

BANKING GUIDANCE NOTE (BGN 5.0)

Liquidity Risk Management

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Financial Supervision Commission Bannrannae Oaseirys

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Part 1 – Banks incorporated in the Isle of Man

1. Rationale for Liquidity Risk Management

- 1.1 Central to liquidity in banking is the fact that most banks are in the business of maturity transformation. They take in deposits that are often repayable on demand or at short notice and use these deposits to fund credit facilities to borrowers over longer periods. Banks are exposed to the risk that depositors' demands for repayment outstrip their ability to realise longer-term assets in cash. For this reason liquidity is a key area for prudential supervision by banking regulators.
- 1.2 All banks need liquidity in order to meet their day-to-day obligations. For example:
 - a) To meet depositors' demands or withdrawals
 - b) To settle wholesale commitments
 - c) To provide funds when borrowers draw on committed credit facilities.
- 1.3 Banks can manage their liquidity requirements in a number of ways, for example:
 - a) Appropriate matching of the maturities of assets and liabilities
 - b) Holding an adequate stock of liquid assets such as cash deposits or marketable securities
 - c) Having available borrowing facilities.
- 1.4 There is a cost to holding liquidity. Cash deposits and marketable assets usually have a lower rate of return than longer term less liquid assets, and facilities and committed credit lines usually have a non-utilisation fee. Banks therefore have to manage the cost of liquidity.
- 1.5 It is important to distinguish between liquidity under normal conditions and liquidity under stressed and crisis conditions. In normal market conditions a bank that is perceived as financially healthy will have relatively easy access to funds from group or parent, or to wholesale funds on the interbank market, and customers will react in a normal rational manner. However, if the market is under stress, liquidity may dry up and be less readily available.
- 1.6 Apart from stress conditions in the liquidity market as a whole, an individual bank may itself come under pressure if there are doubts about its financial position, if for example there are concerns about asset quality, earnings, or as a result of the failure of a similar institution. A bank may find it more difficult to raise funds in the interbank market and depositors may withdraw their

funds. It is therefore important for banks to consider liquidity management under stressed or crisis conditions.

2. Overview of the Commission's Approach to Liquidity Risk Management

- 2.1 The Commission requires a bank to have a prudent liquidity policy and appropriate systems in place to measure and monitor liquidity, and to ensure that the policy is adhered to. The Commission recognises that appropriate systems and controls for liquidity risk will vary with the scale, nature and complexity of a bank's activities. The policy should ensure compliance with the requirements of the Banking (General Practice) Regulatory Code 2005 re hard limits in short-term maturity bands.
- 2.2 The Commission requires banks to monitor their liquidity profile using a mismatch approach, and in certain circumstances may require a bank to maintain a proportion of its assets in highly liquid securities such as government debt or certificates of deposit. In general, banks are required to report sterling positions and aggregate sterling equivalents of currency positions together on one return to the Commission. However the Commission may require banks to report individual currencies separately when, for example, it can be demonstrated that a short maturity cumulative negative mismatch in a particular currency may be obscured by offsetting positive mismatches in other currencies.
- 2.3 It should be noted that the neither the Isle of Man Government nor the Commission have historically undertaken, or will undertake the role of 'lender of last resort' to the local banking market. A robust liquidity management policy that clearly states local responsibilities and limits, the level of group / parental support and involvement, and the recognition of the requirements and expectations of the group's consolidated regulator is therefore extremely important.

3. Liquidity Management Policy

- 3.1 The Commission requires banks to take reasonable steps to maintain appropriate systems for the management of liquidity risk and requires banks to provide the Commission with a copy of their liquidity management policy ("LMP"). It is the responsibility of senior management to draw up the appropriate policy in the light of the particular circumstances of the bank. The LMP should be approved by the Board. It is important that the Board understands the liquidity and funding needs of the bank and ensures that an appropriate and prudent liquidity and funding management policy is established.
- 3.2 The LMP should take into account the bank's significant operations and determine the sources, type and levels of liquidity that are to be maintained

by the bank and should ideally be designed to prevent the bank's funding from becoming unduly concentrated with respect to source, type, and term to maturity or currency of denomination. Where concentrations do exist, the bank will need to manage its assets and its liquidity profile to mitigate the risks caused by the concentration. The Board or senior management should obtain, on a regular basis, reasonable assurance that the bank has ongoing, appropriate and effective liquidity and funding management processes and that the bank's liquidity and funding management policies are being adhered to.

