Guernsey Financial
Services Commission

Guidance on Liquidity Risk Management

2017

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1. Introduction

1.1 In September 2008 the Basel Committee on Banking Supervision (the "Basel Committee") issued a paper entitled "Principles for Sound Liquidity Risk Management and Supervision" (the "Principles'). The Principles provide detailed guidance on the risk management and supervision of funding liquidity risk and were adopted as part of the Commission's Guidance on Liquidity Risk Management (the "Guidance") issued in July 2009. In this revision of the Guidance the requirement for all Guernsey incorporated banks to apply all relevant aspects of the Principles remains in place.

The Basel Committee further strengthened its liquidity framework, complementing the existing Principles with the development of two new liquidity standards: the Liquidity Coverage Ratio ("LCR") and the Net Stable Funding Ratio ("NSFR"). The LCR[1] promotes short-term resilience of a bank's liquidity risk profile by ensuring that it has sufficient High Quality Liquid Assets ("HQLA") to survive a significant stress over 30 days. The NSFR[2] promotes resilience over a longer, 1 year time horizon promoting the funding of bank activities with stable sources of funding.

The Commission has adopted a minimum regulatory liquidity standard consistent with the LCR and has adopted the NSFR as a reporting requirement[3]. The LCR replaces the maximum mismatch limits, the minimum liquidity standard previously in place.

The Basel Committee has recognised that the LCR and NSFR are insufficient to measure all dimensions of a bank's liquidity profile and has therefore developed supplementary monitoring tools which can be used for ongoing monitoring of bank's liquidity risk. The Commission has put in place a monitoring tool framework which addresses the limitations of the minimum requirements and is appropriate for the jurisdiction.

1.2 Liquidity is the ability of a bank[4] to fund increases in assets and meet obligations as they come due, without incurring unacceptable losses.[5] 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.

Effective liquidity risk management helps ensure a bank's ability to meet cash flow obligations, which are uncertain as they are affected by external events

[1] "Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools", January 2013
[2] "Basel III: the net stable funding ratio", October 2014
[3] The NSFR has been designed by the Basel Committee as a minimum standard and, following a period of monitoring, the Commission may seek to implement the NSFR as a minimum standard in the future.
[4] The term bank as used in this document generally refers to those banks and branches licensed under The Banking Supervision (Bailiwick of Guernsey) Law, 1994.
[5] Source – 'Principles for Sound Liquidity Risk Management and Supervision', June 2008.

and other agents' behaviour. Liquidity risk management is of paramount importance because a liquidity shortfall at a single institution can have system-wide repercussions. It should be noted that there is no lender of last resort facility in Guernsey.

1.5 This guidance is effective from 31 July 2017.

2. Minimum Liquidity and Reporting Requirements

Liquidity Coverage Ratio

2.1 The Liquidity Coverage Ratio ("LCR") promotes the short-term resilience of the liquidity risk profile of banks by ensuring that they have sufficient High Quality Liquid Assets ("HQLA") to survive a significant stress scenario lasting 30 calendar days.

The LCR is calculated as follows:

$$\frac{\text{Stock of HQLA}}{\text{Total net cash outflows over the next 30 calendar days}}$$

A detailed description of the calculation of the LCR is set out in the Commission's LCR Guidance.

2.2 All Guernsey incorporated banks (unless the Commission's approval has been granted to apply the alternative Liquidity Mismatch Ratio approach - see section 2.5) are required to submit the LCR monthly return and to follow the applicable completion guidance as published by the Commission.

2.3 Banks reporting the LCR are required to maintain a LCR above or equal to 100% at all times.

2.4 Any breaches of the minimum LCR must be reported to the Commission immediately and remedied promptly. Action should be taken to prevent future similar breaches.

Liquidity Mismatch Ratio

2.5 The Commission may grant approval for the use of the LMR approach following written application by a bank. It is intended that the LMR would be used where a local bank is part of a group that is subject to consolidated liquidity requirements similar to the LCR and where there is significant reliance on group bank inflows.

2.6 The LMR is calculated as follows:

$$\frac{\text{Stock of HQLA + qualifying group inflows + other projected inflows (limited to 75\% of projected outflows)}}{\text{Total cash outflows over the next 30 calendar days}}$$

A detailed description of the calculation of the LMR is set out in the Commission's LMR Guidance.

