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August 18, 2009

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, Northwest
Washington, DC 20551

Docket No. OP-1362 - "Proposed Interagency Guidance – Funding and Liquidity Management"

Thank you for the opportunity to respond to the "Proposed Interagency Guidance - Funding and Liquidity Management." As a firm that provides balance sheet management advisory services to approximately 300 financial institutions (diverse in size, complexity, and location), we bring a unique perspective on liquidity management practices and the impact they have on other safety and soundness components such as profitability, interest rate risk and capital management.

Reasonable & Sound Guidance
Overall, the guidance appears to be both reasonable and sound. It appropriately shifts the emphasis from historically-focused and outdated call report based data, to a forward-looking more proactive approach; one that we have been promoting for over 20 years. The guidance should have the added benefit of helping to clarify differing opinions on liquidity management "best practices" that our clients have observed from agency to agency, region to region, and examiner to examiner. The guidance should add a degree of consistency to regulation as expectations are more clearly defined and conveyed to financial institutions regardless of primary regulator.

Properly administered, the use of wholesale funding by community banks is healthy (not detrimental) for the industry. This guidance acknowledges the important role of wholesale funding for financial institutions, outlines risks of utilizing wholesale funding, and provides a framework for risk management practices required to safely administer a wholesale funding component as part of an overall liquidity management process.

Accordingly, we hope that this guidance will help quell a strong undercurrent of opinion in the regulatory community that implies that wholesale funding sources (in the form of borrowings and brokered CDs) are inherently "bad" and a key contributor to bank failures (a cause and effect linkage that we cannot find to be supported by our analysis of industry-wide data).

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Additional Clarity Can Enhance Effectiveness of Guidance
While an improvement in terms of the communication of current regulatory expectations, we feel there is further opportunity to add clarity to liquidity definitions in the guidance. There are some instances where the reader can interpret some of the liquidity definitions to mean a historical "Uniform Bank Performance Report (UBPR)" metric (such as the liquid asset ratio) rather than what appears to be a "current working" definition of a liquid asset as outlined in the guidance.

We raise this concern because we feel that many of the static liquidity ratios calculated from call report data are limited in terms of what they capture. Clearly, liquidity management has evolved far beyond the day when many of these ratios had truer meaning; a point that is acknowledged by the agencies simply by the issuance of this draft guidance.

Notwithstanding, a number of our clients continue to claim that in recent exams these ratios still trump sound management practices, and become the primary drivers when determining CAMELS ratings.

As such, we feel some of the terms used in the guidance need updated definitions or better clarity. Specifically:

1. Definition of Liquid Assets: We believe that liquid assets are any assets that can be converted to cash quickly, without principal loss, and at a reasonable cost. Often, this is achieved via collateralization of funding with assets on the balance sheet rather than through the sale of assets. The role of collateralized funding is acknowledged in the joint agencies' definition of liquidity (in Paragraph 4 on Page 15). However, we feel that the definition of "liquid assets" in Paragraph 2 on Page 14 should be expanded to more clearly include loans in addition to what historically has been considered an institution's only liquid assets (cash and certain securities). Accordingly, collateral-eligible assets would include loans as well as investment securities so long as borrowing facilities have been established, tested and in good standing (i.e. at the Federal Home Loan Bank or the Federal Reserve Discount Window).
    a. Accordingly, on Page 16, we believe that the text should be modified to more clearly say that financial institutions need to maintain "adequate levels of highly liquid marketable securities *and loans (as collateral)*... " To exclude loans that can be readily converted to cash (via collateralization of funds) at either the FHLB or FRB eliminates a valuable source of liquidity from appropriate consideration. Concerns regarding ongoing availability should be appropriately captured in stress testing and related planning activities

   b. In a similar vein on Page 20, “target amounts of unpledged asset reserves” should be more clearly defined to include loans, as should liquid asset coverage ratios. “Volatile liability dependence” should be clearly defined in a meaningful way. It may actually differ from institution to institution depending upon their liability mix and local market funding sources.

2. Definition of “Short-term Volatile Liabilities”: This phrase also requires a refreshed and clearer definition. Many funding sources deemed “volatile” by UBPR ratio calculation are actually quite reliable from a liquidity perspective. Examples include customer repurchase agreements (collateralized deposit accounts, where collateral is freed if the deposits leave), collateralized borrowings < 1 year (rolled so long as the collateral backing the borrowings is available), CDARS “two way” CDs (very reliable given the strength of the reputation of the full faith and backing of the FDIC as well as the fact that vast majority of monies relate to existing “core customers”). Many institutions have sufficient historical data to prove these funding sources to be reliable.
   a. The “volatile” label for funding from a liquidity perspective needs to be reserved for those funds that are more likely to be withdrawn without notice and/or not renewed at maturity.
   b. On Page 16, we agree with the notion that every financial institution needs a diverse mix of funding sources. However, proper diversification should include the availability of funding beyond deposits in the local market. Often, these alternative sources of funds (FHLB advances, brokered CDs, national market CDs, CDARS and, ultimately, potential borrowing from the Federal Reserve Bank) appear to fall into categories considered “volatile” with many clients reporting that they are outright frowned upon during examinations. This creates some potential confusion unless talking points in the field during examination become more in line with the proposed guidance. For the vast majority of community banks, these funds have proven to be highly reliable from a liquidity perspective. Also, it has been our experience that the prudent use of these funding sources helps manage the high marginal costs of raising local deposits and can be structured to better manage interest rate risk.

3. The discussion about funding concentrations on Page 21 should also include the importance of the interest rate risk profile in determining the correct funding mix for a financial institution. For example, an institution in which fixed rate term lending is the norm may require term funding only available in bulk and at a reasonable cost from wholesale sources; whereas a financial institution with a predominance of short term, Prime or LIBOR based loans would require an entirely different funding mix.

4. One other item that could be clarified in regards to liquidity planning and stress testing is the time horizon that should be examined. For example, Page 22, Paragraph 15 refers to cash flow forecasting "over an appropriate set of time horizons." Page 39, Paragraph 44 refers to holding company liquidity capacities "for an extended period of time." We have heard widely varying answers to what the regulatory community deems to be appropriate horizon periods. Accordingly, it would be beneficial if the guidance could be expanded upon to better enable banks to develop models *a priori* that encompass reasonable timeframes (e.g. suggested time horizons or the factors that determine it). It has been our experience that "sources / uses" exercises lose accuracy and meaning beyond a 90-180 day time horizon as so much changes as the next 90-180 days unfold (e.g. the future looks different once it becomes history). However, we can understand a need to be more forward-looking to better head off liquidity risk events, even if the exercise can become admittedly more academic. We believe that a 6-month horizon is meaningful, especially when performing stress tests which by design are more immediate in nature.

5. We believe there is a typographical error on Page 29, Section 27. The word "whole" we believe was intended to be "wholesale."

In conclusion, we reiterate our pleasure with the overall guidance in terms of its reasonableness and soundness. It reflects an important and practical change in emphasis from static ratios with limited utility to an assessment of the overall liquidity management process; including the role of forward-looking analysis and contingency planning. We also concur with the recognition of the important role that diversified funding sources (beyond local market deposit gathering) play in effective liquidity management for financial institutions.

Thank you for the opportunity to submit our comments on the proposed interagency guidance for Funding and Liquidity Risk Management. If helpful, we would welcome the opportunity to discuss our letter in more detail.

Sincerely,

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