3.3 The LMP should be regularly reviewed, (annually or more frequently as necessary) to reflect changing circumstances and to ensure that it remains appropriate and prudent. If the bank is part of a banking group the liquidity policy should be part of or complement, the group liquidity policy and any interdependencies should be explicitly communicated to the Commission.

3.4 The main points that need to be considered when drawing up a liquidity management policy are given below:

3.4.1 *Nature of business & asset types*

The LMP needs to reflect the nature of the bank's business and the type of assets it is funding. If, for example, a bank is making long-term loans the impact of this on liquidity needs to be addressed.

3.4.2 *Funding strategy*

The LMP is tied into the bank's funding strategy. For example, does the bank aim to fund itself through retail deposits or wholesale funds? If a bank uses wholesale funds the diversity of its sources of funding is important. Relying on just a few lines of credit is obviously less robust than having access to a range of funding sources such as certificates of deposit or medium term notes. A further consideration is the maturity of wholesale funds. It is generally desirable to maintain a balance between short-term funds and medium term funds.

3.4.3 *Customer base*

When applicable, the nature of a bank's retail deposit base needs to be considered. Some banks have established relatively stable customer bases while others attract deposits by offering higher rates of interest that regularly place them in the "best buy" tables. Depositors who look for the best interest rates are likely to move their deposits to another bank if it is offering better rates and therefore provide a less stable deposit base.

3.4.4 *Commission requirements*

The LMP should reflect the Commission's requirements of the bank, and the bank's obligation to report its liquidity position to the regulator and to its

group or parent. The most obvious instances of this are hard limit mismatch guidelines set by the Commission for the banking industry as a whole and the procedures for reporting any breaches to the Commission.

3.4.5 *Measuring & reporting*

The LMP needs to identify who is responsible for measuring and reporting liquidity internally within the bank, the frequency of internal reporting (usually daily) and how senior management monitors liquidity.

3.4.6 *Relationships between group entities*

The LMP should describe interrelationships between group entities in respect of liquidity risk management and clearly define procedures and responsibilities. On the basis that many banks provide funding to group or parent companies, it is particularly important that the effect of maturity transformation is recognised in their LMP.

3.4.7 *Independence*

The Commission looks for an appropriate degree of independence for the local entity in managing and maintaining its own liquidity position, as a first line of defence in the event that external developments make group assistance temporarily unavailable.

3.4.8 *Marketable assets*

The LMP should identify classes of marketable assets that may be purchased, and detail how these should be reported for liquidity purposes. The LMP should also detail any discounts that the assets should be subject to.

3.4.9 *Behavioural adjustments*

The LMP should include details of any specific assets or deposit liabilities that may be subject to behavioural adjustments for liquidity purposes. (See **Appendix II** – Behavioural Adjustments)

4. Procedures and Systems

4.1 The Commission requires banks to monitor their liquidity on a frequent and timely basis. In practice most major retail banks are able to measure and monitor their liquidity continuously and the Commission would expect most banks to be in a position to measure their liquidity profile daily. It follows from this that a bank must have adequate procedures and systems for monitoring liquidity. This means:

- a) A clear allocation of the responsibility for measuring and reporting liquidity

- b) The maintenance of reliable systems that can produce accurate liquidity reports promptly
 - c) Active senior management involvement in, and clearly allocated responsibility for liquidity reporting and monitoring
 - d) Regular reporting to group or parent companies.
- 4.2 The system that produces the liquidity reports should be linked to the bank's core systems and the data used in the liquidity reports should be capable of being reconciled back to base financial data. Such reconciliations should be a regular part of the bank's quality control procedures over the accuracy of its liquidity reports.
- 4.3 Liquidity reports should follow the principles of good management information, for example:
- a) Clarity
 - b) Highlight key information, in particular breaches or exceptions
 - c) Explicitly highlight trends and anomalies
 - d) Use an exception based commentary.

5. Quantitative Requirements

For all banks a mismatch calculation should be used. The Commission in certain circumstances may require individual banks to hold a defined quantity of marketable assets in addition to adhering to the hard mismatch limits as defined in the Banking (General Practice) Regulatory Code 2005.

6. The Maturity Mismatch Approach

- 6.1 The mismatch approach measures liquidity through the difference or mismatch between inflows and outflows in various maturity bands. A mismatch figure is obtained by deducting the outflows from inflows, the net mismatch. Mismatches are measured on a net cumulative basis by accumulating the net mismatches in each successive maturity band and are evaluated in the cumulative maturity bands of sight to eight days, sight to one month, sight to three months, sight to six months and so on.
- 6.2 A worst-case basis is used to determine the timing of flows, with inflows being recorded at the latest maturity and outflows at the earliest. This approach allows a bank's liquidity to be assessed in the circumstances of depositors withdrawing their funds and lenders being unwilling to renew their facilities.

