EASTERN CARIBBEAN CENTRAL BANK

GUIDELINES ON LIQUIDITY RISK MANAGEMENT
FOR INSTITUTIONS LICENSED
TO CONDUCT BANKING BUSINESS UNDER THE BANKING ACT

April 2006

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Banking Prudential Guidelines No.1 of 2006

The Eastern Caribbean Central Bank, in exercise of the powers conferred on it by section 36 of the Banking Act[1] makes the following Prudential Guidelines -

INTRODUCTION

I OVERVIEW

a) Sound liquidity management involves prudently managing assets and liabilities on a daily basis to ensure that cash inflows are suitably matched with cash outflows.

b) These guidelines seek to provide guidance to financial institutions licensed under the Banking Act, on minimum standards that should be implemented for the identification, measurement, monitoring and management of liquidity risk.

c) These guidelines highlight key principles for the management of liquidity risk and minimum requirements for liquidity risk management programmes. While the guidelines are general in nature and have broad applicability to all financial institutions, each institution should establish its own liquidity risk management policy to guide its activities. The liquidity risk management policy adopted by an institution depends largely on the size, sophistication, nature and complexity of that institution's activities.

II INTERPRETATION

[1] Anguilla Banking Act No. 9 of 2005;
Antigua and Barbuda Banking Act No. 14 of 2005;
Dominica Banking Act No. 16 of 2005;
Grenada Banking Act No. 19 of 2005;
Montserrat Banking Act No. 2 of 2005;
Saint Christopher and Nevis Banking Act No. 4 of 2004;
Saint Lucia – Not yet passed;
Saint Vincent and The Grenadines – Not yet passed.

The following terms are defined for the purpose of these guidelines:

a) ***Institution***

A financial institution licensed under Section 3 of the Banking Act.

b) ***Liquidity***

The extent to which an institution is able to satisfy its cash flow needs, including off-balance sheet commitments, at a reasonable cost as they arise.

c) ***Liquidity Risk***

The potential that an institution will not be able to meet its cash flow needs as they arise, in a cost effective manner.

d) ***Liquidity Management***

A composite of the strategies, systems and tools used by an institution to ensure that the institution is always able to satisfy its cash flow needs as they arise, in a cost effective manner.

e) ***Liquid Assets***

Cash, marketable securities and any other assets that can be easily and cost effectively converted to cash. These are usually assets nearing maturity or that will mature within 90 days[2].

f) ***Liquid Liabilities***

Demand or other liabilities at call or nearing maturity (maturing within 90 days).

g) ***Net Liquid Assets***

Liquid assets less liquid liabilities.

h) ***Required Reserves***

The portion of an institution's total deposit liabilities that is required to be maintained in accordance with Section 33 of the Eastern Caribbean Central Bank Agreement Act 1983.

[2] These excludes any encumbered assets.

i) ***Volatile Liabilities***

Those liabilities that are generally short-term in nature and are highly risk and price sensitive.

III APPLICATION

These guidelines apply to all financial institutions licensed under the Banking Act.

IV REGULATORY REPORTING REQUIREMENTS

a) Each institution shall submit a copy of its liquidity risk management policies and procedures to the ECCB. Changes to these policies and procedures shall be submitted to the ECCB as they occur.

b) Minutes of Risk Management Committee meetings shall be forwarded to the ECCB on a quarterly basis.

V COMMENCEMENT

These guidelines shall come into effect on 15 May 2006.

1 IDENTIFICATION AND MEASUREMENT

The proper identification and measurement of sources and uses of liquidity are critical to the liquidity management process.

1.1 Identification

The potential sources and uses of funds are important factors in managing liquidity. Management should understand the characteristics of fund providers, the funding instruments used, and any legal and regulatory constraints on funding. In order to accomplish this, management should have an understanding of the volume, mix, pricing, cash flows, concentration and risks of the institution's assets and liabilities. A periodic review of existing and potential funding sources should be conducted to ensure adequate management of liquidity risk.

1.2 Ongoing Liquidity Measurement

Liquidity is dynamic, and as such, it requires regular and intense monitoring. In assessing the adequacy of liquidity, an institution should consider the following:

1.2.1 The extent to which potential cash outflows are supported, over a specific period of time, by cash inflows (maturing assets or assets that can be easily and cost effectively converted into cash, cash on hand, and access to discretionary funding);

1.2.2 It's dependency on volatile liabilities;

1.2.3 The diversity or concentration of liabilities by individuals or groups of individuals;

1.2.4 The level of required reserves;

1.2.5 Interest rate trends;

1.2.6 The impact of non-performing assets; and

1.2.7 Off-balance sheet commitments.

1.3 Cash Flow Projections

A comprehensive projection of cash flows should include consideration of the following: short-term liquidity needs; loan growth; marketable securities; large liability maturities; off-balance sheet requirements; market environment; credit ratings[3]; and funding sources.

