FEDERAL RESERVE BANK of NEW YORK

Financial Institution Funding & Liquidity Risk Considerations

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March 20, 2012

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Overview – Maturity Transformation

- Public policy consideration: short funding allowed depositors with uncertain investment horizons to benefit from cash availability while consumers could benefit from lowered loan pricing

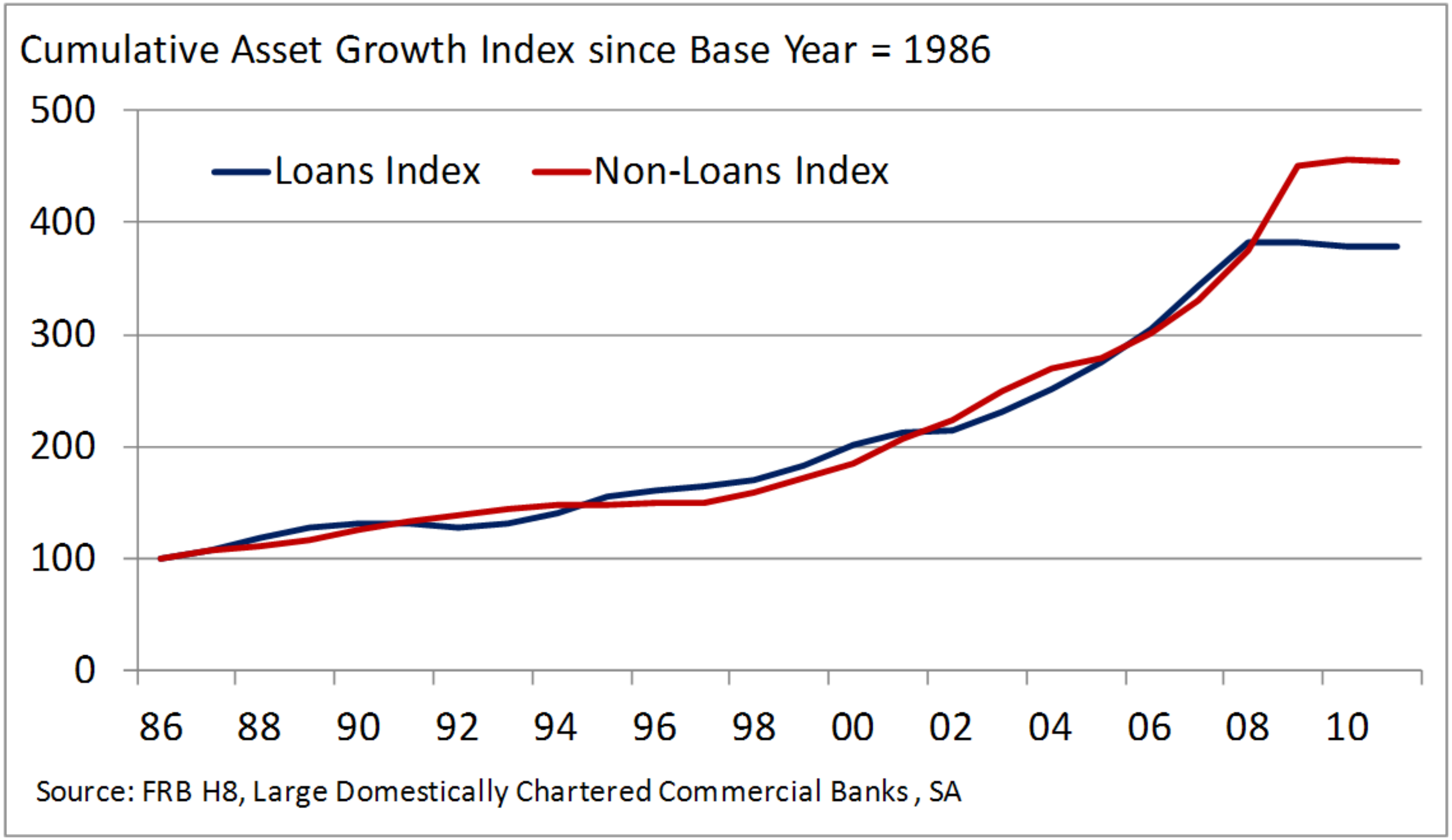
- However … refinancing risks (availability and price) associated with short funding were often not fully considered
  - S&L crisis in the 1980s (short funding of mortgage assets) highlighted the risk

