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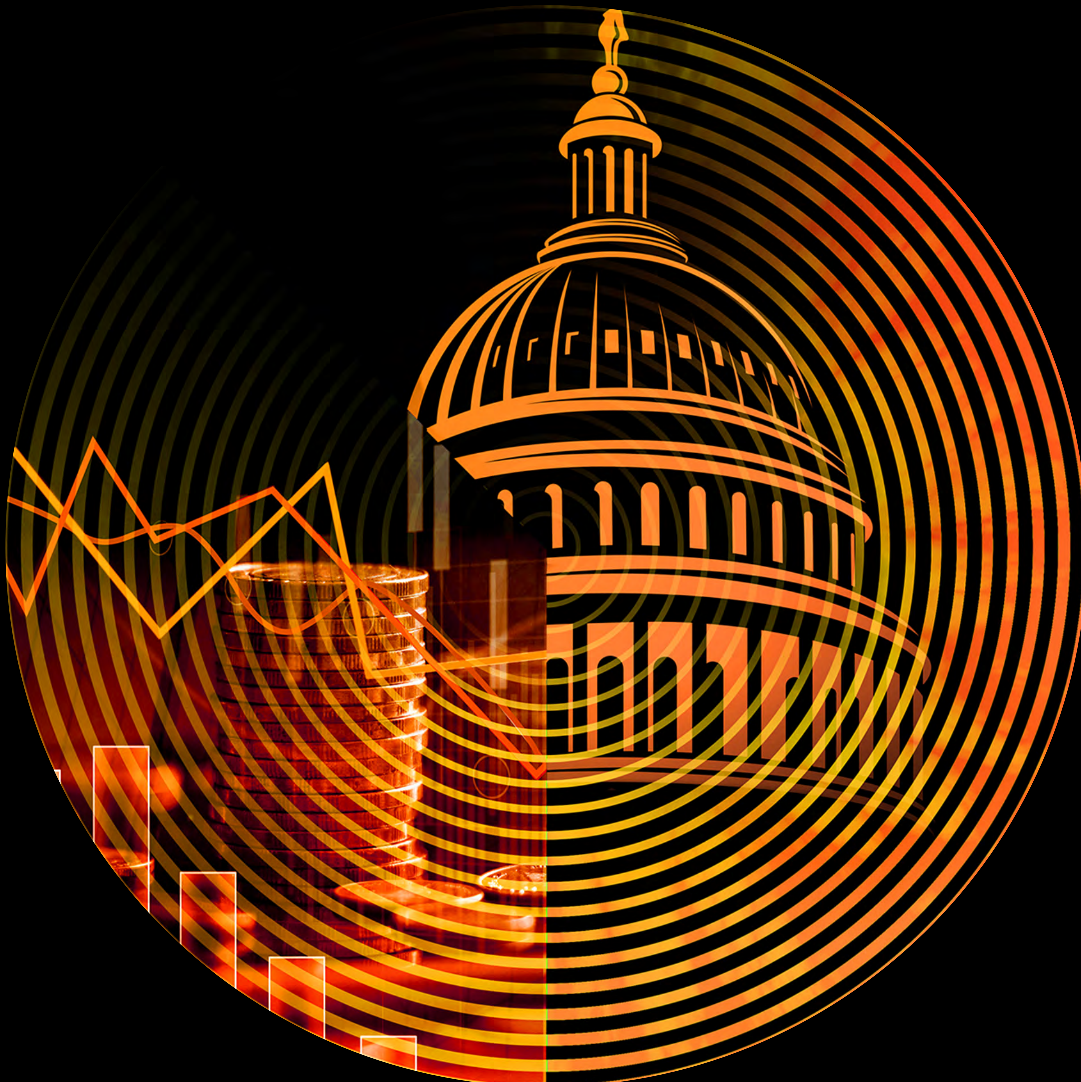

Keeping banks 'on the balls of their feet'

Center *for*
Regulatory Strategy
US

The OCC takes actions to promote improved liquidity risk management at supervised banks

