
LIQUIDITY & RATE RISK: FASB proposes challenging rules

New financial instrument proposal needs scrutiny

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It seems as though 2010 began a decade that will see increased disclosure and documentation requirements for banks related to the risks associated with liquidity and interest rate risk. Beginning with the Interagency Guidance on Interest Rate Risk and Liquidity Risk Management and continuing through the Financial Accounting Standards Board's issuance of Topic 825 "Accounting for Financial Instruments," there appears no end in sight for additional reporting requirements.

Following the May 2010 FASB proposal of fair-value accounting, FASB accumulated feedback from stakeholders and determined that there was no way to represent all of the risks inherent in a financial instrument with a single measurement and concluded that supplemental disclosure was required. Therefore, FASB has issued the new exposure draft (2012-200) to amend ASC 825 and enhance the disclosure requirements for liquidity and interest rate risk.

With the issuance of this draft, FASB is attempting to provide information about the risk that banks will encounter difficulty meeting their financial obligations as well as the potential exposure of financial assets and liabilities to fluctuations in market interest rates. FASB is proposing

many new disclosures that provide varying degrees of information for users of financial statements.

Liquidity risk disclosures

Under this exposure draft, banks would be required to disclose a table (see sample in Exhibit 1) that includes the carrying amounts of the various classes of financial assets and liabilities segregated by expected maturities. The "expected" maturity differs from the instrument's "contractual" maturity when options are factored into the analysis. Potential options include call/put options, prepayments on loans, early withdrawals on time deposits, and decay assumptions for non-maturity deposits. [Editor's Note: Exhibits will open in a separate window. Several are very large sample financial documents that are not readable at the width of this article's text.)

One of the issues here is that the likelihood that an option on funding will be exercised may change depending on market (interest rate or credit) conditions. For example, if mortgage rates spike by one percentage point, prepayments will slow, and asset cash receipt expectations will decrease.

Taking this one variable another step, it is as meaningful to know the potential variation of cash flow as it is to know the expectation based on current market conditions. Many risk management practitioners compensate for this variable by performing multiple "what if" analyses, thereby presenting a more complete picture of the liquidity risk profile. It would be very difficult to capture this in the context of disclosure footnotes.

But what is "expected" for one bank may not be for another.

One of the biggest variables for a liquidity gap would be the placement of non-maturity deposits. Most community banks find themselves awash in liquidity right now, with deposits continuing to flow into the bank. Some issues that would have to be considered:

How should core vs. non-core balances be determined and reflected in the gap?

Should non-maturity deposits be reported with an estimated decay of the existing portfolio or net of expected growth?

Should all institutions be required to have a deposit study performed to determine the "reasonable" decay assumptions to incorporate into the analysis?

And for loans, how should commercial loan restructurings and lines of credit be handled?

These are many questions that still need to be answered to promote consistency across the reporting entities and to determine the ultimate usefulness of the information provided in these supplemental reports.

Under FASB's proposal, banks would also be required to provide disclosure on their cost of funds by reporting the total amounts and rates of time deposits issued and brokered deposits acquired over the previous four quarters (see Exhibit 2).

In addition to the disclosures mentioned above, banks would also be required to provide a table, broken down by asset class, for all of their available liquid funds.

Available liquid funds are defined for this purpose as unencumbered cash and highly liquid assets, as well as available borrowing lines, unpledged securities, and lines of credit.

Exhibit 3 provides an example of the table outlining a bank's liquid funds.

Most information regarding "traditional" liquid assets is already disclosed publicly in regulatory call report filings. The most substantive addition with this disclosure would be available borrowing lines. The dependability of the funding lines often hinges on collateralization with assets, often through the Federal Home Loan Bank, and done via a blanket lien agreement that affords the FHLB the legal right to certain assets such as loans. There could be some confusion for the user of the financial statement when reviewing these supplemental disclosures. The expected cash flow from an asset could be reflected on one table, while its collateral value is reflected elsewhere in the proposed evaluation of liquidity.