1.4 Maturity Gap Analysis

1.4.1 The adequacy of liquidity could also be assessed by use of a maturity gap analysis. A maturity gap analysis determines excess or shortage of funds at selected maturity dates by tracing cash inflows and outflows over a series of specified time periods. The time periods used in this analysis should be reflective of the maturity periods for the institution's assets and liabilities.

1.4.2 Maturity should be assessed based on the terms and conditions for assets and/or liabilities, as well as the behaviour of customers, based on their history and current relationship with the institution. The maturity gap analysis or any other method employed should separately identify cash flows by domestic currency and foreign currencies. A long-term funding gap often requires planning and time to obtain assets with appropriate maturities to offset the gap.

[3] This refers to the credit rating of funding sources, as well as instruments held by the institution for liquidity purposes.

2 POLICY AND CONTROL FRAMEWORK

Each institution should formulate a written liquidity management policy, identifying sources and amounts of liquidity necessary to ensure the continuation of the institution's operations, and establishing prudent limits on the degree of concentration of its sources and uses of funds. The policy must be supported by effective procedures to measure, achieve and maintain liquidity.

2.1 Board of Directors

The role of the board of directors in the management of liquidity risk should include *inter alia*:

i) Establishing and guiding the institution's strategy and tolerance for liquidity risk.

ii) Ensuring appropriate policies and procedures are established to guide the management of the institution's liquidity risk. These policies and procedures should be reviewed periodically; at least annually.

iii) Selecting senior managers with the authority, responsibility and competence to manage liquidity risk.

iv) Monitoring the institution's performance against the established liquidity risk profile.

v) Ensuring that liquidity risk is identified, measured, monitored and controlled.

vi) Specifying the content and frequency of management's liquidity reports to the board.

2.2 Asset/Liability Management Committee

Depending on the size and sophistication of the institution and its activities, an institution may need to establish a sub-committee of the board, known as the asset/liability committee (ALCO). The range of the institution's activities will determine the size of such a committee. The following minimum responsibilities are proposed for the ALCO:

i) Developing and recommending liquidity policies for approval by the board.

ii) Overseeing the implementation and maintenance of management information systems that effectively identify, measure, monitor, and control the institution's liquidity risk.

iii) Ensuring adherence to the lines of authority and responsibility that the board has established for managing liquidity risk.

iv) Reviewing periodic management liquidity reports.

v) Reporting comprehensively on the liquidity management programme to the board at least quarterly.

2.3 Liquidity Management Policy

An institution's liquidity management policy should at a minimum:

2.3.1 Establish clear guidance on the composition and role of the asset/liability committee.

2.3.2 Provide for periodic review of the deposit structure. The review should include the volume and trend of various types of deposits offered; maturity distributions of time deposits; interest rate paid on each type of deposit; prevailing market interest rate; limits on large time deposits; public funds; and non-resident deposits.

2.3.3 Ensure diversification of funding by origin and term structure. The policy should guard against concentration by individuals or groups of depositors; types of deposit instruments; market sources of deposit; geographical sources; term to maturity; and deposit currencies.

2.3.4 Address the establishment of adequate information systems for accurate and timely reporting to management.

2.3.5 Detail the method for computing the cost of funds and other key liquidity ratios.

2.3.6 Detail officers' borrowing limits and responsibilities.

2.3.7 Establish in conjunction with the loan policy, the method of loan pricing, including cost of funds, overhead and administrative costs; the types of loans that are permissible and desirable; the desired mix among loan types; and desired profits.

2.3.8 Establish the desired volume of loans compared to total deposits, total loans, upcoming loan maturities, and loan commitments outstanding.

2.3.9 Establish in conjunction with the investment policy, the desired investment mix, maturity distributions, projected interest rate movements, pledged requirements and available funds.

2.3.10 Require periodic calculations to determine the extent to which the institution is funding long-term assets with short-term liabilities. Target ratios or parameters for the funding of long-term assets with short-term liabilities should be established.

2.3.11 Provide for the review of alternate funding sources including stand-by facilities and lines of credit.

2.3.12 Include measures to ensure that liquidity ratios are maintained within prudential and statutory requirements. This does not preclude the institution from setting additional targets in relation to its internal measures of liquidity, as appropriate to the nature of its business.