With the focus of recent economic and banking sector impacts, the Office of the Comptroller of the Currency (OCC) has taken the opportunity to revise its guidance to institutions for liquidity risk management. Along with the other federal banking regulators, policymakers and supervisors (including the OCC) have been evaluating their calls to action for the industry across many topics, including the nature and extent of supervision concerning liquidity risk management. During his May 18, 2023, testimony before the Senate Banking Committee, Acting Comptroller of the Currency Michael Hsu assured the Committee that the agency's examination staff was engaging with supervised banks to confirm "that they are 'on the balls of their feet' with regard to risk management."[1] The following week, the agency issued an updated version of the Liquidity booklet of their ***Comptroller's Handbook***.[2] Changes to the OCC's Liquidity booklet of the ***Comptroller's Handbook*** highlight increasing regulatory focus on banks' liquidity positions and risk management practices.

The booklet provides guidance on assessing the quantity of a bank's liquidity risk and quality of the liquidity risk management. The OCC's updates provide general clarity on certain topics and enhanced expectations from the federal banking regulatory agencies; and take into account significant changes in technology, product innovation, and funding dynamics that have collectively complicated liquidity risk management practices. OCC-supervised banks will need to be mindful where changes to the booklet warrant corresponding policy, procedure, or practice changes.

Liquidity booklet update

The OCC added and expanded certain sections within the booklet to highlight and define areas that needed more clarity as per details of the regulation. The OCC's expansions and additions, albeit not new regulatory expectations, better align the OCC's booklet with the text included in examination manuals across regulatory agencies like the Board of Governors of the Federal Reserve System's (FRB) ***Commercial Bank Examination Manual***[3] and the Federal Deposit Insurance Corporation's (FDIC) ***Risk Management Manual of Examination Policies***.[4]

In this piece, we place focus on a total of 16 sections that were either added to (five sections) or updated in (11 sections) the OCC's booklet. The majority of the revisions are deemed medium impact with the only high-impact change involving contingency funding plans (CFPs). Recent market events have underscored the importance of contingency funding planning, and the booklet revisions place further emphasis on accounting for funding restrictions in CFPs and related stress testing, as well as bank management's role to maintain and monitor liquidity sources. Figure 1 shows a summary of the changes.

Figure 1. Summary of updates to the OCC's Liquidity booklet[5]

Section	Page (PDF)	Description of addition	Potential impact (high •••••, medium •••, low •)
Sources of liquidity (Updated Section)	7	• Listing service deposits are reflected as an example of alternate funding sources.	●
Pledging of assets (Updated Section)	13	• Banks' tangible generally accepted accounting principles (GAAP) accounting position is now considered a factor that could influence both the counterparty collateral requirements and assets required to obtain funding	●●●
Reserve balances (New Section)	14	• Discusses Regulation D and the FRB's March 2020 amendment that set reserve requirement ratios to zero; the establishment of the initial Interest On Reserve Balances (IORB) rate and how banks earn IORB; banks managing reserve levels to balance liquidity needs, opportunity costs, and interest earned.	●
Public or municipal deposits (Updated Section)	16	• Pledging requirements vary by state and are based on banks' financial condition metrics. Banks usually pledge investment securities as collateral but may participate in state pledging pools, substitute FHLB letters of credit, or offer reciprocal deposits to their public funds depositors as alternatives.	●
Federal Home Loan Bank (FHLB) borrowings (New Section)	17	• Covers FHLB borrowing, including the provision of wholesale funding (short or long term) to member banks; credit standards and collateral types required for FHLB advances; other lending products offered by the FHLB; limitations on advances, calculated as a percentage of a bank's total assets.	●
Federal Reserve discount window (New Section)	17	• Introduces the Federal Reserve discount window and its ability to help banks control liquidity risk; restrictions on discount window borrowings, especially for banks that are not well rated or well capitalized; use of the discount window to address temporary or unforeseen liquidity needs in stress; the Federal Reserve Banks are not obligated to lend through the discount window and may deny banks.	●●●
Deposit listing services and internet deposits (Updated Section)	18	• Internet deposits and internet-based deposits are now reflected in the heading and in the body of the section, respectively.	●
Reciprocal deposits (New Section)	19	• Outlines the definition and functionality of reciprocal deposits; explains how certain banks can provide their customers with access to FDIC deposit insurance above the deposit insurance limit via reciprocal deposits.	●●●