- 6.3 The Commission assesses a bank's liquidity by expressing the net cumulative mismatches as percentages of total deposit liabilities and compares these to the hard limits (after agreed behavioural adjustments if applicable). Any breaches of the mismatch guidelines should be reported immediately with an explanation of the reason for the breach. A bank is expected to remedy the breach promptly and to take action to prevent future breaches.
- 6.4 The Commission requires maximum mismatch limits for the time periods of sight to eight days and sight to one month (0% and -5% respectively). This is because mismatches are usually only a concern over shorter time horizons. Over longer time horizons the bank should identify and correct large mismatches by adjusting the mix of assets and liabilities.
- 6.5 If a bank experiences liquidity difficulties it may be the qualitative factors that weaken first. Qualitative factors that are relevant are:
- a) The asset profile
 - b) The quality of management information
 - c) The standing and reputation in the market of an individual bank including any branches or subsidiaries and also that of its parent or fellow group companies
 - d) Management ability and skills in the treasury area
 - e) Access to funds from a parent or head office
 - f) Political, economic or geographic factors in relation to the group or parent and the bank's primary customer base.

7. Contingency or Crisis Planning

- 7.1 Either within its LMP or separately, a bank is expected to have a contingency plan in the event of it experiencing liquidity problems. The liquidity policy should be designed to ensure that adequate liquidity is maintained at all times. The liquidity contingency plan should contain a number of key elements:
- The identification and definition of what constitutes a liquidity crisis
 - Early warning indicators, including the impact of external events not directly related to the financial condition of the bank
 - Actions to be taken
 - Roles and responsibilities
 - Management coordination and escalation of issues

- Channels of communication
 - Communication with the Commission
 - Scenario planning and testing.
- 7.2 A copy of this plan must be provided to the Commission.
- 7.3 Liquidity contingency plans vary considerably depending on the nature and size of the bank. A major bank that experiences liquidity problems may require widespread support from the market and its plan should address this possibility. The plan should also clearly state the level of parental support that is available to the bank and the role of the parental supervisor in such a situation.
- 7.4 A contingency plan should state the particular indicators that would warn it of impending liquidity problems. The purpose of early warning indicators is to alert management to the possibility of a liquidity problem so that action can be taken quickly and early enough to prevent the problem turning into a crisis.
- 7.5 Examples on the liability side may include:
- Unexpected and significant withdrawals of retail deposits or non-renewal of wholesale funding facilities
 - Core retail deposit volumes falling below projected levels
 - A shortening of deposit maturities and a rise in requests to break fixed term deposits.
- 7.6 And on the asset side:
- Retail advances growing faster than projected
 - A lengthening of loan maturities
 - Larger than expected drawdown of committed facilities
 - A significant rise in undrawn committed facilities
 - A rise in defaults and delinquencies
 - Prepayments of loan facilities falling below historic behavioural norms.
- 7.7 The monitoring of these indicators should be part of the normal liquidity monitoring procedures. Should any of the defined early warning indicators signal the approach of an impending liquidity problem the contingency plan

should call for a series of predetermined responses. The aim of the plan should be to restore the status quo as soon as possible, while at the same time avoiding any unnecessary overreaction or bad publicity which could aggravate the problem and lead to contagion of the wider market.

- 7.8 The individuals responsible for managing liquidity under problem or crisis conditions should be identified together with the actions that should be taken. These actions might include:
- a) Who should be notified locally, (including the Commission), and at group or parent level
 - b) What reports need to be produced for whom
 - c) Steps that can be taken to improve liquidity for example:
 - o Raising retail deposit interest rates
 - o Raising loan interest rates to discourage new borrowings and stabilise the balance sheet
 - o Reduce liquid assets to the regulatory minimum
 - o Place a cap on balance sheet growth
 - o Increase the volume of advertising.
 - d) Deciding what public statements, if any, should be made locally and internationally.
- 7.9 A contingency plan needs to cover what sources of funding are likely to be available in the event of a liquidity crisis and which source will prove most reliable. Potential sources of funds in a liquidity crisis would include outright sales or sales under repurchase agreements of marketable assets, undrawn committed facilities, other group entities or, where applicable, head office. Banks should take into account that some customers may withdraw fixed term deposits under interest penalty and factor these balances into their immediate contingency funding requirements.
- 7.10 Effective management of a liquidity crisis can only be achieved if responsibilities are clearly defined in advance. There should be a single source of authority. For banks the Treasury function should report directly to the Board. Each member of staff involved with liquidity should be issued with explicit written instructions about how to proceed if any of the early warning indicators trigger a need for action. It is essential that immediate actions are taken in the event of a crisis without the need to assemble a formal committee. Clear lines of communication should already be established and senior management with defined responsibilities should be issued with clear guidelines of what is expected of them in the event of a crisis. All senior and executive management should have a copy of the contingency plan.
- 7.11 The contingency plan and policy should be subjected to regular scenario planning and stress testing.

