LIQUIDITY MANAGEMENT AND REPORTING

GUIDANCE NOTES

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1 – EXECUTIVE SUMMARY

OVERVIEW

1.1 Liquidity risk is the risk that a firm is not able to fund increases in assets and meet obligations as they come due. Guidance on this subject is provided by the Basel Committee on Banking Supervision ("**BCBS**") in its paper "Sound Practices for Managing Liquidity in Banking Organisations". Liquidity risk arises because banks are in the business of maturity transformation; they take in deposits that are often repayable on demand or at short notice and use these deposits to fund credit facilities to borrowers over longer periods.

1.2 The Commission set out in its consultation paper on this subject, issued in November 2006, that it would not seek to generally prescribe methods to manage liquidity but that there is a need to ensure that all Jersey incorporated deposit takers are, and remain, sufficiently liquid. This will be achieved through requiring compliance with minimum standards for liquidity risk management. Changes to the reporting of liquidity risk to the Commission will be incorporated within the reporting required under Basel II from Q1 2008.

1.3 The risk management requirements are a minimum and are not intended to replace or represent an entity's liquidity management policy ("**LMP**"). The Codes of Practice for Deposit-taking refer entities to the BCBS paper for guidance. The Commission has set out additional guidance in Section 2 of this paper.

1.4 The Commission requires that all Jersey incorporated banks abide by standard mismatch limits for time periods out to one month from 1/1/2008. During the period before this, affected banks should approach the Commission with proposals so that appropriate and prudent behavioural adjustments can be agreed to reflect the actual liquidity risk they face. This will allow the Commission to assess liquidity risk for all banks using a consistent basis for mismatch limits while also recognising the unique behavioural aspects of their individual customer bases.

Behavioural adjustments

1.5 The purpose of allowing behavioural adjustments is to makes allowance for the fact that some assets/liabilities may behave differently to their contractual terms. A key example is "notice" deposits where customers may be able to access funds without notice by paying a penalty. The penalty may affect the behaviour of customers in normal circumstances but it does not inhibit the contractual ability of customers to access their funds.

1.6 Further guidance addressing this issue is contained in Appendix A: Guidance Regarding Behavioural Adjustments.

Cumulative Mismatch Limits:

1.7 The appropriate classification of liquid assets, coupled with establishing behavioural adjustments, enables a Bank to accurately demonstrate its liquidity risk profile.

1.8 For all Jersey incorporated subsidiaries, uniform maximum mismatch limits for [sight to < 8 days] and [sight to < 1 month] are established on this basis.

Banks' Internal Reporting

1.9 Each Jersey incorporated deposit taker will be required to monitor its liquidity daily, based on the stated methodology. This requirement must be incorporated within each entity's LMP. Daily monitoring is considered necessary because liquidity risk is one of the key prudential risks affecting deposit-taking institutions and liquidity positions can vary significantly on a daily basis.

1.10 All Jersey incorporated deposit takers will be required to calculate a daily liquidity requirement using this methodology, and immediately report to the Commission instances where any limit is exceeded.

2 GUIDANCE: LIQUIDITY MANAGEMENT POLICIES

INTRODUCTION

2.1 The Commission requires registered deposit takers to maintain appropriate systems for the management of liquidity risk. As part of the Commission's supervision of this requirement, it requires the provision to it of each deposit taker's liquidity management policy ("**LMP**"). It is the responsibility of senior management to prepare and maintain an appropriate LMP. The LMP should be approved by the board, or in the case of a branch of an overseas bank, by the senior manager. It is vital that the Board/senior manager understands the liquidity and funding needs of the deposit taker and ensures that an appropriate and prudent LMP is established.

2.2 The LMP should take into account all operations of significance and determine the sources, type and levels of liquidity that are to be maintained by the bank. One aim of the LMP should be to prevent the bank's funding from becoming unduly concentrated with respect to source, type, and term to maturity or currency. Where concentrations do exist, the bank will need to manage its assets and liquidity risk profile to mitigate the risks caused by the concentration. The Board or senior manager should satisfy itself that the bank has ongoing, appropriate and effective liquidity and funding management processes and that the bank's LMP is being adhered to.

2.3 The LMP should be regularly reviewed (minimum annually but more frequently if necessary) to take into account changing circumstances and to ensure that it remains appropriate and prudent. The LMP may be part of, or complement, the group LMP and any interdependencies should be explicitly addressed in the Jersey entity's LMP.

