<u>Questions submitted, and Answers, for the OCC Liquidity Risk Management Telephone Seminar May 15 and May 16, 2001</u>

1. **Many banks choose to include non-relationship, rate-sensitive (national market, less than 100K) deposits as a funding source. What specific risk management safeguards should a bank using this liquidity source employ?**

   Bank management should employ risk management systems and safeguards equal to the complexity of the liquidity and funding risks it has undertaken. As explained in OCC Advisory Letter AL 2001-5 *Brokered and Rate-sensitive Deposits*, such systems should incorporate the following principles:

   - **Proper funds management policies.** Generally a good policy should provide for forward planning, establish an appropriate cost structure, and set realistic limits and business strategies. It should convey clearly the board's risk tolerance and should not be ambiguous about who is responsible for funds management decisions.

   - **Adequate due diligence when assessing deposit brokers**. Bank management should establish adequate due diligence procedures before entering any business relationship with a deposit broker. Deposit brokers are not regulated by the Agencies.

   - **Due diligence in assessing the potential risk to earnings and capital associated with brokered or other rate-sensitive deposits, and prudent strategies for their use.** Bankers should manage highly sensitive funding sources carefully, avoiding excessive reliance on funds that may be available only temporarily or that may require premium rates to retain.

   - **Reasonable control structures to limit funding concentrations.** Limit structures should consider typical behavioral patterns for depositors or investors and be designed to control excessive reliance on any significant source(s) or type of funding. This includes brokered funds and other rate-sensitive or credit-sensitive deposits obtained through Internet or other types of advertising.

   - **Management information systems (MIS) that identify clearly non-relationship or higher-cost funding programs and allow management to track performance, to manage funding gaps, and to monitor compliance with concentration and other risk limits.** At a minimum, MIS should include a listing of funds obtained through each significant program; rates paid on each instrument and on an average per program; information on the maturity of the instruments; and, the concentration or other limit monitoring and reporting. Management should also ensure that brokered deposits are reported properly in Consolidated Reports of Condition and Income.

- **Contingency funding plans that address the risk that these deposits may not "roll over" and provide a reasonable alternative funding strategy**. Contingency funding plans should consider the potential for changes in market acceptance if reduced rates are offered on rate-sensitive deposits. The plan should also allow for the possible triggering of legal limitations that restrict the bank's access to brokered deposits under Prompt Corrective Action standards and the effect on the bank's liability structure.

2. **If a bank can obtain non-relationship deposits from the national market and finds that it is a cheaper source of funding after evaluating the marginal cost of funds of the local market deposits vs. the national market, would you say it is in the bank's best interest to use this alternative? What documentation would you suggest the bank maintain to address this issue if questioned by an examiner?**

   No, it is not necessarily in the bank's best interest to use national market funding merely because it is cheaper. Although the cost of funding is important, you must consider the risk the funds may pose to the bank.

   Customers who focus exclusively on rates are highly rate-sensitive and provide less stable funding than do those with local retail deposit relationships. Those rate-sensitive customers have easy access to, and are often well informed about, alternative markets and investments. They may have no other relationship with or loyalty to the bank. If market conditions change or more attractive returns become available, those customers may transfer their funds rapidly to new institutions or investments.

   Banks that are less than "well capitalized" under Prompt Corrective Action standards cannot accept, renew, or roll over any brokered deposit without a waiver from the FDIC, and rate restrictions apply. Rate-sensitive customers with deposits that exceed insurance limits also may be alert to and sensitive to changes in a bank's financial condition. Accordingly, those rate-sensitive depositors, both under and over the $100,000 FDIC insurance limit, may exhibit characteristics more typical of wholesale investors.

   The bank should keep documents that support its analysis of all related issues, including potential risks posed by its various activities and products, for its own risk management process and to provide to an examiner, when requested.

3. **Have the regulatory agencies established guidelines for concentration limits in any area of funding outside of local market deposits? What percentages are considered acceptable for non-relationship or rate-sensitive deposits?**

   A funding concentration exists when a single decision or factor could cause a significant and sudden withdrawal of funds. No designated amount or size could constitute a liability concentration; a concentration depends on the bank and its balance sheet structure. The dollar amount of a funding concentration is an amount that, if withdrawn alone or at the same time as a few other large accounts, would cause the bank to change its day-to-day funding strategy significantly. Concentrations are explained more fully in the OCC 's *Comptroller's Handbook on Liquidity*, issued in February 2001.

4. **What would you consider "aggressive growth"?**

   There are no predetermined measures of "aggressive growth." Instead, per 12 CFR 30, Appendix A, paragraph F, *Asset growth,* states that "An institution's asset growth should be prudent and consider: 1) The source, volatility and use of the funds that support asset growth; 2) Any increase in credit risk or interest rate risk as a result of growth; and 3) The effect of growth on the institution's capital." These factors should be considered to determine the "aggressiveness" of a bank's growth.

5. **If a bank draws deposit funding from the national market and participates in what may be considered a rate-sensitive environment, is it considered a "safeguard" and to its benefit, from a risk management standpoint, if it also uses an unbiased information service to monitor current market rates and historical trends for that market?**

   A bank drawing funding from the market should always have a way to determine reliable and accurate current market rates and historical trends for that market. The bank may develop and document its own market information based on reliable sources or use an unbiased information service as it sees fit. Certainly a combination and comparison of two or more methods would likely enhance risk management.