Liquidity

Examiners should evaluate the above-captioned function against the following control and performance standards. The Standards represent control and performance objectives that should be implemented to help ensure the bank operates in a safe and sound manner, and that the entity's objectives are carried out. Associated Risks represent potential threats to the bank if the standards are not achieved and maintained. The Standards are intended to assist examiners in analyzing important functions that may warrant additional review. All of the following Standards may NOT need to be considered at every bank. Conversely, these do NOT represent all of the control and performance standards needed for every bank. Examiners should continue to use their judgement when assessing risk.

Standards	Associated Risks
MANAGEMENT AND CONTROL	
The board maintains prudent policy parameters and procedures. The board receives frequent reports reflecting the bank's funding needs and funding sources. Management adheres to and supports policy.	Inadequate policies and procedures may expose the bank to excessive liquidity risk. The board may be unaware of liquidity risk. Noncompliance of policy requirements may indicate lack of understanding or disregard for policy guidelines and could result in excessive liquidity risk.
Management actively monitors and determines funding needs.	Failure to monitor funding needs may result in the inability to meet liquidity requirements.
Management establishes sources to meet funding needs. Sufficient liquid assets, or other reliable funding sources, are available to meet liquidity needs.	Inability to meet funding needs could impair the bank's financial condition. The bank may lose public confidence if unable to meet funding needs.
Management properly monitors noncore funding.	Disproportionate amount of funding from one source could strain liquidity if that source is eliminated. Failure to monitor noncore funding may negatively impact earnings and capital. .
PERFORMANCE	
Liquidity requirements are manageable.	Liquidity requirements may not be met. Excessive costs to liquidate assets or obtain funding could impair earnings and negatively impact capital. Large lines of credit or commitments may not be funded.
Asset quality is satisfactory.	Large volumes of problem assets could present a strain on liquidity since anticipated cash flow may not be received.

Standards	Associated Risks
	Liquidity may be strained if the bank's reputation is tainted by significant financial and asset quality problems.
Concentrations of credit are appropriate.	Inappropriate concentrations of credit to industries with present or anticipated problems may result in decreased cashflows.
Funding sources are stable. The bank is able to meet funding needs and maintain market share without incurring abnormal funding costs or creating an asset and liability mismatch.	Unstable funding sources may result in increased funding costs. Substantial reductions in large liability accounts could create a liquidity strain. Higher than anticipated costs in obtaining funds can lead to poor earnings and may in turn entice management to seek higher-yielding, riskier investments. Preoccupation with obtaining funds at the lowest possible cost, without proper consideration given to maturity distribution, could increase the bank's exposure to interest rate fluctuations.

Liquidity

Core Analysis Decision Factors

Examiners should evaluate Core Analysis in this section for significance and to determine if an Expanded Analysis is necessary. Negative responses to Core Analysis Decision Factors may not require proceeding to the Expanded Analysis. Conversely, positive responses to Core Analysis Decision factors do not preclude examiners from proceeding to the Expanded Analysis if deemed appropriate.

Do Core Analysis and Decision Factors indicate that risks are appropriately identified, measured, monitored, and controlled?

Core Answer: General Comment:(If any)

Core Analysis Decision Factors

C.1. Are policies, procedures, and risk limits adequate?

C.2. Are internal controls adequate?

C.3. Are the audit or independent review functions adequate?

C.4. Are information and communications systems adequate and accurate?

C.5. Is the use of less stable funding sources reasonable?

C.6. Does the overall assessment of liquidity, including provisions for back-up funding sources, indicate liquidity needs can be met without adversely affecting operations or financial condition?

C.7. Do the board and senior management effectively supervise this area?

Liquidity

Expanded Analysis Decision Factors

This section evaluates the significance and materiality of deficiencies or other specific concerns identified in the Core and Expanded Analyses.

Do Expanded Analysis and Decision Factors indicate that risks are appropriately identified, measured, monitored, and controlled?

Expanded Answer: General Comment:(If any)

<u>Expanded Analysis Decision Factors</u>

E.1. Are deficiencies immaterial to management's supervision of liquidity?

E.2. Are liquidity deficiencies immaterial to the bank's financial condition?

Liquidity

Consider the following procedures at each examination. Examiners are encouraged to exclude items deemed unnecessary. This procedural analysis does not represent every possible action to be taken during an examination. The references are not intended to be all-inclusive and additional guidance may exist. Many of these procedures will address more than one of the Standards and Associated Risks. For the examination process to be successful, examiners must maintain open communication with bank management and discuss relevant concerns as they arise.

PRELIMINARY REVIEW

1 Review prior examination reports and file correspondence for an overview of any previously identified liquidity concerns.

2 Review available UBPR and other financial data to develop a preliminary assessment of liquidity trends and risk. Identify significant trends or changes in source and use of funds that may require further analysis.