KEY ASPECTS THAT SHOULD BE CONSIDERED WHEN DRAWING UP A LMP

Nature of Business & Asset Types

2.4 The LMP needs to reflect the nature of the bank's business and the type of assets it is funding. This will fundamentally revolve around the term of commitments and established behaviour surrounding early repayments.

Funding types

2.5 The LMP will be influenced by the bank's funding strategy. The diversity of its sources of funding is important. Relying on just a few lines of credit is less robust than having access to a range of funding sources and types.

Customer Base

2.6 The nature of a bank's retail deposit base needs to be considered. For example, banks that have established relatively stable customer bases, perhaps through providing high levels of customer service and cross-selling of products, may enjoy greater "stickiness" of deposits than banks that rely on attracting deposits mainly through offering higher rates of interest.

Commission Reporting and Limit Requirements

2.7 The LMP should reflect both group and regulatory reporting requirements. Regulatory requirements include agreed behavioural adjustments, mismatch limits and procedures for reporting breaches.

Measuring, Reporting and Internal Limits

2.8 Each Jersey incorporated deposit taker will be required to monitor its liquidity daily, based on the Commission's stated methodology and immediately report to the Commission instances where any limit is exceeded.

2.9 The LMP needs to identify who is responsible for measuring and reporting liquidity internally within the bank, the frequency of internal reporting (usually daily) and how senior management monitors liquidity, including the framework of limits applied. This may be both broader and tighter than the minimum standards required by the Commission.

Relationships between group entities

2.10 The LMP should describe inter-relationships between group entities in respect of liquidity risk management, clearly identify procedures and define responsibilities. On the basis that many Jersey deposit takers provide funding to parent or group companies, it is particularly important that the effect of related maturity transformation is recognised in the LMP and that of their group or parent. For example, if funds placed with parent are treated as being repayable within one week by the Jersey deposit-taker within its LMP, those funds must receive the same (or more conservative) treatment within the parent's LMP.

Independence

2.11 The Commission looks for an appropriate degree of independence in Jersey subsidiaries in managing and maintaining their liquidity positions, as a first line of defence in the event that external developments make group assistance temporarily unavailable.

Marketable Assets

2.12 The LMP should identify classes of marketable assets that may be held and detail how these should be reported for liquidity purposes. The LMP should also detail any discounts that the assets should be subject to.

Behavioural Adjustments

2.13 The LMP should include details of any specific assets or deposit liabilities that may be subject to behavioural adjustments for liquidity purposes (see Appendix A: Guidance Regarding Behavioural Adjustments).

Contingency Planning

2.14 The LMP should identify the entity's Liquidity Contingency Plan ("**LCP**"), which may be an integral part of the LMP. The Commission must be provided with a copy if it is separate. Further guidance relating to LCPs can be found in Appendix B.

3 MAXIMUM MISMATCH LIMITS

3.1 The Commission measures a bank's liquidity by expressing net cumulative mismatches as percentages of total deposit liabilities, once behavioural adjustments have been made.

3.2 The Commission has, for Jersey incorporated deposit takers, set standard limits for maximum negative mismatch percentages permitted. Any breach of the mismatch limits should be reported immediately, with an explanation of the cause. Any breaches must be remedied promptly and action taken to prevent future similar breaches.

3.3 The Commission only sets maximum mismatch limits for the cumulative mismatch reported for the time periods [sight to < 8 days] of 0% and [sight to < 1 month] of –5%. This is because mismatches are normally only a concern over shorter time horizons. Over longer time horizons there is more opportunity to correct mismatches by adjusting the mix of assets and liabilities in good time.

3.4 Adherence to these limits must be monitored daily and any breaches must be reported to the Commission immediately.

APPENDIX A:

GUIDANCE REGARDING BEHAVIOURAL ADJUSTMENTS

A.1 **Rationale for Behavioural Adjustments**

The behaviour of banks' deposits is central to their liquidity. The actual cash flows from a bank's deposit liabilities may have little relationship with contractual maturity. In particular, only a small percentage of demand deposits are likely to be withdrawn on any one day, and fixed term deposits are often renewed automatically on each maturity date. This behaviour reflects customers' desire to maintain a certain level of availability in respect of their savings, rather than a specific intention to withdraw funds.

Reporting banks should note that branches of banks incorporated in other jurisdictions should report liquidity risk to the Commission on a contractual basis only.

