XV. LIQUIDITY

Liquidity is the ability to fund future asset growth and/or pay liabilities, in a timely manner, at a reasonable cost. Banks use a variety of funding strategies to support credit card portfolios. They often rely on a mixture of borrowings, brokered deposits, and securitization activities, and, as such, banks with substantial credit card holdings might exhibit a relatively high volatile liability dependency ratio. The advent of credit card securitizations dramatically expanded funding avenues for credit card portfolios.

Liquidity, especially for banks with large and/or higher-risk credit card portfolios, is sensitive to negative trends in credit and capital. Reputation risk also plays a critical role in the banks' ability to access funds readily and at reasonable terms. Deterioration in a bank's financial condition, management composition, or other relevant issues might result in reduced access to funding. A failure by bank staff responsible for managing liquidity to consider all information (such as downgrading by a rating agency) that could affect external perceptions of the bank's soundness may result in unanticipated and critical liquidity problems.

SIMILARITIES TO OTHER BANKS

Examiners should confirm whether the bank has board-approved written policies and procedures for day-to-day liquidity management as well as MIS adequate to measure, monitor, control and report liquidity risk. They should direct their attention to situations in which management does not, as part of a process for the ongoing measurement of funding requirements, analyze liquidity under various scenarios and/or periodically review underlying assumptions for such scenarios. Other situations requiring examiner attention include those in which the relationships with lenders, other liability holders, and market participants is not diversified and/or is not reviewed periodically to ensure adequate funding capacity exists. A failure by management to establish contingency funding plans (CFP), including strategies to handle emergency cash flow shortfalls and liquidity crises, normally also elevates concern.

Determining whether liquidity is adequate requires analysis of the current liquidity position, present and anticipated asset quality, present and future earnings capacity, historical funding requirements, anticipated future funding needs, and options for reducing funding needs or obtaining additional funds. Although liquidity risk dynamics vary according to a bank's funding market, balance sheet, and inter-corporate structure, the most common signs of possible liquidity problems include rising funding costs, requests for collateral, a rating downgrade, decreases in accessible credit lines, or reductions in the availability of long-term funding. The necessary sophistication of a bank's liquidity management process depends on its business activities and overall level of risk. Nevertheless and regardless of the bank's size and complexity, the principles of liquidity management are straightforward: to be well-managed, liquidity risk must be identified, measured, monitored, and controlled in a timely and comprehensive manner. Because concepts in this and the prior paragraph are similar to liquidity concepts for all banks (whether or not they have credit card activities), examiners should refer to the Liquidity chapter of the Risk Management Manual of Examination Policies for additional guidance.

FUNDS MANAGEMENT POLICIES

Well-developed funds management policies and practices provide for forward planning while taking into account any unique characteristics of the bank's credit card activities. They take into account the overall objective of the bank regarding asset and liability mix and desired earnings and also consider anticipated funding needs and the means available to meet those needs. Policy guidelines, in general, provide for:

- Establishment of an asset/liability committee, including identification of the committee's responsibilities, meeting intervals, and board reporting requirements.
- Periodic review of the bank's funding structure, including maturity distributions, interest rates paid, securitization activities, and alternative funding sources.
- A means of computing the cost of funds and ascertaining if it is within established objectives.
- Acceptable asset management parameters such as type and amount of short-term investments held, loan pricing, credit limits, and scheduled minimum payment rates.
- Suitable target ratios and/or parameters by which to gauge liquidity and volatile liability dependency.
- Periodic review to determine if the bank is within the stated ratios and parameters.

CONTINGENCY FUNDING PLAN

A liquidity crisis can occur without warning and leaves little time for strategy development. Further, projections of funding sources and uses are inherently imperfect. Examiners look at the liquidity policy to determine if it provides for a CFP that addresses alternate funding in the event initial funding projections are notably incorrect or a liquidity crisis arises. A comprehensive CFP is especially critical for banks with credit card activities that have a substantial or increasing reliance on alternative or potentially volatile funding sources, such securitizations.