2.7 All Guernsey incorporated banks with approval to apply the LMR approach are required to submit the LMR monthly return and to follow the applicable completion guidance as published by the Commission.

2.8 Banks reporting the LMR are required to maintain a LMR higher than 100% at all times.

2.9 Any breaches of the minimum LMR must be reported to the Commission immediately and remedied promptly. Action should be taken to prevent future similar breaches.

Net Stable Funding Ratio

2.10 The NSFR has been developed to ensure a stable funding profile in relation to the characteristics of the composition of an institution's assets and off-balance sheet activities. A sustainable funding structure is intended to reduce the likelihood that disruptions to a bank's regular sources of funding will erode its liquidity position in a way that would increase the risk of its failure and potentially lead to broader systemic stress. This metric establishes a minimum level of stable funding based on the liquidity characteristics of a bank's on- and off-balance sheet items over a one year horizon.

2.11 The NSFR is defined as the ratio of the amount of available stable funding to the amount of required stable funding. A detailed description of the calculation of the LMR is set out in the Commission's NSFR Guidance.

2.12 All Guernsey incorporated banks are required to report the NSFR as part of the applicable LCR or LMR monthly return and to follow the relevant completion guidance as published by the Commission.

Reporting

2.13 The reference date for the LCR and the LMR monthly returns is the last day of the month, with data submitted 28 calendar days later.

3. Additional Liquidity Monitoring

3.1 In addition to the Minimum Liquidity and Reporting Requirements the Commission also requires the reporting of additional liquidity information as follows.

Maturity Analysis

3.2 All banks, Guernsey incorporated banks and Guernsey branches, are required to complete Module 9 Maturity Analysis of their applicable BSL/2 quarterly return. This Module measures liquidity through the difference or mismatch between contractual inflows and outflows in various maturity bands. Banks should refer to the Module 9 Guidance to completing the Maturity Analysis module of BSL/2 for further details.

Prudential Information

3.3 Information on concentration of funding (connected deposits and ten largest depositors) and asset encumbrance is required to be reported by all banks under Module 8 of the BSL/2 quarterly return. Banks should refer to the Module 8 Guidance to completing the Prudential Information module of BSL/2 for further details.

Bank-specific Monitoring Tools

3.4 The Commission, on a case-by-case basis, may require additional reporting of bank's internal liquidity risk management reports. Principle 5 requires that banks employ a range of customised measurement tools, or metrics in managing their liquidity risk. The Commission may require additional reporting for example in periods of market-wide or idiosyncratic stress, where there has been a breach of a minimum requirement or where a particular, material aspect of a bank's liquidity risk is not adequately captured in the standard reporting framework. The nature and frequency of such reporting would reflect the particular circumstances of the request.

4. Liquidity Management Policy ('LMP')

4.1 The Commission requires Guernsey incorporated banks to take reasonable steps to maintain appropriate systems for the management of liquidity risk and to provide the Commission with a copy of their LMP for review. It is the responsibility of senior management to draw up the appropriate policy in the light of the particular circumstances of the bank. However, the LMP should be discussed and specifically ratified by the local Board.

4.2 It is important to distinguish between liquidity under normal conditions and liquidity under stressed and crisis conditions. In normal market conditions a bank that is perceived as financially healthy will have relatively easy access to funds from within group or its parent or to wholesale funds on the interbank market, and customers will react in a normal rational manner. However, if the market is under stress, liquidity may dry up and be less readily available.

4.3 Apart from stress conditions in the liquidity market as a whole, an individual bank may itself come under pressure if there are doubts about its financial position, if for example there are concerns about asset quality, earnings, or as a result of the failure of a similar institution. A bank may find it more difficult to raise funds in the interbank market and depositors may withdraw their funds. It is therefore important for banks to consider liquidity management under stressed or crisis conditions.

4.4 The Commission expects all Guernsey incorporated banks to conduct regular stress tests, including bank specific and market wide scenarios to identify sources of potential liquidity strain and to ensure that current exposures remain within the bounds of the bank's established liquidity risk tolerance. Further guidance on stress testing is contained in Appendix 1.

4.5 The LMP should be reviewed annually and any changes ratified by the Board to reflect changing circumstances and to ensure that it remains appropriate and prudent.

