



BANK OF JAMAICA

STANDARDS OF SOUND BUSINESS PRACTICES

LIQUIDITY MANAGEMENT

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LIQUIDITY MANAGEMENT

A. PURPOSE

This document sets out the minimum policies and procedures that each institution needs to have in place and apply within its liquidity management programme, and the minimum criteria it should use to prudently manage and control its liquidity.

Although this document focuses on the institution's responsibility for managing liquidity, and is intended to address liquidity management within the context of a strategic liquidity plan under ordinary or reasonably expected business conditions, liquidity management cannot be conducted in isolation from other asset/liability management considerations, such as interest and foreign exchange rate risk, or other risks. However, since liquidity determines the day-to-day viability of an institution, it must remain the principal consideration of asset/liability management.

Moreover, this document presents the management of liquidity undifferentiated as to currency denomination, since in principle, through the foreign exchange markets, commitments in one currency may be met by the availability of funds in another. However, institutions that conduct substantial business in foreign currencies need to make distinctions between the management of liquidity in domestic currency (Jamaican dollars) and that in other currencies.

B. DEFINITION

Liquidity is the availability of funds, or assurance that funds will be available, to honour all cash outflow commitments (both on- and off-balance sheet) as they fall due. These commitments are generally met through cash inflows, supplemented by assets readily convertible to cash or through the institution's capacity to borrow. The risk of illiquidity may increase if principal and interest cash flows related to assets, liabilities and off-balance sheet items are mismatched.

C. LIQUIDITY MANAGEMENT PROGRAMME

Managing liquidity is a fundamental component in the safe and sound management of all financial institutions. Sound liquidity management involves prudently managing assets and liabilities (on- and off-balance sheet), both as to cash flow and concentration, to ensure that cash inflows have an appropriate relationship to approaching cash outflows. This needs to be supported by a process of liquidity

planning which assesses potential future liquidity needs, taking into account changes in economic, regulatory or other operating conditions. Such planning involves identifying known, expected and potential cash outflows and weighing alternative asset/liability management strategies to ensure that adequate cash inflows will be available to the institution to meet these needs.

The objectives of liquidity management are:

- honouring all cash outflow commitments (both on- and off-balance sheet) on an ongoing, daily basis;
- avoiding raising funds at market premiums or through the forced sale of assets; and
- satisfying statutory liquidity and statutory reserve requirements.

Although the particulars of liquidity management will differ among institutions depending upon the nature and complexity of their operations and risk profile, a comprehensive liquidity management programme requires:

- establishing and implementing sound and prudent liquidity and funding policies; and
- developing and implementing effective techniques and procedures to monitor, measure and control the institution's liquidity requirements and position.

Liquidity Policies

Sound and prudent liquidity policies set out the sources and amount of liquidity required to ensure it is adequate for the continuation of operations and to meet all applicable regulatory requirements. These policies must be supported by effective procedures to measure, achieve and maintain liquidity.

Operating liquidity is the level of liquidity required to meet an institution's day-to-day cash outflow commitments. Operating requirements are met through asset/liability management techniques for controlling cash flows, supplemented by assets readily convertible to cash or by an institution's ability to borrow.

Factors influencing an institution's operating liquidity include:

- cash flows and the extent to which expected cash flows from maturing assets and liabilities match; and

- the diversity, reliability and stability of funding sources, the ability to renew or replace deposits and the capacity to borrow.

For regulatory purposes an institution is required to hold a specific amount of assets classed as "liquid", based on its deposit liabilities. Generally, undue reliance should not be placed on these assets, or those formally pledged, for operating purposes other than as a temporary measure, as legally they may not be available for encashment if needed.

In assessing the adequacy of liquidity, each institution needs to accurately and frequently measure:

- the term profile of current and approaching cash flows generated by assets and liabilities, both on- and off-balance sheet;
- the extent to which potential cash outflows are supported by cash inflows over a specified period of time, maturing or liquefiable assets, and cash on hand;
- the extent to which potential cash outflows may be supported by the institution's ability to borrow or to access discretionary funding sources; and
- the level of statutory liquidity and reserves required and to be maintained.

