Guidance Note

AGN 210.1 - Liquidity Management Strategy

1. ADIs are particularly vulnerable to sudden and unexpected demands on them for funds. Since liquidity problems in one ADI can have significant implications for other ADIs and for the financial system as a whole, liquidity management is pivotal to an ADI's operations.

2. APRA follows a systems based approach in supervising the liquidity of all ADIs. This approach places primary responsibility for liquidity management on the board of directors and management of an ADI, and focuses on the processes and controls adopted by the ADI.

3. APRA recognises that the scope of the liquidity management strategy may vary among ADIs depending on the nature and complexity of their operations. In assessing the adequacy of an ADI's liquidity management strategy, APRA may need to distinguish between institutions having regard to:

   (a) the institution's market standing – an ADI's ability to borrow and deal in various markets, especially in the wholesale and interbank markets, depends critically on the ADI's standing in those markets;

   (b) liability diversification and volatility – an ADI with a widely diversified, stable funding base is likely to be less exposed to changes in the perceptions of a narrow group of depositors or investors;

   (c) asset profile and quality – an ADI with a greater proportion of high quality marketable assets is able to have a quicker and easier access to funding when required by selling or pledging these assets;

   (d) activities across currencies;

   (e) the availability and reliability of standby facilities and intra-group funding;

   (f) access to industry-based liquidity support schemes; and

(g) staff expertise and the quality of policies and systems for managing liquidity.

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Policy Statement

4. An ADI's liquidity management policy statement should document in detail the strategy adopted for managing liquidity as described in paragraph 5 of APS 210. Australian branches of foreign ADIs should identify in their policy statements where responsibility resides for monitoring the liquidity of their Australian operations, and should include in the statement details of the reporting arrangements to head office. APRA will familiarise itself with the global liquidity management policy of the foreign ADI group, particularly in relation to the monitoring of branches, and with the home regulator's supervisory arrangements regarding liquidity management.

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Systems for Measuring, Assessing and Reporting Liquidity

5. An ADI, as part of its liquidity management strategy, should put in place a management information system capable of measuring, assessing and reporting liquidity on a regular basis as appropriate for the operations of the ADI.

6. While the sophistication of an ADI's management information system will depend on the nature and complexity of the ADI's operations, the system must produce timely, accurate and relevant information for managing and monitoring the liquidity positions of an ADI in all operating circumstances. At a minimum, the management information system must be able to:

   (a) report the composition and market values of an ADI's liquid holdings; and

   (b) construct maturity profiles of an ADI's cash flows to identify cumulative net funding positions at selected maturity dates.

7. To construct maturity profiles an ADI needs to make assumptions of future cash flows associated with its assets, liabilities and off-balance sheet activities. In principle the cash flows will be allocated to time bands in accordance with the contractual maturity dates. In practice the ADI must determine:

   (a) the proportion of maturing assets and liabilities that it will rollover or renew;

   (b) the behaviour of assets and liabilities with no clearly specified maturity dates (e.g. repayments of overdrafts, at call deposits and those with early withdrawal options);

   (c) potential cash flows from off-balance sheet activities, including draw downs under loan commitments, contingent liabilities and market-related transactions;

   (d) its ability to access various markets for funds and to undertake transactions in different markets;

   (e) the convertibility of foreign currencies; and

   (f) access to standby facilities and intra-group funding.

8. An ADI should document in its liquidity management policy statement the underlying assumptions used in constructing the maturity profiles of its cash flows as well as the reasoning behind them. There should be provisions to review these assumptions regularly to take account of available statistical evidence and/or changing business profile. APRA will assess the suitability of each ADI's assumptions.

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Procedures for Managing Liquidity

9. An ADI may pursue a range of procedures to manage its liquidity. The relevance and effectiveness of particular procedures will depend on the nature of an ADI's business and its standing in the market. As a guide, APRA expects the following procedures to be adopted:

   (a) Maturity Mismatch Limits

An ADI should establish maturity mismatch limits for its cumulative funding positions as identified under the maturity profiles at various selected time bands. These mismatch limits should be realistic and commensurate with the ADI's funding capacity.

(b) Liquid Holdings

An ADI should maintain an adequate stock of high quality liquid assets to cater for any unexpected liquidity pressures or fluctuations under both normal and adverse operating conditions. These readily liquefiable assets can provide an ADI with the capacity to meet its obligations while the underlying problems affecting liquidity are being addressed. This also lowers the likelihood of an ADI needing to undertake an urgent sale of illiquid assets, or purchasing liabilities at a higher cost than is sustainable over the medium term.

