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CIRCULAR TO ALL BANKS

GUIDELINES FOR THE DEVELOPMENT OF LIQUIDITY MANAGEMENT POLICIES

Liquidity is crucial to the on-going viability of any bank, as illiquidity can have dramatic and rapid adverse effects on even well capitalized banks.

Where a crisis develops in a bank as a result of other problems such as deterioration in asset quality, the time available to the bank to address the problem will be determined by its liquidity. Therefore, the measurement and management of liquidity, are amongst the most vital activities of banks.

The importance of liquidity transcends the individual bank, as a liquidity shortfall in a single institution can have system-wide repercussions. Consequently, the analysis of liquidity requires bank's Managements to measure, not only the liquidity positions of their banks, on an ongoing basis, but also to examine how funding requirements are likely to evolve under crisis scenarios.

In view of the above considerations, a viable framework has been developed to guide banks' the management of their liquidity in line with international standards and best practices.

Banks are, therefore required to develop and implement their liquidity management policies, in line with the attached guidelines. The policies should limit liquidity risk to acceptable levels and clearly define managerial responsibilities for managing liquidity. These policies and systems are to be observed at all times and further reviewed from time to time, to reflect changing circumstances.

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DIRECTOR OF BANKING SUPERVISION

APPENDIX

GUIDELINES FOR THE DEVELOPMENT OF LIQUIDITY MANAGEMENT POLICIES IN NIGERIAN BANKS

This document sets out the *minimum policies and procedures* that each bank needs to put in place and apply within its liquidity management program, and the *minimum criteria* it should employ, to prudently manage and control its liquidity and associated risks.

1.0 ISSUES TO CONSIDER IN FORMULATING A LIQUIDITY MANAGEMENT POLICY

1.1 SETTING OBJECTIVES

The objectives of each bank's liquidity management policy should include:

(i) The effective monitoring of the bank's liquidity position at all times.

(ii) Ensuring that an adequate liquidly cushion is maintained such that all maturing obligations (both on-and off-balance sheet) are met on an on-going basis.

(iii) Protecting the bank against associated market risks.

(iv) Controlling the bank's dependence on wholesale funds, usually sourced at exorbitant and uncompetitive rates, by building an effective contingency funding plan.

(v) Ensuring that timely information is available for liquidity decisions.

(vi) Maintaining a liquidity posture, consistent with regulatory requirements.

(vii) Complying with all regulatory liquidity reporting requirements.

1.2 *SUGGESTED STRATEGIES*

To stay liquid, each bank is expected to have a steady cash flow, hold a reasonable stock of liquid assets, and have the capacity to borrow. To this end, banks may choose to adopt a combination of the following strategies:

1.2.1 Well Defined Assets and Liabilities Mix

The liquidity policy should clearly define sources of liquidity. Since virtually every financial transaction or commitment has implications for bank's liquidity, the liquidity management strategy should include policies on the composition of assets and liabilities (i.e. assets and liabilities mix). The policy should *stipulate the proportion of each asset and liability component* that the bank should hold at all times. Specific items to be defined should include liquid assets, deposit liabilities, off-balance sheet items and risk assets (all to be expressed as a percentage of *loanable funds).*

1.2.2. Diversified Funding Base

Each bank should develop and maintain a diversified and stable funding base. It should *set maximum levels of funding concentrations* in terms of volume and sector. Specifically, limits should be set for mono-sources of funds (to avoid undue reliance on large individual depositors) and the proportion of demand deposits to total deposits.

1.2.3. Maintaining Adequate Stock of Liquid Assets

An adequate stock of high quality liquid assets can provide a bank with the capacity to meet its obligations while any underlying problems affecting liquidity are addressed. Banks' liquidity policies should clearly identify such assets, and *establish minimum holdings* for each. **Please note that such thresholds should not be below the existing minimum requirements such as the minimum liquidity ratio prescribed for all banks and the requirement to hold at least 10 percent of liquid assets in Treasury Bills.**

1.2.4. Setting Limits on Maturity Mismatches

Depending on the size and nature of the business engaged in, banks should determine and *set tolerable limits for maturities,* on a monthly basis (i.e. maturing deposits as a percentage of total deposits). This could be further extended by specifying limits for cumulative cash flow mismatches, also expressed in relation to total deposits.

