CENTRAL BANK OF TRINIDAD & TOBAGO

Guideline on the Management of Liquidity Risk

for Institutions Licensed under the Financial Institutions Act, 2008

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1. INTRODUCTION

1.1 Liquidity refers to the ability of a financial institution to fund increases in assets, and meet obligations as they come due, without incurring unacceptable losses[1].

1.2 Liquidity problems can quickly escalate and jeopardize the financial soundness of institutions with a sound capital base. For example, the management of liquidity risk is particularly important for banks as their fundamental role in the maturity transformation of short-term deposits into long-term loans makes them inherently vulnerable to liquidity risk.

1.3 A liquidity stress event may also have negative consequences for other institutions and the financial system as a whole. The 2007 global financial crisis is a prime example of the severe adverse institutional and systemic consequences of poor liquidity risk management by financial institutions.

1.4 The sources of liquidity risk to financial institutions are numerous. Sources endemic to business operations include increases in operational costs, deterioration in asset quality, a decline in earnings performance or projections, concentrations in assets or liabilities or unplanned capital expenditure. Further, other risks to the institution such as reputational risk and contagion risk threaten the liquidity of an institution and external or market events such as unexpected catastrophes and pandemics can also trigger liquidity crises.

1.5 Given the myriad of sources of liquidity risk and its potentially debilitating impact, it is of critical importance that financial institutions effectively manage their liquidity needs. Specifically, financial institutions should ensure that they are able to meet both expected and unexpected cash flows and collateral needs without adversely affecting daily operations or the financial condition of their institutions.

1.6 Given the importance of liquidity to the sustainability of financial institutions and financial markets as a whole, the Basel Committee on Banking Supervision (BCBS)[2] encourages robust liquidity risk management standards for financial institutions. The

[1] Basel Committee on Banking Supervision (BCBS), "Principles for Sound Liquidity Risk Management and Supervision"- September 2008

[2] The BCBS is a committee of banking supervisory authorities that provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. The BCBS frames international standards on areas such as capital adequacy and the Core Principles for Effective Banking Supervision.

Central Bank has refenced the principles and best practices espoused by the BCBS in developing this Guideline.

2. DEFINITIONS

2.1 **"Central Bank"** means the Central Bank of Trinidad &Tobago;

2.2 **"financial institution" or "institution"** means an institution referred to in paragraph 4 of this Guideline;

2.3 **"funding liquidity risk"** means the risk that a financial institution will not be able to meet efficiently both expected and unexpected current and future cash flow and collateral needs without affecting its daily operations or financial condition[3];

2.4 **"Guideline"** means the Central Bank's "Guideline on the Management of Liquidity Risk";

2.5 **"liquidity risk"** means funding liquidity risk and/or market liquidity risk;

2.6 **"market liquidity risk**" means the risk that a financial institution cannot easily offset or eliminate a position at the market price because of inadequate market depth or market disruption.

3. PURPOSE OF THE GUIDELINE

3.1 This Guideline outlines key principles and minimum requirements for the management of liquidity risk by financial institutions. The primary focus of this Guideline is the management of funding liquidity risk by financial institutions.

3.2 This Guideline establishes minimum standards against which the Central Bank will assess the sufficiency of the liquidity risk management framework of institutions. The Central Bank expects an institutions' liquidity risk management framework to reflect the tenets of this Guideline and be commensurate with the size, nature and complexity of their operations.

[3] BCBS publication "Principles for Sound Liquidity Risk Management and Supervision"- September 2008.

4. APPLICATION AND SCOPE

4.1 This Guideline applies to all licensees and financial holding companies (FHCs) under the Financial Institutions Act, 2008 ('FIA')[4].

4.2 In addition, the following financial institutions which have been deemed as systemically important financial institutions[5] pursuant to section 123 of the FIA should be guided by the principles in this Guideline:

- 4.2.1 The Trinidad and Tobago Mortgage Finance Company Limited;
- 4.2.2 The Home Mortgage Bank;
- 4.2.3 The Trinidad and Tobago Unit Trust Corporation; and
- 4.2.4 The Agricultural Development Bank.

