Turks & Caicos Islands Financial Services Commission

Banking Institutions: Principles for Liquidity Risk Management

Guideline under section 43 of the Financial Services Ordinance

Introduction

1 Liquidity refers to the ability of a bank to generate or obtain sufficient cash (or equivalents) in a timely manner and at a reasonable price to enable it to meet its commitments as they fall due. It represents a particular risk for banks because of the process of maturity transformation whereby short term deposits provide a basis for longer term lending. A failure to maintain adequate liquidity may be catastrophic for an individual bank, and a single bank's liquidity problem may have the potential to create wider systemic repercussions in a jurisdiction.

2 This guideline sets out prudential considerations relating to the management and control of liquidity risk by institutions licensed under the Banking Ordinance. It is issued pursuant to section 43 of the Financial Services Commission Ordinance 2007 (‘the FSC Ordinance’) with a view to advising banks on the procedures and conduct expected of them in the operation of their licensed business. Section 43(4) of the FSC Ordinance provides that the Commission may take into account any failure to follow guidelines in determining whether there has been a contravention of the Ordinance, any financial services Ordinances or of any Code issued under the FSC Ordinance.

Approach to Liquidity Risk Management

3 Banks must establish and implement sound and prudent liquidity and funding policies. Senior management, with oversight from the Board of Directors, must develop policies that recognize the fundamental importance of liquidity, and that are appropriate to the particular size, nature and complexity of the operations of the bank. These policies must take full account of the environment within which banks operate – in particular, in the case of the TCI, they need to have regard to the absence of any ‘discount window’ or ‘lender of last resort’ mechanisms within the jurisdiction, as well as the very limited opportunities to realize assets quickly in a secondary market.

4 Banks need to put in place appropriate and effective internal controls around their liquidity risk management process. These include developing a properly documented policy framework, appropriate arrangements for identifying and managing liquidity risks, suitable mechanisms for ensuring timely reporting via management information systems, and regular independent oversight to ensure compliance with the control framework.

5 Banks' liquidity policies should be properly documented, in sufficient detail to explain their practical application and to demonstrate how they are linked to overall liquidity risk management strategies that are consistent with the bank's stated risk tolerance. They must be duly approved by the Board of Directors and subject to review on at least an annual basis to ensure that they remain adequate and up to date.

6 Banks need to put in place appropriate arrangements whereby senior management obtain regular detailed reports from those responsible for overseeing the liquidity position enabling them to monitor implementation of, and compliance with, the Board-approved liquidity policies and controls. The Board should receive and review, with sufficient frequency for appropriate action and response, regular reports on the liquidity position. In larger banks, this role is typically delegated to an Assets and Liabilities Committee (ALCO) or similar committee, subject to suitable reporting back to the Board. The ALCO and/or the Board should be aware immediately of new or emerging liquidity concerns (e.g. increasing funding cost or concentrations, increasing size of funding gap, reducing availability of alternative sources of funding, material or persistent breaches of operating limits, a decline in unencumbered high quality liquid assets or material changes in external market conditions). Arrangements in place for monitoring liquidity risk need to include a robust framework for the comprehensive projection of cash flows arising from assets, liabilities and off-balance sheet items over suitable time horizons.

7 The choice of analytical tools and the level of sophistication of internal information systems will reflect the size of the bank, the range and stability of its funding sources, the extent of both its US and non-US currency operations and whether it has more than a single operating unit. Where a bank has more than one operating unit (e.g. a branch or subsidiary in a different jurisdiction) it needs to ensure that arrangements are in place to ensure that worldwide liquidity is adequately monitored and controlled, either through a centralized liquidity management system, decentralization with limits imposed by, and regular reporting to, the centre, or the allocation of responsibility for foreign currency liquidity to the branch or subsidiary within the issuing country for each relevant currency. In the case of banks that operate as subsidiaries or branches of institutions headquartered abroad, TCI operations need to demonstrate that they have liquidity policies in place for the TCI operations, that their liquidity position is adequately monitored by parent or Head Office, and that suitable contingency plans are in place to deal with any funding difficulties which may emerge.

8 Senior management must also ensure that the bank's compliance with approved policies is continuously subject to scrutiny, including via independent checks on at least an annual basis; these should normally be conducted by an internal audit or compliance function.

