

From: Farin & Associates, Inc., Tom Farin  
Subject: Funding & Liquidity Risk Management

---

Comments:

Agency: OCC  
Docket ID OCC-2009-0009

Comment Letter on Proposed Interagency Guidance - Funding and Liquidity Risk

Thomas A. Farin  
Farin & Associates, Inc.

The "Proposed Interagency Guidance - Funding and Interest Rate Risk Management" provides guidance on a very significant issue - liquidity risk management. I believe the guidance addresses many critical issues institutions should deal with when developing a liquidity strategy, liquidity policy statement, and contingency funding plan. Hopefully the final version will be better organized and reduce some of the redundancy within the document.

In the review I see two major gaps that need to be addressed.

#### 1.2.Core Deposit Strategies

I think we all agree that core deposits are the most important and desirable source of funds available to insured financial institutions when meeting liquidity needs. Yet, when you read through the guidance document, the majority of the non-framework content is focused on alternative sources of funding and asset based liquidity. There is little mention of management of the core deposit base.

Looking back over the last few decades, it is obvious that portfolio loans have outgrown core deposits across the industry. Much of that growth mismatch is a byproduct of an aging certificate of deposit base. In most shops, balance weighted age of CD holders in well into their 70s. As that wealth transfers to Gen X, Gen Y and Boomers, it is not likely to go into financial institution CDs. They are the mutual fund generations, and are much more likely to invest in the mutual fund industry than in financial institution CDs. To the extent loans outgrew deposits in the last two decades, the gap was funded by reducing the size of the investment portfolio, through securitization and sale of loans, and by increasing the use of non-core funding, particularly that from alternative funding sources like the FHLB and brokered CDs. All of these tactics raise liquidity issues.

While asset-based liquidity is stronger in most financial institutions today than a few years ago, the strengthening is primarily a byproduct of lessening demand for quality loans and an infusion of 'flight to safety' funds into deposit accounts - both brought on by the current recession.

When the economy rebounds, loan demand will strengthen and it is likely much of the 'flight to safety funding' will return to the markets. We'll be back in the same liquidity crunch we experienced a few years ago. At the present time there is tremendous regulatory pressure being placed on institutions to reduce their reliance on brokered CDs and FHLB advances, which are the two largest sources of alternative funding to the industry. I understand where regulators

are coming from in applying this pressure. The question is, "Where will institutions find core funding to replace non-core funding resources?" Across the industry there is some potential for addressing this problem over the short-term as core deposits have been outgrowing loans during the current recession. But I'm much more pessimistic about the ability of the industry to reduce its reliance on non-core funding over the long haul.

Now let's take this issue down to the individual financial institution level, the level at which the guidance is directed. Individual institutions need to do a much better job in developing and implementing core deposit growth and acquisition strategies than they have in the past. While the industry may suffer from a lack of core funding growth, individual institutions with best practices funding processes may not. Those institutions wishing to implement upgraded core deposit acquisition and retention strategies need to focus on three key components:

### 1.2.3.Risk/Risk and Risk/Return Relationships

The Proposed Interagency Guidance - "Funding and Liquidity Management" places liquidity risk into a silo. There are also regulatory silos in place for dealing with capital risk, operations risk, interest rate risk, etc. Yet we all know actions taken to address liquidity risk may impact on credit risk, interest rate risk, capital risk, and create operations risk issues. At certain points of the interagency document, credit risk, operations risk, and capital risk problems are identified as triggers for liquidity risk problems and events. Yet there is little discussion as to the potential effect of liquidity risk solutions on other forms of risk as well as return. For example, a decision to extend FHLB Advance or Brokered CD terms to improve liquidity may make an asset sensitive institution even more asset sensitive. The decision to convert loans to investments, to shorten investments, or to make the investment portfolio more liquid to meet asset-based liquidity needs is likely to have a negative effect on return. Diminished returns lead to less accumulation of capital which could lead to larger capital risk issues.

I expected to see more discussion of these issues in this document. You might respond by saying that those tradeoffs should be obvious. Yet the unaddressed tradeoffs raise a number of issues in the document's discussion of tools and decision making frameworks for liquidity risk management.

1. I applaud the interagency players for significant movements away from static measures of liquidity in the form of balance sheet ratios (loans/deposits, dependency ratios, etc.) and toward a framework that primarily focuses on sources and uses of funds and contingency funding plans. There is a very strong undercurrent in this document that liquidity risk comes from a combination of current balance sheet structure, the institution's proposed business strategy, and unanticipated events that trigger liquidity issues. Your framework for dealing with liquidity risk has moved from the static approach of years past to the dynamic approach needed in the future.

Yet the framework regulatory guidance suggests for interest rate risk management is still biased in the direction of static measures of interest rate risk. Regulatory guidance states that value at risk testing of fluctuations in EVE, NPV, and NEV is to be performed on existing balance sheets. Yes, the interest rate risk guidance documents I reviewed in preparing this comment letter suggest the institution might consider modeling income at risk based on

business strategy. Yet, many field examiners are still asking to see income at risk analysis performed by holding the current balance sheet constant over the 1-2 year horizon commonly used for measuring income at risk. Much of the regulatory interest rate risk guidance hasn't been updated in a number of years by the agencies involved in the development of this interagency document. After having been a contract IRR instructor to FSLIC then OTS all through the thrift crisis, I became more than familiar with the disconnect that often exists between what regulatory policy makers say an institution should be doing and what examiners are asking for in the field.

It is time to move interest rate risk guidance forward to match what the interagency document does to liquidity guidance.

a.b.c.d.

i.

There is significant potential in many shops for fluctuations in fee income (mortgage banking) as rates change.

ii. Boards

understand measures of risk much better when they are framed as a fluctuation in commonly used measures of return (ROE, ROA, earnings per share). All three have net income in the numerator.

e.f.g.h. Value at risk stress tests should be applied to both the current balance sheet and at least the forecast base case balance sheet that exists at the end of the income at risk tests. Without doing so, the long-term effect of the business strategy being executed on interest rate risk is not assessed. Doing so converts value at risk analysis from being solely static to a combination of static and dynamic.

2. All this brings me to the second issue not addressed in the guidance document. It fails to suggest a framework for evaluating the tradeoffs in risk/risk and risk/return tradeoffs. Maybe it is inappropriate for a regulator to provide such guidance. The recent increase in interest rate risk analysis outsourcing by financial institutions to firms that perform static analysis testing to satisfy minimal regulatory requirements removes from the institution the ability to model the impact of alternative strategies on risk versus return. I'll admit that most small to medium sized institutions fail to effectively use models in this way, even when the model is in house. However, lack of regulatory guidance in this area encourages institutions to take minimalist approaches to measuring and managing interest rate risk. That in turn sub-optimizes the relationship between the institution's risk and return.

I realize that most of the modifications suggested in this document will add to 'regulatory burden', although placing liquidity risk and interest rate risk modeling in the same strategy framework would have some offsetting effects. But leaving the core funding strategies and risk/risk/return discussion out of the picture turns this document into what will primarily be perceived as a cost of regulatory compliance. Yet if institutions were asked to actually develop and implement core funding strategies, and if they were encouraged to adopt frameworks that allow them to continually evaluate the relationship between risk and return, we'd have financial institutions that have a better chance of recovering their compliance costs through better performance.

I would think this document would better serve both regulatory and industry needs if it at least suggested a framework for improved decision making and plugged the obvious hole in the rather sparse material on the role of core

deposit strategies in liquidity risk management.

Thomas Farin  
Farin & Associates, Inc.