary market issuances and borrowings, are especially important when they are used to evaluate the availability of alternative sources of funds under adverse contingent liquidity scenarios. Such scenarios include, but are not limited to, deterioration in the institution’s asset quality or capital adequacy.

16. Institutions should ensure that assets are properly valued according to relevant financial reporting and supervisory standards. An institution should fully factor into its risk management practices the consideration that valuations may deteriorate under market stress and take this into account in assessing the feasibility and impact of asset sales on its liquidity position during stress events.

17. Institutions should ensure that their vulnerabilities to changing liquidity needs and liquidity capacities are appropriately assessed within meaningful time horizons, including intraday, day-to-day, short-term weekly and monthly horizons, medium-term horizons of up to one year, and longer-term liquidity needs of one year or more. These assessments should include vulnerabilities to events, activities, and strategies that can significantly strain the capability to generate internal cash.
Stress Testing

18. Institutions should conduct stress tests regularly for a variety of institution-specific and marketwide events across multiple time horizons. The magnitude and frequency of stress testing should be commensurate with the complexity of the financial institution and the level of its risk exposures. Stress test outcomes should be used to identify and quantify sources of potential liquidity strain and to analyze possible impacts on the institution’s cash flows, liquidity position, profitability, and solvency. Stress tests should also be used to ensure that current exposures are consistent with the financial institution’s established liquidity risk tolerance. Management’s active involvement and support is critical to the effectiveness of the stress testing process. Management should discuss the results of stress tests and take remedial or mitigating actions to limit the institution’s exposures, build up a liquidity cushion, and adjust its liquidity profile to fit its risk tolerance. The results of stress tests should also play a key role in shaping the institution’s contingency planning. As such, stress testing and contingency planning are closely intertwined.

Collateral Position Management

19. An institution should have the ability to calculate all of its collateral positions in a timely manner, including the value of assets currently pledged relative to the amount of security required and unencumbered assets available to be pledged. An institution’s level of available collateral should be monitored by legal entity, jurisdiction, and currency exposure, and systems should be capable of monitoring shifts between intraday and overnight or term collateral usage.
An institution should be aware of the operational and timing requirements associated with accessing the collateral given its physical location (i.e., the custodian institution or securities settlement system with which the collateral is held). Institutions should also fully understand the potential demand on required and available collateral arising from various types of contractual contingencies during periods of both marketwide and institution-specific stress.

*Management Reporting*

20. Liquidity risk reports should provide aggregate information with sufficient supporting detail to enable management to assess the sensitivity of the institution to changes in market conditions, its own financial performance, and other important risk factors. The types of reports or information and their timing will vary according to the complexity of the institution’s operations and risk profile. Reportable items may include but are not limited to cash flow gaps, cash flow projections, asset and funding concentrations, critical assumptions used in cash flow projections, key early warning or risk indicators, funding availability, status of contingent funding sources, or collateral usage. Institutions should also report on the use of and availability of government support, such as lending and guarantee programs, and implications on liquidity positions, particularly since these programs are generally temporary or reserved as a source for contingent funding.
**Liquidity across Currencies, Legal Entities, and Business Lines**

21. A depository institution should actively monitor and control liquidity risk exposures and funding needs within and across currencies, legal entities, and business lines. Also, depository institutions should take into account operational limitations to the transferability of liquidity, and should maintain sufficient liquidity to ensure compliance during economically stressed periods with applicable legal and regulatory restrictions on the transfer of liquidity among regulated entities. The degree of centralization in managing liquidity should be appropriate for the depository institution’s business mix and liquidity risk profile. The agencies expect depository institutions to maintain adequate liquidity both at the consolidated level and at significant legal entities.

22. Regardless of its organizational structure, it is important that an institution actively monitor and control liquidity risks at the level of individual legal entities, and the group as a whole, incorporating processes that aggregate data across multiple systems in order to develop a group-wide view of liquidity risk exposures. It is also important that the institution identify constraints on the transfer of liquidity within the group.

23. Assumptions regarding the transferability of funds and collateral should be described in liquidity risk management plans.

