Liquidity Policy Statement

XYZ Bank

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# Purpose

The purpose of this policy is to establish and implement financial procedures that maintain the bank’s liquidity and optimize net income. The policy outlines the structure under which the liquidity of the assets and liabilities of the bank will be managed. The policy will provide guidelines and procedures in addition to those set forth in our written loan, asset/liability management (ALM), and investment policies. It will be the responsibility of XYZ management to recommend and implement appropriate strategies. This policy is intended to manage XYZ’s liquidity risk in a manner consistent with the Interagency Policy Statement on Funding and Liquidity Risk Management issued in March, 2010.

# Governance

## Board of Directors

The Board of Directors of XYZ assumes the responsibility of ensuring that the bank’s liquidity is adequate for both normal operations and unanticipated stress events. By approving the policy statement, the board specifically:

* Approves policy limits, monitoring, and reporting systems
* Sets up line management responsibilities
* Puts systems in place to review actual performance relative to policies and controls
* Agrees to hold management accountable to measure, monitor, and control liquidity risk
* Reviews liquidity reports on a regular basis to ensure liquidity risk is within policy limits
* Acknowledges that it understands and reviews Contingency Funding Plans (CFP)

## Senior Management

Senior management of XYZ agrees to take the primary management responsibilities for liquidity risk management including:

* Execution of board-approved policies, procedures and strategies
* Development and communication of liquidity risk policies and procedures
* Development and administration of liquidity risk measurement systems
* Maintenance of adequate liquid asset and borrowing capacity buffers
* Development of Contingency Funding Plans and Stress Event Scenarios
* Development and monitoring of internal control infrastructure

## Operational Responsibilities

The primary responsibility for execution of this policy rests with the XYZ Asset Liability Committee (ALCO). Liquidity management reports and analysis are produced on at least a quarterly basis as part of the ALCO packet. The ALCO has primary responsibility for developing alternative strategies to deal with liquidity management issues. Strategies are evaluated based on their impact on liquidity risk and projected return as well as other risks managed by ALCO. The analysis and discussion results in recommendations to the board on both the institution’s business strategy and on strategies needed to deal with events causing the institution to experience liquidity stress.

## Internal Controls

Management has the responsibility to insure that the policies adopted by the board of directors and the reports specified in this policy are being executed. In addition, management periodically back-tests model results against financial data to ensure that the results coming out of the model are consistent with XYZ’s performance in real-world financial results.

# Liquidity Risk Management Strategies

Liquidity risk management strategies will be developed with the objective of optimizing the relationship between liquidity risk and other forms of risk such as interest rate risk, credit risk and capital risk, while providing maximum returns to stockholders. These strategies will:

* Identify the primary sources of funding
* Provide for alternative responses to business scenarios
* Deal with temporary, short-term and long-term liquidity disruptions
* Operate within liquidity risk tolerance levels
* Incorporate periodic review of assumptions used in liquidity projections
* Utilize cash flow projections
* Maintain target levels of unpledged liquid asset reserves
* Consider and manage volatile liability dependence
* Address funding concentrations
* Consider contingent exposures like undrawn credit lines
* Provide management reporting of the type and frequency specified in the policy.

# Funding Sources

It is the intention of XYZ management to develop a diverse set of funding sources. Our primary source of funding will be our retail deposit base. We will generate this funding by aggressively marketing in our trade area and by actively seeking demand deposits through service-related tactics and savings deposits through competitive pricing tactics.

Our bank has historically recognized the need for funding sources that go beyond our most important source – our retail deposit business – and we have created a funding program that identifies various wholesale funding sources that can be used whenever appropriate. We execute a liquidity program that uses both asset-based and liability-based sources and we do favor retail deposits whenever they are available at efficient cost. To sustain growth of retail deposits while managing our cost of funds, we have developed and actively manage a Core Funding strategy. In those circumstances where wholesale funding offers either a funding structure or cost efficiency not available with retail deposits, we will evaluate and use these sources as part of our normal funding program.

