

Overview

All banks are expected to have a formalized, functioning contingency funding plan (CFP) to guide bank management during stressful liquidity events when unexpected cash flow needs may arise. A bank's liquidity risk management program, including its CFP, should receive appropriate oversight from the board of directors and senior management.

Contingent liquidity events may arise from both bank-specific factors (such as a reputational crisis) and market-based/external events (such as economic deterioration). A CFP provides a readiness guide for these events, while also serving as a regular risk management tool for evaluating and managing the bank's liquidity exposures. Because the types and degrees of liquidity risk vary across banks, the CFP should be tailored to a bank's risk profile.

Federal Reserve Supervision and Regulation (SR) letter 10-6, "Interagency Policy Statement on Funding and Liquidity Risk Management,"¹ describes seven important quantitative and qualitative elements of a sound CFP, which allow a bank to respond promptly to a contingent liquidity event with flexibility. The purpose of this document is to (1) briefly describe the underlying principles of the seven elements and describe examiner expectations for evaluating these elements at a community bank, and (2) identify opportunities for improvement frequently recommended by examiners when assessing banks' CFPs.

¹ SR letter 10-6, "Interagency Policy Statement on Funding and Liquidity Risk Management," is available at www.federalreserve.gov/boarddocs/srletters/2010/sr1006.htm.

Seven Critical Elements of a CFP

The seven elements of an effective CFP are:



1 Governance and Oversight

Key Principles: An effective governance framework enables a controlled, coordinated response to a liquidity emergency. The CFP should address procedures for managing a stressful event and establish periodic testing expectations. The CFP should provide sufficient detail to guide actions if implementation becomes necessary, and management should be prepared to implement it.

The board of directors retains ultimate responsibility for establishing, reviewing, and approving the bank's CFP. At a minimum, the CFP should be reviewed annually with the understanding that certain conditions may warrant more frequent review.

Examiner Expectations: Examiners expect the board of directors to monitor and approve annually the bank's liquidity risk management practices, including the bank's CFP. Examiners assess whether senior managers under-

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stand their roles and responsibilities in responding to a liquidity event, and can efficiently execute such a response. Examiners also evaluate the CFP policies and plans to assess the governance structure.

2 *Stress Events*

Key Principles: The CFP should outline expectations for responding to market-wide and institution-specific events that could impact liquidity levels. Liquidity events may arise not only over a short-term horizon but also over medium- or long-term horizons and, therefore, the CFP should consider stress events with various time horizons.

As a guiding principle, the stress scenarios in a bank's CFP should be specific to the bank's balance-sheet structure and vulnerabilities. For example, the CFP for a bank that relies heavily on wholesale funding should include a stress scenario where wholesale funding becomes constrained due to market disruption.

As noted in SR letter 10-6, insured banks should also consider regulatory restrictions that will apply to a bank if it becomes less than well capitalized pursuant to prompt correction action (PCA) under the Federal Deposit Insurance Corporation Improvement Act.

Examiner Expectations: Examiners evaluate the CFP to determine whether it includes planning for short-, medium-, and long-term events, as well as whether it includes a range of marketwide, idiosyncratic, and combination scenarios that reflect the bank's business activities and risk exposures. For insured banks, examiners assess whether management has considered the effect on liquidity if capital were to drop below well-capitalized thresholds and PCA restrictions were to be imposed on certain funding options such as brokered deposits.

3 *Levels of Severity and Timing*

Key Principles: Liquidity events typically move through stages; the CFP should identify these stages and delineate the different levels of stress severity that can occur over time. Short-term, temporary disruptions may develop quickly, while others may develop over a longer time horizon. Each scenario should depict the full duration of

the event and not end before the stress has fully developed and has subsided. These scenarios can inform management's assessment of potential liquidity needs over the various time horizons and assist in creating sound response plans. Additionally, the scenarios should be considerably stressful, even if the probability of the scenarios occurring is remote. By considering severe scenarios, management is better able to prepare for their possible, though unlikely, occurrence.

Examiner Expectations: Examiners focus on the overall reasonableness of stress scenarios to ensure that they reflect outcomes that are likely to occur in the event of a liquidity event. In making this determination, examiners assess whether the horizons are appropriate for the scenario depicted and whether they portray the likely stages an event may move through as it develops. Examiners recognize that the bank may have difficulty meeting all liquidity requirements during the most stressful events. The CFP should plan for low-probability/high-impact events. Examiners evaluate the scenarios to determine whether they are sufficiently severe and depict true stressors.

4 *Funding Sources and Needs*

Key Principles: A critical element of a CFP is the projection of expected cash flows under stress. This projection should include sources and uses of funds, as well as mitigating actions for different time intervals over the stress event.

A bank's ability to withstand a stressful liquidity event often depends on the availability of highly liquid assets that can be immediately sold or pledged so the bank may continue meeting its obligations. These liquid assets are considered the firm's "liquidity buffer." This buffer stands as ready insurance against potential liquidity emergencies or prolonged events and is critical to maintaining safety and soundness. Liability sources of liquidity, such as Federal Home Loan Bank funding, serve as secondary sources of liquidity. Additionally, as an overarching principle of liquidity risk management, overreliance on a funding source in normal liquidity environments may create a serious cash flow deficiency if that source becomes unavailable during a contingent liquidity event. Cash flow projections should include well-diversified funding sources, if possible and appropriate.