---

13 Institutions subject to multiple regulatory jurisdictions should have management strategies and processes that recognize the potential limitations of liquidity transferability, as well as the need to meet the liquidity requirements of foreign jurisdictions.
Intraday Liquidity Position Management

24. Intraday liquidity monitoring is an important component of the liquidity risk management process for institutions engaged in significant payment, settlement, and clearing activities. An institution’s failure to manage intraday liquidity effectively, under normal and stressed conditions, could leave it unable to meet payment and settlement obligations in a timely manner, adversely affecting its own liquidity position and that of its counterparties. Among large, complex organizations, the interdependencies that exist among payment systems and the inability to meet certain critical payments has the potential to lead to systemic disruptions that can prevent the smooth functioning of all payment systems and money markets. Therefore, institutions with material payment, settlement and clearing activities should actively manage their intraday liquidity positions and risks to meet payment and settlement obligations on a timely basis under both normal and stressed conditions. Senior management should develop and adopt an intraday liquidity strategy that allows the institution to:

- Monitor and measure expected daily gross liquidity inflows and outflows.
- Manage and mobilize collateral when necessary to obtain intraday credit.
- Identify and prioritize time-specific and other critical obligations in order to meet them when expected.
- Settle other less critical obligations as soon as possible.
- Control credit to customers when necessary.
• Ensure that liquidity planners understand the amounts of collateral and liquidity needed to perform payment-system obligations when assessing the organization’s overall liquidity needs.

**Diversified Funding**

25. An institution should establish a funding strategy that provides effective diversification in the sources and tenor of funding. It should maintain an ongoing presence in its chosen funding markets and strong relationships with funds providers to promote effective diversification of funding sources. An institution should regularly gauge its capacity to raise funds quickly from each source. It should identify the main factors that affect its ability to raise funds and monitor those factors closely to ensure that estimates of fund raising capacity remain valid.

26. An institution should diversify available funding sources in the short-, medium-, and long-term. Diversification targets should be part of the medium- to long-term funding plans and should be aligned with the budgeting and business planning process. Funding plans should take into account correlations between sources of funds and market conditions. Funding should also be diversified across a full range of retail as well as secured and unsecured wholesale sources of funds, consistent with the institution’s sophistication and complexity. Management should also consider the funding implications of any government programs or guarantees it uses. As with wholesale funding, the potential unavailability of government programs over the intermediate- and long-term should be fully considered in the development of liquidity risk management strategies, tactics, and risk tolerances. Funding diversification should be implemented using
limits addressing counterparties, secured versus unsecured market funding, instrument type, securitization vehicle, and geographic market. In general, funding concentrations should be avoided. Undue over-reliance on any one source of funding is considered an unsafe and unsound practice.

27. An essential component of ensuring funding diversity is maintaining market access. Market access is critical for effective liquidity risk management as it affects both the ability to raise new funds and to liquidate assets. Senior management should ensure that market access is being actively managed, monitored, and tested by the appropriate staff. Such efforts should be consistent with the institution’s liquidity risk profile and sources of funding. For example, access to the capital markets is an important consideration for most large complex institutions, whereas the availability of correspondent lines of credit and other sources of wholesale funds are critical for smaller, less complex institutions.

28. An institution should identify alternative sources of funding that strengthen its capacity to withstand a variety of severe institution-specific and marketwide liquidity shocks. Depending upon the nature, severity, and duration of the liquidity shock, potential sources of funding include, but are not limited to, the following:

- Deposit growth.
- Lengthening maturities of liabilities.
- Issuance of debt instruments\(^{14}\).

\(^{14}\) Federally insured credit unions can borrow funds (which includes issuing debt) as given in section 106 of the Federal Credit Union Act (FCUA). Section 106 of the FCUA as well as section 741.2 of the NCUA Rules and
• Sale of subsidiaries or lines of business.
• Asset securitization.
• Sale (either outright or through repurchase agreements) or pledging of liquid assets.
• Drawing down committed facilities.
• Borrowing.

**Cushion of Liquid Assets**

29. Liquid assets are an important source of both primary (operating liquidity) and secondary (contingent liquidity) funding at many institutions. Indeed, a critical component of an institution’s ability to effectively respond to potential liquidity stress is the availability of a cushion of highly liquid assets without legal, regulatory, or operational impediments (i.e., unencumbered) that can be sold or pledged to obtain funds in a range of stress scenarios. These assets should be held as insurance against a range of liquidity stress scenarios including those that involve the loss or impairment of typically available unsecured and/or secured funding sources. The size of the cushion of such high-quality liquid assets should be supported by estimates of liquidity needs performed under an institution’s stress testing as well as aligned with the risk tolerance and risk profile of the institution. Management estimates of liquidity needs during periods of stress should incorporate both contractual and noncontractual cash flows, including the possibility of funds being withdrawn. Such estimates should also assume the inability to obtain unsecured and uninsured funding as well as the loss or impairment of access to funds secured by assets other than the safest, most liquid assets.

