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Handbook: **Thrift Activities**

Subject: **Cash Flow and Liquidity Management** **Section: 530**

Examiner Guidance on Wholesale Borrowings

Summary: This bulletin provides guidance to examiners for the review of complex wholesale borrowings by savings association.

For further information contact: Your Office of Thrift Supervision (OTS) Regional Office or the Risk Management and Capital Markets Division of the OTS, Washington, DC. You may access this bulletin at our web site: www.ots.treas.gov. If you wish to purchase a handbook and a subscription to the updates, please contact the OTS Order Department at (301) 645-6264.

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In recent years, wholesale borrowings, including Federal Home Loan Bank advances, have become an increasing important source of funding for some savings associations. Wholesable borrowings frequently have attractive features, and can, if properly assessed and prudently managed, facilitate the management of interest rate and liquidity risks. The initial cost of the borrowings is often low when compared to other liabilities with similar maturities. However, certain wholesale borrowing instruments contain embedded options that can increase borrowing costs under certain circumstances. If not properly evaluated and prudently managed, these instruments have the potential to significantly increase an institution's sensitivity to interest rate and liquidity risks.

The growing use of wholesale borrowings and risks associated with the complex instruments make it increasingly important for examiners to assess the risks associated with these funding sources. Examiners should take the following steps, as appropriate, when evaluating a savings association with material amounts of wholesale borrowings:

1. **Review borrowing concentrations.** The examiner should review the institution's wholesale borrowings to determine whether the amount of borrowings from a single source poses an undue risk.

2. **Review borrowing contracts**. The examiner should review the institution's borrowing contracts for embedded options or other features that may affect the institution's interest rate and liquidity risks. In addition, examiners should review the collateral agreements for fees; collateral maintenance requirements, including triggers for increases in collateral; and other features that may affect liquidity and earnings.

3. **Review stress tests**. Examiners should review the institution's compliance with Thrift Bulletin 13a-2, *Structured Advances*. In particular, examiners should review the institution's procedures for identifying and monitoring the risks of the various terms of each borrowing contract, including penalties and option features. Examiners should determine whether management or an independent third party completed stress tests before the institution entered into the borrowing agreement, as well as periodically thereafter. The stress tests employed should cover a reasonable range of contractual triggers and external events, such as interest rate changes that may result in the exercise of embedded options or the termination of the borrowing agreement. In general, stress test results should depict the potential impact of these variables on the individual borrowing facility, as well as on the overall earnings and liquidity position of the institution.

4. **Review CMR Reporting and Impact on Interest Rate Risk Exposure**. Examiners should determine whether the institution has reported properly its complex borrowings on schedule CRM. In addition, examiners should assess the effect of the use of complex borrowings on the institution's interest rate risk exposure.

5. **Evaluate contingency plans**. Examiners should evaluate management processes for controlling liquidity and interest rate risks arising from wholesale borrowings. Proper controls include contingent funding plans in the event that borrowings or lines are terminated prior to the original expected maturity.

6. **Board and Senior Management Review.** Examiners should determine whether the asset/liability management committee or board of directors, as appropriate, is fully informed of the risks of complex wholesale borrowing agreements prior to engaging in the transactions, as well as on an ongoing basis.

7. **Suitability and Appropriateness**. Examiners should determine whether the instruments being used by the savings association are consistent with both the portfolio objectives of the institution and the level of sophistication of the institution's risk management practices. Institutions without the technical knowledge and risk management systems sufficient to adequately identify, monitor, and control the risks of complex wholesale borrowings should not use this funding.

Reliance on wholesale borrowings is consistent with safe and sound practices when management understands the risks of these activities and has systems and procedures in place to properly monitor and control the risks. Supervisors and examiners should take appropriate follow-up steps with respect to institutions that utilize complex funding instruments without an adequate understanding of the risks or without proper risk management systems and controls. Examiners should also seek corrective action when funding instruments or strategies are inconsistent with safe and sound practices.

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