A CFP is a cash flow projection and comprehensive plan that forecasts funding needs and funding sources under different market scenarios, including aggressive asset growth or rapid liability erosion. It should be updated on a regular basis and should represent management's best estimate of balance sheet changes that may result from a liquidity or credit event. A CFP helps management to monitor liquidity risk, ensure that an appropriate amount of liquid assets is maintained, measure and project funding requirements during various scenarios, and manage access to funding sources. Concerns arise when the intricacy and sophistication of the CFP is not commensurate with the bank's complexity and risk exposures, activities, products, and organizational structure. A robust list of features of an effective, comprehensive CFP is included in the Liquidity chapter of the Risk Management Manual of Examination Polices. A few of those characteristics include:

- Assessing the possible range of liquidity events that the bank might encounter.
- Examining the potential for erosion (magnitude and rate of outflow) by funding source under optimistic, pessimistic, and status quo scenarios.
- Considering potential liquidity risk posed by activities such as securitizations.
- Analyzing and making quantitative projections of all significant on- and off-balance sheet funds flows and associated effects.
- Establishing indicators that alert management to a predetermined level of potential risks.
- Identifying the adequacy of contingent funding sources, including the identification of any back-up facilities, any limiting conditions related to their use, the circumstances under which the bank might use them, and the anticipated sequences of use.
- Assessing the potential for triggering legal restrictions on access to brokered deposits under Prompt Corrective Action (PCA) standards and for affecting the liability structure.

CASH FLOWS FOR CREDIT CARD LENDING

Banks, particularly those in which credit card operations constitute a major part of their business, are exposed to liquidity risk from the credit card portfolio(s). Payments remitted by cardholders can provide a significant amount of cash flow. However, under the structure of retail payment systems, as discussed in the Merchant Processing chapter, card issuers fund cardholders' purchases and cash advances shortly after the transaction, regardless of when cardholders will remit their payments. Many consumers use their cards more at certain times, such as around gift-giving holidays. Further, credit cards generally do not have a fixed payment amount or fixed amortization period. Both seasonal demand and payment activity can substantially impact the bank's current and anticipated liquidity position. The liquidity position is also impacted by funding growth from new accounts generated and paying amounts due on liabilities. The Associations also might call upon the bank to provide collateral protection (such as a deposit pledge) in the event elevated risk is evident.

The UBPR details, among other things, the dollar amount and the interest rate on borrowed funds and brokered deposits, along with balance sheet and trend analysis. The following ratios are not a substitute for the quantitative analysis normally performed during examinations and involving review of the UBPR. Rather, these ratios supplement UBPR reviews and are intended to provide insight to liquidity facets about the credit card portfolio.

- *Usage Ratio* – The usage ratio equals total outstanding credit card receivables (including those receivables securitized and sold) divided by total outstanding credit card receivables (including those securitized and sold) and outstanding credit card commitments. It measures the percentage of aggregate credit card lines currently in use by cardholders and can aid management in evaluating consumer usage patterns and predicting the timing and amount of funding increases to outstanding credit card lines. A thorough understanding of the influence of over-limit volumes and practices is necessary to effectively analyze this ratio.
- *Unused Credit Card Commitments to Total Assets* – This ratio measures the amount of unused credit lines to total assets. Analyzed in conjunction with the usage rate, it determines the amount of funding needed to meet current credit card commitments. For some banks, unused commitments exceed on-balance sheet assets and capital by several multiples.
- *Payment Rate* – This ratio measures monthly collection of principal, interest, and fees and is stated as a percentage of outstanding credit card receivables. Cardholder's payments may be available to support unfunded credit card commitments and/or future growth. A decline in the payment rate might be the result of normal seasonal payment patterns or could signal potential liquidity challenges.

In addition to receiving cash flows from cardholder payments, the bank might use funding mechanisms such as securitizing credit card receivables, soliciting deposits, or establishing other borrowings from other banks and/or affiliates. This chapter focuses on inter-company relationships, brokered and other rate sensitive deposits, and securitization. Other types of funding sources are addressed in the Risk Management Manual of Examination Policies.