3 Review board or committee minutes for evidence of oversight, responsibility, routine management reports, and any identified liquidity concerns.

4 Determine if there are any recent or planned changes in strategic direction and discuss with management the implications for liquidity risks.

POLICIES, PROCEDURES, AND RISK LIMITS

5 Review liquidity and funds management policies. Policies should provide sufficient guidance to management with regard to the board's risk tolerances and oversight responsibilities. Liquidity guidelines may also be found in other policies, such as the Investment Policy or Loan Policy, but taken together should:

5 A Provide authorization to an individual(s) or committee, delineating responsibilities for planning, executing, and reporting.

5 B Describe acceptable funding sources and an acceptable mix of uses, by type and maturities (e.g. Investment securities, loan mix, other assets).

5 C Define and place limits upon certain types of funding sources and uses of funds, including significant off-balance-sheet positions. Some common limits include:

1. Maximum loan-to-deposit ratio and/or loan-to-asset ratio.
2. Reliance on less stable funding of longer-term assets.
3. Maximum limits on borrowed funds, brokered CDs, national CDs, etc.
4. Minimum amount of short-term investments.

5 D Provide contingency liquidity plans for use in emergency funding situations.

6 Review the funds management process with management. Consider attending an ALCO meeting to evaluate the process.

7 Determine if polices, procedures, and risk limits are reasonable in relation to management abilities, current economic conditions, the nature and complexity, and the overall condition of the bank.

INTERNAL CONTROLS

8 Determine if sufficient separation of duties (or comparable controls) exists over the preparation of reports used in managing the liquidity function.

9 Determine that internal management reports concerning liquidity needs and available sources of funds are prepared regularly and reviewed by senior management and the board of directors.

10 Determine if management complies with policy guidelines and documents the reasons for any variance.

AUDIT OR INDEPENDENT REVIEW

11 Determine that the independence and scope of the audit or independent review is sufficient to identify policy, reporting, internal control, and compliance deficiencies.

12 Determine that results are properly reported to the board.

13 If recent reviews disclosed any deficiencies, determine if management responses are reasonable.

INFORMATION AND COMMUNICATION SYSTEMS

14 Determine if internal management reports provide sufficient information for ongoing liquidity management decisions and for monitoring the results of those decisions.

15 Determine if board and senior management reports provide sufficient information to monitor compliance with board policies and guidelines.

16 Determine if liquidity needs and risks are effectively communicated to all areas affected.

17 Consider testing reports for accuracy by comparing data with regulatory reporting schedules and subsidiary records.

ANALYSIS OF FUNDING SOURCES AND USES

18 Determine the composition and stability of deposits considering the following factors:

18A Core deposit trends relative to total deposits.

18B Deposit Mix.

18C Seasonality.

18D Out of area deposits, including National CDs and internet banking relationships.

18E Use of brokered deposits.

18F Stability of public or other local large depositors.

18G Reaction to any recent positive or adverse events.

18H Deposit management programs or strategies such as CD specials, other special deposit account rate incentives, and internet banking initiatives.

18I Reputational risk including merger activity, management turnover, litigation, asset-quality problems, or poor financial performance.

19 Identify sources and terms of all significant borrowings or use of market instruments (e.g. FHLB, Repos, Fed Funds, Discount Window, asset securitization) and determine the extent and use of those funds, considering the following factors:

19 A Trends in use of such funds, either seasonally or as a more permanent funding vehicle.

19 B Stability and diversification of those sources.

19 C Use of those funds relative to strategic plans, controls, and alternate funding sources.

19 D Remaining borrowing capacity.

20 Assess the potential impact on liquidity of asset sales that include recourse provisions.

21 Compare rates paid for deposits and other funding sources with published indices and local market rates. Determine the cause of any significant variances.

22 Review UBPR aggregate cost data and determine reason(s) for any significant variances or adverse trends in cost of funds, relative to peer data.

23 Determine the extent of liquidity provided by the security portfolio and other investments considering:

23 A Maturity structure and marketability.

23 B Portfolio depreciation.

23 C Pledging requirements and pledging suitability of unpledged securities.

23 D Significant changes or trends in composition and maturity.

24 As necessary, determine the extent of liquidity available from the loan portfolio in the form of government guaranteed loans, loans held for re-sale, loans supported by firm take-out commitments or participation agreements, pledgable or other high-quality marketable loans.

25 Review recent asset sales or unusual borrowings prompted by unplanned liquidity needs and determine if there were any adverse affects on operations or financial performance.

26 Evaluate management provisions for anticipated, but unusual liquidity needs, such as large unfunded loan commitments, maturity of a significant volume of time deposits or borrowed funds, branch closings, new products, mergers, litigation, growth initiatives, etc.

27 Explore and assess the impact of any other significant trends or changes in sources and use of funds identified during the preliminary review process.