9 Particular care is needed where a bank is conducting material amounts of business in currencies other than the US dollar. Where non-US dollar funding represents 10% or more of a bank's total funding, it must put in place a separate formal written foreign currency liquidity policy, providing how its foreign currency funding needs will be met,

including through use of the foreign exchange markets, currency swaps, standby lines of credit etc.

Managing Liquidity

10 Banks need to put in place a sound framework for managing their liquidity. This framework generally includes four fundamental elements, all of which need careful consideration and review:

- a prudent approach to maturity transformation, aligning the maturity structure of assets to synchronize reasonably with cash flows from maturing assets;
- maintenance of an appropriate stock of high quality marketable assets to cover the short-term maturity mismatch together with an allowance for unexpected needs;
- evaluation of ongoing funding requirements based on expected cash flows; and
- .consideration of the need for back-up sources of funding such as committed lines of credit which can provide flexibility in the event of any disruption to expected inflows.

While such aspects may be subject to minimum statutory requirements imposed by supervisory authorities, it is for the Board and senior management of each bank to determine the norms, in excess of any stipulated minimum requirements which they regard as prudent for day to day management purposes, having regard to the nature of the bank's operations.

Stock of Liquid Assets

11 In order to be treated as high quality for liquidity purposes, assets need to be able to be turned into cash quickly and without incurring a substantial price discount. This means essentially that there needs to be a deep and active secondary market in which they can be readily sold to a wide range of counterparties. Banks need to determine which securities they believe they are able to rely on as dependable sources of cash flow. Treasury bills or bonds issued or guaranteed by the US Federal Government clearly fall into this category. Other types of US public sector paper and issues by highly rated corporates may also qualify, subject to banks adopting a prudent approach in pricing such securities (e.g. by applying a standard 'haircut' to market values) as well as implementing concentration risk limits to try to manage associated credit risk. A bank's liquidity policies need to:

a) define clearly the role to be played by liquid assets within its overall liquidity management system;
b) establish the credit quality, marketability and valuation process for securities that are to be regarded as part of its stock of high quality liquid assets; and
c) set target levels for minimum holdings of high quality liquid assets.

12 When establishing minimum targets for its stock of liquid assets, a bank should review carefully its overall liquidity profile, including factors such as asset quality, stability of funding sources, cost and diversity of funding, short term funding requirements and, where applicable, the degree of integration of liquidity management

with that of a parent bank or overseas Head Office, as well as the financial strength of that parent or Head Office. The objective must be for the judgment as to prudent stock to be informed by the bank's expected funding requirement, based on expected cash flows and the scale of potential shortfalls in time of stress.

13 In determining its stock of liquid assets, a bank must consider not only credit quality and marketability but also the existence of encumbrances that would prevent the immediate sale of assets to meet unexpected cash shortages. Crucially, any assets pledged to secure specific obligations (e.g. against advances made to the bank or where assets are held as margin requirements for trades on an exchange) cannot be considered part of a stock of liquid assets for these purposes. In the case of certain settlement arrangements, some bank assets may be subject to intra-day encumbrances, typically released at completion of the settlement cycle: such a scenario should be identified and taken into account in framing the liquid assets policy.

Ongoing Funding Requirements

14 Banks need to analyze their funding requirements through the use of a maturity ladder which calculates the cumulative excess (or deficit) of funds at selected maturity dates. The requirements are determined by examining future cash flows based on the expected behaviour of assets, liabilities and off-balance sheet items. In assessing the funding surplus or deficit, a bank needs to consider at a minimum the following factors: the size of its stock of high quality liquidity relative to the surplus or deficit; the size of the surplus or deficit relative to total funding; the diversity of available funding sources; and the quality of its assets (since not all anticipated inflows may be received on a timely basis).

15 The most crucial time frame for active liquidity management is generally quite short and in most cases banks should give particularly close scrutiny to the shorter time-bands – notably, their next day position, their position out to one week and out to one month. However, longer term time-bands should also be kept under review.

16 Banks’ policies should apply limits to their short term funding requirements which conform with the bank’s demonstrated capacity to fund itself in the market at a reasonable price. These limits should apply on a total currency basis and, where material, by individual currency. Depending on a bank’s organizational structure, internal limits on short-term funding requirements may also be appropriate for individual legal entities or for different geographic markets.