An ADI should clearly identify the composition of such a liquid portfolio, define its role, establish minimum levels (including trigger ratios to warn management of potential breaches) and concentration limits in its liquidity management policy statement. The liquid portfolio should be diversified (unless otherwise agreed with APRA) to ensure there will not be an undue reliance on any one class of liquid assets.

An ADI participating directly in settlement should, for the purpose of managing its intra-day liquidity under the Real-Time Gross Settlement system, hold within its stock of high quality liquid assets an appropriate amount of securities that are eligible for intra-day repurchase transactions with the Reserve Bank.

An ADI which is active in providing clearing / settlement services to others in the payments system should have regard to the potential risks associated with such agency arrangements. In determining the size of its holding of high quality liquid assets, the ADI should also take into account the volume and volatility of transactions which it has undertaken to process.

(c) Diversification of Liabilities

An ADI should seek to maintain a diversified and stable funding base. This can be achieved by establishing a policy limiting the concentration in funding sources to avoid excessive reliance on any one counterparty (including related counterparties), product or market as well as by building strong and lasting relationships with depositors and other liability holders.

An ADI should also undertake appropriate analysis on the pattern of its liabilities and the potential impact this may have on the ADI's liquidity position (e.g. to detect any signs that the deposit base is becoming more volatile).

(d) Access to Wholesale Markets

The ability to obtain funds in the interbank and other wholesale markets is an important source of liquidity for an ADI in both normal and crisis conditions. However, in formulating its liquidity management procedures, an ADI should recognise that its ability to access funds from these markets may be radically reduced or delayed in crisis conditions.

An ADI should be able to estimate its "normal" borrowing capacity in the wholesale markets and to establish a policy regarding dealing in markets against that capacity. An ADI making unusual demands on the wholesale markets may face difficulties due to the exposure limits set by counterparties.

An ADI may maintain standby credit lines with other ADIs or counterparties as a potential source of liquidity. An ADI should recognise that its right to draw on these facilities may be denied in a crisis or there might be calls for early repayment of drawings under these facilities triggered by events of default or breaches of any material adverse change clauses. In formulating standby arrangements, an ADI should ensure that the facilities are fully committed and irrevocable. Where standby facilities form an integral element of an ADI's crisis liquidity management, APRA will seek to be satisfied as to the certainty of these arrangements.

(e) Foreign Currency and Other Markets

An ADI with active involvement in multiple currencies and/or with significant positions in specific foreign currencies should address the procedures for liquidity measurement and management of these individual currencies in its strategy. The ADI should assess the convertibility of individual currencies, the timing of access to funds, the impact of potential disruptions to foreign exchange markets and exchange risks before presuming that surplus liquidity in one currency can be used to meet the shortfall in another currency. The ADI should have in place backup liquidity procedures for circumstances in which normal access to funding in individual currencies is disrupted.

An ADI active in securities and other markets should, in a similar vein, take account of the impact on its liquidity management of disruption in those markets.

(f) Intra-group Liquidity

An ADI's liquidity management procedures should address any regulatory or legal impediments to accessing liquidity from related sources. Excess liquidity in related entities and overseas branches may not be readily available to the ADI when needed.

An Australia-based ADI, which decentralises or partially delegates liquidity management amongst operating units, should clearly document the policies and limits established for those units as well as any internal liquidity support arrangements provided to those units. The policies should also address how the liquidity of those units is monitored and controlled by head office management in Australia.

An ADI providing significant funding and other liquidity support to related entities will need to satisfy APRA that such support is appropriately captured in the measurement of its liquidity position. APRA may require an ADI to place limits on such support.

Australian branches of foreign ADIs and foreign owned subsidiary ADIs may have lines of liquidity support from their head office or overseas parents (or associates). This support would be of particular value in a crisis affecting only local operations but could prove ineffective if the crisis impinged upon the group as a whole.

Foreign owned subsidiary ADIs should have adequate procedures in place for managing their liquidity in their own right. In the case of foreign ADI branches, APRA is prepared to consider their liquidity management in a global context, having regard to:

(i) the extent to which liquidity of the foreign ADI is managed, and supervised, on an integrated global basis;

(ii) the reliance placed on funding from head office and other branches;

(iii) the ability and willingness of head office to provide liquidity at all times as required – APRA may seek an assurance from the head office regarding the provision of liquidity to the branch;

(iv) whether the home country supervisor of the foreign ADI is aware of, and has no objections to, any dependence by the branch on head office for liquidity support and any assurance provided by head office regarding the provision of such support – APRA will require confirmation to this effect from the home country supervisor; and

(v) the particular policies governing the branch's liquidity management in Australia.