28 Review contingency funding plans and determine if they are adequate given the bank's past, present, and prospective liquidity position, strategic plans, and overall financial condition. Consider:

28 A Sources of contingency funding.

28 B Reliability of contingency funding (eg. Revocable, irrevocable vs. "as available").

28 C Terms and conditions of alternative or contingency funding arrangements.

Liquidity

Generally, procedures used in the Expanded Analysis should target concerns identified in the Core Analysis and Decision Factors. Expanded procedures associated with Core Analysis and Decision Factors of no concern need not be used. The flexible guidelines specified for the Core Analysis also apply here.

POLICIES, PROCEDURES, AND RISK LIMITS

1 Investigate why the policy and procedure deficiencies identified in the Core Analysis exist. Discuss recommendations with management. Possible reasons for policy deficiencies may include the following circumstances:

1A Management overlooked these issues.

1B Management is unfamiliar with prudent liquidity guidelines and procedures.

1C Management is unwilling to create or enhance policies and procedures.

2 If poor compliance with policies and procedures exist, determine the reasons. Possible reasons are detailed below:

2A Lack of awareness of policies' existence.

2B Disregard for established policies.

2C Misunderstanding the intent of policy guidelines.

2D Poor internal communication of subsequent revisions to policies and procedures.

3 Determine if management commits to and supports proper controls and monitoring to ensure policy guidelines are followed in the future. Determine if proposed controls, if any, are reasonable.

INFORMATION AND COMMUNICATION SYSTEMS

4 If management is not properly monitoring the bank's liquidity position, determine where the weaknesses lie and formulate recommendations to correct deficiencies. Prudent liquidity management techniques include the following items:

4A Monitoring and managing of seasonal or cyclical factors that may cause loan and deposit levels to move in opposite directions. Failure to monitor these factors may cause insufficient liquidity to meet loan demand or deposit withdrawals.

4B Monitoring daily cash letters as well as long-term liquidity needs through intelligent forecasting.

4C Monitoring of changes in economic climate.

4D Planning for contingencies including identifying minimum and maximum liquidity needs and weighing alternative courses of action.

4E Monitoring the price and availability of credit and the level of liquid assets available to meet funding requirements.

4F Monitoring the incremental cost of liquidity, whether gained through asset management, liability management, or a combination of both.

ANALYSIS OF FUNDING SOURCES AND USES

5 Consider completing a cashflow projection if liquidity requirements are significant.

5A Determine if cash needs are likely to exceed available funding sources.

5B Determine how management plans on meeting significant liquidity demands.

6 For banks with high levels of off-balance sheet commitments, review the historical funding of commitments.

7 If specific deposit rates are significantly above peer, determine if the bank is soliciting brokered deposits or experiencing pricing pressures from competitors.

7A Review internally prepared rate sheets, reflecting the bank's and competitors' rates, if available.

7B Review local newspapers' weekly interest rate reports of area banks.

7 C Verify compliance with interest rate restriction that apply to "adequately capitalized" and "undercapitalized" banks. Refer to Section 29 of the FDI Act, Section 337.6 of the FDIC Rules and Regulations, and Regional Director Memo 97-020 (FDIC).

8 If the Core Analysis indicates that the bank is relying on unstable funding sources, perform an in-depth analysis of these sources to determine the extent of this reliance:

8A Perform a migration analysis using internally prepared deposit schedules, the UBPR, or IRRSA (FDIC). Determine if certain deposit accounts are experiencing declines, the reasons for the declines, and the potential liquidity risk.

8B Compare deposit volumes with rate histories to see if a significant correlation exists and how future events are likely to impact these rates and volumes.

8C Review deposit accounts for any significant out-of-area deposits. Determine if these deposits are stable funding sources or merely chasing attractive rates.

8D Review insider deposit relationships.

9 Determine if the bank has securities that may be used for sale under agreements to repurchase and if repurchase arrangements exist.

10 Determine if the bank has adequate documentation to support lines of credit from other financial institutions.

11 Determine if funding commitments are periodically tested.

12 Determine whether credit lines contain material adverse change clauses that would preclude their use in problem situations.

Liquidity

Impact Analysis reviews the impact that deficiencies identified in the Core and Expanded Analysis and Decision Factors have on the bank's overall condition. Impact Analysis also directs the examiner to consider possible supervisory options.

1 Measure the significance or impact deficiencies identified during the Core and Expanded Analysis have on the bank's financial condition.

2 If liquidity is severely strained, determine how management plans to meet daily cash needs.

3 Determine if the bank can continue to operate profitably. Assess if severe liquidity problems will impair growth objectives, profits, and the bank's reputation to a point where the bank's future viability is questionable.

4 Determine the need for administrative and enforcement actions, formulate specific recommendations, and advise appropriate supervisors on the nature of the concerns. (FDIC: Field Office Supervisor, Regional Office.)

5 Discuss the possibility of administrative and enforcement actions with appropriate supervisory officials, executive management, and the board of directors.