Regulations establish specific limitations on the amount that can be borrowed. Federal Credit Unions can borrow from natural persons in accordance with the requirements of part 701.38 of the NCUA Rules and Regulations.
30. Management should ensure that unencumbered, highly liquid assets are readily available and are not pledged to payment systems or clearing houses. The quality of unencumbered liquid assets is important as it will ensure accessibility during the time of most need. An institution could use its holdings of high-quality securities, for example, U.S. Treasury securities, securities issued by U.S. government-sponsored agencies, excess reserves at the central bank or similar instruments, and enter into repurchase agreements in response to the most severe stress scenarios.

**Contingency Funding Plan**\(^{15}\)

31. All financial institutions, regardless of size and complexity, should have a formal CFP that clearly sets out the strategies for addressing liquidity shortfalls in emergency situations. A CFP should delineate policies to manage a range of stress environments, establish clear lines of responsibility, and articulate clear implementation and escalation procedures. It should be regularly tested and updated to ensure that it is operationally sound. For certain components of the CFP, affirmative testing (e.g., liquidation of assets) may be impractical. In these instances, institutions should be sure to test operational components of the CFP. For example, ensuring that roles and responsibilities are up-to-date and appropriate; ensuring that legal and operational documents are up-to-date and appropriate; and ensuring that cash and collateral can be moved where and when needed, and ensuring that contingent liquidity lines can be drawn when needed.

\(^{15}\) Financial institutions that have had their liquidity supported by temporary government programs administered by the Department of the Treasury, Federal Reserve and/or FDIC should not base their liquidity strategies on the belief that such programs will remain in place indefinitely.
32. Contingent liquidity events are unexpected situations or business conditions that may increase liquidity risk. The events may be institution-specific or arise from external factors and may include:

- The institution’s inability to fund asset growth.
- The institution’s inability to renew or replace maturing funding liabilities.
- Customers unexpectedly exercising options to withdraw deposits or exercise off-balance-sheet commitments.
- Changes in market value and price volatility of various asset types.
- Changes in economic conditions, market perception, or dislocations in the financial markets.
- Disturbances in payment and settlement systems due to operational or local disasters.

33. Insured institutions should be prepared for the specific contingencies that will be applicable to them if they become less than Well Capitalized pursuant to Prompt Correction Action (PCA) provisions under the Federal Deposit Insurance Corporation Improvement Act\(^{16}\). Contingencies may include restricted rates paid for deposits, the need to seek approval from the FDIC/NCUA to accept brokered deposits, and the inability to accept any brokered deposits\(^{17}\).

\(^{16}\) See 12 USC 1831o; 12 CFR 6 (OCC), 12 CFR 208.40 (FRB), 12 CFR 325.101 (FDIC), and 12 CFR 565 (OTS) and 12 USC 1790d; 12 CFR 702 (NCUA).

\(^{17}\) Section 38 of the FDI Act (12 USC 1831o) requires insured depository institutions that are not well capitalized to receive approval prior to engaging in certain activities. Section 38 restricts or prohibits certain activities and requires an insured depository institution to submit a capital restoration plan when it becomes undercapitalized. Section 216 of the Federal Credit Union Act and part 702 of the NCUA Rules and Regulations establish the requirements and restrictions for federally insured credit unions under Prompt Corrective Action. For brokered, nonmember deposits, additional restrictions apply to federal credit unions as given in parts 701.32 and 742 of the NCUA Rules and Regulations.
34. A CFP provides a documented framework for managing unexpected liquidity situations. The objective of the CFP is to ensure that the institution’s sources of liquidity are sufficient to fund normal operating requirements under contingent events. A CFP also identifies alternative contingent liquidity resources\(^{18}\) that can be employed under adverse liquidity circumstances. An institution’s CFP should be commensurate with its complexity, risk profile, and scope of operations. As macroeconomic and institution-specific conditions change, CFPs should be revised to reflect these changes.