Part 2 – Banks operating in or from the Isle of Man which are incorporated outside the Isle of Man (“branches”)

1 Rationale for Liquidity Risk Management

- 1.1 Central to liquidity in banking is the fact that most banks are in the business of maturity transformation. They take in deposits that are often repayable on demand or at short notice and use these deposits to fund credit facilities to borrowers over longer periods. Banks are exposed to the risk that depositors' demands for repayment outstrip their ability to realise longer-term assets in cash. For this reason liquidity is a key area for prudential supervision by banking regulators.
- 1.2 All branches need liquidity in order to meet their day-to-day obligations. For example:
 - a) To meet depositors' demands or withdrawals
 - b) To settle wholesale commitments
 - c) To provide funds when borrowers draw on committed credit facilities.
- 1.3 Regulators are required to monitor the liquidity of branches by the Basel Concordat. Although no hard limits will be applied to branches, Form SR-3A should be completed.
- 1.4 Banks can manage their liquidity requirements in a number of ways, for example:
 - a) Appropriate matching of the maturities of assets and liabilities
 - b) Holding an adequate stock of liquid assets such as cash deposits or marketable securities
 - c) Having available borrowing facilities.
- 1.5 Apart from stress conditions in the liquidity market as a whole, an individual bank (which has a branch in the Isle of Man) may itself come under pressure if there are doubts about its financial position, if for example there are concerns about asset quality, earnings, or as a result of the failure of a similar institution. A bank may find it more difficult to raise funds in the interbank market and depositors may withdraw their funds. It is therefore important for branches (as part of the bank) to consider liquidity management under stressed or crisis conditions.

2. Overview of the Commission's Approach to Liquidity Risk Management

- 2.1 The Commission requires a branch to be subject to a prudent liquidity policy and have appropriate systems in place to measure and monitor liquidity. The Commission recognises that appropriate systems and controls for liquidity risk will vary with the scale, nature and complexity of a branch's activities, and that the branch is likely to be part of the wider policies and procedures of the bank.
- 2.2 The Commission requires branches to report their liquidity profile using a mismatch approach, but recognises that monitoring is likely to be performed by the bank, of which the branch is a part. In general, branches are required to report sterling positions and aggregate sterling equivalents of currency positions together on one return to the Commission. However the Commission may require banks to report individual currencies separately when for example, it can be demonstrated that a short maturity cumulative negative mismatch in a particular currency may be obscured by offsetting positive mismatches in other currencies.
- 2.3 It should be noted that the neither the Isle of Man Government nor the Commission have historically undertaken, or will undertake the role of 'lender of last resort' to the local banking market. A robust liquidity management policy that clearly states local responsibilities and limits, the level of group / parental support and involvement, and the recognition of the requirements and expectations of the group's consolidated regulator is therefore extremely important.

3. Liquidity Management Policy

- 3.1 The Commission requires branches to take reasonable steps to maintain appropriate systems for the management of liquidity risk and requires branches to provide the Commission with a copy of the liquidity management policy ("LMP"). The LMP will often be drawn up by the bank but should include reference to the branch. The LMP should be reviewed by local senior management. It is important that senior management understand the liquidity and funding needs of the bank and ensures that an appropriate and prudent liquidity and funding management policy is established in relation to the branch.
- 3.2 The LMP should be regularly reviewed, (annually or more frequently as necessary) to reflect changing circumstances and to ensure that it remains appropriate and prudent.

4. Procedures and Systems

4.1 The Commission requires branches to monitor their liquidity on a frequent and timely basis. In practice most major retail banks are able to measure and monitor their liquidity continuously. It follows from this that a branch must have adequate procedures and systems for monitoring liquidity. This means:

- a) A clear allocation of the responsibility for measuring and reporting liquidity
- b) The maintenance of reliable systems that can produce accurate liquidity reports promptly
- c) Active senior management involvement in, and clearly allocated responsibility for liquidity reporting and monitoring
- d) Regular reporting to group or parent companies.

