FJÁRMÁLAEFTIRLITIÐ
THE FINANCIAL SUPERVISORY AUTHORITY, ICELAND

Unofficial translation
January 2014

Guidelines

No. 2/2010

Guidelines for Sound Liquidity Risk Management and Supervision

Issued in accordance with the second paragraph of Art. 8 of Act No. 87/1998 on Official Supervision of Financial Activities

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THE FINANCIAL SUPERVISORY AUTHORITY, ICELAND
4 October 2010

Introduction

The Financial Supervisory Authority issues revised Guidelines for sound Liquidity Risk Management of financial undertakings; cf. the second paragraph of Art. 8 of the Act on Official Supervision, No. 87/1998. The Guidelines are directed to financial undertakings and shall apply as appropriate to both parent companies and groups of financial undertakings. The Guidelines will replace Guidelines No. 1/2008, for sound Liquidity Risk Management of financial undertakings.

These Guidelines are based on the *Principles for Sound Liquidity Risk Management and Supervision*, issued by the Basel Committee on Banking Supervision, which were last revised in September 2008, and set out a number of principles for best practice in liquidity management. The document referred to from the Basel Committee provides a more detailed discussion and reference is made to it for further details.

Liquidity, or the ability to fund increases in assets and meet obligations as they come due, is crucial to the on-going viability of any financial undertaking. Managing liquidity is therefore among the most important aspects of financial undertakings' activities. Sound liquidity management can reduce the probability of serious crisis. The importance of liquidity management is not limited to individual financial undertakings, since a shock at a single institution can impact the stability of the entire financial system. For this reason it is important to analyse how funding needs may develop under different conditions, including difficult external circumstances, as well as measuring liquidity position on a regular basis.

As a result of the difficulties which began in the international arena around mid-2007 it proved necessary to review the importance of the liquidity management and liquidity position of financial undertakings. The Basel Committee on Banking Supervision reached the conclusion that the liquidity management of most financial undertakings was unsatisfactory. Among those lessons which the Basel Committee considers can be learned from the financial crisis is that more detailed instructions need to be given on:

- the importance of defining risk tolerance in connection with liquidity risk;
- maintaining acceptable liquidity, in part by maintaining reserves of sufficiently liquid assets;
- the necessity of spreading liquidity cost, benefits and risk to all important areas of activity;
- analysing and assessing of all types of liquidity risk, including unforeseen liquidity risk;
- developing and using crisis scenarios in stress testing;
- the need for a robust and effective contingency plans;
- management of intra-day liquidity risk and monitoring of collateral; and
- public disclosure to strengthen market discipline.

The Guidelines also emphasise the role of regulators[1] in assessing Liquidity risk management and the quality of liquid assets. The Guidelines are based on liquidity

[1] The term regulators refers to the role of the Central Bank of Iceland, as provided for in Art. 12 of Act N. 36/2001, and the role of the Financial Supervisory Authority, as provided for in Art. 83 of Act No. 161/2002, on Financial Undertakings.

management in larger financial undertakings but generally apply as a best practice in all financial undertakings. Application must take into consideration the nature, size and complexity of financial undertakings.

The Guidelines are based on the following 17 principles for the management and supervision of liquidity risk.

II. Contents of Guidelines on best practice for liquidity management of financial undertakings

Management and supervision of liquidity risk

1: A financial undertaking is responsible for the sound management of liquidity risk. A financial undertaking should establish a robust liquidity risk management framework that ensures it maintains sufficient liquid, 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, the Financial Supervisory Authority and, as the case may be, the Central Bank of Iceland, should assess the adequacy and both a financial undertaking liquidity risk framework and its liquidity position and should take prompt action if a financial undertaking is deficient in either area in order to protect depositors and to limit potential damage to the financial system.

Financial undertakings must send monthly liquidity reports to the Central Bank of Iceland. The Financial Supervisory Authority may demand special liquidity reports from financial undertakings whose operating licence is subject to various conditions.

Governance of liquidity risk management

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

3: Senior management should adopt a strategy, policies and practices to manage liquidity risk in accordance with risk tolerance and to ensure that the financial undertaking maintains sufficient liquidity. Senior management should continuously review information on the financial undertaking´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 effectively.

4: A financial undertaking 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 financial undertaking as a whole.

Measurement and management of liquidity risk

5: A financial undertaking 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 financial undertaking 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 financial undertaking should establish a funding strategy that provides effective diversification in the sources and tenor of funding. It should maintain an on-going presence in its chosen funding markets and strong relationships with funds providers to promote effective diversification of funding sources. A financial undertaking 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 remain valid.

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

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

11: A financial undertaking should have a formal contingency funding plan that clearly sets out the strategies for addressing liquidity shortfalls in emergency situations. A contingency plan 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 financial undertaking 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 financial undertaking 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.

Role of regulators

14: The Financial Supervisory Authority should regularly perform a comprehensive assessment of a financial undertaking's overall liquidity risk management framework and position to determine whether they deliver an adequate level of resilience to liquidity stress given its role in the financial system.

15: The Financial Supervisory Authority should supplement their regular assessment of a financial undertaking's liquidity risk management framework and liquidity positions by monitoring a combination of internal reports, prudential reports and market information.

16: The Financial Supervisory Authority should intervene to require effective and timely remedial action by a financial undertaking to address deficiencies in its liquidity risk management processes or liquidity position.

17: The Financial Supervisory Authority should communicate with other relevant supervisors and public authorities, such as the Central Bank of Iceland, 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

Reykjavík, 4 October 2010

FINANCIAL SUPERVISORY AUTHORITY

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[1] http ://www.bis.org/publ/bcbs 144. htm