Diversity is promoted by utilizing other sources of funds in addition to our retail deposit base and then placing policy limits on the use of any Near-Core and Non-Core Funding. Some of these funding sources will be used as ***base funding sources*** to meet business plan liquidity needs. Other sources will be reserved as ***contingent funding sources*** so they are available should stress events occur that cause unusually high levels of cash outflows (uses) or restrict availability of one or more regular sources of funding. Some sources will serve as both base and contingent sources. Funding sources developed will include both secured and unsecured sources.

The following table lists the Near-Core and Non-Core Funding source, its status, role, and policy limits as a percentage of total assets, applicable to XYZ Bank only.

|  |  |  |  |
| --- | --- | --- | --- |
| Source | Status | Role | Policy Limit |
| Near-Core |  |  |  |
| Jumbo CDs | Large balance CDs only partially insured | Base | 30% |
| CDARS Reciprocal | Large Balance Insured CDs | Base and Contingent | 10%, on top of brokered deposits |
| Money Aisle | Internet CDs from local market | Base and Contingent | 10% |
| Non-Core |  |  |  |
| FHLB Chicago | Sec Overnight Borrowings and Secured Advance Lines | Base and Contingent | 25% |
| The Federal Reserve | Secured Borrowings | Contingent | 20% |
| QwickRate | Unsec Insured CDs | Contingent | 25% |
| Fed Funds | Unsec Fed Funds  | Base and Contingent | 10% |
| Brokered CDs | CDs obtained through brokers covered by FDIC insurance shield | Base and Contingent | 25% |

# Measurement Monitoring and Reporting Systems

Incorporated in reporting to senior management and to the board of directors will be the following reports, either in summary form or in detail depending on the audience:

* **Liquidity Gap Report** – This is a pro-forma cash flow statement based on the business strategy or liquidity strategy being considered. This cash flow statement will compare sources and uses of funds. The resulting funding gaps will be monitored and controlled by policies herein. One of the key outputs from this report will be the one-year cumulative liquidity gap/asset ratio. Liquidity gaps are calculated including highly liquid unencumbered marketable securities and unused borrowing capacity. The one-year cumulative liquidity gap/asset ratio will be controlled via policy limits.
* **The effect of adverse liquidity stress event scenarios**, specifically on the Liquidity Gap ratios using stress assumptions and methodology prescribed in the Interagency Guidance on Liquidity and Funds Management issued in March, 2010.
* **Assessment of bank’s need for highly liquid, unencumbered, marketable securities (HLUMS)** through the Liquidity Coverage Ratio as specified in the Basel III International Framework for Liquidity Risk Measurement, Standards and Monitoring issued December 2010. This report serves as the evaluation tool to determine whether there is a sufficient level of highly liquid unencumbered marketable securities to cover cash outflows under a defined stress event occurring in a 30-day period. Actual coverage will be compared to a policy limit.
* **Early Warning Indicators Report** – this report will contain a list of early warning indicators with actions triggered at various levels. It will show actual results for the various event triggers described in this document.
* **Available Unencumbered Assets Report** – This report will list the highly liquid unencumbered assets backing up the values used in the above reports.
* **Contingent Funding Source Status** – This report will list the contingent funding sources available, credit availability, actual usage relative to policy limits, and date of most recent test of the facility.
* **Trigger Threshold Report** – Report that reflects triggers to actual performance.
* **Comparison of Policy Limits to Actual Performance** – This report will compare policy limits to actual performance and provide explanation of any exceptions to the policy.

## Quarterly Reporting on Liquidity Management

On a quarterly basis, XYZ management will do the following:

* Calculate pledged securities to total securities
* Review market value of pledged securities
* Review the amount of collateral available to meet needs of liquidity stress events
* Review and test collateral pledging procedures to ensure collateral needs can be met on a timely basis

## Intra-Day Liquidity Management

On a daily basis the CFO reviews XYZ’s cash position including:

* Cash letters
* ACH activity and clearings
* Wire transfers
* Securities transactions
* Other items affecting the bank’s cash position

Based on the analysis, overnight investments and overnight borrowings transactions are executed to maintain daily liquidity within tolerance levels set by XYZ management. Management reviews the daily overnight position on the balance sheet and investigates circumstances causing significant swings in the overnight position.

XYZ has relationships with multiple sources of overnight funding, some secured and some unsecured. Should policy limits or collateral limits with a single institution be reached, XYZ management will make use of its other sources of overnight funding.