17 Particular difficulties arise for banks in estimating cash flows from their liabilities where a significant element of funding may not be subject to any contractual maturity or repayment provisions. Banks therefore need to assess the ‘stickiness’ of their funding sources – that is to say, their tendency not to run off or be withdrawn quickly in conditions of stress. Where a bank is materially reliant on wholesale funding, it needs to assess regularly the likelihood that its funding lines may not be rolled over or that secured

or unsecured funding may dry up in times of stress. It must not be assumed that funding will automatically roll over. The availability of back-up facilities also needs to be monitored. Lines of credit should not be taken into account unless they are clearly committed (and normally subject to payment of a specific commitment fee). The stickiness of retail deposits must similarly be assessed, with due consideration given to factors such as the size of deposits, their likely interest-rate sensitivity, the geographic location of depositors and the particular channel used for deposits (e.g. direct, internet or brokered).

Scenario Testing

18 It is critical that a bank should not set its required liquidity stock and maximum funding gap figures without at the same time seeking to evaluate the potential impact on its cash flows of different stress conditions. Banks must conduct scenario tests on a regular basis to assess the likely impact of a variety of short-term and more protracted pressures that may affect an individual bank as well as market-wide stress scenarios. As a result of such tests, it may be necessary for banks to adjust their liquidity risk management strategies, policies and positions, as well as to develop appropriate contingency plans. Stress scenarios need to have regard to the nature of a bank's business, the scale and scope of its activities and vulnerabilities including from particular products and funding sources.

19 Banks need to take a conservative approach in devising stress scenario assumptions. Scenarios for consideration would include such events as:

- illiquidity in key asset markets and falls in the values of liquid assets;
- significant loss of retail funding;
- unavailability of secured or unsecured wholesale funding;
- additional margin calls or collateral requirements;
- rising contingent claims e.g. through increased drawdowns of committed lines extended by the bank;
- continued availability of lines of credit extended to the bank;
- impact of credit rating triggers;
- foreign currency convertibility and access to foreign exchange markets.

Managing Market Access

20 Banks need to review periodically how effectively they are maintaining prudent diversification of their liabilities, how successful they are in managing relationships with their depositors and, what avenues may be open to them for developing asset-sales markets. The level of reliance on individual funding sources (including by instrument type, provider of funds and geographic market) needs to be kept under review and internal limits considered for the maximum amount that it might be prudent to accept in the normal course from any individual counterparty or any specific funding market. Close monitoring of market developments may allow banks to take anticipatory action e.g. lengthening their funding profile. Consideration can also be given to establishing a presence in different funding markets to help maximize access and reduce concentrations.

At the same time, building strong relationships with providers of third party funding can provide an important line of defence in liquidity management. Frequency of contact and frequency of use of a funding source may offer some indication of the reliability of a funding source. In addition to asset sale possibilities, banks will also wish to look at options for arrangements under which they can borrow against assets held by them as a further element in managing their market access.

Contingency Planning

21 A bank's ability to withstand a specific disruption to its funding may also depend on the effectiveness of its formal contingency plans. A variety of components should be considered in setting effective contingency plans. These include:

- procedures to ensure timely and uninterrupted information flows to senior management;
- clear allocation of responsibilities within management in dealing with a crisis situation;
- action plans for altering normal asset and liability management patterns (e.g. marketing assets more aggressively, raising interest rates paid on deposits, selling assets intended to be held to maturity);
- prioritizing among alternative sources of funds;
- classifying borrowers and trading customers in order of importance in order to help maintain critical customer relationships; and
- planning strategies and procedures for communicating with the media.

Role of the Commission

22 The Commission assesses carefully the overall liquidity risk management framework in place within licensed banks as well as the resilience of their liquidity position; where weaknesses are identified, it seeks appropriate remedial action. This involves scrutiny of banks' policies and procedures, together with review of regular reporting of their liquidity position. The Commission will also review, through its monitoring procedures and on-site reviews of banks, the use made of scenario tests of banks' liquidity arrangements, together with their contingency plans, and the effectiveness of action taken by management to reduce any material vulnerabilities which are identified.

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