

B&B REVIEW

Financial Services and Transactions

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CORPORATE GOVERNANCE FOR LIQUIDITY RISK MANAGEMENT

INTRODUCTION

The past two years of turmoil in the financial services industry have shown banking regulators that many banks need to improve the ways they manage liquidity risk. Those shortcomings include:

- Insufficient liquid assets
- Funding risk or illiquid asset portfolios with volatile short-term liabilities
- Lack of meaningful cash flow projections and liquidity contingency plans

Several of the FDIC Inspector General's "material loss reviews" (which are required for all failures that cause a material loss to the bank insurance fund) cite poor liquidity risk management practices as a contributing cause of bank failures. Several reviews have noted that failed banks lacked adequate contingency liquidity planning and primary funding sources were extremely volatile and high-rate in nature. For a list of recent material loss reviews, go to: http://www.fdicoinc.gov/mlr_shtml.

To combat liquidity risk mismanagement, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision and the National Credit Union Administration have jointly issued new guidance entitled "Interagency Policy Statement on Funding and Liquidity Risk Management," which takes effect on May 21, 2010. A complete version is available at: <http://edocket.access.gpo.gov/2010/pdf/2010-6137.pdf>.

This **B&B Review** summarizes the portion of the Guidance that deals with corporate governance for liquidity risk management. The banking supervisors consider effective corporate governance crucial, and define it as "oversight by the board of directors and active involvement by management in an institution's control of liquidity risk."

The Guidance addresses the following liquidity risk management topics:

- Policies and procedures
- Measurement, monitoring and reporting
- The need for a cushion of liquid assets
- Contingency funding plans
- Internal controls

BOARD ROLE

The Guidance reiterates that the board of directors is ultimately responsible for a bank's liquidity risk, as it is for each of the "CAMELS" risks (capital, assets, management, liquidity, earnings and sensitivity to market risk). The board may delegate oversight responsibility to a committee of the board, but the board may not abdicate its responsibilities (1) to understand the bank's approach to balancing liquidity risk and short-term profits (sometimes called "liquidity risk tolerance"), and (2) to clearly communicate that approach to management. (See the March 2010 **B&B Review**, entitled "*Ladies and Gentlemen, This is a Bank*," for a description of the online "Bankers Desktop" tool developed by the Federal Reserve Bank of Kansas City for educating directors about liquidity and other risks.)

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The Guidance provides that the board should understand the following:

- The nature of the bank's liquidity risks
- The comprehensive contingency funding plans for handling potentially adverse liquidity events
- The liquidity risk profiles of important subsidiaries and affiliates

The Guidance also lists several specific action items for boards, including:

- Establish executive level lines of authority for managing liquidity risk
- Enforce management's duties to identify, measure, monitor and control liquidity risk
- Establish and approve liquidity management strategies, policies and procedures and review them at least annually

SENIOR MANAGEMENT ROLE

Of course, good corporate governance extends beyond the boardroom. The Guidance provides that senior management is responsible for ensuring that all board-approved strategies, policies and procedures for liquidity risk management are appropriately executed according to the lines of authority established by the board.

In particular, senior management must establish and oversee the following measurement and reporting systems:

- Systems for liquid buffers, such as cash, unencumbered marketable securities and market instruments
- Comprehensive contingency funding plans
- Adequate internal control infrastructure
- Systems for reporting to the board of directors on the institution's liquidity risk profile

INDIVIDUAL MANAGEMENT MEMBERS OR COMMITTEES OF MANAGEMENT

The Guidance expects that senior management will clearly identify the specific individuals or committees who are responsible for implementing and making liquidity risk decisions. Many banks use an asset/liability committee (ALCO) consisting

of members of senior management to make these decisions. The Guidance notes that the ALCO members should include those with authority over the units responsible for executing liquidity-related transactions, including lending, investment securities and wholesale and retail funding.

The specific functions of the ALCO or other responsible individuals should include the following:

- Actively monitor the bank's liquidity risk profile
- Ensure that the bank's liquidity risk measurement system adequately identifies and quantifies risk exposure
- Ensure that the reporting process communicates accurate, timely and relevant information about the level and sources of risk exposure

CONCLUSION

The Guidance underscores the importance of a board of directors and management team that are always cognizant of their respective roles in managing the bank's risk profile. Whenever federal banking regulators unite on a policy statement, banks should be keenly aware that on-the-ground bank examiners will be instructed to make the topic a top priority in examinations. So long as deficient liquidity risk management is cited as a cause for continued bank failures, banks should expect their regulators to concentrate their focus on the management of liquidity risk and carefully review their policies to ensure compliance with the new Guidance.