Essentially, operating liquidity is adequate if the institution's approaching cash inflows, supplemented by assets readily convertible to cash or by an institution's ability to borrow are sufficient to meet approaching cash outflow obligations. In this context, because the timing and amount of these cash flows are not completely predictable because of risks such as credit defaults, and events including honouring customer drawdowns on credit commitments, deposit redemptions, and prepayments, either on mortgages or term loans, sound and prudent liquidity policies must deal with this uncertainty by carefully controlling the maturity of assets, ensuring assets are readily convertible to cash, or securing sources to borrow funds.

Liquid assets should have the following attributes:

- diversified, residual maturities appropriate for the institution's specific cash flow needs;
- readily marketable or convertible into cash; and
- minimal credit risk.

Holding assets in liquid form for liquidity purposes will often involve some loss of earnings capacity relative to other investment opportunities. Nevertheless, the primary objective with respect to managing the liquid asset portfolio is to ensure its quality and convertibility into cash.

Liquidity lines and funding facilities may also have a role within an institution's liquidity programme by helping an institution protect itself against temporary difficulties that might occur when honouring cash outflow commitments. Examples are the need to draw on credit facilities to meet unforeseen clearing commitments, and to meet credit commitments with drawdown at the customer's option. Undue reliance should not be placed on these facilities (including those that may be irrevocable or for which a fee is paid) as substitutes for traditional funding sources, as they are generally very short term in nature, they are costly compared with other funding sources, and their availability could be withheld by the provider of the facility. Institutions using these sources for liquidity need to ensure that the provider of a facility has an appropriate credit standing and capacity.

Funding Policies

Deposit liabilities are the primary source of funding for all institutions. In this context, an important element of an institution's liquidity management programme is the diversification of funding by origination and term structure. Each institution needs to have explicit and prudent policies that ensure funding is not unduly concentrated with respect to:

- individual depositor;
- type of deposit instrument;
- market source of deposit;
- term to maturity; and
- currency of deposit, if the institution has liabilities (both on- and off-balance sheet) in foreign currencies.

The primary funding risk is the unplanned deposit withdrawal or the reduced rate of deposit renewal at the time of maturity. Deposits may decline due to a loss of confidence in the institution, a general decline in savings, more attractive investments elsewhere, or as a result of other factors.

Concentrated funding sources leave the institution open to potential liquidity problems as a result of such unexpected deposit withdrawal and may also restrict an institution's flexibility in managing its cash flow. Institutions with excessive funding concentrations may require additional liquid assets.

In the context of foreign currency deposits, funding policies also need to ensure that foreign currency cash flows are prudently managed and controlled within the policies and procedures set out under the institution's foreign exchange risk management programme.

Liquidity Management and Control Procedures

Each licensee needs to develop and implement effective and comprehensive procedures and information systems to manage and control liquidity in accordance with its liquidity and funding policies. These procedures must be appropriate to the size and complexity of the institution's liquidity and funding activities.

Internal inspections/audits are a key element in managing and controlling an institution's liquidity management programme. Each institution should use them to ensure that liquidity management complies with liquidity and funding policies and procedures. Internal inspections/audits should, at a minimum, randomly test all aspects of liquidity management in order to:

- ensure liquidity and funding policies and procedures are being adhered to;
- ensure effective controls apply to managing liquidity;
- verify the adequacy and accuracy of management information reports; and
- ensure that personnel involved in the liquidity management fully understand the institution's liquidity and funding policies and have the expertise required to make effective decisions consistent with the liquidity and funding policies.

Assessments of the liquidity management operation should be presented to the institution's Board of Directors on a timely basis for review.

D. ROLE OF THE BOARD OF DIRECTORS

The Board of Directors of each institution is ultimately responsible for the institution's liquidity. In discharging this responsibility, a Board of Directors usually charges management with developing liquidity and funding policies for the board's approval, and developing and implementing procedures to measure, manage and control liquidity within these policies.

A Board of Directors needs to have a means of ensuring compliance with the liquidity management programme. A Board of Directors generally ensures compliance through periodic reporting by management and internal inspectors/auditors. The reports must provide sufficient information to satisfy the Board of Directors that the institution is complying with its liquidity management programme.

At a minimum, a Board of Directors should:

- review and approve liquidity and funding policies based on recommendations by the institution's management;

- review periodically, but at least once a year, the liquidity management programme;
- ensure that an internal inspection/audit function reviews the liquidity and funding operations to ensure that the institution's policies and procedures are appropriate and are being adhered to;
- ensure the selection and appointment of qualified and competent management to administer the liquidity management function; and
- outline the content and frequency of management liquidity reports to the board.