Figure 1. Summary of updates to the OCC's Liquidity booklet[5]

Section	Page (PDF)	Description of addition	Potential impact (high ●●●●●, medium ●●●, low ●)
Sweep deposits (New Section)	20	• Explains sweep deposits and details the entities from where these deposits may be "swept" into the bank; sweep deposits may or may not be categorized as brokered deposits under 12 CFR 337.6.	●●●
Funding from the financial markets (Updated Section)	20	• Debt providers may have provisions that link to GAAP tangible capital measures. Such provisions may trigger debt payment acceleration or other actions if the GAAP tangible capital measure falls below certain thresholds. Such provisions, however, are likely to make the debt instrument ineligible to qualify as tier 2 capital.	●●●
Operational risk (Updated Section)	23	• Highlights the expectation that Federal Reserve Banks have for banks to monitor compliance with their agreed-upon account exposure positions.	●●●
Strategic risk (Updated Section)	24	• Mentions strategic plans that use innovative products or approaches, such as bank accounts offered through a financial technology partner, could introduce risk. • Considers strategic challenges associated with surge deposits and forecasting their stability; differences in characteristics compared to typical bank deposits; similarities to brokered deposits (e.g., rate and market sensitivity); supervisory assessments of how banks monitor and manage surge deposits.	●●●
Risk management (Updated Section)	26	• Third-party risk management is now among the elements that should be included in a sound liquidity risk management process.	●●●
Policies, procedures, and limits (Updated Section)	27	• Monitoring is now included as part of a bank's board-approved approach to liquidity risk management.	●
Liquidity risk measurement and monitoring systems (Updated Section)	30	• Statutory or other restrictions that third-party funds providers must follow (e.g., tangible GAAP capital-based restrictions) is now mentioned in the discussion of liquidity risk measurement and monitoring systems. • The list of considerations for retail deposit stability assumptions now includes material changes to the mix of customers or funds providers that may cause funding sources to respond differently to current or future business conditions.	●●●
Contingency funding plans (Updated Section)	36	• CFPs and stress testing plans should now consider and incorporate the potential statutory or other restrictions on third-party funds providers (e.g., tangible GAAP capital-based restrictions). • Suggests that the onus is on bank management to ensure that sufficient sources of liquidity are maintained, and to be aware of the implications of any financial deterioration of funds providers.	●●●●●

Source: OCC

Enhancements to the handbook also included additional regulatory expectations as it pertains to third-party risk management, surge deposits, and generally accepted accounting principles (GAAP) implications on tangible capital equity positions.

Third-party risk management (TPRM)

New language establishes the expectation that banks "practice effective risk management regardless of whether the bank performs the activity internally or through a third party" and that "a bank's use of third parties does not diminish the responsibility of its management to ensure that the activity is performed in a safe and sound manner and in compliance with applicable laws."[6] The OCC highlights the importance of understanding the bank's TPRM program, with the expectation that third-party risks must be assessed and managed with the same level of scrutiny across the bank.

In addition to the discussion of TPRM in the Liquidity booklet, the OCC joined the FRB and FDIC in the June 6, 2023, issuance of "Interagency Guidance on Third-Party Relationships: Risk Management."[7] The guidance presents an updated, coordinated view of expectations.

Surge deposits

As recent events have demonstrated, deposits tend to surge above normal levels during declines in economic conditions and changes in market conditions. Banks should appropriately monitor and manage the volume of surge deposits given their less stable nature and characteristics that differ from deposits gathered in normal conditions.

GAAP implications

An emphasis was placed on GAAP implications (e.g., available-for-sale securities), as they relate to tangible capital accounting and how that could affect banks' liquidity needs. Banks should maintain awareness of the implications and incorporate the impact into normal and stressed liquidity scenarios analyses.