In order to most accurately reflect the behaviour of a specific subsidiary's deposit liabilities, the Commission will consider proposals for reports to be submitted on a behaviourally adjusted basis. Such proposals will be agreed with on a case-by-case basis, taking into account the factors outlined in A.3, A.4 and A.5.

A.2 **Overview of the Commission's Approach to Behavioural Adjustments**

The Commission requires deposit takers to have prudent liquidity management policies in place, together with appropriate systems to measure and monitor liquidity, and to ensure that policies are adhered to. Policies should reflect Commission requirements and may take into account any prudent level of behavioural adjustments agreed between the Commission and the bank.

Liquidity limits exist to ensure that a Jersey incorporated deposit taker has a sufficient pool of available funds or liquid assets to enable it to meet its obligations in times of liquidity stress or disruption. As banks' business and risk profiles differ significantly, relevant factors and their impact for individual banks during a period of liquidity stress will vary significantly and will need to be fully taken into account before a prudential level of behavioural adjustment can be agreed.

It should be noted that the Commission will monitor and assess banks' behavioural adjustments on an ongoing basis. It may not always consider it appropriate for behavioural adjustments to be applied. In some instances, the Commission may require a Jersey incorporated deposit taker to maintain a stock of liquidity, either in the form of placements with third party banks, or in the form of holdings of investments that meet the Commission's definition of marketable investments for the purpose of reporting liquidity.

A.3 **Deposit Liabilities - The Commission's Requirements**

The Commission classifies deposits into three broad groups:

- Wholesale:

  This includes deposits from banks or building societies (including non-committed funding from other group companies) and deposits from large corporates, international life companies, central governments and their agencies (or equivalent bodies). These are potentially the first that would be withdrawn in the event of liquidity disruption. The Commission does not consider that behavioural adjustments in respect of wholesale deposits are appropriate.

- Corporate:

  This may include deposits from, or controlled by, small and medium sized enterprises, trust companies, collective investment schemes, investment managers, accountants and lawyers. This represents the large middle area between wholesale and retail deposits. Typically, these deposits will be substantially "stickier" and less price sensitive than wholesale. It should be noted that deposits introduced from firms with a fiduciary responsibility to their clients are considered considerably less "sticky" than retail deposits.

- Retail

  These include deposits placed by individuals in their own names. Deposits from investment companies and other corporate vehicles such as Special Purpose Vehicles ("SPVs") would normally be regarded as "Corporate" deposits, other than personal investment vehicles being managed by the beneficial owners. Retail deposits tend to be most stable and therefore may attract a higher behavioural adjustment.

The Commission will require Jersey incorporated deposit takers to analyse the following factors when presenting an application for behavioural adjustments. Please ensure that all are addressed so that the Commission can adequately determine the appropriate level of these adjustments.

a) Deposit Profile

- Deposit mix – retail/corporate/wholesale deposits as percentages of total deposits

- Deposit concentration (as defined by the bank) by depositor and connected parties, sector, industry, or geographic classification.

b) Product Profile

- Core products and their contractual liquidity profiles.

c) **Deposit behaviour analysis**

- The "stickiness" of deposits by product. The bank's own statistical analysis should be provided. It may be agreed that further analysis is necessary to support the behavioural adjustments requested.

- Numbers and values of new and closed accounts.

A.4 Behavioural Adjustments to Assets

A standard behavioural adjustment should be made in respect of overdrafts. Although technically repayable upon demand, overdrafts should be reported in the one to three month maturity band. All other behavioural adjustments with respect to assets have to be agreed with the Commission.

A.5 Methodology

When determining levels of behavioural adjustment, the Commission will, in addition to the above, examine a number of areas, including, but not limited to, the following:

- Degree of likely parental support in a liquidity disruption;

- Parent's standing;

- Parent's country of domicile;

- Level and quality of independent liquidity held, defined as placements with third party banks, or holdings of investments that meet the Commission's definition of marketable investments for the purpose of reporting liquidity;

- Nature of business;

- Business strategy;

- Asset mix; and

- Pricing policy.

The Commission will wish to discuss with the bank all relevant factors when considering the proposed behavioural adjustment.

A condition of registration will be issued to the bank, detailing the levels of adjustments that may be made.

