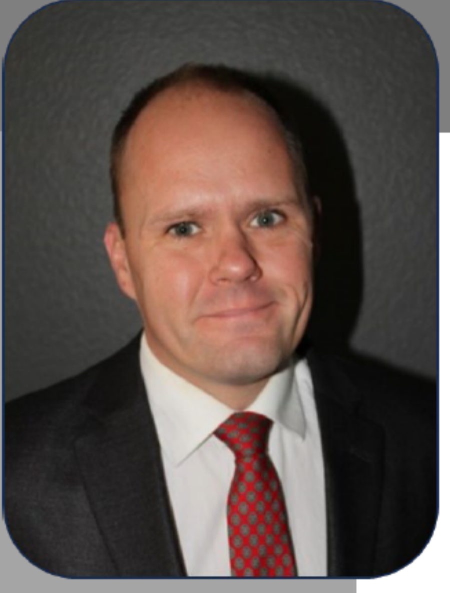
Aaron Brock

Supervisory Examiner
Department of Savings and Mortgage Lending



Aaron Brock joined the Department of Savings and Mortgage Lending in 2010 and has served as a Supervisory Examiner since 2021. In his current role with the Department, he leads the examination scoping process and conducts onsite work at examinations. In addition to field examinations, Aaron assists in quarterly offsite interest rate risk monitoring of the SSB portfolio on a quarterly basis. He is a graduate of Hardin Simmons University in Abilene, Texas, earning a BBA in Finance and Economics and a Master of Business Administration. Aaron is also a graduate of the Graduate School of Banking at Colorado, Boulder, Colorado.

Sensitivity and Liquidity

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Thrift Industry Day - 2023

Liquidity

- Pop Quiz! In what document does the following quote appear?
- *"Recent events illustrate that liquidity risk management at many financial institutions is in need of improvement. Deficiencies include insufficient holdings of liquid assets, funding risky or illiquid asset portfolios with potentially volatile short-term liabilities, and a lack of meaningful cash flow projections and liquidity contingency plans."*

2010 Guidance Revisited

- Failures at Signature and SVB have led to increased scrutiny from regulators related to liquidity risk management.
  - An addendum to the 2010 Interagency Policy Statement was released early this year – FIL 39-2023 - Updated Guidance: Interagency Policy Statement on Funding and Liquidity Risk Management on the Importance of Contingency Funding Plans
    - https://www.fdic.gov/news/financial-institution-letters/2023/fil23039a.pdf

Liquidity

- Answer: Interagency Policy Statement on Funding and Liquidity Risk Management (2010)

FIL 39-2023 – Updated Guidance

- The new guidance emphasizes the importance of maintaining an actionable CFP that considers a range of potential stress scenarios.
- Banks are expected to assess the stability of funding sources, and maintain a broad range of contingent sources to be accessed in adverse circumstances.
- CFP should also include an assessment of which contingency sources may be <u>unavailable</u> during times of stress.
- CFPs should be periodically reviewed and updated to address evolving liquidity risks.
- ***Having a range of reliable contingency funding sources is a key component of safety and soundness.***

Liquidity

- Changes in examination posture.
- Changes to calculation of liquid assets – may exclude securities in significant unrealized loss positions.
  - Particularly if earnings or capital would not support sales at a loss.
  - If your bank is in an unrealized loss position, expect to hear questions to this effect.
- Many more questions on stress testing contingency funding plans.
  - Have elements of the plan been tested?
  - Are stress scenarios reasonable?
  - Is cash flow modeling comprehensive?

Cash Flow Projections - Reminders

- Should be institution-specific and incorporate high-probability/low-impact as well as low-probability/high impact scenarios.
    - Does not necessarily have to be a “break the bank” scenario but should illustrate how the bank could endure a high degree of stress.
- Should include consideration of how borrowing lines would be affected. Would there be curtailments or less available due to securities depreciation or economic stress?
- Should also consider any concentrations in the deposit base? What is the plan if those deposits leave together?
    - Are there any industry-specific concentrations to account for?
    - Increased competition, large depositors, aging deposit base.
- Plans should also incorporate a scenario simulating the effect of being less than well capitalized.
    - Brokered deposits, rate restrictions, etc.