## Alignment with Budgeting and Risk Management Process

It is the intention of XYZ management to develop budgets and business plans and test those plans under a variety of rate environments to test interest rate risk and liquidity risk. Cash flow reports will be generated from these plans that measure sources and uses of funds. XYZ will project the Liquidity Coverage Ratio in conjunction with its business plan to assess the levels of short-term, asset-based liquidity available from plan actions. In addition, XYZ will monitor the one-year liquidity gap/asset ratio under business plan scenarios.

It is understood by XYZ’s Board and management that there are trade-offs between managing one risk that impact other risk areas. It is the ALCO’s duty to monitor and report the risk and return options associated in the current and alternative strategies available for managing related risk positions.

# Policy Measurements and Limits

## Primary Policy Limits

In order to assess liquidity levels for XYZ’s needs we will use the following primary policy limits that set minimum liquidity buffers for both asset-based liquidity and total liquidity:

* Liquidity Coverage Ratio
* 12-Month Cumulative Liquidity Gap Ratio
* Near-Core and Non-Core Funding/Total Assets

Liquidity Coverage Ratio

The LCR measures whether the institution has sufficient levels of highly liquid unencumbered marketable securities and expected cash flow to cover a short-term liquidity crisis event covering 30 days. XYZ performs this analysis incorporating all of the Basel III assumptions relating to issues like deposit runoffs and lack of access to wholesale funding.

The following are XYZ’s Liquidity Coverage Ratio Policy Limits along with management actions that will be taken based on the level of this ratio.

|  |  |  |
| --- | --- | --- |
| **LCR** | **Level** | **Required Actions** |
| > 105% | Green Light | No change required. |
| 100-105% | Yellow Light | Demonstrate in the business plan the return to more stable levels in the coming 6 months, monitor and report quarterly on plan to actual. |
| < 100% | Red Light | Immediate actions taken to return to yellow levels within 3 months and green within 9 months. Reporting to be communicated monthly until yellow level achieved. |

### Twelve-Month Cumulative Liquidity Gap Ratio

This measure will be calculated for XYZ’s business plan in the most likely rate environment used for interest rate risk analysis and business planning. Sources of funding will be the sum of incoming cash flows from the business plan, unused borrowing capacity, and highly liquid unencumbered marketable securities. Uses of funding will be the sum of all outgoing cash flows. The twelve-month liquidity gap ratio will be the difference between sources and uses over a twelve-month cumulative period. The following policy limits are used in evaluating XYZ liquidity over one year for its base business plan strategy. Stress tests will be applied to these cash flows as part of the XYZ Contingency Funding Plan and these policy limits used in a modified manner as stated in the Contingency Funding Plan.

|  |  |  |
| --- | --- | --- |
| **12-Month Liquidity Gap/Asset Ratio** | **Threat Level** | **Actions** |
| > 15% | Green Light | No actions required; continue normal monitoring and reporting. |
| 10% - 15% | Yellow Light | Develop options for asset or liability changes in plan to return to green within 6 months. |
| < 10% | Red Light | Immediate plan changes should be implemented and impact of Contingency Funding Plan assessed for realistic stress events. Monitor monthly until return to yellow. |

### Near-Core Plus Non-Core Funding/Total Assets

It is the bank’s position that the total of Near-Core and Non-Core Funding sources (brokered CDs, CD’s >250k, borrowed funds, CDARS and other such sources) be limited to no more than 40% of total assets. It is our belief that these sources of Near-Core and Non-Core funding serve two purposes:

* Provide funding sources to meet contingent needs under stress events specified in the contingency funding plan
* As structural tools for balance sheet management when Near-Core and Non-Core Funding is substantially cheaper than Core Funding or when funding structures available from Near-Core and Non-Core sources allow XYZ to adequately meet interest rate risk management needs created by the structure of the XYZ balance sheet

In setting Near-Core and Non-Core Funding/Asset policy limits, it is XYZ’s goal to maintain sufficient excess Near-Core and Non-Core Funding availability beyond that needed for structural purposes so that XYZ can respond to stress events specified in its contingency funding plan without exceeding its policy limits.