5. IMPLEMENTATION OF A SOUND LIQUIDITY RISK MANAGEMENT FRAMEWORK

5.1 A financial institution must establish and maintain a robust liquidity risk management framework that ensures it maintains sufficient liquidity. The framework should ensure that the institution is able to meet its daily liquidity obligations and withstand periods of stress.

5.2 Financial institutions should ensure that liquidity risk management is not considered in isolation but is part of a comprehensive enterprise-wide risk management framework[6]. In particular, the impact of other risks such as credit, market, operational and reputation risk on the institution's liquidity should be considered.

5.3 The liquidity risk management framework should take into account, inter alia, the institution's structure, scale of business and complexity of operations, business model and business strategies, risk profile, products, geographic coverage and currencies in

[4] Reference to a statute includes subordinate legislation made under the relevant statute and any amendment, re-enactment or modification thereunder.

[5] Five financial institutions, other than licensed banks or nonbanks or registered insurers, were deemed as systemically important financial institutions by Cabinet Note in 2013. Four of the five are listed here. The fifth, the National Insurance Board, will be included in a similar guideline for insurers when developed.

[6] The enterprise risk management framework should address any financial or other activities (e.g. maturity transformation, securities lending, credit risk mitigation) undertaken by the institution that may change its liquidity risk profile.

which it transacts business. It should also address the institution's group-wide operations including any legal and practical issues that may compromise its liquidity position, for example, any impediments to cross-border transfer of assets.

5.4 The liquidity risk management framework of a financial institution should include, at a minimum:

5.4.1 a board-approved tolerance for liquidity risk that is reflected in documented liquidity and funding policies;

5.4.2 a governance framework in which the board of directors (Board) is ultimately responsible for the management of liquidity risk at the institution and the senior management develops and implements appropriate strategies to manage and control the institution's liquidity risk in line with the board-approved tolerance for liquidity risk;

5.4.3 systems, policies and processes for on-going identification, measurement, monitoring and control of liquidity risk;

5.4.4 any limitations of the liquidity risk management framework;

5.4.5 information systems and internal controls to ensure compliance with established liquidity risk management policies and procedures, including disciplinary actions where appropriate;

5.4.6 regular monitoring and management of intra-day and intra-group liquidity needs;

5.4.7 a funding strategy that ensures effective diversification of sources and tenor of funding;

5.4.8 a strategy to ensure that the institution maintains a portfolio of unencumbered high quality liquid assets (HQLA)[7] that are available to withstand a range of stress events;

5.4.9 regular stress testing to identify and quantify exposure to possible future liquidity stresses (*see section 5.11*); and

5.4.10 a formal, documented, board-approved liquidity contingency plan (LCP) that clearly sets out strategies for addressing liquidity shortfalls in emergency situations (*see section 5.12*).

5.5 Governance Framework

5.5.1 The Board of a financial institution has ultimate responsibility for overseeing the prudent management of liquidity risk at the institution and should, at a minimum:

[7] Assets are considered to be HQLA if they can be easily and immediately converted into cash at little or no loss of value.

a) articulate clearly the liquidity risk tolerance for the institution. The liquidity risk tolerance should guide the institution's liquidity strategies, policies, risk management and control functions. It should also be consistent with the size, sophistication, business objectives, relevant funding markets and overall risk appetite of the institution;

b) ensure the institution's liquidity tolerance is clearly communicated and understood by senior management;

c) establish and approve lines of authority and responsibility for managing the institution's liquidity risk;

d) oversee senior management's identification, measurement, monitoring and control of liquidity risk;

e) understand the nature of the liquidity risks of the institution and the tools used by senior management to monitor and control liquidity risk;

f) approve the institution's liquidity risk strategy and other significant policies and processes related to liquidity risk management, including contingency fund planning;

g) review the institution's liquidity risk tolerance, strategy, policies and procedures at least annually. Reviews should also be conducted where there is any major change in operations or business activities that could impact the institution's liquidity risk profile;

h) keep under constant review the liquidity risk profile of the institution and, where relevant, that of its key subsidiaries. Among other things, the Board should regularly review and understand the financial position of the institution with regard to liquidity and the liquidity risk exposures of the institution;

i) ensure that senior management and appropriate personnel have the necessary expertise and that the financial institution has adequate processes and systems to measure, monitor, and control all sources of liquidity risk;

j) have a thorough understanding of the close links between funding liquidity risk and market liquidity risk, as well as how other risks affect the institution's overall liquidity risk strategy. For example, they should consider situations where the institution obtains liquidity from capital markets and recognize that these sources may be more volatile than traditional funding sources. Liquidity risk management strategies should incorporate these considerations;

k) notify the Central Bank as soon as they become aware of any material developments that may have an adverse impact on the institution's liquidity risk profile.