- *Lender of last resort access in the US is not available to insolvent institutions, even against high quality collateral. In all cases, duration of any borrowings is expected to be short (days!)*

- Liquidity pools often were sized only to cover business as usual cash flow timing mis-matches even though banks' business models have been noticeably broadened

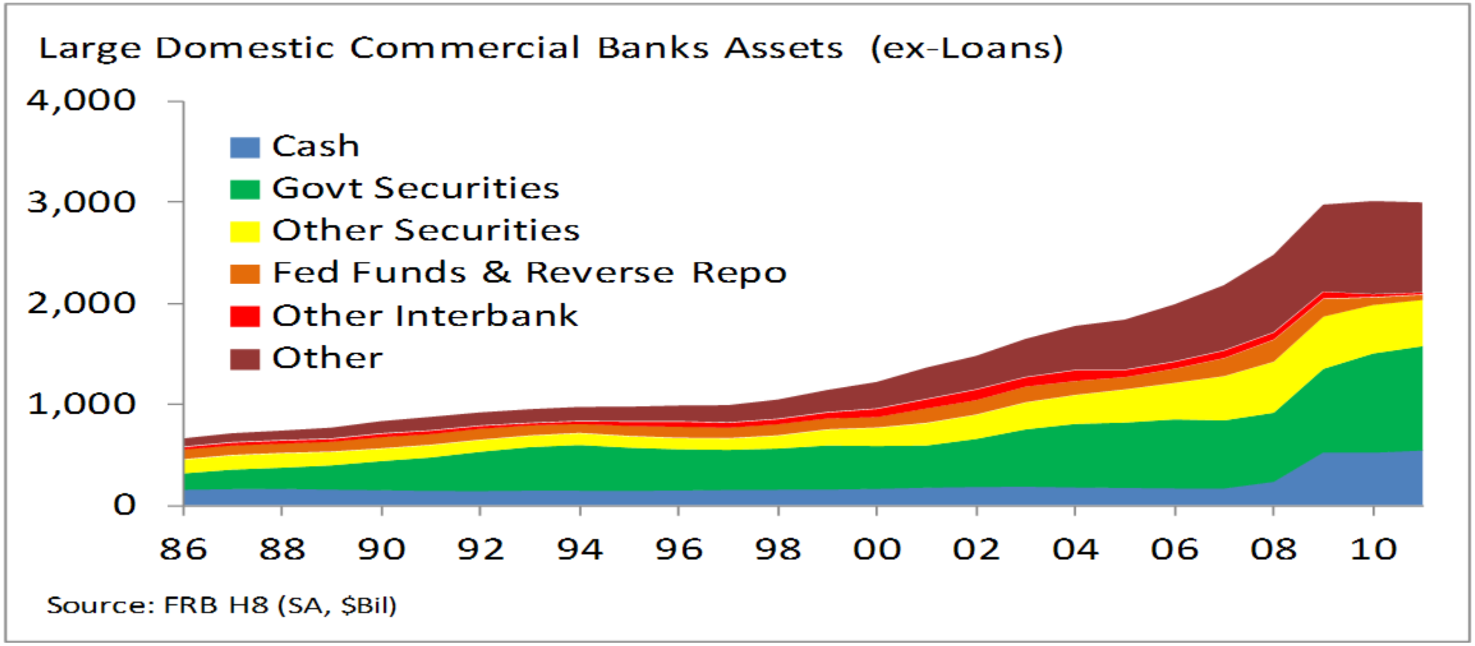
Banks' Asset Base

- While loans have remained a bank staple, Non-Loan growth has outpaced Loan growth



