FEDERAL HOUSING FINANCE AGENCY

ADVISORY BULLETIN

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LIQUIDITY RISK MANAGEMENT

Introduction

This Advisory Bulletin establishes guidelines for liquidity risk management at Fannie Mae and Freddie Mac (the Enterprises). The guidelines describe the principles the Enterprises should follow to identify, measure, monitor, and control liquidity risk. The Division of Enterprise Regulation (DER) will evaluate the Enterprises' liquidity risk management programs as part of the examinations.

This guidance does not supplant existing regulations that pertain to risk management at the Enterprises.

Background

Liquidity risk is the risk that an Enterprise is unable to meet its financial obligations as they come due or meet the credit needs of its customers in a timely and cost-efficient manner. The Enterprises must be financially sound to perform their public missions and should have a comprehensive liquidity risk management framework to limit and control liquidity risk exposures.

Federal Housing Finance Agency (FHFA) Prudential Management and Operations Standards (PMOS) were effective August 7, 2012, and supplement existing FHFA regulations. They address ten separate areas relating to the management and operation of the Enterprises. Standard 5 (Adequacy and Maintenance of Liquidity and Reserves) highlights the need for each Enterprise to establish a liquidity management framework, articulate liquidity risk tolerances, and establish a process for identifying, measuring, monitoring, controlling, and reporting its liquidity position and liquidity risk exposures. In addition, Standard 5 includes requirements for conducting stress tests to identify sources of potential liquidity strain and requirements for establishing contingency funding plans (CFP). Standard 8 (Overall Risk Management Processes) establishes the responsibilities of boards of directors and senior management and the need for the Enterprises to establish risk management practices that measure, monitor, and control liquidity risk.

Guidance

Each Enterprise's risk management processes should enable it to identify, measure, monitor, and control their liquidity exposures. Management should be able to accurately identify and quantify the primary sources of risk to liquidity. To properly identify the sources of risk, management should understand both existing and emerging risks.

Key elements of an effective risk management process include adequate board of directors (board) and senior management oversight; appropriate liquidity management policies, procedures, and limits; appropriate risk measurement methodology, monitoring, and reporting systems; adequate management information systems and internal controls; an effective contingency funding plan; adequate levels of highly liquid assets; a funding strategy that provides appropriate diversification of funding, regularly assesses market access, and identifies alternative sources of funding; and active management of intraday liquidity and collateral.

Adequate board of directors and senior management oversight

The board is ultimately responsible for the liquidity risk assumed by the Enterprise and for guiding the strategic direction of liquidity management. The board, or a committee thereof, should establish and approve appropriate liquidity risk tolerances and limits, and should oversee the establishment and approval of liquidity management strategies, policies, and procedures, and review them at least annually. In addition, the board should have a fundamental understanding of the Enterprise's business activities and associated liquidity risks and should ensure that senior management has the necessary expertise to effectively manage liquidity.

Senior management oversees the daily and long-term management of liquidity and is responsible for carrying out the strategic objectives of the board. Senior management should develop liquidity risk management strategies, policies, and practices for approval by the board, implement sound internal controls for managing liquidity risk, and establish effective information systems and contingency funding plans. In addition, senior management must also establish reporting systems that produce timely and accurate information on the Enterprise's liquidity position and sources of risk exposure, and provide regular reports to the board.

Senior management should also maintain an organizational structure that clearly assigns responsibility, authority, and relationships for managing liquidity risk and ensure that personnel are appropriately trained and competent with regard to the Enterprise's established policies and tolerances.

Appropriate liquidity management policies, procedures, and limits

Each Enterprise should implement a risk management policy that addresses standards regarding day-to-day operational liquidity needs and plans for dealing with contingent liquidity needs, including potential temporary, intermediate-term, and long-term liquidity disruptions. Policies should specify the Enterprise's board established liquidity risk tolerances and procedures for controlling risk exposures within those limits. The policy should be consistent with the Enterprise's overall business strategy.

The policy should include: an enumeration of specific types of investments to be held for liquidity purposes, a description of the Enterprise's ability to access capital markets during periods of market stress, and the methodology to be used for determining the Enterprise's operational and contingency liquidity needs. Policy guidelines should include both quantitative and qualitative targets and should contain provisions for documenting and periodically reviewing assumptions used in liquidity projections. In addition, the policy should specify the nature and frequency of liquidity risk reporting for management and the board, and establish responsibilities and accountability at every level of the management structure, particularly in regard to actions to be taken if limits or positions are breached.