The agreed adjustments will represent the percentage of the amount maturing in the [sight to less than eight days] and [eight days to one month] maturity bands that should be factored out of the contractual maturity bands and placed in an alternative maturity band. Different levels of adjustment may be allocated to different classes.

In certain circumstances, e.g. during a period of liquidity disruption, the Commission may wish to vary levels of behavioural adjustments.

A.6 Procedures and Systems

Only the behavioural adjustments agreed with the Commission should be reflected in the bank's LMP.

A bank should maintain ongoing analysis to support its case for behavioural adjustments. Such analysis should be made available to the Commission upon request. Should a bank's deposit or asset profile undergo material change, the bank should notify the Commission immediately, providing full details.

Banks may, at any time, apply to the Commission to alter the levels of behavioural adjustments previously agreed. Any request for an increase in the levels should be supported by empirical evidence.

Liquidity mismatch positions should be reported first on a contractual basis, following which allowance may then be made for behavioural adjustments.

APPENDIX B:

GUIDANCE: LIQUIDITY CONTINGENCY PLANS

B.1 Either within its Liquidity Management Policy ("**LMP**") or separately, a bank is expected to have a liquidity contingency plan ("**LCP**") covering the eventuality of it experiencing a liquidity crisis. The LCP should be designed to ensure that adequate liquidity is achieved at such times and should contain a number of key elements:

- The identification and definition of what constitutes a liquidity crisis;
- Early warning indicators, including the impact of external events not directly related to the financial condition of the bank;
- Actions to be taken;
- Roles and responsibilities;
- Management coordination and escalation of issues;
- Channels of communication;
- Communication with the Commission; and
- Scenario planning and testing of the plan.

B.2 A copy of the current LCP must be provided to the Commission.

B.3 **Early Warning Indicators**

The purpose of early warning indicators is to alert management to the possibility of an impending liquidity crisis so that action can be taken quickly and early enough to avert it.

Examples of such indicators, on the liability side may include:

- Unexpected and significant levels of withdrawals of retail deposits or non-renewal of wholesale funding facilities;
- Core retail deposit volumes falling below projected levels; and
- A shortening of deposit maturities and a rise in requests to break fixed term deposits.

And on the asset side:

- Retail advances growing faster than projected;

- A lengthening of loan maturities;
- Larger than expected drawdown of committed facilities;
- A significant rise in undrawn committed facilities;
- A rise in defaults and delinquencies; and
- Prepayments of loan facilities falling below historic behavioural norms.

The monitoring of these indicators should be part of normal liquidity monitoring procedures. The LCP should call for a series of predetermined responses in the event of any of the defined early warning indicators signalling the approach of an impending liquidity crisis. The aim of the plan should be to restore adequate liquidity for the current circumstances as soon as possible, while at the same time avoiding any unnecessary overreaction or negative publicity that could aggravate the problem.

B.4 Management Action

The individuals responsible for managing liquidity under near or actual crisis conditions should be identified, together with the actions that should be taken. These actions might include:

- Who should be notified locally, (including the Commission), and at group or parent level;
- What reports need to be produced and for whom; and
- Steps that can be taken to improve liquidity, for example:
    - Raising retail deposit interest rates;
    - Raising loan interest rates to discourage new borrowings and stabilise the balance sheet;
    - Realising liquid assets;
    - Capping balance sheet growth;
    - Increasing advertising; and
    - Issuing of public statements (both locally and internationally).

B.5 Funding

A contingency plan needs to cover the sources of funding that are likely to be available in the event of a liquidity crisis and which sources should prove most reliable. Potential sources of funds in a liquidity crisis would include:

- Outright sales, or sales under repurchase agreements, of marketable assets;
- Drawdown of committed facilities; and
- Funding from other group entities.

Banks should take into account that some customers may withdraw fixed term (where contractually permitted) or notice deposits under interest penalty and factor these balances into their contingency planning.

B.6 Effective management of a liquidity crisis can only be achieved if responsibilities are clearly defined in advance. Key aspects are:

- There should be a single source of authority on critical matters;
- For Jersey incorporated banks, the Treasury function should, in crisis circumstances, report directly to the Board;
- Each member of staff involved with liquidity management should be issued with explicit written instructions on how to proceed if any of the early warning indicators trigger a need for action;
- Clear lines of communication should already be established and senior management with defined responsibilities should be issued with clear guidance on what is expected of them in the event of a crisis; and
- All senior and executive management should have a copy of the LCP.