5.5.2 The senior management of a financial institution is responsible for the implementation of the institution's liquidity risk management framework. To achieve this effectively they should, at a minimum:

a) develop and implement policies and procedures that accord with the Board's liquidity goals, objectives and risk tolerance;

b) review the institution's liquidity risk policies and procedures at least annually, or where there is any major change in operations or business activities that could impact the institution's liquidity risk profile. The senior management should revise the policies and procedures, where appropriate;

c) ensure that the institution's liquidity risk strategy is consistent with the Board's intent and is effectively communicated to, and well understood by, the institution's staff;

d) adhere to the lines of authority and responsibility that the Board has established for managing liquidity risk;

e) oversee the implementation and maintenance of a management information system that supports the day to day and longer term management of the institution's liquidity risk. The systems should be suitable for the scale and complexity of the operations and enable timely and appropriate information to be readily available to all relevant stakeholders including the Board, senior managers and the Central Bank (*see section 5.9*);

f) establish effective internal controls over the liquidity risk management process and ensure:

   i. that appropriately trained and competent personnel are responsible for implementing internal controls;

   ii. independent control personnel have sufficient authority to challenge information and modelling assumptions; and

   iii. competitive pressures are not allowed to compromise the integrity of the control function;

g) establish an appropriate reporting framework (see section 5.10) that:-

   i. ensures the Board is provided with information on all potentially material liquidity risks facing the institution. Information should be comprehensive, accurate, complete and timely and, where relevant, include material information on foreign branches and subsidiaries; and

ii. provides for the timely dissemination of liquidity risk information to staff involved in liquidity management at the institution and the Central Bank and public, as required.

5.5.3 Responsibility for managing overall liquidity may be delegated to a specific individual or group (for example, the committee with responsibility of asset liability management) within the institution. In particular,

a) this individual or group of individuals should:-
   i. be employed at the senior management level at the institution; and
   ii. have clear authority over the units responsible for executing liquidity-related transactions such that directives reach these line units unimpeded;
b) ideally, the group of individuals should have broad representation from across major business and operational lines that can influence, directly or indirectly, the institution's liquidity risk.

5.6 Liquidity Risk Management Strategy, Policies and Procedures

5.6.1 A financial institution should have a liquidity risk management strategy that sets out the general approach that it will adopt in managing its liquidity risk consistent with its risk tolerance. Key elements of the liquidity risk strategy include the:

a) goals and objectives underlying the strategy;
b) composition and maturity of assets and liabilities;
c) level of diversity and stability of funding sources targeted by the institution;
d) approach to managing liquidity in different currencies, across borders, and across business lines and legal entities, where applicable, taking into consideration home and host regulatory requirements in the jurisdictions in which the institution operates;
e) approach to be adopted in the event liquidity support is withdrawn from any part of the institution;
f) approach to intraday liquidity management; and
g) assumptions on the liquidity and marketability of assets.

5.6.2 The financial institution should ensure that the goals and risk tolerances set out in the liquidity risk strategy are translated into robust policies, processes and systems which guide operating standards and are understood by the relevant staff at the institution.

5.6.3 The policies, processes and systems should enable the institution to sufficiently identify, measure, manage and mitigate liquidity risk over an appropriate set of time horizons, including intra-day, so as to ensure that it maintains adequate levels of liquidity buffers.

5.6.4 While specific details vary across institutions according to the nature of their business, risk management policies, processes and systems should address, inter alia, the:

a) general liquidity strategy (short and long-term), the specific goals and objectives of the institution in relation to liquidity risk management and the process for strategy formulation;
b) roles and responsibilities of individuals performing liquidity risk management functions;
c) institution’s funding plan and process including ongoing analysis of the deposit or other funding base, pricing, contingency planning, management reporting, lines of authority and responsibility for liquidity decisions where appropriate; and
d) institution’s risk management structure for monitoring, reporting and reviewing liquidity.