1.2.5. Restricting Dependence on Intra Group Liquidity

(i) For all banks with group relationships, limits for intra-group exposures should be set and the liquidity management strategies should also address any regulatory or legal impediments to accessing liquidity on a group basis.

(ii) Where a bank decentralizes or partially delegates' liquidity management amongst operating units, it should clearly document the policies and limits established for those units as well as any internal liquidity support arrangements provided to those units. It should also address how the

liquidity of these units will be monitored and controlled from the head office.

(iii) Where a bank provides significant funding and other liquity support to subsidiaries and associates, such support should be appropriately captured in the measurement of its liquidity position.

1.2.6 *Ability to Access Wholesale Markets*

In formulating liquidity management strategies, banks should recognize that the ability to access funds from the interbank market and other wholesale markets might be radically reduced or delayed in crisis conditions. Each bank should, therefore, be able to estimate its ability to borrow funds from the interbank market at short notice and during periods of crisis. Minimum levels should be set for committed standby lines. Such arrangements, which should be documented, should be irrevocable and should lack material adverse change clauses.

Banks are expected to estimate their “normal” borrowing capacity in wholesale markets and establish a policy regarding dealing in markets against that capacity. A bank making unusual demands on the wholesale markets may face difficulties due to the exposure limits set by counter parties.

1.2.7 **Use of Assets**

A policy regarding the use of assets to generate additional funding either by outright sale repurchase agreements or securitisation structures, can be an important part of banks’ liquidity strategies.

1.3. Controls and Systems

1.3.1 Each bank should have an adequate system of internal controls over its liquidity risk management process. The controls should be an integral part of the overall system of internal controls.

1.3.2 Bank managements should ensure that each bank's internal control system over its liquidity risk management process is regularly monitored, evaluated and reviewed. This should include:

(i) ensuring that the bank's personnel are following established policies and procedures; and

(ii) ensuring the validity and continued relevance of the assumptions on which the liquidity management policies were based.

1.3.3. Banks are required to have in place internal limits and other control mechanisms consistent with their strategies for managing liquidity.

1.3.4. Each bank is required to have comprehensive information systems and a well defined reporting structure to ensure that management is provided with all information necessary to manage the liquidity of the bank in all circumstances.

1.3.5. At the core of each bank's liquidity management systems, there should be the continuous monitoring of:

(i) the maturity profile of cash flows under varying scenarios;

(ii) the stock of liquid assets available to the bank and their market values;

(iii) the ability of the bank to execute assets sales in various markets (notably under adverse conditions) and to borrow in the markets;

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

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

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

(vii) the impact of market disruptions on cash flow and on customers;

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

(ix) concentration in sources and applications of funds.

1.3.6. Banks are required to render returns to the CBN and the NDIC each quarter, on the results of the periodic reviews/monitoring highlighted in 1.3.5 above.

2.0 **CONTINGENCY PLANNING**

Each bank is expected to have in place formal contingency plans approved by its board for dealing with major liquidity problems as defined in the Framework for Contingency Planning for Banking Systemic Crisis. The plan should specify the following:

(i) early warning signals that portend signs of impending crisis;

(ii) procedures for making up cash flow shortfalls in crisis situations, including action trigger points and time-frames within which each action should be taken;

(iii) actions to be taken to alter assets and liabilities behaviour in a crisis period i.e. plans to embark on aggressive deposit mobilization, debt recovery, sale of illiquid assets, standby arrangements, etc;

(iv) 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

(v) the methods of public relations management to contain adverse liquidity situations i.e. diffusing rumours that could trigger off a run on the bank.

3.0 THE ROLE OF THE BOARD AND MANAGEMENT OF BANKS

3.1 It is the responsibility of the board and management of banks to ensure that each bank has sufficient liquidity to meet its obligations as they fall due.

3.2 The board will also be responsible for the following:

(i) Understanding the liquidity and funding needs of the bank;

(ii) Establishing appropriate and prudent liquidity and funding management policies;

(iii) Reviewing the policies, at least, once every year, to ensure that they remain prudent and appropriate;

(iv) Obtaining, on a regular basis, reasonable assurance that the liquidity management policy is being adhered to.

3.3. A bank must inform the CBN of any concerns it has about its current or future liquidity profile, and of its plan to rectify any problems.

3.4 In formulating the liquidity management policies, banks are advised not to assume that the CBN will provide support if they are faced with liquidity problems.