35. Contingent liquidity events can range from high-probability/low-impact events to low-probability/high-impact events. Institutions should incorporate planning for high-probability/low-impact liquidity risks into the day-to-day management of sources and uses of funds. Institutions can generally accomplish this by assessing possible variations around expected cash flow projections and providing for adequate liquidity reserves and other means of raising funds in the normal course of business. In contrast, all financial institution CFPs will typically focus on events that, while relatively infrequent, could significantly impact the institution’s operations. A CFP should:

- **Identify Stress Events.** Stress events are those that may have a significant impact on the institution’s liquidity given its specific balance-sheet structure, business lines, organizational structure, and other characteristics. Possible stress events may include deterioration in asset

---

\(^{18}\) There may be time constraints, sometimes lasting weeks, encountered in initially establishing lines with FRB and/or FHLB. As a result, financial institutions should plan to have these lines set up well in advance.
quality, changes in agency credit ratings, PCA capital categories and CAMELS\textsuperscript{19} ratings downgrades, widening of credit default spreads, operating losses, declining financial institution equity prices, negative press coverage, or other events that may call into question an institution’s ability to meet its obligations.

- **Assess Levels of Severity and Timing.** The CFP should delineate the various levels of stress severity that can occur during a contingent liquidity event and identify the different stages for each type of event. The events, stages, and severity levels identified should include temporary disruptions, as well as those that might be more intermediate term or longer-term. Institutions can use the different stages or levels of severity identified to design early-warning indicators, assess potential funding needs at various points in a developing crisis, and specify comprehensive action plans. The length of the scenario will be determined by the type of stress event being modeled and should encompass the duration of the event.

- **Assess Funding Sources and Needs.** A critical element of the CFP is the quantitative projection and evaluation of expected funding needs and funding capacity during the stress event. This entails an analysis of the potential erosion in funding at alternative stages or severity levels of the stress event and the potential cash flow mismatches that may occur during the various stress levels. Management should base such analysis on realistic assessments of the behavior of funds providers during the event and incorporate alternative contingency funding sources. The analysis also should include all material on- and off-

\textsuperscript{19} Federally insured credit unions are evaluated using the “CAMEL” rating system, which is substantially similar to the “CAMELS” system without the “S” component for rating Sensitivity to market risk. Information on NCUA’s rating system can be found in Letter to Credit Unions 07-CU-12, CAMEL Rating System.
balance-sheet cash flows and their related effects. The result should be a realistic analysis of cash inflows, outflows, and funds availability at different time intervals during the potential liquidity stress event in order to measure the institution’s ability to fund operations.

Common tools to assess funding mismatches include:

- **Liquidity gap analysis** – A cash flow report that essentially represents a base case estimate of where funding surpluses and shortfalls will occur over various future time frames.
- **Stress tests** – A pro forma cash flow report with the ability to estimate future funding surpluses and shortfalls under various liquidity stress scenarios and the institution’s ability to fund expected asset growth projections or sustain an orderly liquidation of assets under various stress events.

- **Identify Potential Funding Sources.** Because liquidity pressures may spread from one funding source to another during a significant liquidity event, institutions should identify alternative sources of liquidity and ensure ready access to contingent funding sources. In some cases, these funding sources may rarely be used in the normal course of business. Therefore, institutions should conduct advance planning and periodic testing to ensure that contingent funding sources are readily available when needed.

- **Establish Liquidity Event Management Processes.** The CFP should provide for a reliable crisis management team and administrative structure, including realistic action plans used to execute the various elements of the plan for given levels of stress. Frequent communication
and reporting among team members, the board of directors, and other affected managers optimize the effectiveness of a contingency plan during an adverse liquidity event by ensuring that business decisions are coordinated to minimize further disruptions to liquidity. Such events may also require the daily computation of regular liquidity risk reports and supplemental information. The CFP should provide for more frequent and more detailed reporting as the stress situation intensifies.

- **Establish a Monitoring Framework for Contingent Events.** Institution management should monitor for potential liquidity stress events by using early-warning indicators and event triggers. The institution should tailor these indicators to its specific liquidity risk profile. The early recognition of potential events allows the institution to position itself into progressive states of readiness as the event evolves, while providing a framework to report or communicate within the institution and to outside parties. Early-warning signals may include, but are not limited to, negative publicity concerning an asset class owned by the institution, increased potential for deterioration in the institution’s financial condition, widening debt or credit default swap spreads, and increased concerns over the funding of off-balance-sheet items.