Contingency Funding Plan - Reminders

- Should include both quantitative and <u>qualitative</u> early warning indicators (EWIs) and event triggers.
- If EWIs or triggers are breached, there should be a clear understanding in the CFP of roles and responsibilities.
  - Who can declare a liquidity event? What are next steps? Who decides if liquidity event has passed?
  - Is the contingency funding plan being followed?
- Should have as many tools in the toolkit as possible. CFP should outline these tools and any operational considerations.
  - How is pledging arranged?
  - Will collateral need to be delivered? What collateral is eligible?
  - Are unsecured lines still active?
  - Are borrowing authorities current?

Bank Term Funding Program

- https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20230312a1.pdf
- Key takeaways:
  - Any depository institution is eligible under the program.
  - Eligible collateral consists of various types of securities <u>owned by the borrower as of March 12, 2023</u>.
  - Borrowing terms up to one year.
  - Priced at 1y overnight index swap rate + 10bp (fixed).
  - Advances available until at least March 11, 2024.

Liquidity – Common Exam Recommendations

- Lack of comprehensive cash flow analysis.
  - High degree of reliance on unsupported assumptions.
  - Future projections that do not align to budgeting/strategic plan.
- Cash flow analysis too highly aggregated
  - For example, 0-90 days. A lot can happen in 90 days! Won't be able to detect a large outflow within that window if it is too highly aggregated.
- Insufficient stress testing.
  - Should be sufficiently severe to reflect a significant stress.
- Lack of detail in CFP.
  - Criticisms of EWIs, unclear roles and responsibilities, and vague action plans.
- Policy limits from ALM vendor do not match those in your ALM Policy.

Sensitivity to Market Risk

- With recent rate increases, increased scrutiny on the SMR component.
- Has bank management kept up with their IRR oversight with the historical "low for long" environment?
- How is your bank adapting to the new competitive pressure for funding?
- Changing the bank's IRR profile is a long process, so examiners are focused on management and Board oversight.

Sensitivity – Policy Limits

- Policy Limits – what was an acceptable tolerance in a stable rate environment may no longer be the true risk appetite.
- Example – Some IRR policies permit a 25% decline in net interest income, is that an exposure the board is comfortable with when that is carried through to the bottom line?
  - Would your bank still be profitable if NIM declined from 4% to 3%?
- Policy Exceptions – should always be approved by committee/board and <u>include a plan to reduce exposure</u>.

Sensitivity – Management Oversight

- Historical assumptions in the current rate environment.
- Competition for deposits has led to many institutions where actual increases in cost of funds are more prevalent than IRR model assumptions would suggest.
  - Highly dependent on local market conditions.
- Do assumptions in the current environment remain appropriate?
- Are deposits migrating between types? Should be factored into your IRR analysis.

Sensitivity – Model Risk Management

- Renewed focus from federal regulators on the 2017 guidance on Model Risk management.
- FIL 17 – 2022 https://www.fdic.gov/news/financial-institution-letters/2017/fil17022.html
- Applicable to banks over $1 billion in assets, but the guidance has useful information for institutions of all sizes.

Model Risk Management

- Model risk should be managed like other types of risk, ID sources of risk and assess potential magnitude.
- Should be aware of what your model says and <u>what it is not saying</u>.
  - *"All models are wrong, but some models are useful."*
  - It's important to be aware of external factors that your model is not accounting for.
- Should incorporate a method of "effective challenge" to identify model limitations and develop mitigants for shortcomings of the model.

Model Risk Management

- Policies governing model risk management should emphasize:
  - Testing and analysis
  - Development of model accuracy targets
  - Acceptable levels of discrepancy
  - Procedures to review and address unacceptable variances
- Documentation is key for understanding how the model operates and its key assumptions, and provides for continuity of operations.

SMR – Common Exam Recommendations

- Policy exceptions – exceptions either lacking approval or lacking a documented plan to reduce exposure.
- Policy limits – too generous and leading to excessive exposure (i.e. not supported by the current level of earnings or capital)
- Assumptions – poor documentation or unsupported assumptions.
  - We cannot tell you assumptions are wrong, but you should have support for why they are right!
- Sensitivity testing – either not performed or not a meaningful amount of stress.

Questions?

Contact Information:

Aaron Brock
Supervisory Examiner

325-725-2765

abrock@sml.texas.gov