(g) Use of Assets

An ADI's ability to use assets (e.g. through sales, repurchase agreements or securitisation structures) may provide much needed liquidity and support in adverse circumstances. Prearrangements to convert less liquid assets (e.g. mortgages or other loans) to generate additional funding when required can be an important part of an ADI's liquidity management procedures.

(h) Industry Liquidity Support Arrangements

APRA recognises that ADIs may participate in industry-based liquidity support arrangements for standby liquidity in the event of a crisis. In assessing the potential strength of the industry support arrangement, APRA will seek to be satisfied with the capacity of the participants to provide support, and the certainty that funds will be readily available when needed. Industry support contracts certified by APRA provide an acceptable level of certainty required. However, a participating ADI should have regard to the potential loss of its liquidity as a result of its contingent obligation to provide liquidity support to other participants under such arrangement.

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Responsibilities and Controls

10. An ADI should set internal limits consistent with its liquidity management strategy and have appropriate control mechanisms in place to ensure that the internal limits and procedures established for managing liquidity are adhered to at all times.

11. At the core of an ADI's liquidity management strategy there should be a well-defined management responsibility and control structure for

monitoring, reporting and responding to the ADI's liquidity in a timely and effective manner. Senior management should be responsible for reviewing an ADI's liquidity management information on a regular basis. The monitoring and review should, where appropriate, cover:

(a) the maturity profiles of an ADI's cash flows;

(b) the stock of liquid assets available to the ADI and their market values;

(c) concentration in sources and application of funds;

(d) the ability to borrow in various markets;

(e) intra-group cash flows and the accessibility of intra-group funding;

(f) potential sources of volatility in assets and liabilities (and claims and obligations arising from off-balance sheet business);

(g) credit standing and the capacity of providers of standby facilities to meet their obligations;

(h) the impact of market / operational disruptions on cash flows and on customers;

(i) the impact of adverse trends in asset quality on future cash flows and market confidence in the ADI; and

(j) the ability to undertake asset sales in various markets.

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Contingency Planning

12. In relation to paragraph 3 of APS 210, indicators of liquidity concerns may include one or more of the following:

(a) regular breaches of internal limits;

(b) experiencing difficulty or inability to borrow in the wholesale markets;

(c) lenders demanding a higher than standard funding premium or seeking collateral for funding provided;

(d) deteriorating cash flow positions as evidenced by widening negative maturity mismatches, especially in the short term time bands;

(e) unusual volatility in the deposit base;

(f) frequent utilisation of overdraft or standby facilities;

(g) deterioration in asset quality or profitability;

(h) adverse ratings changes; and

(i) problems with related entities.

13. As set out in paragraph 5(e) of APS 210, APRA requires an ADI to formulate a formal contingency plan for dealing with a liquidity crisis. The plan should be approved, in the case of locally incorporated ADIs, by the board of directors or a board committee, and in the case of foreign ADI branches, by an appropriate senior officer from outside Australia.

14. As a guide, the plan should:

(a) designate who would be responsible for identifying crises (including speedy notification of the problems to APRA) and crisis management. Responsibilities should be clearly assigned so that all personnel understand what is expected of them during a crisis;

(b) specify the early warning signals indicative of an approaching crisis and the mechanisms to facilitate constant monitoring and reporting of these signals;

(c) establish reporting procedures to deliver all necessary information to senior management to enable them to make quick decisions;

(d) set out procedures for making up cash flow shortfalls in crisis situations, including trigger points and timeframes within which each action should be taken. The procedures should identify all key sources of funds, their expected reliability and the priority in which those funds would be accessed. The plan should also include an assessment of the cost of alternative funding strategies and the impact on the ADI's capital;

(e) outline courses of action for altering asset and liability behaviour e.g. plans to market assets more aggressively, raise deposits, etc;

(f) assess the likely impact of particular courses of action on the market's perception of the ADI;

(g) provide procedures to determine priority of customer relationships in the event of liquidity problems e.g. the order in which lines of credit would be withdrawn from specific customers; and

(h) detail plans for dealing with staff and the public including customers, key market participants and the media. Astute public relations management is important to avoid the spread of rumours which could result in a significant run-off of funds.

15. An ADI should review and update its contingency plan regularly (at least annually) to ensure that it remains robust over time and reflects the ADI's changing operating circumstances. An ADI should have adequate procedures in place to ensure relevant staff (including those nominated as back-ups) involved in the implementation of the plan are well-informed of their role under the plan and of any subsequent changes to the plan.

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