Key Principles for Liquidity Management

Fundamental principle for the management and supervision of liquidity risk:

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. Supervisors should assess the adequacy of both a bank's liquidity risk management framework and its liquidity position and should take prompt action if a bank is deficient in either area in order to protect depositors and to limit potential damage to the financial system.

Governance of liquidity risk management:

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

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.

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.

Measurement and management of liquidity risk:

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.

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.

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.

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.

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

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.

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.

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.

Public disclosure:

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

The role of supervisors:

14. Supervisors should regularly perform a comprehensive assessment of a bank's overall liquidity risk management framework and liquidity position to determine whether they

deliver an adequate level of resilience to liquidity stress given the bank's role in the financial system.

15. Supervisors should supplement their regular assessments of a bank's liquidity risk management framework and liquidity position by monitoring a combination of internal reports, prudential reports and market information.

16. Supervisors should intervene to require effective and timely remedial action by a bank to address deficiencies in its liquidity risk management processes or liquidity position.

17. Supervisors should communicate with other supervisors and public authorities, such as central banks, both within and across national borders, to facilitate effective cooperation regarding the supervision and oversight of liquidity risk management. Communication should occur regularly during normal times, with the nature and frequency of the information sharing increasing as appropriate during times of stress.

Liquidity Risk Management in Banks

While introducing the concept of **Asset-Liability Management (ALM)**, it has been mentioned that the object of any ALM policy is twofold — ensuring profitability and liquidity. Working towards this end, the bank generally maintains profitability/spreads by borrowing short (lower costs) and lending long (higher yields). Though this process of price matching can be done well within the risk/exposure levels set for rate fluctuations it may, however, place the bank in a potentially illiquid position.

Efficient matching of prices to manage the interest rate risk does not suffice to meet the ALM objective. Price matching should be coupled with proper maturity matching. The inter-linkage between the interest rate risk and the liquidity of the firm highlights the need for maturity matching. The underlying implication of this inter-linkage is that rate fluctuations may lead to defaults severely affecting the asset-liability position. Further in a highly volatile situation it may lead to liquidity crisis forcing the closure of the bank.

Thus, while management of the prices of assets and liabilities is an essential part of **Asset-Liability Management**, so is liquidity. Liquidity, which is represented by the quality and marketability of the assets and liabilities, exposes the firm to liquidity risk. Though the **management of liquidity risks** and interest rate risks go hand in hand, there is, however, a phenomenal difference in the approach to tackle both these risks. A bank generally aims to eliminate the liquidity risk while it only tries to manage the interest rate risk. This differential approach is primarily based on the fact that elimination of interest rate risk is not profitable, while elimination risk does result in long-term sustenance. Before attempting to analyze the elimination of liquidity risk, it is essential to understand the concept of liquidity management.

The core activity of any bank is to attain profitability through fund management i.e. acquisition and deployment of financial resources. An intricate part of fund management is liquidity management. Liquidity management relates primarily to the dependability of cash flows, both inflows and outflows and the ability of the bank to meet maturing liabilities and customer demands for cash within the basic pricing policy framework. Liquidity risk hence, originates from the potential inability of the bank to generate cash to cope with the decline in liabilities or increase in assets.

Thus, the cause and effect of liquidity risk are primarily linked to the nature of the assets and liabilities of the bank. All investment and financing decisions of the bank, irrespective of whether they have long term or short term implications do effect the asset-liability position of the bank which may further affect its liquidity position. In such a scenario, the bank should continuously monitor its liquidity position in the long run and also on a day-to-day basis.