5.6.5 Policies, processes and systems should also be developed to ensure the institution is able to assess and maintain, on an ongoing basis, the adequacy, types and sources of its liquidity resources.

5.6.6 The policies, processes and systems should provide a comprehensive institution-wide view of liquidity risk. They must be proportionate to the institution’s complexity, risk profile, scope of operations and liquidity risk tolerance and must reflect the jurisdictions in which it carries on business;

5.6.7 The institution’s liquidity risk management framework should be subject to periodic compliance review and independent audits, the frequency of which should be documented in the institution’s liquidity risk management policies.

5.7 Internal Controls

5.7.1 A financial institution should implement a robust system of internal controls to ensure the integrity of the liquidity risk management framework. A robust control system should allow the institution to monitor the effectiveness of its liquidity strategy, the degree of liquidity risk undertaken and compliance with established policies and procedures and with applicable legislation and/or guidelines governing liquidity risk.

5.7.2 An effective internal control system for liquidity risk management should include, at a minimum, the following:

a) clearly defined roles and reporting lines, including appropriate segregation of duties, along with the involvement of senior management as key elements in the control process.
b) adequate monitoring of liquidity and liquidity risk by relevant stakeholders, for example, treasury managers and the Chief Risk Officer.
c) internal targets and limits (on both an individual and consolidated basis) that align with the institution's stated liquidity risk tolerance including early warning indicators and targets and limits for:
    i. concentration and diversification;
    ii. cash flow mismatches over certain extended time horizons;
    iii. exposures and liquidity positions in each currency in which it operates;
    iv. asset encumbrance (taking into account the institution's cost of funding and the sustainability of its long-term liquidity position); and
    v. liquidity risk ratios (internal or prudential).
d) periodic review and, where appropriate, adjustment of targets and limits when conditions or risk tolerances change.
e) clearly articulated and documented policies that set out:
    i. procedures for dealing with limit exceptions, permissions or authorization to set and change limits;
    ii. notification responsibilities and escalation procedures;
    iii. sign-off by senior management; and
    iv. prompt remedial follow-up and/or disciplinary actions for failure to adhere to established limits or procedures.
f) frequent compliance reviews and regular independent audits of the liquidity risk management framework, the results of which (including

deficiencies and limitations) should be communicated to the Board and available to the Central Bank upon request.

5.8 Management Information Systems (MIS)

5.8.1 A financial institution should have reliable management information systems (MIS) that provide the Board, senior management and other relevant staff with timely and forward-looking information on its liquidity positions, on both and individual and group basis.

5.8.2 The MIS should be fit for purpose (i.e. commensurate with the financial institution's size, complexity and risk) and support the financial institution's day-to-day and long-term liquidity risk management and continuous monitoring of compliance with established policies, procedures and limits.

5.8.3 The MIS reports should be customized to the financial institution so as to be capable of supporting the Board and senior management of the institution in identifying emerging concerns on liquidity, as well as in managing liquidity stress events.

5.8.4 The MIS should include mechanisms to keep track of material intra-group transactions, where relevant, that can have significant consequences for the institution.

5.8.5 A financial institution's MIS should encompass information in respect of the financial institution's liquidity cushion, major sources of funding and significant sources of liquidity risk, including contingent risks and related triggers and those arising from new activities.

5.8.6 The MIS should have the ability to calculate risk measures to monitor liquidity positions: –

a) in all currencies, both individually and on an aggregate basis;
b) under normal business conditions and during stress events, with the ability to deliver more granular and time-sensitive information for the latter;
c) for different time horizons (e.g. on an intraday basis, day to day or over a 30 day time horizon or over a series of more distant time periods); and
d) at appropriate intervals.

5.8.7 In times of stress, the MIS reports should be capable of being produced at more frequent intervals e.g. daily, or even intraday, if necessary.

5.9 Reporting on Liquidity Risk

5.9.1 A financial institution should implement a liquidity risk reporting framework that ensures all stakeholders are kept apprised of relevant information regarding liquidity risk at the institution.

5.9.2 At a minimum the reporting framework should outline the following to the various stakeholders including treasury and funding departments of the financial institution, its Board and senior management and the Central Bank:

a) lines of responsibility for reporting liquidity;
b) the scope of information to be provided; and
c) the frequency of reporting, including, inter alia, the need for increased frequency of reporting in times of stress.