4.6 The main points that need to be considered when drawing up a LMP are given below (the list is not exhaustive):

Nature of business & asset types
The LMP needs to reflect the nature of the bank's business and the type of assets it is funding.

Funding strategy
The LMP should reflect the bank's funding strategy and acknowledge that the diversity of the 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
The nature of a bank's retail deposit base needs to be considered. Some banks have established relatively stable customer bases while others attract deposits by offering higher rates of interest that regularly place them in the "best buy" tables. Depositors who

look for the best interest rates are likely to move their deposits to another bank if it is offering better rates and therefore provide a less stable deposit base.

Commission requirements
The LMP should reflect both group and regulatory reporting requirements. The regulatory requirements may include LCR limits, LMR approval, reporting of any breaches, additional reporting requirements etc.

Measuring & reporting
A bank needs to employ a range of measurement tools or metrics as there is no single metric that can comprehensively quantify liquidity risk. The metrics should cover, as a minimum, static ratios (e.g. assessing the structure of the balance sheet) and a forward-looking view of liquidity risk exposures. As a minimum the Commission expects that the forward looking approach adopted by the banks will cover at least a two year period.

Relationships between group entities
The LMP should describe the inter-relationship between group entities in respect of liquidity risk management and clearly define procedures and responsibilities. On the basis that many banks provide funding to group or parent companies, it is particularly important that the effect of maturity transformation is recognised in their LMP. A particular emphasis will be put by the Commission, as part of its on-going supervision of liquidity risk management practices, on the Guernsey licensees' legal, and actual, ability to call on placements with group entities and parent organisations. This may entail an exploration by the Commission of group and/or parental liquidity. The Guernsey bank may be required to give evidence to the Commission as to how liquidity in the Guernsey bank can be assured where it has a dependency on the wider liquidity of the group or parent.

Independence
The Commission looks for an appropriate degree of independence for the local entity in managing and maintaining its own liquidity position, as a first line of defence, in the event that external developments make group assistance temporarily unavailable. This can be strengthened through the use of inter-bank deposits and marketable assets.

Marketable assets
The LMP should identify classes of marketable assets that may be purchased, and detail how these should be reported for liquidity purposes.

Treatment of currency
The LMP should include details of the bank's material exposure to foreign currency and how liquidity is addressed for such currency exposure. Whilst recognising that consolidated currency reporting assumes a high level of fungibility across currencies, this approach does not recognise the existence of settlement risk.

4.6 Guernsey incorporated banks must demonstrate adherence to the Principles. This should be done by production of an LMP in line with the Principles to be specifically agreed by the Commission.

5. Fundamental principles for the management of liquidity risk

Principle 1
A bank is responsible for the sound management of liquidity risk. A bank should establish a robust liquidity risk management framework that ensures it maintains sufficient liquidity, including a cushion of unencumbered, high quality liquid assets, to withstand a range of stress events, including those involving the loss or impairment of both unsecured and secured funding sources.

Principle 2
A bank should clearly articulate a liquidity tolerance that is appropriate for the business strategy of the organisation and its role in the financial system.

Principle 3
Senior management should develop a strategy, policies and practices to manage liquidity risk in accordance with the risk tolerance and to ensure that the bank maintains sufficient liquidity. Senior management should continuously review information on the bank's liquidity developments and report to the board of directors on a regular basis. A bank's board of directors should review and approve the strategy, policies and practices related to the management of liquidity at least annually and ensure that senior management manages liquidity risk effectively.

Principle 4
A bank should incorporate liquidity costs, benefits and risks in the internal pricing, performance measurement and new product approval process for all significant business activities (both on and off balance sheet), thereby aligning the risk taking incentives of individual business lines with the liquidity risk exposures their activities create for the bank as a whole.

Principle 5
A bank should have a sound process for identifying, measuring, monitoring and controlling liquidity risk. This process should include a robust framework for comprehensively projecting cash flows arising from assets, liabilities and off-balance sheet items over an appropriate set of time horizons.

Principle 6
A bank should actively monitor and control liquidity risk exposures and funding needs within and across legal entities, business lines and currencies, taking into account legal, regulatory and operational limitations to the transferability of liquidity.