|  |  |  |
| --- | --- | --- |
| **Near-Core & Non-Core Funding/Total Assets** | **Threat Level** | **Actions** |
| < 35% | Green Light | Monitor and report as normal. |
| 35% - 40% | Yellow Light | Actions to restore adequate green light levels will be outlined and assessed for risk/return trade-off on other risk areas. Compliance with green light levels should be achieved within 6 months as deemed reasonable while meeting other risk area needs. |
| > 40% | Red Light | Immediate action required to reduce reliance on Near-Core and Non-Core Funding is identified and implemented with changes in business plan moving to yellow range within 6 months with Board notification. |

## Event Triggers

In addition to the primary policy limits, XYZ’s ALCO will monitor the following ratios and events to ensure rapid changes in liquidity levels do not adversely impact available sources. When the thresholds below are “triggered,” it will cause additional review of the base policy limits and strategies to ensure adequate liquidity availability:

* Asset growth exceeding 5% per month
* Real or perceived negative publicity leading to reductions in deposit balances greater than 5% in one quarter
* Decline in asset quality
	+ Non Performing Assets/Total Assets > 5% (NPA = Non Accruals + 90
	days and over past dues and OREO)
	+ Net Charge-Offs/Assets >2%
* Correspondent Banks or other wholesale funding sources decrease or eliminate credit line availability
* Capital ratios drop to within 0.5% of Prompt Corrective Action (PCA) Well-Capitalized levels
* Negative earnings for three consecutive months

# Contingency Funding Plans

The Board of Directors and management of XYZ recognize the importance of liquidity in the day-to-day operation of our franchise and believe it crucial to have a plan for addressing liquidity in times of stress. We believe that liquidity stress events can occur both from internal as well as external events and our plan addresses both contingencies.

In assessing overall liquidity, it is important that the base business plan be stressed in such a manner as to consider unplanned liquidity stress events that result in outgoing cash flows exceeding those anticipated in the base strategy liquidity gap calculations. XYZ management will have contingency funding plans in place to manage short-term and long-term crises. The plan for the most significant stress events will be reviewed annually in conjunction with the planning process, or more frequently as needed. Specific plan items will be updated in Appendix A by reference and used in the liquidity testing process until new plans are developed and approved. Contingency plans will consider the following sources of funding:

Liabilities

* Retail Deposit Base – generated by actively seeking deposits through service-related tactics and competitive pricing tactics
* Non-Core Funding – considers the use of all Primary and Contingent Funding Sources discussed in the Funding Sources section of this document

Assets

* Sale of highly liquid unencumbered marketable securities
* Sale of other securities should losses on sales be affordable
* Loan Participations/Sales
* Cuts in loan originations
* Sale of branches and/or business entities

## Facilities Periodically Tested

XYZ management recognizes the importance of periodically testing the availability and time to deliver of the various sources of funds. It is our intent to test these facilities at least once per year on a rotating basis so that at least one source is tested every quarter. The time of the most recent test will be contained on a contingent funding source status report. A contingent funding source status report is a list of Near-Core and Non-Core Funding sources, their current utilization, the policy limit, unused capacity, and the last time the source was tested.

## Timelines to Raise Funding Documented

Results of testing will be stored in a facility testing file. This file will contain reports on each test conducted in terms of the amount and nature of funding availability tested. Notes will also indicate how long it took to bring the funds on line.

# Liquidity Stress Events

Liquidity Stress events can be both short- and long-term and can be created by internal or external situations.

## Short-Term Crises

Short-term crises may revolve around weather-related issues, acts of war, or public relations issues that could reflect badly on the bank leading to large deposit withdrawal or withdrawal of funding sources. Short-term crises may also entail the freeze-up of the securitization markets, making it impossible to sell mortgages originated for sale.

To model short-term crises, management will conduct the LCR, which is a short-term (30-day) stress test which includes the following:

* XYZ is totally cut off from all Non-Core Funding sources for 30 days.
* There is a significant deposit runoff.
* A portion of unused credit lines is drawn down.

Conducting the LCR evaluates whether there is sufficient asset based liquidity in the form of highly liquid unencumbered marketable securities, cash, and cash equivalents to cover net outflows of funds (outflows less inflows).