E. ROLE OF MANAGEMENT

The management of each institution is responsible for managing and controlling the day-to-day liquidity of the institution according to the liquidity management programme.

Although specific liquidity management responsibilities will vary from one institution to another, management should be responsible for:

- developing and recommending liquidity and funding policies for approval by the Board of Directors;
- implementing the liquidity and funding policies;
- ensuring that liquidity is managed and controlled within the liquidity management and funding management programmes;
- ensuring the development and implementation of appropriate reporting systems with respect to the content, format and frequency of information concerning the institution's liquidity position, in order to permit the effective analysis and the sound and prudent management and control of existing and potential liquidity needs;
- establishing and utilizing a method for accurately measuring the institution's current and projected future liquidity;
- monitoring economic and other operating conditions to forecast potential liquidity needs;
- ensuring that an internal inspection/audit function reviews and assesses the liquidity management programme;
- developing lines of communication to ensure the timely, dissemination of the liquidity and funding policies and procedures to all individuals involved in the liquidity management and funding risk management process; and
- reporting comprehensively on the liquidity management programme to the Board of Directors at least once a year.

GLOSSARY OF TERMS

Assets/Liability Management

The management and control, within set parameters, of the impact of changes in the volume, mix, maturity, quality, and interest and exchange rate sensitivity of assets and liabilities on an institution.

Concentrated Funding

Occurs when an institution's liabilities contain an excessive level of exposure to individual depositor, type of deposit instrument, market source of deposit, term to maturity, and if the institution has liabilities (either on- or off-balance sheet) in foreign currencies, currency of deposit.

Credit Risk

The risk of financial loss resulting from the failure of a debtor, for any reason, to fully honour financial or contractual obligations to an institution.

Foreign Exchange Risk

The exposure of an institution to the potential impact of movements in foreign exchange rates. The risk is that adverse fluctuations in exchange rates may result in a loss in Jamaican dollar terms to the institution.

Foreign exchange risk arises when there are unhedged currency mismatches in an institution's assets and liabilities, and related cash flows (both on- and off-balance sheet) which are not subject to a fixed exchange rate vis-à-vis the Jamaican dollar. This risk continues until the open position is covered by means of a hedging transaction. The amount at risk is a function of the magnitude of potential exchange rate changes and the size and duration of the foreign currency exposure.

Hedging

A risk management technique to reduce or eliminate price, interest rate or foreign exchange risk exposures. The elimination or reduction of such exposures is accomplished by entering into transactions that create offsetting risk positions. The concept is that when an institution has an open position which entails a risk that it

wishes to avoid or minimize, the institution can undertake a further transaction which compensates for the risk and acts as a hedge. If the hedge is effective, any gain or loss on the hedged risk position will be offset by a loss or gain on the hedge itself.

Interest Rate Risk

The potential impact of movements in interest rates on an institution. Interest rate risk arises when an institution's principal and interest cash flows (including final maturities), both on- and off-balance sheet, have mismatched repricing dates. The amount at risk is a function of the magnitude of interest rate changes and the size and maturity structure of the mismatch position.

Liquid Assets

Cash and securities and other assets readily convertible to cash.

Liquidity

Liquidity is the availability of funds, or assurance that funds will be available, to honour all cash outflow commitments (both on- and off-balance sheet) as they fall due.

Liquidity Management

Managing assets and liabilities (on- and off-balance sheet), both as to cash flow and concentration, to ensure that cash inflows have an appropriate relationship to approaching cash outflows.

Liquidity Planning

Assessing potential future liquidity needs, taking into account changes in economic, regulatory or other operating conditions and weighing alternative asset/liability management strategies to ensure that adequate cash inflows will be available to an institution to meet these needs.

Operating Liquidity

The liquidity required to meet day-to-day cash outflow commitments, taking into account asset/liability management techniques for controlling liquidity through the management of cash flows, supplemented by assets readily convertible to cash or by the institution's ability to borrow.

Risk Management

The process of controlling the impact of risk-related events on the institution.

Risk Position

The amount of an institution's exposure to a particular risk.

Statutory Liquidity

The liquidity that an institution may be required to hold for statutory or regulatory purposes.