Appropriate risk measurement methodology, monitoring, and reporting systems

Each Enterprise should establish appropriate models to accurately measure its liquidity exposures, identify potential liquidity shortfalls, and simulate various market scenarios. Measurement systems should include robust methods for projecting cash flows and an Enterprise's liquidity needs over appropriate time horizons, including intraday, day-to-day, short-term weekly and monthly horizons, medium-term horizons of up to one year, and longer-term liquidity needs of one year or more. These systems should also measure tenor and provider concentrations to ensure reliance on certain funding structures or sources of funds is appropriately identified and controlled.

Cash flow and model assumptions should be reasonable, appropriate, and adequately documented, and should be periodically reviewed by senior management. Measuring and reporting systems should capture all significant on- and off-balance-sheet items and be adjusted as products or risks change.

Each Enterprise should ensure that assets are properly valued according to relevant financial reporting and supervisory standards. In determining potential liquidity needs and risk management strategies, the possibility of losses and deterioration in valuations from potential credit and market events should be considered and the Enterprise should take this into account in assessing the feasibility and impact of asset sales on its liquidity position during stress events.

Stress Testing

Each Enterprise should conduct stress tests on a regular basis for a variety of Enterprise-specific and market-wide stress scenarios across a range of time horizons. Stress test results should be used to identify sources of potential liquidity strain, to ensure that current exposures remain in accordance with established risk tolerances, and to analyze effects on the Enterprise's cash flows, profitability, and solvency. Management should use results of stress tests to adjust liquidity management policies and positions and to develop effective contingency plans.

Collateral Position Management

An Enterprise should have the ability to calculate all of its collateral positions in a timely manner, including the value of assets currently pledged relative to the amount of security required and unencumbered assets available to be pledged. An Enterprise should be aware of the operational and timing requirements associated with accessing the collateral given its physical location (*i.e.*, the custodian entity or securities settlement system with which the collateral is held). The Enterprises should also fully understand the potential demand for additional collateral arising from various types of contractual contingencies during periods of both market-wide and Enterprise-specific stress.

Management Reporting

Senior management should receive reports on the adequacy of an Enterprise's liquidity, including the level and trend of risks to the Enterprise's liquidity at least monthly; the board, or a committee thereof, should receive reports at least quarterly. If liquidity risk is high or if it is moderate and increasing, the reports should be more frequent. These reports should convey how much risk the Enterprise is assuming, its compliance with risk limits, and whether strategies are consistent with the board's expressed risk tolerance. Additional reportable items may include cash flow projections, critical assumptions used in cash flow projections, asset and funding concentrations, key early warning or risk indicators, funding availability, status of contingent funding sources, or collateral usage.

Adequate management information systems and internal controls

Senior management should establish adequate internal controls to ensure board-established liquidity risk policies and objectives will be achieved. Adequate internal controls should address items such as the Enterprise's compliance with policies, procedures, and regulations, and the effectiveness of risk measurement and reporting.

Internal audit should regularly review and evaluate the various components of the Enterprise's liquidity risk management process. These reviews should assess the extent to which the Enterprise's liquidity risk management practices comply with both supervisory guidance and industry sound practices, and should report instances of noncompliance to management and the board. The reviews should ensure that front- and back-office systems capably support current and projected operations.

An effective contingency funding plan (CFP)

Each Enterprise should have a formal contingency funding plan that clearly sets out strategies for addressing liquidity shortfalls in emergencies. The CFP should represent management's best estimate of balance sheet changes that may result from a liquidity event based on stress testing and scenario analysis. The CFP should be clearly integrated into the Enterprise's overall liquidity risk management framework. It should provide plans, courses of actions, clear lines of responsibility, and escalation procedures to ensure liquidity sources are sufficient to fund normal operations during potential temporary, intermediate-term, and long-term liquidity disruptions. The CFP should provide a framework with significant flexibility so an Enterprise can respond quickly to a variety of situations.

Effective contingency funding plans should identify Enterprise-specific and market-wide stress events and scenarios that may have a significant effect on an Enterprise's liquidity. A CFP should then identify minimum and maximum liquidity needs under various stress events and weigh alternative courses of action designed to meet those needs. The result should be a realistic analysis of cash inflows, outflows, and funds availability at different time intervals during the potential liquidity stress event in order to measure the Enterprise's ability to fund operations and address intraday liquidity needs. A CFP should also identify alternative contingent liquidity resources that can be employed under adverse liquidity circumstances.