The Commission recognises that the above will most likely be performed by the bank, rather than at branch level, but expects senior management of the branch to understand the procedures and systems in place.

4.2 The system that produces the liquidity reports should be linked to the branch's/bank's core systems and the data used in the liquidity reports should be capable of being reconciled back to base financial data. Such reconciliations should be a regular part of the branch's/bank's quality control procedures over the accuracy of its liquidity reports.

4.3 Liquidity reports should follow the principles of good management information, for example:

- a) Clarity
- b) Highlight key information, in particular breaches or exceptions
- c) Explicitly highlight trends and anomalies
- d) Use an exception based commentary.

5. Quantitative Requirements

For all branches a mismatch calculation should be used.

6. The Maturity Mismatch Approach

6.1 The mismatch approach measures liquidity through the difference or mismatch between inflows and outflows in various maturity bands. A mismatch figure is obtained by deducting the outflows from inflows, the net mismatch. Mismatches are measured on a net cumulative basis by

accumulating the net mismatches in each successive maturity band and are evaluated in the cumulative maturity bands of sight to eight days, sight to one month, sight to three months, sight to six months and so on.

- 6.2 A worst-case basis is used to determine the timing of flows, with inflows being recorded at the latest maturity and outflows at the earliest. This approach allows a branch's liquidity to be assessed in the circumstances of depositors withdrawing their funds and lenders being unwilling to renew their facilities. The Commission recognises that this does not take into account the bank as a whole.
- 6.3 If a branch experiences liquidity difficulties (usually because of the bank) it may be the qualitative factors that weaken first. Qualitative factors that are relevant are:
- a) The asset profile
 - b) The quality of management information
 - c) The standing and reputation in the market of an individual bank including any branches or subsidiaries of other group banks, and also that of its parent or fellow group companies
 - d) Management ability and skills in the treasury area
 - e) Access to funds from a parent or head office
 - f) Political, economic or geographic factors in relation to the group or parent and the bank's primary customer base.

7. Contingency or Crisis Planning

- 7.1 Either within its LMP or separately, a bank is expected to have a contingency plan that covers the branch in the event of it experiencing liquidity problems. The liquidity policy should be designed to ensure that adequate liquidity is maintained at all times. The liquidity contingency plan should contain a number of key elements:
- The identification and definition of what constitutes a liquidity crisis
 - Early warning indicators, including the impact of external events not directly related to the financial condition of the bank
 - Actions to be taken
 - Roles and responsibilities
 - Management coordination and escalation of issues

- Channels of communication
 - Communication with the Commission
 - Scenario planning and testing.
- 7.2 A copy of this plan must be provided to the Commission.
- 7.3 Liquidity contingency plans vary considerably depending on the nature and size of the bank. A major bank that experiences liquidity problems may require widespread support from the market whereas a branch may be able to rely solely on support from its head office. The plan should clearly state the level of parental support that is available to the branch and the role of the parental supervisor in such a situation.
- 7.4 A contingency plan should state the particular indicators that would warn it of impending liquidity problems. The purpose of early warning indicators is to alert management to the possibility of a liquidity problem so that action can be taken quickly and early enough to prevent the problem turning into a crisis.
- 7.5 Examples on the liability side may include:
- Unexpected and significant withdrawals of retail deposits or non-renewal of wholesale funding facilities
 - Core retail deposit volumes falling below projected levels
 - A shortening of deposit maturities and a rise in requests to break fixed term deposits.
- 7.6 And on the asset side:
- Retail advances growing faster than projected
 - A lengthening of loan maturities
 - Larger than expected drawdown of committed facilities
 - A significant rise in undrawn committed facilities
 - A rise in defaults and delinquencies
 - Prepayments of loan facilities falling below historic behavioural norms.
- 7.7 The monitoring of these indicators should be part of the normal liquidity monitoring procedures. Should any of the defined early warning indicators signal the approach of an impending liquidity problem the contingency plan

should call for a series of predetermined responses. The aim of the plan should be to restore the status quo as soon as possible, while at the same time avoiding any unnecessary overreaction or bad publicity which could aggravate the problem and lead to contagion of the wider market.

