Jersey Financial Services Commission

GUIDANCE NOTE

BASEL III: LIQUIDITY MANAGEMENT AND REPORTING FOR JERSEY INCORPORATED DEPOSIT TAKERS

Guidance Note on the management of liquidity risk by Jersey incorporated deposit takers (**JIBs**), incorporating changes to reflect the introduction of Basel III and superseding for such firms the Guidance Note "Liquidity Management and Reporting", issued by the Jersey Financial Services Commission (**JFSC**) in May 2007.

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1 Executive Summary

1.1 Overview

1.1.1 Liquidity risk is the risk that a firm is not able to fund increases in assets and meet obligations as they come due. JIBs should take into account guidance on this subject provided by the Basel Committee on Banking Supervision (**Basel Committee**) in its paper "Principles for Sound Liquidity Risk Management and Supervision", issued September 2008 (**Basel Liquidity Principles**)[1].

1.1.2 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.

1.1.3 The *JFSC* does not seek to generally prescribe methods to manage liquidity but there is a need to ensure that all *JIBs* are, and remain, sufficiently liquid and hence the Code of Practice for Deposit-Taking Business (**Banking Code**) establishes a framework of requirements.

1.1.4 This framework has been revised to implement the new international standards for liquidity promulgated by the *Basel Committee* as part of its wider **Basel III** project, intended (as a whole) to address deficiencies in international standards identified as part of work undertaken after the 2007/2008 financial crisis.

1.1.5 The main components of the liquidity framework (as established by the *Banking Code)* are:

1.1.5.1 ongoing monitoring of the Liquidity Coverage Ratio (**LCR**) or the alternative Liquidity Mismatch Ratio (**LMR**), together with a requirement to report to the JFSC any instance where this falls below 100%;

1.1.5.2 each JIB to establish Liquidity Management Polices (**LMPs**) and Liquidity Contingency Plans (**LCPs**), which this document provides guidance on;

1.1.5.3 self-assessment of the adequacy and effectiveness of these to be included within its Pillar 2 self-assessment (the **ICAAP**), which formerly was concerned with capital adequacy maintenance only; and

1.1.5.4 Prudential Reporting requirements, including regarding compliance with the *LCR*/*LMR*, the Net Stable Funding Ratio (**NSFR**) and other liquidity-relevant data.

1.1.6 Changes to the reporting of liquidity risk to the JFSC will be incorporated within the prudential reporting required for the quarter ending 31 December 2018 and thereafter.

1.1.7 For the avoidance of doubt, the *JFSC's* liquidity risk management requirements are minimum requirements only. They are not intended to replace or represent an entity's *LMP*.

1.1.8 Section 2 of this paper provides guidance on the *LMP* that should be considered alongside that provided in the *Basel Liquidity Principles*. Section 3 provides guidance on the *LCP*.

1 https://www.bis.org/publ/bcbs144.htm

1.2 *LCR/LMR*

1.2.1 The purpose of establishing bank-specific adjustments to be used when computing the *LCR/LMR* (**LCR/LMR adjustments**) is to makes allowance for the fact that some assets/liabilities may behave differently to the minima/maxima established in the guidance issued on the Prudential Return for the *LCR*/*LMR*.

1.2.2 Guidance on the *JIB's* self-assessment of the appropriateness of *LCR/LMR adjustments* is contained in the Guidance Note Pillar 2 in Jersey, re-issued in May 2018 at the same time as this Note.

1.3 Reporting

1.3.1 The Banking Code requires:

1.3.1.1 each JIB to monitor its liquidity daily, based on the agreed methodology (*LCR* or *LMR*). 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 ; and

1.3.1.2 *JIBs* must immediately report to the *JFSC* any instances where the minimum level of 100% (or any higher level agreed) is not met.

2 Guidance: Liquidity Management Policies

2.1 Introduction

2.1.1 It is the responsibility of senior management to prepare and maintain an appropriate *LMP*. The *LMP* should be approved by the board. It is vital that the Board understands the liquidity and funding needs of the *JIB* and ensures that an appropriate and prudent *LMP* is established.

2.1.2 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 should satisfy itself that the bank has ongoing, appropriate and effective liquidity and funding management processes and that its *LMP* is being adhered to.

2.1.3 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*.

2.2 Minimum level

2.2.1 A *JIB* must measure its short-term liquidity via either:

2.2.1.1 the Liquidity Coverage Ratio (***LCR***): the ratio of *HQLA* held to the net predicted outflows, once agreed *LCR/LMR adjustments* have been applied; or

2.2.1.2 the Liquidity Mismatch Ratio (**LMR)**: the ratio of *HQLA* held plus gross predicted inflows to the gross predicted outflow, once agreed *LCR/LMR adjustments* have been applied.

2.2.2 The *Banking Code* establishes that *JIBs* must, in either case, maintain a ratio of at least 100% or higher level agreed. Any breach of the minimum level should be reported immediately, with an explanation of the cause.

2.2.3 Adherence to the minimum level must be monitored daily and any breaches, or reasonable grounds for believing that a breach may be about to occur, must be reported to the *JFSC* immediately. The notification should include an explanation of the circumstances and any actions to be taken to remedy the breach and prevent future similar breaches. As noted above, these are minimum requirements only, and the LMP may set higher internal requirements

2.2.4 The *JFSC* has not established a minimum level for the *NFSR* or other longer term metrics. This is because mismatches are normally only a concern over shorter time horizon whereas over longer time horizons there is more opportunity to correct mismatches by adjusting the mix of assets and liabilities in good time. Nonetheless, the *NSFR* metric must be reported (as part of prudential reporting) to provide insight on longer-term liquidity risk profile changes and banks are required to consider setting internal limits as part of their *ICAAP*.

