



Proposed Interagency Guidance on Funding and Liquidity Risk Management

On June 30, 2009, several agencies released for comment proposed guidance to communicate consistent expectations on sound practices for the management of funding and liquidity risks. The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve (the Federal Reserve), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), and National Credit Union Administration (NCUA) joined in the guidance in order to bring into alignment liquidity risk principles with guidance issued in September 2008 by the Basel Committee on Banking Supervision (BCBS). The BCBS liquidity principles focus on large financially active financial institutions, and these guidelines will set expectations for domestic institutions. When finalized, the principles will apply to all domestic financial institutions, including banks, thrifts and credit unions.

Sound Practices of Liquidity Risk Management

In the release, the agencies noted that liquidity risk management needs improvement and note that the failure to maintain adequate liquidity risk management processes is considered an unsafe and unsound practice. The guidance will require that institutions have a comprehensive management process for identifying, measuring, monitoring and controlling liquidity risk. Institutions should identify critical elements of sound liquidity risk management. The release cites the importance of cash flow projections, diversified funding sources, stress testing, a cushion of liquid assets, and a contingency funding plan to manage liquidity risk. The following are included as critical elements of liquidity risk management:

- Effective corporate governance;
- Appropriate strategies, policies, procedures and limits used to manage and mitigate liquidity risk;
- Comprehensive liquidity risk measurement and monitoring systems;
- Active management of intraday liquidity and collateral;
- An appropriately diverse mix of existing and potential future funding sources;
- Adequate levels of highly liquid and unencumbered marketable securities;
- Comprehensive contingency funding plans that address potential adverse events; and
- Internal control and internal audit processes sufficient to determine the adequacy of the institution's liquidity risk management process.

Supervisors will assess critical elements in their reviews of an institution's liquidity risk management process.

Corporate Governance

The interagency statement emphasizes the importance of effective corporate governance policies and procedures as an element of effective liquidity management and notes that the board of directors is ultimately responsible for a financial institution's liquidity risk. The board should oversee establishment and approval of liquidity management strategies, policies and procedures and should review these at least annually. Senior management of a financial institution is responsible for ensuring the execution of board approved strategies, policies and procedures for managing liquidity risk. The policies and procedures should be documented. If an institution has an asset liability committee, the committee should actively monitor the institution's liquidity profile should have sufficiently broad representation across major institutional functions.

Strategies, Policies, Procedures and Risk Tolerances

Institutions should have documented strategies for managing liquidity risk and clear policies and procedures for limiting and controlling risk exposure. Institutions should implement strategies that identify funding sources and that address adverse business scenarios. Policies and procedures should:

- Address liquidity disruptions;
- Articulate a liquidity risk tolerance appropriate for the institution's business strategy, considering the institution's complexity, business mix, liquidity risk profile and role in the financial system;
- Contain provisions for documenting and periodically reviewing assumptions used in liquidity projections;
- Employ both quantitative targets and qualitative guidelines; and
- Supply measurements and limits relating to cashflow projections, target amounts of unpledged liquid asset reserves, asset concentrations, funding concentrations, contingent liability exposures and exposures of material activities.

The interagency statement suggests that in normal business environments, senior managers should receive liquidity reports at least monthly. Institutions should consider liquidity costs, benefits, and risks in strategic planning and budgeting processes.

Liquidity Risk Management, Monitoring and Reporting

Institutions should implement systems and procedures to measure liquidity risk, including methods for projecting cash flows arising from assets, liabilities and off balance sheet items. Institutions should ensure that assets are properly valued according to relevant financial reporting and supervisory standards. Institutions should conduct stress tests regularly and the stress test results should be used to identify and quantify sources of potential liquidity strain and ensure that current exposures are consistent with the financial institution's liquidity risk tolerance. An institution should have the ability to calculate its collateral positions in a timely manner. Risk reports should provide aggregate information with sufficient supporting detail to permit management to assess the sensitivity of the institution to changes in market conditions and other factors. Institutions should monitor and control liquidity risk exposures and funding needs within and across legal entities and business lines.

Intraday Liquidity Position Management

Institutions engaged in payment, settlement and clearing activities should incorporate intraday liquidity monitoring into their liquidity risk management processes. An intraday liquidity strategy should permit 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 in order to meet them when

expected; settle other less critical obligations as soon as possible; control credit to customers when necessary; and ensure that liquidity planners understand the collateral and liquidity needed to meet payment system obligations.

Diversified Funding

Institutions should establish a funding strategy that provides effective diversification of funding sources and maturities. Senior management should manage access to capital markets.

Cushion of Liquid Assets

Management should ensure that an institution has a cushion of high quality liquid assets. Management estimates of liquidity needs during periods of stress should inform the amount of assets that are appropriate for the institution.

Contingency Funding Plan

Institutions should have a formal contingency funding plan, or CFP, that sets out a plan for addressing liquidity shortfalls in emergencies. The CFP should provide a framework for managing unexpected liquidity challenges and should identify alternative liquidity resources. A CFP should:

- Identify stress events, including a deterioration in asset quality, changes in agency credit ratings, widening of credit default swaps, or other similar events;
- Assess levels of severity and timing in order to develop early warning indicators;
- Assess funding sources and needs during the stress event;
- Identify potential alternative funding sources;
- Establish liquidity event management processes, including the action plan used to execute the CFP; and
- Establish a monitoring framework by using early warning indicators and event triggers (which may include triggers embedded in the terms of debt securities, derivatives contracts, etc.).

Internal Controls

A financial institution's internal controls should address relevant elements of liquidity risk management.

Holding Company—Liquidity Risk Management

Financial holding companies should also develop and maintain liquidity management processes and funding programs.

Contacts

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