The effects of the LCR test assumptions are likely to be much more severe than the effects of the short-term crises envisioned by management. In the stress events envisioned, XYZ is likely to have access to its unused borrowing capacity in addition to its asset-based liquidity. For that reason, XYZ management feels the LCR test more than adequately stress tests the effect of either of these two scenarios.

XYZ’s plan in these situations is to utilize XYZ’s stock of highly liquid unencumbered marketable securities (measured using the Liquidity Coverage Ratio) to maintain XYZ’s liquidity position while working through a short-term crisis. If necessary, XYZ would supplement the asset-based funding through the most desirable sources of Non-Core Funding (from the standpoint of cost and structure), such as the following:

* Use fed funds lines, brokered CDs, national market CDs, Federal Home Loan Bank (FHLB) advances and the Federal Reserve discount window
* Lengthen the maturity of CDs
* Ensure all securities that are not pledged could be available for repurchase agreements (repos)
* Monitor daily demand and time deposit activity of the bank’s largest customers
* Calculate the current amount of collateral available for pledging at the FHLB or Federal Reserve Bank
* Establish a policy for premium pricing of deposits, if necessary, consistent with the rules governing brokered deposits

## Long-Term Crises

Long-term crises may revolve around significant loan or investment losses that might lead to loss of PCA well-capitalized status. This long-term risk could be part of a larger industry-wide problem and we recognize that funding ourselves in that scenario could be much more difficult to obtain.

Appendix A contains the results of the most recent annual stress test review and fully documents the assumptions and methodology used in the stress tests. This document will be reviewed and updated on an annual basis as part of the business planning process.

As part of its quarterly ALCO review, XYZ will run a capital failure stress test. This kind of event would potentially remove several normal funding sources. Therefore, management’s focus would be on continually managing XYZ’s balance sheet to ensure that there are adequate levels of stable funding to support those assets requiring support from stable funding as measured by the Net Sources and Uses Ratio stress tests.

In addition, should XYZ find itself in a long-term crisis it will consider the following additional sources of funding:

* Deposit gathering, FHLB advances and the Federal Reserve discount window
* Reduce the target cash balance at Correspondent Bank
* Roll maturing investments into Fed Funds Sold
* Liquidation of securities and the sale of loans; decision based on the expected losses created by such a sale
* If base sources of Non-Core Funding are cut off or restricted with higher collateral haircuts, make use of contingent funding sources
* Identify the amount of unused credit commitments which could be activated in the next 90 days
* Use of funding sources like CDARS to reduce collateral pledging requirements and to offer access to insurance on large CDs
* Suspend lending activity as needed

## Stress Test Evaluation

While liquidity stress tests will be run in conjunction with interest rate risk testing at the frequency spelled out earlier in the document, the detailed plan for dealing with this scenario will normally be updated annually. However, should XYZ fall into the yellow light range on the following threat level guidelines for the one-year cumulative liquidity gap/asset ratio, updates of CFP Strategies will be moved to quarterly.

|  |  |  |
| --- | --- | --- |
| **12 Month Liquidity Gap/Asset Ratio** | **Threat Level** | **Actions** |
| > 15% | Green Light | No actions required; continue normal monitoring and reporting. |
| 10% - 15% | Yellow Light | Develop options for asset or liability changes to return to green within 6 months. |
| < 10% | Red Light | Implement immediate plan changes; assess impact of CFP for realistic stress events; Monitor monthly until return to yellow. |

The above threat level guidelines also call for XYZ to make changes to the business strategy should they fall into the red light range on the stressed threat level guidelines.

# Contingency Funding Plan Team

In the event of a liquidity crisis, we will activate our CFP Team. Our team has been selected based on the key roles we see as required in such an event. We believe that this event will create enhanced communication between our bank and several key constituents – our regulators, our shareholders, our Board, our clients, local media, and our funding source providers. Our team will include one Board member and is comprised of the following:

* President and CEO – main constituents are our regulators, shareholders and clients.
* Board Member – will keep our board of directors informed
* CFO – will stay in contact with our funding sources and work with CEO and with regulators
* Communications Director – will work with CEO on communications to shareholders, clients, and local media
* Senior Credit Officer – will work with the team on all credit issues if that is the root cause of the liquidity event

This team will also be responsible for communicating with our own staff on a regular and consistent basis so long as the crisis is on-going.

Appendix A –Stress test documentation and response