2.3 Nature of business & asset types

2.3.1 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.

2.4 Funding types

2.4.1 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.

2.5 Customer base

2.5.1 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.

2.6 *JFSC* reporting and minimum level requirements

2.6.1 The *LMP* should reflect both group and regulatory reporting requirements.

2.6.2 Regulatory requirements include agreed behavioural adjustments, the minimum levels set for the *LCR*/*LMR* and procedures for reporting breaches.

2.7 Measuring, reporting and internal Limits

2.7.1 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 (i.e. the *LCR/LMR*, as established by the *Banking Code)*.

2.8 Relationships between group entities

2.8.1 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 *JIBs* 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 *JIB* within its *LMP*, those funds must receive the same (or more conservative) treatment within the parent's *LMP*.

2.9 Independence

2.9.1 Irrespective of whether permission has been granted to use the *LMR*, the *JFSC* looks for an appropriate degree of independence in *JIBs* in managing and maintaining their liquidity positions, as a first line of defence in the event that external developments make group assistance temporarily unavailable.

2.10 High Quality Liquid Assets (HQLA)

2.10.1 The *LMP* should identify classes of *HQLA* that may be held and detail how these should be reported for liquidity purposes. The *LMP* should also detail any day-to-day processes the *JIB* uses to determine eligibility, with the full assessment process to be described in the *ICAAP*.

2.11 *LCR/LMR adjustments*

2.11.1 The *LMP* should include details of any specific assets or deposit liabilities that are subject to *LCR/LMR adjustments* for liquidity purposes.

2.12 Contingency planning

2.12.1 The *LMP* should identify the entity's *LCP* which may be an integral part of the *LMP*.

2.12.2 Further guidance on *LCPs* can be found in **Section 3**.

3 Guidance: Liquidity Contingency Plans

3.1 Overview

3.1.1 A *JIB's LCP* must cover the possibility of it experiencing a liquidity crisis. The *LCP* may be a standalone document or be part of its *LMP* but may also be combined with recovery plans[2].

3.1.2 The *LCP* should be designed to ensure that adequate liquidity is maintained even in the event of a stress scenario and should contain a number of key elements:

3.1.2.1 the identification and definition of what constitutes a liquidity crisis;

3.1.2.2 early warning indicators, including the impact of external events not directly related to the financial condition of the bank;

3.1.2.3 mitigating actions to be taken by the *JIB*;

3.1.2.4 roles and responsibilities;

3.1.2.5 management coordination and escalation of issues;

3.1.2.6 channels of communication;

3.1.2.7 communication with the *JFSC*; and

3.1.2.8 scenario planning and testing of the plan.

3.1.3 Guidance on the content of an *LCP* can be found in the *Basel Liquidity Principles*, where the establishment of such plans is set out within Principle 11 and where the term "contingency funding plan" (and the acronym **CFP**) is used to refer to such plans.

3.2 Early Warning Indicators (EWIs)

3.2.1 The purpose of *EWIs* 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. These may relate to the *JIB*, its group or wider financial conditions.

3.2.2 Examples of such indicators , may include:

on the liability side:

3.2.2.1 unexpected and significant levels of withdrawals of retail deposits or non-renewal of wholesale funding facilities;

3.2.2.2 core retail deposit volumes falling below projected levels; and

3.2.2.3 a shortening of deposit maturities and a rise in requests to break fixed term deposits;

on the asset side:

3.2.2.4 retail advances growing faster than projected;

3.2.2.5 a lengthening of loan maturities;

3.2.2.6 larger than expected drawdown of committed facilities;

3.2.2.7 a significant rise in undrawn committed facilities;

2 See guidance on recovery plans contained within the Guidance Note "Pillar 2 in Jersey", issued by the JFSC in May 2018, available at http://www.jerseyfsc.org/banking-business/policy-statements-and-guidance-notes/

3.2.2.8 a rise in defaults and delinquencies; and

3.2.2.9 prepayments of loan facilities falling below historic behavioural norms;

and qualitatively:

3.2.2.10 significant actual or potential reputational damage, including, as an example only, as a result of operational issues such as its website repeatedly crashing, loss of personal data, failure to process transactions or the uncovering of a rogue trader; and

3.2.2.11 negative market press.

3.2.3 Where *EWIs* have been established with respect to solvency recovery planning, consideration should be given to the use of such indicators to identify a potential liquidity crisis and vice versa. *JIBs* may establish a single set of *EWIs* that indicate an impending crisis supplemented with specific indicators for solvency and liquidity crisis indicators.

3.2.4 The monitoring of *EWIs* 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.

3.2.5 Plans should seek to minimise the risk of negative publicity that could aggravate the problem.

3.3 Management Action

3.3.1 The individuals responsible for managing liquidity under near or actual crisis conditions should be identified, together with the actions that should be taken. Up to date lists should be maintained listing those with primary responsibility and those responsible in case of absence.

3.3.2 Management actions might include:

3.3.2.1 Who should be notified locally (including the *JFSC*) and at group or parent level;

3.3.2.2 What reports need to be produced and for whom; and

3.3.2.3 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).

3.4 Funding

3.4.1 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:

3.4.1.1 Outright sales, or sales under repurchase agreements, of marketable assets;

3.4.1.2 Drawdown of committed facilities; and

3.4.1.3 Funding from other group entities.

3.4.2 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.

3.5 Management

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

3.5.1.1 there should be a single source of authority on critical matters;

3.5.1.2 the Treasury function should, in crisis circumstances, report directly to the Board;

3.5.1.3 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;

3.5.1.4 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

3.5.2 All senior and executive management should have a copy of the *LCP*.