INTER-COMPANY RELATIONSHIPS

Some banks often rely on the parent company or other affiliates as a primary source of borrowed funds. Banks of larger parent companies frequently hold a minimal volume of liquid assets, choosing instead to borrow from affiliates as loan demand occurs. This practice not only reflects the parent company's desire to manage these specialized entities on a consolidated basis to take advantage of a lower cost of funds, but also enables the bank to maximize the significant level of higher-yielding credit card receivables supported on the balance sheet. Sometimes liquidity management decisions and planning functions are performed at the corporate level. As such, it can be misleading to limit the review to only the mix and maturity of the bank's balance sheet. Rather, examiners should obtain holding company-wide information for the consolidated organization's approach to liquidity management. That information should detail items such as where decisions are being made and what funding alternatives or options are available within the organization. Centralized planning and decision making is not a problem in and of itself. Nevertheless, examiners must determine whether the bank's board of directors is effectively exercising its legal responsibility to manage the bank's independent and unique affairs. Examiners must also closely inspect the support of the parent and affiliates. While the bank might be able to benefit by drawing on funds available from affiliates, there are other cases where the bank might be called upon to support and provide funding for its affiliates.

BROKERED AND RATE SENSITIVE DEPOSITS

While core deposits can be a key funding source, many banks, including those engaged in credit card lending, have experienced difficulty attracting core deposits or are prohibited from soliciting demand deposits depending on their legal structure, and, thus, may look to wholesale funding sources, including, but not limited to, brokered deposits and other rate-sensitive deposits. Brokered deposits usually exhibit highly-volatile characteristics and carry higher interest rates than other sources of funds. The use of brokered deposits is limited to well-capitalized depository banks and, with an appropriate waiver, to adequately capitalized banks. Certain other deposits are increasingly being attracted over the Internet, through listing services, or through special advertising programs that offer premium rates to potential depositors who have little or no other relationship with the bank. These deposits may not fall within the technical definition of a brokered deposit but, nevertheless, reflect similar features. They are high-yielding products that are 1) attractive to rate sensitive customers who do not have any other significant relationship with the bank, 2) potentially volatile and risky, and 3) deserving of management's attention.

Safety and soundness concerns arising from the acceptance of brokered deposits by adequately capitalized banks are ordinarily addressed by the conditions imposed in granting the waiver. The examiner should not only verify compliance with those conditions but should also assess whether any unanticipated problems are being created. The acceptance of brokered deposits by well-capitalized banks is subject to the same considerations and concerns applicable to any other type of special funding. The concerns relate to volume, availability, cost, volatility, and maturities. They also relate to how use of the funding fits into the bank's overall liability and liquidity management plans.

The proper use of these types of deposits should not be discouraged. However, customers who focus exclusively on yield (whether considered brokered or not) are highly rate sensitive and can be a volatile source of funding because if more attractive returns become available elsewhere, these depositors may rapidly transfer funds to other banks or investments. The departure of such deposits is especially concerning when these types of deposits have been used as a consistent and heavy funding source to support ill-planned or rapid expansion of credit card portfolios. Examiners are tasked with determining whether management is aware of the number, magnitude, and features of these types of deposits. Examiners should not wait for the PCA provisions of Part 325 to be triggered, or the viability of the bank to be in question, before raising relevant safety and soundness issues with regard to the use of these funding sources to support the bank's credit card lending activities.

SECURITIZATION

Securitizations are another form of rate- and credit-sensitive wholesale funding sources. Credit card securitizations are considered one of the most important financing innovations in the card industry's history, particularly for those entities where a majority of their business is credit card lending. Banks that securitize essentially transform a pool of assets (in this case, credit card receivables) into cash. The securitization typically involves the transfer or sale of on-balance sheet credit card receivables to a third party who then issues asset-backed securities that are sold to investors in the public debt market. The investors are paid from the cash flow generated by the transferred receivables.

