The BakerGroup

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It's Time to Enhance Your Contingency Funding Plan

The great financial crisis of 2008 brought a slew of new banking regulations and guidance. More specifically, guidance related to best practices for liquidity risk management. As loan related asset quality problems occurred during that financial crisis, many institutions were left in a less than desirable liquidity position. As a result, many of their off-balance sheet or contingent liquidity sources became impaired or unavailable as asset quality problems were severe enough to negatively impact their earnings and capital positions. The lack of access to readily available secondary liquidity sources left many banks scrambling for balance sheet funding. The need for a comprehensive, well-developed contingency funding plan (CFP) that sufficiently addresses potential liquidity events and emergency cash flow requirements soon became a regulatory requirement.

Recent Events

The importance of funding and liquidity risk management was starkly evident in recent bank failures. Silicon Valley Bank, Signature Bank, and First Republic Bank faced liquidity challenges, leading to their downfall. While multiple factors contributed to these failures, inadequate liquidity management played a central role. As a direct result of the bank failures and tighter liquidity environment, the regulators released an "Addendum to the Interagency Policy Statement on Funding and Liquidity Risk Management: Importance of Contingency Funding Plan" in July 2023. The guidance reiterates the need for an actionable CFP that considers a range of possible stress scenarios. Additionally, the guidance called for depository institutions to test the operational readiness of their CFP by regularly testing their borrowing lines to ensure their staff are well versed in how to access the lines. Lastly, the guidance encourages depository institutions to incorporate the discount window as part of their contingency funding planning.

A Written Plan

All financial institutions, regardless of size or complexity, need to have a formal written CFP that clearly defines strategies for addressing liquidity shortfalls in emergency situations. While CFPs should be tailored to the business model, risk, and complexity of the individual institutions, most CFPs require management to:

- Establish a liquidity event-management framework (including points of contact and public relation plans),
- Establish a monitoring framework,
- Identify potential contingent funding events,
- Identify potential funding sources,
- Require stress testing, and
- Require periodic testing of the CFP framework.

Early Warning Triggers

A key component of a sound CFP is early warning triggers. Early warnings triggers serve as warning signs for identifying potential funding risks. They can be institution-specific or systemic. These triggers need to be measurable to properly alert management of potential funding risks. Some examples of common early warning triggers include the following:

- Deteriorating trend in loan performance, classified loans, nonperforming and past due loans,
- Decline in regulatory capital levels,
- Significant decline in earnings performance,
- Internal issues that could lead to negative news coverage,
- Significant declines in overall deposits, and
- Elimination of committed credit lines by counterparties.

Intertwine CFP with Stress Testing

Institutions should conduct stress tests regularly for a variety of institution-specific and marketwide events across multiple time horizons. Liquidity stress testing involves running various low,

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moderate, and high impact scenarios through the balance sheet to expose potential weaknesses or vulnerabilities. The results of stress tests should also play a key role in shaping the institution's contingency planning. In short, liquidity stress testing exposes vulnerabilities and the CFP provides a roadmap to address them, ensuring the institution can weather the storm.

Summary

In conclusion, community banks must recognize that a robust CFP is not just a regulatory requirement—it is a strategic imperative. By proactively addressing liquidity risk through a well-prepared CFP, community banks can safeguard their stability, protect their depositors, and continue serving their communities effectively. It's never a bad time to dust off your current CFP and make some enhancements.

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