Examiner Expectations: In assessing the appropriateness of the liquidity buffer (the level and composition of highly liquid assets), examiners confirm that the liquid cushion is supported by estimates of liquidity needs under stress and aligns with the board’s risk tolerance. SR letter 10-6 notes undue overreliance on any one funding source as a safety-and-soundness concern so, accordingly, examiners will assess whether any such concentrations exist. Overreliance exists if significant funding is concentrated in a single provider (or highly correlated providers) or in a single time horizon, or both. Examiners evaluate cash flow projections for reasonableness, with the expectation that sources and uses of funds and mitigating actions are presented separately for evaluation. Examiners also note that liquidity risk projections and stress tests rely on key assumptions; these assumptions should be reasonable, documented, and formally approved.

5 *Potential Funding Sources*

Key Principles: Bank management should identify various traditional and alternative funding sources that could be accessed during a liquidity shock. The bank may not routinely use these liquidity sources in a normal funding environment, which increases the importance of establishing the contingent liquidity sources before a stressful event occurs. Ensuring that all legal documents have been completed and collateral has been arranged is important. Banks should periodically test contingent funding sources to ensure that they are readily available if needed. Moreover, bank management should also be prepared to respond to liquidity events if those contingent sources become unavailable; prior market access testing does not guarantee that these contingent funding sources will remain available within the same time frames and/or on the same terms during these events.

Examiner Expectations: Examiners expect bank management to identify and describe traditional and alternative funding sources, and to address any potential difficulties in accessing these liquidity sources under stress. For example, a scenario depicting economic deterioration may produce contagion amongst funding sources and limit availability of funds; the CFP should address this contagion potential. Examiners will assess whether periodic

operational testing of potential funding sources has been conducted.

6 *Liquidity Event Management Processes*

Key Principles: A response structure is fundamental to effective liquidity management. The CFP should describe roles and responsibilities and identify a crisis management team with participants from all key areas of the bank. Just as important, the CFP should describe the specific actions to be taken by management or personnel, and outline expected interactions between these individuals. The plan should also describe how the bank will communicate with both internal and external stakeholders, including the media, customers, regulators, rating agencies, business lines, and employees.

Examiner Expectations: Examiners evaluate whether the management framework promotes timely, active responses to liquidity events. Response plans should not only describe roles and responsibilities, but also provide a step-by-step plan to carry out these responsibilities. Particularly due to community banks’ infrequent communication with the media or other stakeholders, response plans should outline communication strategies, authorities, and timing.

7 *Monitoring Framework*

Key Principles: Early-warning indicators and event triggers inform the bank of a developing liquidity event before it has progressed to a stage that poses serious risk to the bank. By choosing triggers that are appropriate for the bank’s risk profile, management can watch for developments that could indicate an impending liquidity crisis. Further, maintaining a comprehensive set of effective liquidity measures in a business-as-usual environment can assist management in identifying key contingent monitoring metrics to be used in an emergency situation.

Examiner Expectations: Examiners expect the CFP to be a regular part of liquidity risk management practices by including a monitoring framework that notifies management of a potential liquidity event. Triggers and early-warning indicators for both internal and external events permit mitigation of further disruptions to liquidity.

Examiner Observations

In reviewing CFPs across a wide range of community banks, examiners have detected certain common areas of improvement. Specifically, examiners often recommend the following actions to strengthen a bank's contingency funding plan:

- **Ensure the CFP is actionable.** Pre-established action plans, crisis teams, communication strategies, and authority levels can help avoid a chaotic response to a liquidity event. A CFP should consider all key people and activities throughout the bank, and guidance on communication strategies and messages should be included as well.
- **Establish a liquid asset buffer of cash and readily marketable securities to help withstanding a liquidity event.** Management should regularly assess the bank's liquidity buffer, which should consist of highly liquid assets. This cushion of liquid assets should be based on management expectations of liquidity needs under stress and should be readily available as insurance against a contingent event.
- **Identify sources and uses of funds, as well as mitigating actions, separately from cash projections to help uncover hidden risks.** When sources and uses of funds and mitigating actions are intermingled in cash projections, it can be difficult to discern management expectations for each stress scenario. Mitigating actions may not prove successful, so showing them separately lets the board and senior management discern what cash flows can be expected with and without management actions.
- **Consider the potential for PCA restrictions on brokered deposits.** The bank should be prepared for the possibility of becoming less than well capitalized and subject to PCA restrictions on brokered deposits, particularly if the bank relies on brokered deposits in normal times or under stress.
- **Strengthen underlying assumptions.** Cash flow projections are quantitative expressions of a possible fu-

ture event, which means they are highly subject to management assumptions. Because these assumptions have such a significant impact on stress test results, banks should ensure these assumptions are clearly documented and submitted for regular review and approval by an oversight body, such as the board of directors or the asset-liability management committee.

- **Identify early-warning indicators and event triggers to facilitate prompt responses to liquidity stress.** The CFP should contain triggers that alert management to an impending event in a timely manner. If an event is identified through early-warning indicators, an appropriate response and the CFP can be enacted quickly.

Resources

SR letter 10-6, "Interagency Policy Statement on Funding and Liquidity Risk Management," issued on March 17, 2010, emphasizes the importance and expected components of a robust CFP.

www.federalreserve.gov/boarddocs/srletters/2010/sr1006.htm

Section 4020.1, "Liquidity Risk," of the Federal Reserve's *Commercial Bank Examination Manual*, guides examiners in making their assessments of a bank's CFP.

www.federalreserve.gov/boarddocs/supmanual/cbem/cbem.pdf

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