Effective liquidity management requires:

An understanding of reliable funding that is available to an organization.

A method of forecasting probable net funding demands over a given time horizon.

The knowledge of what hypothetical events might place a stress on that position.

A contingency plan for dealing with liquidity stress of varying degrees.

While these tables provide some useful information, additional analysis is required to most accurately and completely reflect the bank's liquidity risk profile.

Interest rate risk disclosures

The proposed exposure draft would require banks to prepare a repricing gap report that reflects carrying amounts of classes of financial assets and liabilities segregated by time intervals. This table would include, in addition to carrying amount, the weighted-average contractual yield by class for each interval as well as the total duration for each class (see Exhibit 4).

It is important to remember that a repricing gap only reflects the cash flow and repricing stream of a single rate scenario. In this regard, financial institutions need to carefully examine the convexity in each portfolio and change assumptions accordingly as cash flow estimates will vary in different scenarios due to options purchased and sold in the cash market as well as in derivatives form.

Therefore, readers of financial statements would really need disclosure on multiple repricing gaps to understand the degree to which cash flow and repricing behaviors may vary under different rate conditions.

In different rate scenarios, asset and liability cash flows could vary significantly.

Embedded cap/floor contracts will restrict repricing activity for variable/adjustable rate balance

sheet items (e.g. adjustable rate mortgages). Additionally, placement of non-maturity deposit balances (typically, the largest balance sheet item in community banks) is highly subjective given lack of contractual repricing and maturity dates.

Therefore, it is important to note that gap analyses could potentially lead to false conclusions regarding mismatch risk and potential margin/earnings sensitivity.

Disclosures of interest rate sensitivities for net income and shareholders' equity are also a requirement of this proposed exposure draft (see Exhibit 5). FASB is recommending the use of instantaneous and permanent parallel rate shocks of +/- 100 and 200 basis points as well as "hypothetical" rate curves (i.e. flattenings and steepenings of the yield curve).

Earnings-based simulation analysis is the most effective method of determining potential meaningful changes in margin/earnings levels under reasonable and plausible rate scenarios.

One could argue, however, that immediate rate shocks of 100 bps or greater are highly improbable scenarios. A review over a longer historical timeline (e.g. from 1970 to 2010) reveals that the average monthly change in the targeted fed funds rate has been 30 bps. The average rolling 1-year change in the funds rate has been 180bps--more consistent with a ramping of interest rates versus an instantaneous and permanent rate shock.

Note that there's more to this than just reporting the results in tables.

Under the proposal, banks will need to include written explanations to provide the users of the financial statements with an understanding of the bank's exposure to liquidity and interest rate risk. The bank must also clearly explain significant changes in the timing and amounts of the assets and liabilities in all tabular disclosures.

What are banks to do?

With the proposed disclosure requirements from FASB, as well as the proposed changes to liquidity measurements and monitoring with Basel III (Liquidity Coverage Ratio and Net Stable Funding Ratio measurements) banks are finding themselves having to deal with the potential for increased regulatory requirements. These could come at sizeable costs to the bank--either through the costs to prepare the reports or through lower earnings due to having to manage liquidity differently under new regulations.

Add to that the fact that the additional accounting disclosures do not line up with the regulatory requirements being proposed, and banks are being asked to jump through many more hoops than would be necessary if FASB and the regulators could agree on one set of requirements.

It is incumbent upon all bankers to fully understand the implications of the proposed disclosures and what they will mean to their institution. Evaluate the benefits to be derived and at what cost, and make certain to take the opportunity to comment on the proposed accounting standards update (Topic 825) prior to the September 25 deadline. FASB provides this opportunity to let your voice be heard on the proposed updates, so join your fellow bankers in letting FASB know your thoughts.

About Mark Haberland

Mark is a Managing Director at Darling Consulting Group. In this role, he works directly with financial institutions to help provide asset-liability management solutions. He provides support to clients in the areas of liquidity risk management, ALM modeling, regulatory compliance, and executive-level education.

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