Credit card securitization activities sometimes represent a majority of a bank's total funding and can be an effective funding method. Given adequate planning and an efficient process, it can create a more liquid balance sheet as well as leverage origination capacity. However, it can also be a volatile funding source and is closely tied to asset quality. Certain structures as well as excessive reliance on a single funding vehicle increase liquidity risk. Considerations and risks associated with using securitizations generally include:

- *Early amortization clauses* - Most securitizations have early amortization clauses to protect investors if the performance of the receivables does not meet the specified criteria. When early amortization is triggered, the issuing bank begins paying principal to bondholders earlier than originally scheduled and has to fund new receivables that would have otherwise been transferred to the trust. Examiner attention should be directed to situations in which the issuing bank is not monitoring deal performance to anticipate cash flow and funding ramifications that may stem from early amortization clauses. While issuers can seek an early amortization waiver, there is no guarantee that a waiver would be granted, and such waivers usually require the bank to provide compensation which could be quite costly.
- *Limitations of residual interests* - If the issuing bank has a concentration of residual interests, its overall cash flow might be dependent on the residual cash flows from the performance of the underlying receivables. If that performance is worse than projected, the bank's overall cash flow will be less than anticipated. In addition, retained residual interests typically do not have an active market and are not acceptable collateral to pledge for borrowings.
- *Marketplace reputation* - An issuer's marketplace reputation is crucial to its ability to generate cash from future securitizations. If this reputation is damaged, issuers might not be able to economically securitize assets and generate cash from future sales of credit card receivables to the trust. This is especially true for banks that are relatively new to the securitization market. Also, if the loans held-for-sale are funded with short-term funding, the bank will have to find alternative funding sources if it is not able to sell the receivables quickly.
- *Investor demands* - A bank can sell and operate in the asset-backed market at a reasonable cost only if it is able to meet investors' demands. Card portfolios comprised of higher-risk assets or that reflect unusual volatility can be difficult to securitize and/or sell. For example, investors often quickly lose their appetite for risk in an economic downturn or when financial markets become volatile. Further, developments such as a rise in delinquencies or charge-offs could have significant implications. For example, the securitization of assets whose performance has deteriorated may result in a negative market reaction that could increase the spreads on a bank's subsequent issues. Or, similar deterioration may result in the bank having to increase enhancements (such as a spread account).
- *Time to implement* - A first-time securitization deal may take a few months (and maybe longer) to complete. Subsequent deals usually process quicker, and sometimes may take less than a month. Nonetheless, securitization still takes time to complete, and concerns would normally arise when that timing has not been factored into the bank's liquidity plans. Other credit facilities or funding sources (such as a **warehouse facility**) are usually needed for flexibility during deal negotiations.
- *Capital allocation* - Banks originating credit card receivables specifically for securitization sometimes depend too much on securitization markets to absorb new asset-backed security issues and might only allocate just enough capital to support a flow of assets to the securitization market. This strategy could cause funding difficulties if circumstances were to force the bank to hold assets on its books.

There are many ways management mitigates some of the risks associated with credit card securitizations. For example, they correlate maturities of securitizations with overall planned balance sheet growth and put adequate monitoring systems in place to alert it well in advance of an approaching trigger. An advance warning mechanism allows management time to consider preventative actions as well as factor the maturity and potential funding needs of the receivables into shorter-term liquidity planning. A failure by management to consider the liquidity implications of securitizations in the bank's day-to-day liquidity management and the CFP is cause for concern. Examiners should look for evidence that management has analyzed each actual or contemplated securitization for its impact on liquidity both as an individual transaction and as a component of the aggregate funds position. Discussion about credit card securitization activities, including its cash flows, is housed in the Risk Management Credit Card Securitization Manual.