Principle 7
A bank should establish a funding strategy that provides effective diversification in the sources and tenor of funding. It should maintain an ongoing presence in its chosen funding markets and strong relationships with funds providers to promote effective diversification of funding sources. A bank should regularly gauge its capacity to raise funds quickly from each source. It should identify the main factors that affect its ability to raise funds and monitor those factors closely to ensure that estimates of fund raising capacity remain valid.

Principle 8
A bank should actively manage its intraday liquidity positions and risks to meet payment and settlement obligations on a timely basis under both normal and stressed conditions and thus contribute to the smooth functioning of payment and settlement systems.

Principle 9
A bank should actively manage its collateral positions, differentiating between encumbered and unencumbered assets. A bank should monitor legal entity and physical location where collateral is held and how it may be mobilised in a timely manner.

Principle 10
A bank should conduct stress tests on a regular basis for a variety of short-term and protracted institution specific and market wide stress scenarios (individually and in combination) to identify sources of potential liquidity strain and to ensure that current exposures remain in accordance with a bank's established liquidity risk tolerance. A bank should use stress test outcomes to adjust its liquidity risk management strategies, policies, and positions and to develop effective contingency plans.

Principle 11
A bank should have a formal contingency funding plan (CFP) that clearly sets out the strategies for addressing liquidity shortfalls in emergency situations. A CFP should outline policies to manage a range of stress environments, establish clear lines of responsibility, include clear invocation and escalation procedures and be regularly tested and updated to ensure that it is operationally robust.

Principle 12
A bank should maintain a cushion of unencumbered, high quality liquid assets to be held as insurance against a range of liquidity stress scenarios, including those that involve the loss or impairment of unsecured and typically available secured funding sources. There should be no legal, regulatory or operational impediment to using these assets to obtain funding.

Principle 13
A bank should publicly disclose information on a regular basis that enables market participants to make an informed judgement about the soundness of its liquidity risk management framework and liquidity position.

Appendix 1 - Stress Testing

1. Stress testing process

1.1 The Commission requires all Guernsey incorporated banks to conduct stress tests.

1.2 Tests should consider the implication of scenarios across different time horizons, including on an intraday basis.

1.3 The extent and frequency of testing should be commensurate with the size of the bank and its liquidity risk exposures, but as a minimum the Commission expects stress testing on annual basis. Banks should build in the capability to increase the frequency of tests in special circumstances, such as in volatile market conditions or at the request of the Commission.

1.4 Senior executives (ie CEO and Finance Director / or CFO, or equivalent) should be actively involved in the stress testing and should ensure that rigorous and challenging stress scenarios are considered, even in times when liquidity is plentiful.

1.5 The Commission requires all Guernsey incorporated banks to submit annually a written statement on the utilization of the results from the stress testing. Additional guidance on the utilization of the results is provided in section 3 of the appendix.

1.6 The annual review of the LMP and ratification by the Board should take account of the findings of the stress testing process.

2. Scenarios and assumptions

2.1 In designing stress scenarios, the nature of the bank's business, activities and vulnerabilities should be taken into consideration so that the scenarios incorporate the major funding and market liquidity risks to which the bank is exposed. These include risks associated with its business activities, products (including complex financial instruments and off-balance sheet items) and funding sources. The defined scenarios should allow the bank to evaluate the potential adverse impact these factors can have on its liquidity position.

2.2 History may serve as one guide when designing stress tests; however, historical events may not prove to be a good predictor of future events. A bank should carefully consider the design of scenarios and the variety of shocks used. A bank should consider short-term and protracted, as well as institution-specific and market-wide, stress scenarios in its stress tests, including:

- a simultaneous drying up of market liquidity in several previously highly liquid markets;
- severe constraints in accessing secured and unsecured funding;
- restrictions on currency convertibility; and

- severe operational and / or settlement disruptions affecting one or more payment or settlement systems.

Regardless of how strong its current liquidity situation appears to be, a bank should consider the potential impact of severe stress scenarios, and not dismiss severe scenarios as “implausible”. These need to be realistic and plausible, but on the other hand are expected to cover very unusual and unexpected events. Banks need to consider and select carefully the correct balance.

2.3 A bank should specifically take into account the link between reductions in market liquidity and constraints on funding liquidity. A bank should also consider the insights and results of stress tests performed for various other risk types when stress testing its liquidity position and consider possible interactions with these other types of risk.

2.4 A bank should recognise that stress events may simultaneously give rise to time-critical liquidity needs in multiple currencies and multiple payment and settlement systems. Moreover, these liquidity needs could arise both from the institution’s own activities, as well as from those of its customer banks and firms. They also could arise from the special roles a bank might play in a given settlement system, such as acting as a back-up liquidity provider or settlement bank.

2.5 Tests should reflect accurate time-frames for the settlement cycles of assets that might be liquidated, and the time required to transfer liquidity across borders. In addition, if a bank relies upon liquidity outflows from one system to meet obligations in another, it should consider the risk that operational or settlement disruptions might prevent or delay expected flows across systems. This is particularly relevant for firms relying upon intra-group transfers or centralised liquidity management.

2.6 A bank should take a conservative approach when setting stress testing assumptions. Based on the type and severity of the scenario, a bank needs to consider the appropriateness of a number of assumptions, potentially including but not limited to the following:

- asset market illiquidity and the erosion in the value of liquid assets;
- the run-off of retail funding;
- the (un)availability of secured and unsecured wholesale funding sources;
- the correlation between funding markets or the effectiveness of diversification across sources of funding;
- additional margin calls and collateral requirements;
- funding tenors;
- contingent claims and more specifically, potential draws on committed lines extended to third parties or the bank's subsidiaries, branches or head office;
- the liquidity absorbed by off-balance sheet vehicles and activities (including conduit financing);
- the availability of contingent lines extended to the bank;
- liquidity drains associated with complex products/transactions;
- the impact of credit rating triggers;
- FX convertibility and access to foreign exchange markets;
- the ability to transfer liquidity across entities, sectors and borders taking into account legal, regulatory, operational and time zone restrictions and constraints;
- the access to central bank facilities;

- the operational ability of the bank to monetise assets;
- the bank's remedial actions and the availability of the necessary documentation and operational expertise and experience to execute them, taking into account the potential reputational impact when executing these actions;
- estimates of future balance sheet growth.

2.7 A bank should consider in its stress tests the likely behavioural response of other market participants to events of market stress and the extent to which a common response might amplify market movements and exacerbate market strain. A bank should also consider the likely impact of its own behaviour on that of other market participants.

2.8 A bank’s stress tests should consider how the behaviour of counterparties (or their correspondents and custodians) would affect the timing of cash flows, including on an intraday basis. Where a bank uses a correspondent or custodian to conduct settlement, the analysis should include the impact of those agents restricting their provision of intraday credit. A bank should also understand the impact of the stress event on its customers’ use of their intraday credit, and how those needs affect its own liquidity position.

2.9 The scenario design should be subject to regular review to ensure that the nature and severity of the tested scenarios remain appropriate and relevant to the bank. Reviews should take into account changes in market conditions, changes in the nature, size, or complexity of the bank’s business model and activities, and actual experiences in stress situations.

2.10 In order to identify and analyse factors that could have a significant impact on its liquidity profile, a bank may conduct an analysis of the sensitivity of stress test results to certain key assumptions. Such sensitivity analyses can provide additional indications of a bank’s degree of vulnerability to certain factors.

3. Utilisation of results

3.1 Senior executives should review stress test scenarios and assumptions as well as the results of the stress tests. The bank’s choice of scenarios and related assumptions should be well documented and reviewed together with the stress test results. Stress test results and vulnerabilities and any resulting actions should be reported to and discussed with the board and a written statement sent to the Commission (this statement forms part of the Annual Compliance Form). Senior executives should integrate the results of the stress testing process into the bank’s strategic planning process (e.g. bank management could adjust its asset-liability composition) and the firm's day-to-day risk management practices (e.g. through monitoring sensitive cash flows or reducing concentration limits). The results of the stress tests should be explicitly considered in the setting of internal limits.

3.2 Senior executives should incorporate the results of scenarios in assessing and planning for related potential funding shortfalls in the institution's contingency funding plan. To the extent that projected funding deficits are larger than (or projected funding surpluses are smaller than) implied by the bank’s liquidity risk tolerance, executives should consider whether to adjust its liquidity position or to bolster the bank’s contingency plan in consultation with the board.