'Ask the Regulators' session

Subsequent to several failures and the recognition of significant issues concerning liquidity risk management, the OCC along with the FRB, FDIC, and Conference of State Bank Supervisors (CSBS) hosted a webcast called "Ask the Regulators: Supervisory Update on Funding and Liquidity Risk Management."[8] This session served as another opportunity for the OCC along with other federal and state bank supervisors to underline the most critical aspects of liquidity risk management in the current environment and to improve transparency of supervisory expectations. Figure 2 reflects our summary of the materials covered by the regulators during the recent session.

The critical elements of sound liquidity risk management discussed during the session are consistent with long-standing supervisory standards and expectations. However, the OCC continues to stress the importance of conducting liquidity risk management activities that consider challenges present in the current environment.

Figure 2. Regulators share views on liquidity risk management and supervision[9]

Critical elements of sound liquidity risk management

Effective corporate governance by board of directors and management	Appropriate strategies, policies, procedures, and limits	Comprehensive liquidity risk measurement and monitoring systems	Comprehensive liquidity risk measurement and monitoring systems
A diverse mix of existing and potential future funding sources	Adequate levels of highly liquid marketable securities	Comprehensive contingency funding plans (CFP)	Internal controls and internal audit processes

Supervisory focus

Four things to expect:

1. Open dialogue regarding proactive asset liability management
2. Uniform Financial Institutions Rating System (UFIRS) liquidity rating [assessments]
3. Ongoing contacts outside the examination process may occur
4. Encourage bank managers to reach out to their field, regional, or district supervisory staff

Supervisory priorities

The OCC will likely continue assessing liquidity and interest rate risk at its supervised institutions during the normal course of supervision, as reflected in the agency's previously issued supervisory priorities.[10] The priorities, issued in October 2022, highlighted the potential for "sharp rate increases" to have a negative impact on deposits and otherwise impair banks' liquidity positions due to the pledging or sale of securities.[11] The priorities also mentioned possible losses on available-for-sale securities affecting capital and ultimately creating barriers to accessing funding sources (e.g., Federal Home Loan Bank advances).

The OCC's supervisory priorities for fiscal year 2023 cover the examination of liquidity and interest rate risk in the following ways.

Safety and soundness, and fairness

- "Given the rapidly changing economic environment, examiners should **focus on strategic and operational planning to assess whether banks maintain stable financial positions**, especially regarding capital, allowance for credit losses, management of net interest margins, liquidity, and earnings."

Interest rate risk

- "Examiners should **determine whether banks appropriately manage interest rate risk through effective asset and liability risk management practices**. Risk management should **consider a robust suite of interest rate scenarios and assumption sensitivity analyses**, when appropriate, as rising rates may negatively affect asset values, deposit stability, liquidity, and earnings."

Liquidity risk management

- "Examiners should **assess banks' liquidity risk management practices, including stress testing of primary, secondary, and contingent sources of liquidity and strategic and tactical measures to address liquidity needs**."

The OCC is actively assessing the agency's supervisory approach to determine if revision is necessary.[12] To date, the agency has not indicated any expressed changes to its supervisory priorities or the underlying application of its supervisory approach. However, the Acting Comptroller has been vocal about additional support needed to empower examiners to respond to supervisory concerns quickly and with appropriate intensity. In a broader sense, the Acting Comptroller's perspective concerning strengthening regulations regarding resilience (specifically capital and liquidity) is shared by the other federal regulators. Any such changes to prudential regulation would likely go through the public comment process and could have a longer policy development timeline.

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Endnotes

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3. Board of Governors of the Federal Reserve System (FRB) Division of Supervision and Regulation, *Commercial Bank Examination Manual*,” updated May 2022.
4. Federal Deposit Insurance Corporation (FDIC), “Liquidity and Funds Management,” in *Risk Management Manual of Examination Policies*, last updated October 2019.
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6. Ibid.
7. OCC, “Third-Party Relationships: Interagency Guidance on Risk Management,” news release, June 6, 2023.
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