ASSET MANAGEMENT

Typically, asset management of commercial banks requires managing the bank's asset structure through either the sale or planned run-off of readily marketable assets specifically set aside to meet liquidity needs. While this strategy is not necessarily uncommon to banks with credit card activities, these banks might have a limited amount of liquid assets because of their access to outside funding sources and their ability to devise other strategies such as setting cardholder minimum payment rates at higher levels and establishing lowering credit limits on new accounts. Although simplistic, these strategies allow management the possibility to increase cash inflows while limiting the potential for loan growth.

Banks can also sell their credit card portfolios. The value of a portfolio is predicated on several factors, including, but not limited to, yields, charge-off rates, delinquencies, and market conditions. Changes in any of the factors could dramatically affect the portfolio's valuation. Further, management cannot control certain conditions (market and economic) that exist at the time a portfolio sale would occur. These dynamics can make it difficult to determine whether a portfolio sale would sufficiently cover the bank's obligations without adversely impacting capital and earnings.

FUNDING CONCENTRATIONS

A failure by management to carefully consider potential funding concentrations when selecting liquidity strategies may result in an elevated risk profile. For example, if the provider could not provide additional funds or if it takes action to reduce the bank's access to funds, the bank may be left with few funding alternatives. There are no designated amounts or sizes that define a liability concentration. Rather, it is an amount that, if withdrawn alone or at the same time as a few other large accounts, would cause the bank to significantly change its day-to-day funding strategy. Concentrations most often are very credit sensitive, although collateralization may provide some mitigation depending on its quality and reliability. Examiners normally look to see whether management reviews reports on large funds providers and whether the reports properly consolidate funding obtained from a single provider or a closely-related group of providers.

RENT-A-BINS

Off-balance sheet liquidity risk often exists for issuing Rent-a-BIN (RAB) arrangements because the bank would be required to fund receivables in the event the partner is unable to fund (purchase) the receivables in a timely manner. Further, the bank may be required to post collateral to support programs evidencing elevated risk (even if the receivables are not held by the bank), and the collateral would not then be available for other uses. Issuing RABs are discussed in the Credit Card Issuing Rent-a-BINs chapter.

SUMMARY OF EXAMINATION GOALS - LIQUIDITY

Examiners are tasked with determining whether the bank will be able to support anticipated asset growth and meet its payment obligations in a timely manner and at a reasonable cost. In general, examiners' activities usually involve:

- Reviewing board and applicable committee minutes (in coordination with the EIC).
- Determining and understanding the bank's funding strategies.
- Identifying funding sources, frequency of use, current use, and remaining capacity. When securitization is used, examiners should reference the Risk Management Credit Card Securitization Manual.
- Evaluating the stability and diversification of borrowings or market instruments, including assessing whether any funding concentrations exist.
- Inspecting the composition, maturity distribution, and stability of deposits, including brokered deposits and other rate-sensitive deposits.
- Determining the bank's asset management strategy.
- Investigating the adequacy of liquidity policies and the CFP.
- Reviewing management's analytical analysis of the bank's liquidity.
- Considering the volume of and trends in unfunded commitments and cardholder payments.
- Determining whether management understands seasonal demands and whether those demands can be funded reasonably.
- Analyzing liquidity risks posed by issuing Rent-a-BIN arrangements.

The following items might signal current or future elevated risk and warrant follow-up:

- Ineffective management or oversight of the liquidity position.
- The absence of adequate policy limitations and guidelines.
- Aggressive growth strategies.
- Inadequate internal audit coverage.
- Inadequate information systems and/or reporting of the liquidity position.
- Use of rate sensitive funds not in keeping with the bank's strategy.
- Inadequate consideration of risk, with the focus exclusively on rates and yields.
- Significant shifts in the type of funding sources used.
- Involuntary reduction of available funding lines.
- High delinquency rates or deterioration in other card portfolio quality indicators.
- Deterioration in the general financial condition of the bank.
- Rating downgrades for the bank or its securitization activities.

These lists are not exhaustive, and examiners must exercise discretion in determining the expanse and depth of examination procedures to apply. If examiners identify significant concerns, they should expand procedures accordingly.