To ensure the Enterprise can make timely and well-informed decisions, the CFP should clearly specify roles and responsibilities, including the authority to invoke the CFP and alternates for key roles, and include realistic action plans to execute the various elements of the plan for given levels of stress. The CFP should provide for more frequent and more detailed liquidity risk reporting as the stress situation intensifies and should establish a plan to deliver timely, clear, consistent, and frequent communication to internal and external parties, as appropriate.

A CFP should establish a monitoring framework for contingent events, including the use of early-warning indicators and event triggers. Early-warning signals should identify the emergence of increased liquidity risk and may include, but are not limited to, negative publicity concerning an asset class owned by the Enterprise, increased potential for deterioration in the Enterprise's financial condition, widening debt spreads, growing concentrations in assets or liabilities, difficulty accessing funding, or increasing funding costs.

Each Enterprise's CFP should be revised and updated regularly to reflect changes in market or business conditions. In addition, a CFP should be tested to assess its reliability and operational soundness under stress conditions. Testing should ensure that roles and responsibilities are up-to-date and appropriate; that legal and operational documents are up-to-date and appropriate; that cash and collateral can be moved where and when needed; and that contingent liquidity lines can be drawn when needed.

Adequate levels of highly liquid assets

An Enterprise should maintain adequate reserves of highly liquid assets, including adequate reserves of unencumbered, marketable securities that can be liquidated to meet unexpected needs. These assets should have no legal, regulatory, or operational impediments and should be held as insurance against a range of liquidity stress scenarios including those that involve the loss or impairment of typically available unsecured and secured funding sources.

The quality of unencumbered liquid assets is important as it will ensure accessibility during the time of most need. The size of the liquidity cushion should be supported by estimates of liquidity needs performed under an Enterprise's stress testing, as well as aligned with the risk tolerance and risk profile of the Enterprise.

A funding strategy that provides appropriate diversification of funding, regularly assesses market access, and identifies alternative sources of funding

The Enterprises should each establish funding strategies that provide effective diversification of funding. In general, funding concentrations should be avoided. The Enterprises should diversify available funding sources in the short-, medium-, and long-term. Funding strategies should take into account correlations between sources of funds and market conditions.

An essential component of ensuring funding diversity is maintaining market access. Market access is critical for effective liquidity risk management as it affects both the ability to raise new funds and to liquidate assets. Senior management should identify the main factors that affect the Enterprise's ability to raise funds and monitor those factors and should ensure that market access is being actively managed, monitored, and tested by the appropriate staff.

An Enterprise should identify alternative sources of funding that strengthen its capacity to withstand a variety of severe Enterprise-specific and market-wide liquidity shocks. Depending upon the nature, severity, and duration of the liquidity disruption, potential sources of funding include, but are not limited to, the following:

- Cash and highly liquid US government securities
- Issuance of unsecured or longer-term debt instruments
- Asset securitization
- Sale (either outright or through repurchase agreements) or pledging of liquid assets.

Active management of intraday liquidity and collateral

The Enterprises should actively manage their intraday liquidity and collateral to meet payment and settlement obligations in a timely manner under both normal and stressed conditions. Senior management should establish an intraday liquidity strategy that allows the Enterprise to identify time-specific and other critical obligations, and sequence payments based on priority. In addition, the intraday strategy should:

- Monitor and measure expected daily gross liquidity inflows and outflows.
- Manage and mobilize collateral when necessary to obtain intraday credit.
- Ensure that liquidity planners understand the amounts of collateral and liquidity needed to perform payment-system obligations when assessing the Enterprise's overall liquidity needs.

Related Guidance

12 CFR Part 1720 Safety and Soundness Standards, which addresses balance sheet growth and management and non-mortgage liquidity investments.

12 CFR Part 1236 Prudential Management and Operations Standards.

Advisory Bulletins are public documents that communicate guidance to FHFA supervision staff and the regulated entities on specific supervisory matters pertaining to the Federal Home Loan Banks, Fannie Mae, and Freddie Mac. This bulletin is effective immediately upon issuance. Contact Kari Walter, Senior Associate Director, Office of Supervision Policy or Renee Lindberg, Senior Examiner (Policy), Examination Standards Branch with comments or questions pertaining to this bulletin.