- 7.8 The individuals responsible for managing liquidity under problem or crisis conditions should be identified together with the actions that should be taken. These actions might include:
- a) Who should be notified locally, (including the Commission), and at group or parent level
 - b) What reports need to be produced for whom
 - c) Steps that can be taken to improve liquidity for example:
 - a. Raising retail deposit interest rates
 - b. Raising loan interest rates to discourage new borrowings and stabilise the balance sheet
 - c. Reduce liquid assets to the regulatory minimum
 - d. Place a cap on balance sheet growth
 - e. Increase the volume of advertising
 - d) Deciding what public statements, if any, should be made locally and internationally.
- 7.9 A contingency plan needs to cover what sources of funding are likely to be available in the event of a liquidity crisis and which source will prove most reliable. Potential sources of funds in a liquidity crisis would include outright sales or sales under repurchase agreements of marketable assets, undrawn committed facilities, other group entities or, where applicable, head office. Branches should take into account that some customers may withdraw fixed term deposits under interest penalty and factor these balances into their immediate contingency funding requirements.
- 7.10 Effective management of a liquidity crisis can only be achieved if responsibilities are clearly defined in advance. There should be a single source of authority. Each member of staff involved with liquidity should be issued with explicit written instructions about how to proceed if any of the early warning indicators trigger a need for action. It is essential that immediate actions are taken in the event of a crisis without the need to assemble a formal committee. Clear lines of communication should already be established and senior management with defined responsibilities should be issued with clear guidelines of what is expected of them in the event of a crisis. All senior and executive management should have a copy of the contingency plan.
- 7.11 The contingency plan and policy should be subjected to regular scenario planning and stress testing. This will not necessarily have to be at branch level, however.

Appendix 1 - Maturity Treatment of Specific Assets and Liabilities (aspects of this may not apply to a branch)

This list is not exhaustive and banks should contact their relationship manager with specific questions:

- Banks will be required to report on a residual maturity basis. Additional cash flows, from assets and liabilities, such as interest payable and receivable, may be entered in the line provided on Form SR – 3A if desired.
- Commitments to lend that are not due to be met on a particular date; for example, undrawn overdraft facilities cannot be treated precisely. It is recognised that such facilities are unlikely to be withdrawn in full and that only a proportion of them needs to be included in the sight to eight days maturity band. Where this cannot be based on an analysis of past or forecast trends 35% of outstanding commitments should be included.
- In adverse conditions fiduciary deposits and client money accounts may be withdrawn at short notice. Their treatment for liquidity purposes needs to take account of this.
- Contingent liabilities normally do not have cash flow implications and are therefore excluded from the maturity ladder unless the occurrence of trigger events is likely. For example, if a bank has given a guarantee on behalf of a customer and it is known that the customer is likely to default, then the guarantee should be included in the maturity ladder as an outflow.
- Undrawn committed standby facilities from other banks are treated as sight assets. As with commitments to lend, a percentage of the undrawn committed standby facilities are included. This percentage can be up to 100%, with the prior agreement of the Commission, dependent on such factors as the absence of material adverse event clauses in the facility agreement, the frequency with which the facility is used or tested and the strength of the relationship with the facility provider.
- Assets pledged as collateral are excluded from the maturity ladder, as they are no longer available to the bank to meet obligations.

Appendix 2 - Behavioural Adjustments (this does not apply to branches)

1. Rationale for Behavioural Adjustments

- 1.1 The behaviour of a bank's deposit base is central to their liquidity management policy. It has long been accepted that actual cash flows from a bank's deposit liabilities bear little resemblance to their contractual maturity. In particular, only a small percentage of demand deposits are likely to be withdrawn on any one day, and fixed term deposits are often renewed automatically on each maturity date. This behaviour reflects customers' desire to keep their savings readily available in case of any emergency or unforeseen event, rather than an intention to withdraw their funds.
- 1.2 Additionally some assets, such as certificates of deposit, bills of exchange and bonds can be highly liquid, and may be sold at short notice in order to provide liquidity. Full details of the reporting requirements may be found "Form SR-3A – Liquidity Risk – Notes to Assist Completion", and more general guidance in section 4 below.
- 1.3 The Banking (General Practice) Regulatory Code 2005 includes a measure to impose maximum liquidity mismatch limits in the sight to eight days and sight to 1 month maturity bands (normally 0% and 5% of total deposit liabilities respectively). However, in order to recognise the behaviour of some deposit liabilities, the Commission is offering banks the opportunity to apply to report its cash flows on a behaviourally adjusted basis.
- 1.4 The levels of behavioural adjustments will be agreed with banks on a case by case basis, taking into account a number of factors outlined in sections 3, 4 and 5 below.

2. