

FINANCIAL SUPERVISORY COMMISSION



Cook Islands

PRUDENTIAL STATEMENT

No. 09-2008

POLICY FOR MANAGEMENT OF LIQUIDITY RISK

ISSUED UNDER SECTION 14(3) OF THE BANKING ACT 2003

This Prudential Statement is issued by the Financial Supervisory Commission (FSC) pursuant to the provisions of Section 14 of the Banking Act 2003 and shall be applicable to all bank licensees incorporated in the Cook Islands, both domestic and international.

2. In carrying out its banking supervision functions, the FSC is required to have regard to the adequacy of the liquidity of bank licensees in relation to the bank's liabilities. Therefore, the FSC is providing a Prudential Statement on the management of liquidity risk within banks.

Liquidity Risk

3. Liquidity is defined as the ability to fund increases in assets and meet obligations as they come due, without incurring unacceptable losses¹. The underlying assumption is that obligations will be able to be met "at reasonable cost". The aim of liquidity risk management is to ensure that banks have an ability to do this. Liquidity problems can lead to distress to the bank, public knowledge of such problems can lead to a 'run on the bank' and the problem can then become more widespread, leading to a lack of confidence in the banking sector in general.

¹ *Sound Principles for Managing Liquidity in Banking Organisations*, Basel Committee on Banking Supervision, February 2000

4. For these reasons, the FSC considers that liquidity management is an important part of a bank's operations. While the FSC is setting general supervisory requirements for liquidity management, responsibility for development of a liquidity management policy and implementation of that policy rests with the Board of Directors of each bank. It is recognised that banks in the Cook Islands have different profiles and this will be reflected in their liquidity management strategies.

Basic Requirements

5. There is an expectation that a bank can meet its obligations for the next 5 days. Eligible liquid assets are defined as cash, bank bills and CD's issued by a bank (minimum investment grade) and deposits at call, or convertible within 2 days. Eligible assets should be unencumbered and cannot be exposed to the risks of the bank itself or parties related to the bank.

6. Liquidity measurement involves assessing a bank's cash inflows against its outflows and the liquidity value of its assets to identify the potential for future net funding shortfalls. A bank should be able to measure and forecast its prospective cashflows for assets, liabilities, off-balance sheet commitments and derivatives over a variety of time horizons, under normal conditions and stressed conditions, including severe stress. This should include determining the behaviour of assets and liabilities that do not have specified maturity dates, such as repayments of overdrafts, at call deposits and deposits with early withdrawal options and also making some assumptions about maturing assets and liabilities that it will rollover or renew.

7. It is not the intention of the FSC to set liquidity limits or to require investments in certain classes of assets. However, as part of its off-site monitoring role, the FSC performs liquidity calculations and where there is concern about ratios being unsatisfactory, action will be taken.

Liquidity Management Policy

8. The recent financial market turmoil has led the Basel Committee on Banking Supervision to issue a guidance paper on *Principles for Sound Liquidity Risk Management and Supervision*². Apart from the fundamental principle, Principle 1, that a bank is responsible for the sound management of liquidity risk and should establish a robust liquidity management framework, the principles that apply to banks are grouped into 3 categories:

- Governance of liquidity risk management
- Measurement and management of liquidity risk

² Issued by the Bank for International Settlements, September 2008 Available at www.bis.org

- Public disclosure.

A further category relates to the role of supervisors. It is recommended that banks' management familiarise themselves with this paper.

9. The FSC expects to see that each bank has a liquidity management policy that has been considered, and approved, by the bank's Board of Directors, bearing in mind the risk tolerance of the bank. In addition, the Board should have an oversight role in ensuring that management of the policy is effectively implemented. It is expected that liquidity would be an on-going concern of the Board, with the policy being reviewed at least annually. Limits should be set to control the bank's liquidity risk exposure and vulnerabilities

10. The FSC will be looking for evidence of adequate management reporting systems that are capable of measuring, assessing and reporting on a regular basis. A bank must be able to demonstrate that it has an adequate system of internal controls. Internal controls ensure integrity and a strong control environment provides an adequate process for identifying and evaluating risk. Where an internal audit function exists, it is recommended that the controls should be evaluated by the internal auditors. The liquidity management policy should include the underlying assumptions used in constructing maturity profiles of its cashflows as well as the reasoning behind them.

11. It is expected that senior management should understand how other risks impact on liquidity; for example, operational risk and credit risk, and take account of these in undertaking stress testing. Assumptions used in scenario testing should frequently be reviewed to ensure their validity.

12. In terms of the liquidity management policy, the FSC will be looking for the inclusion of a strategy for dealing with temporary and long-term liquidity disruptions. There must be a process for ongoing measurement and monitoring of net funding requirements. The bank should undertake scenario analysis, which will involve stress-testing, and set its liquidity limits accordingly.

13. The FSC will also be looking for evidence of contingency plans for managing a liquidity crisis. In particular, the existence of arrangements for stand-by funding and whether these arrangements are current and can be activated at short notice. Additionally, the FSC will want to see that the crisis management plans identify a particular person or position who will be responsible for managing the crisis and notifying the FSC of the problems.

14. Cash flows relating to off-balance sheet items and other contingent liabilities should be identified, measured, monitored and controlled. This should include a robust framework for projecting the potential consequences of undrawn commitments being drawn, considering the nature of the commitment and the

creditworthiness of the counter-party. Undrawn loan commitments, letters of credit and financial guarantees represent a potentially significant drain of funds for a bank.

Supervisory Remedial Action

15. Where the FSC is dissatisfied with a bank's policies or where liquidity risk management weaknesses are identified, appropriate remedial action will be taken. This may include a requirement that policies be reviewed with a view to strengthening certain aspects, that contingency planning be upgraded, stronger internal controls implemented or that other action be taken to lower the bank's liquidity risk.

Date of Effect

16. This Prudential Statement takes effect immediately.

Financial Supervisory Commission
20 November 2008