36. To mitigate the potential for reputation contagion, effective communication with counterparties, credit-rating agencies, and other stakeholders when liquidity problems arise is of vital importance. Smaller institutions that rarely interact with the media should have plans in place for how they will manage press inquiries that may arise during a liquidity event. In addition,
groupwide contingency funding plans, liquidity cushions, and multiple sources of funding are mechanisms that may mitigate reputation concerns.

37. In addition to early-warning indicators, institutions that issue public debt, use warehouse financing, securitize assets, or engage in material over-the-counter derivative transactions typically have exposure to event triggers embedded in the legal documentation governing these transactions. Institutions that rely upon brokered deposits should also incorporate PCA-related downgrade triggers into their CFPs since a change in PCA status could have a material bearing on the availability of this funding source. Contingent event triggers should be an integral part of the liquidity risk monitoring system. Institutions that originate and/or purchase loans for asset securitization programs pose heightened liquidity risk concerns due to the unexpected funding needs associated with an early amortization event or disruption of warehouse funding. Institutions that securitize assets should have liquidity contingency plans that address these risks.

38. Institutions that rely upon secured funding sources also are subject to potentially higher margin or collateral requirements that may be triggered upon the deterioration of a specific portfolio of exposures or the overall financial condition of the institution. The ability of a financially stressed institution to meet calls for additional collateral should be considered in the CFP. Potential collateral values also should be subject to stress tests since devaluations or market uncertainty could reduce the amount of contingent funding that can be obtained from pledging a given asset. Additionally, triggering events should be understood and monitored by liquidity managers.
39. Institutions should test various elements of the CFP to assess their reliability under times of stress. Institutions that rarely use the type of funds they identify as standby sources of liquidity in a stress situation, such as the sale or securitization of loans, securities repurchase agreements, Federal Reserve discount window borrowing, or other sources of funds, should periodically test the operational elements of these sources to ensure that they work as anticipated. However, institutions should be aware that during real stress events, prior market access testing does not guarantee that these funding sources will remain available within the same time frames and/or on the same terms.

40. Larger, more complex institutions can benefit by employing operational simulations to test communications, coordination, and decision making involving managers with different responsibilities, in different geographic locations, or at different operating subsidiaries. Simulations or tests run late in the day can highlight specific problems such as difficulty in selling assets or borrowing new funds at a time when business in the capital markets may be less active.

**Internal Controls**

41. An institution’s internal controls consist of procedures, approval processes, reconciliations, reviews, and other mechanisms designed to provide assurance that the institution manages liquidity risk consistent with board-approved policy. Appropriate internal controls should address relevant elements of the risk management process, including adherence to policies and procedures, the adequacy of risk identification, risk measurement, reporting, and compliance with applicable rules and regulations.
42. Management should ensure that an independent party regularly reviews and evaluates the various components of the institution’s liquidity risk management process. These reviews should assess the extent to which the institution’s liquidity risk management complies with both supervisory guidance and industry sound practices, taking into account the level of sophistication and complexity of the institution’s liquidity risk profile\textsuperscript{20}. Smaller, less-complex institutions may achieve independence by assigning this responsibility to the audit function or other qualified individuals independent of the risk management process. The independent review process should report key issues requiring attention including instances of noncompliance to the appropriate level of management for prompt corrective action consistent with approved policy.

\textsuperscript{20} This includes the standards established in this interagency guidance as well as the supporting material each agency provides in its examination manuals and handbooks directed at their supervised institutions. Industry standards include those advanced by recognized industry associations and groups.

John C. Dugan,
Comptroller of the Currency.
[THIS SIGNATURE PAGE PERTAINS TO THE FINAL POLICY STATEMENT TITLED, “INTERAGENCY POLICY STATEMENT ON FUNDING AND LIQUIDITY RISK MANAGEMENT.”]


Jennifer J. Johnson,
Secretary of the Board.
Dated at Washington, D.C., the 4th day of March 2010.

By order of the Federal Deposit Insurance Corporation.

Valerie J. Best,
Assistant Executive Secretary.

By the Office of Thrift Supervision.

John E. Bowman,

Acting Director
Dated: March 4, 2010

By the National Credit Union Administration Board.

Mary F. Rupp

Secretary of the Board
BILLING CODES:
OCC-4810-33-P 20%
FRB-6210-01-P 20%
FDIC-6714-01-P 20%
OTS-6720-01-P 20%
NCUA-7535-01 P 20%