2.3.13 Detail procedures for effectively utilising excess liquidity.

2.3.14 Establish procedures to be followed in the event of internal control breaches.

2.4 Internal Controls

2.4.1 Each institution should have an adequate system of internal controls over its liquidity risk management process. A fundamental component of the internal control system is regular independent reviews and evaluations of the effectiveness of the system and, where necessary, revising and enhancing internal controls. The results of such reviews should be submitted to the ECCB.

2.4.2 Attention should be paid to appropriate approval processes, limits, reviews, and other mechanisms designed to provide reasonable assurance that the institution's liquidity risk management objectives are achieved.

2.4.3 Regular evaluation and review of the risk management process should include ensuring that personnel are adhering to established policies and procedures and that these procedures actually accomplish the intended objectives. Policy breaches should receive the prompt attention of appropriate management and should be resolved according to the process established in the approved policies.

2.4.4 The periodic reviews of the liquidity management process should address any significant changes in the nature of instruments acquired, or in limits and internal controls. Such reviews should address any significant change that may impact the effectiveness of controls.

2.4.5 The internal audit function should periodically review the liquidity management process. Management should address deficiencies in a timely and effective manner.

3 LIQUIDITY MANAGEMENT FRAMEWORK

The management of liquidity is a fundamental component of the safe and sound operations of an institution. It is critical for management to measure and control funding requirements, manage access to funding and maintain a stock of readily available liquid assets to meet cash flow projections.

3.1 Role of Management

In the daily management of liquidity risk, management personnel should, at a minimum, be responsible for the following activities:

i) Implementing policies and procedures, i.e. translating the board's goals, objectives and risk tolerances into operating standards that are disseminated to staff.

ii) Measuring and monitoring the liquidity needs of the institution on an ongoing basis.

iii) Ensuring that liquidity is managed and controlled within the parameters of the liquidity policy.

iv) Establishing and utilising a method for accurately measuring the institution's current and projected liquidity needs.

v) Referring issues outside the scope of their authority to the ALCO.

vi) Reporting periodically (at least monthly) to the ALCO.

3.2 Funding Sources

3.2.1 Funding sources should be carefully reviewed on a regular basis to ensure diversity, reliability, stability and cost effectiveness.

3.2.2 An institution should determine the proportion of maturing assets it can reinvest given its policies on concentration and the associated risks. Likewise, the institution should consider the level of new loan requests expected to be approved, together with normal and abnormal withdrawals, and anticipated drawdown of commitments to lend.

3.2.3 The institution should consider those types of funding sources:

i) that are likely to remain available under any circumstance; and

ii) that are expected to reduce gradually if problems arise.

3.2.4 The institution should be mindful of maturing liabilities that can be called at the first sign of difficulties.

3.2.5 Concentration in funding sources exposes an institution to potential liquidity problems in the event of unanticipated claims on those funds, which may restrict flexibility in cash flow management. An institution should strive to identify and maintain stable funding sources, while minimising reliance on volatile liabilities.

3.3 Foreign Currency Liquidity Management

3.3.1 Institutions should have a measurement, monitoring and control system for liquidity positions in the major currencies in which they are active. Institutions should assess their aggregate foreign currency liquidity needs and the acceptable mismatch in combination with domestic currency commitments. Institutions should also undertake separate analysis of their strategy for each currency.

3.3.2 Where appropriate, institutions should set, and regularly review, limits on the size of cash flow mismatches for foreign currencies in aggregate, and for each significant currency in which the institution operates. Dependent on the level of foreign currency exposure, the institution should hedge its foreign currency obligations.

3.4 Management Reports

Liquidity management reports should include at a minimum:

i) A cash flow analysis highlighting short-term liquidity needs;

ii) Structure, level, and trend of liabilities and liquidity ratios;

iii) Calculation of cost of funds;

iv) Maturity gap analysis;

v) Levels of liquidity compared to established targets and resultant variance analysis; and

vi) Alternative funding sources and funds available, including lines of credit and stand-by facilities, and associated costs.

4 CONTINGENCY PLAN

Institutions should have a documented contingency plan in place with strategies for handling liquidity crises, including procedures for meeting cash flow shortfalls in emergency situations.

Institutions should have several sources of emergency funds, including unused credit facilities. The plan should detail the amount of funds the institution has available from these sources, and under what scenarios the institution could use them.

A contingency plan needs to outline procedures to ensure that information flows remain timely and uninterrupted, and that such communication provides senior management with precise information to facilitate timely and accurate decisions. A clear division of responsibility must be established so that all personnel understand what is expected of them during a crisis.

Made by the Eastern Caribbean Central Bank this 15th day of May 2006.

K Dwight Venner

Governor