5.9.3 The Board and senior management in particular should be provided with contextual information and qualitative guidance to support their understanding of the liquidity risk profile of the institution.

5.9.4 Reports should convey the methods used to determine liquidity coverage for upcoming liabilities and funding needs and elaborate on the level of coverage predicted by these measures.

5.9.5 Among other things, institutions should ensure that reports capture intra-day liquidity positions, track exposures to contingent liabilities and monitor funding sources.

5.9.6 Public disclosure should be included as a component of the reporting framework. Institutions are encouraged to disclose sufficient information regarding its management of liquidity risk (e.g. in their financial statements and annual reports) to enable relevant stakeholders to make an informed judgement about the ability of the institution to meet its liquidity needs.

5.10 Stress Testing

5.10.1 A financial institution should develop a comprehensive liquidity stress testing program that enables it to evaluate its ability to generate sufficient liquidity from both sides of the balance sheet to meet funding needs under adverse conditions. Potential sources of demand for liquidity arising from off-balance sheet commitments and other contingent liabilities should also be addressed.

5.10.2 Among other things, stress tests conducted by financial institutions should:

a) be based on severe but plausible stress scenarios and assist the institution in its assessment of its cash-flow needs;
b) consider multiple scenarios (including catastrophic events) of varying degrees of stress and time horizons (including intra-day) using conservative and regularly reviewed assumptions;
c) be performed for all currencies in aggregate and separately each currency in which the financial institution has significant positions;
d) take into account specific risks associated with its business activities, products or funding sources;
e) consider the results of stress tests performed for other risks e.g. credit or market, including possible interaction with these other risks.

5.10.3 The financial institution should include a variety of short-term and protracted types of scenarios in their stress-testing exercise including:

a) institution-specific stress scenarios;
b) general market stress scenarios; and
c) a combination of both.

5.10.4 The Board and senior management should regularly review the institution's stress test scenarios and assumptions to ensure that their nature and type remain appropriate and relevant to the institution. Major changes should be approved by the Board or its relevant delegated committee(s). Considerations for the Board include prevailing and prospective market conditions or changes in the institution's business model, activities and products.

5.10.5 Stress tests should enable a financial institution to analyze the impact of stress scenarios on its consolidated group-wide liquidity position as well as on the liquidity position of individual entities and business lines in order to understand where risks could arise.

5.10.6 Liquidity stress tests should, at a minimum, be conducted at least annually. However, the stress testing program, including its design and frequency, should be commensurate with the nature, scale and complexity of the financial institution, its liquidity risk exposures as well as with the relative importance of the financial institution within the financial system.

5.10.7 In particular, financial institutions considered to be systemically important should have the capacity to undertake frequent stress testing in order to produce timely and relevant data in special circumstances, such as in volatile market conditions or at the request of the Central Bank.

5.10.8 The senior management should ensure that there is proper documentation of the stress scenarios used and related assumptions. They should also review the scenarios and assumptions at least annually to ensure continued relevance.

5.10.9 Stress-testing results should be linked to the overall liquidity risk management practices of the financial institution. To this end, the results of stress tests should be:–

a) evaluated and signed-off on by the relevant senior management[8] of the institution. Any possible need for remedial or mitigating actions should be considered including, where appropriate, measures to:
   i. limit the institution's liquidity risk exposures;
   ii. obtain more long-term funding;
   iii. structure the composition of assets;
   iv. increase the size of the institution's liquidity cushion[9]; and
   v. adjust the institution's liquidity profile to fit its risk tolerance.

b) reported to the Board (or its relevant delegated committee(s)) along with any vulnerabilities identified and recommendations to address the identified vulnerabilities.

c) integrated into the institution's business planning and liquidity risk management processes (including in the setting of the liquidity risk tolerance and internal liquidity risk limits).

[8] Senior management may include the Chief Risk Officer, Chief Financial Officer or Chief Accountant.