Banks' Asset Base

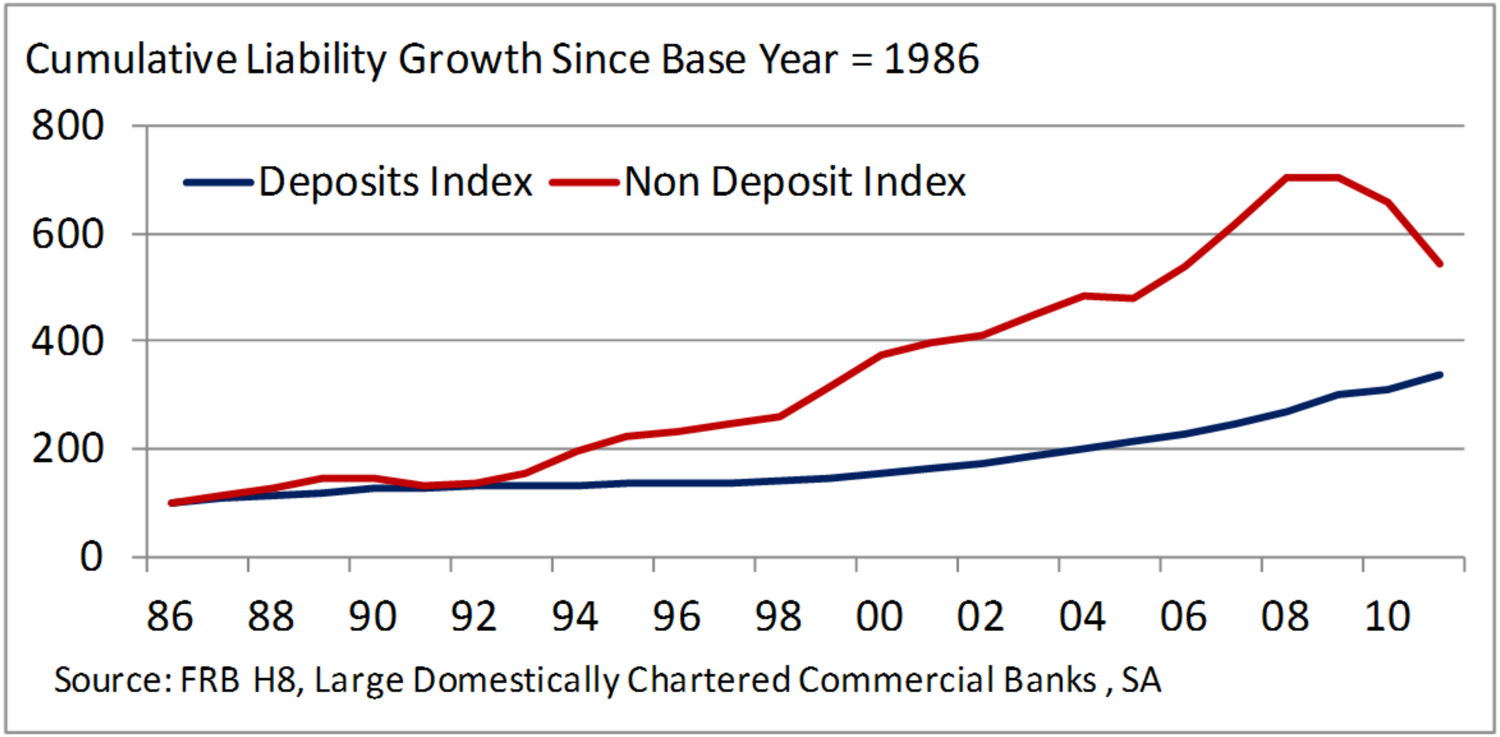
- Non-Loan assets are often quite complex, and now include
  - Deposits with other banks
  - Securities Borrowed/Purchased under agreement to repurchase
  - Brokerage receivables
  - Trading businesses assets



Heavily inter-connected, complex, with material sales and trading assets in addition to traditional retail and corporate loans

Bank's Liability Structure

- As with assets, there has been significant growth in non-deposit funding products, many of which are complex and structured



Significant short funding and reliance on credit sensitive sectors (e.g. money funds) existed … maturity transformation role versus the price of risk management

Bank's Liability Structure

- Fragility of liability structure affected by many factors, including:
  - Type of product (e.g. uninsured versus insured)
  - Nature of lender (e.g. retail versus wholesale)
  - Nature of business relationship (operational versus investment)
  - Short term versus long term "commitment"

Product Considerations - Deposits

Liquidity Risk Spectrum:

Low High

Retail …….. Brokered …….. Sweeps …… Wholesale

Product Considerations

- Retail Deposits
  - Are retail “core” deposits really core?
    - FDIC insurance protection
    - Traditionally sourced from relationship branch banking

    However …

    - Increasing propensity for Internet sourcing
    - Capacity constraints in wholesale capital markets causing a demand for “more stable” retail deposits

Even though “core” characterization may be challenged, retail deposits are still being given preferential treatment by supervisors, rating agencies and in proposed international liquidity standards

Product Considerations

- Brokered Deposits
  - Sourced by retail financial advisors
  - Aggregate CD size often over the FDIC insured limit
  - Apparent “non-relationship” of the depositor to the issuing bank, often led to a “non-stable” characterization.
    - However, individual deposit amounts typically below the insured limit threshold
    - “Death put” or “insanity” clauses restricted early redemption

Stability of this product may have been undervalued?