[9] In particular, there should be continuous availability of an adequate cushion of unencumbered HQLA that can be sold or pledged to obtain funds in a range of stress scenarios. They ensure that the liquid cushion is sized to maintain sufficient resilience to unexpected stress while continuing to meet its timely settlement of their liquidity obligations for the duration of the stress. Further, the size of the liquidity cushion should be aligned with the established risk tolerance of the institution.

d) reflected in the overarching liquidity strategy, policy, processes and systems.
e) used to develop effective liquidity contingency plans.

5.10.10 Where appropriate, in addition to normal stress-testing reporting arrangements stipulated by the Central Bank, the institution should, as soon as is practicable, ensure the Central Bank is informed of stress test results and anticipated actions if they are material to the institution.

5.11 Liquidity Contingency Planning

5.11.1 A financial institution should have in place a formal documented liquidity contingency plan (LCP) which is approved by the Board and details the institution's strategy for handling unexpected events that severely strain the firm's liquidity.

5.11.2 The LCP should consider, among other things, liquidity shortfalls or excesses generated from (as well as in excess of) the stress tests performed by the institution under institution-specific, market-wide and combined stress scenarios.

5.11.3 The LCP should:

a) be robust, sufficiently flexible and consistent with the risk profile of the institution and overall business continuity plans of the institution;
b) contain policies, procedures and action plans that:
   i. prepare the financial institution to deal with relevant liquidity stress events including but not limited to those assumed in the stress tests;
   ii. set out specific procedures for raising cash and outline possible sources of funds an institution expects to have available from various sources;
   iii. are closely integrated with the institution's ongoing analysis of liquidity risk;
   iv. enable the management of the institution to make timely and well-informed decisions, communicate the decisions effectively, and execute contingency measures swiftly and proficiently; and
   v. outline clear escalation and prioritization actions;

c) address liquidity issues over a range of different time horizons, including intraday;

d) include clearly established and delineated lines of responsibility and escalation procedures;

e) define a set of triggering events that will activate the plan as well as the mechanisms for identification, monitoring and reporting of such events at an early stage; and

f) include a comprehensive communication strategy that:

  i. ensures clear, timely and consistent communication with relevant internal and external stakeholders; and

  ii. helps reduce uncertainty or speculation about the institution in the market.

5.11.4 A financial institution should test and update the operational readiness of the LCP to ensure continued relevance and execution effectiveness in times of stress. These tests should be conducted at least annually or more often as warranted by changes in business or market circumstances.

5.11.5 Testing exercises should include (but not be limited to):

a) verifying the availability of the contingency sources of funding listed in the LCP;

b) verifying the key assumptions of stress tests, such as the ability to sell certain assets or periodically draw down credit lines;

c) ensuring that roles and responsibilities are appropriate and understood;

d) confirming that contact information is up-to-date, with reporting lines clearly stated and synchronized with the latest organization chart;

e) proving the transferability of cash and collateral (especially across borders and entities in the case of group companies); and

f) reviewing that the necessary legal and operational documentation is in place to execute the plan at short notice.

5.11.6 Senior management should review all aspects of the LCP following each testing exercise and ensure that follow-up actions are completed.

5.11.7 Results of the LCP testing exercises should be documented and reported to the Board. Any revisions to the LCP should also be approved by the Board.

The results of the testing exercises should also be available to the Central Bank on request.

6. ROLE OF THE CENTRAL BANK

6.1 The Central Bank shall, as part of its supervisory framework, assess the sufficiency of the liquidity risk management framework instituted by financial institutions. The requirements of this Guideline together with any other requirement on liquidity risk imposed by the Central Bank will be used as a baseline for the assessment, including compliance with any minimum liquidity ratios specified by the Central Bank.

6.2 The Central Bank expects the liquidity risk management framework to be appropriate for the institution. In assessing liquidity risk management practices the Central Bank will therefore have regard for the specific characteristics and risks of the institution.

6.3 The Central Bank will scrutinize more closely the liquidity risk management practices of large and systemically important financial institutions.

6.4 The Bank will, where appropriate, consult with other supervisory authorities in assessing the liquidity risk profile of a financial institution.

6.5 The Central Bank may require a financial institution to undertake remedial actions to address any deficiencies identified with its liquidity risk management framework.

7. EFFECTIVE DATE

7.1 This Guideline comes into effect on the date of issue.

7.2 Financial institutions are required to review this Guideline and take the necessary measures to ensure compliance with its contents within six months of the issue date.