Product Considerations

- Sweep Deposits
  - Independent cash accumulators
    - Surplus cash swept from brokerage trading accounts to FDIC insured bank deposits
    - Banks' belief that in stressed markets, move to cash, and thus, this could be a counter-cyclical source of stable funding for banks

Liquidity concerns arise from: i) existence of MAC clauses

ii) accumulators operate on only a best efforts basis on "guaranteed" amounts iii)Given lack of LOLR support for broker/dealers, will clients leave cash at those entities? Has a bank developed its other channels of deposit taking to benefit from a possible brokerage client shift to direct bank deposits?

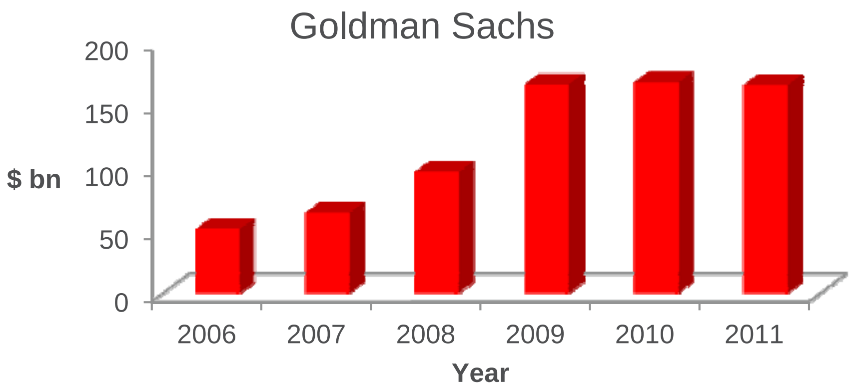
Product Considerations

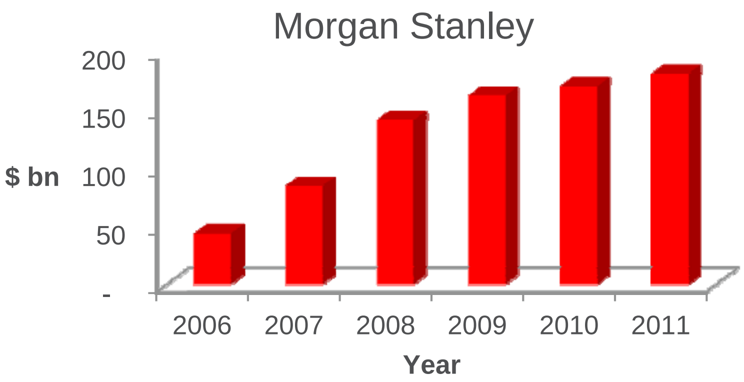
- Wholesale Deposits
  - Typically viewed as Hot Money!
    - Depositor behavior may vary depending on size/sophistication
    - Post crisis, clients are setting up accounts at different banks as a protective diversification strategy
    - Banks' inability to clearly identify nature of client and purpose of deposits make questionable their claim to resiliency of this funding source
    - Traditionally has not enjoyed the benefit of FDIC insurance

Current FDIC insurance program on large deposits through Dec 2012 may be giving a false sense of stability

Liquidity Risk Mitigant – Liquidity Pools

- To mitigate liquidity risk, banks typically hold pools of unencumbered assets
  - High quality – Cash, US Treasuries, Agencies
- Process to identify risks and size coverage pools much more robust
  - Stress testing frameworks now a focus
- Liquidity pool sizes significantly increased compared to pre-crisis
- Collateral management systems and procedures also now a focus





Resiliency of the system has improved compared to pre-crisis. However, much work remains with regard to legal entity analysis, foreign exchange risk and IT infrastructure.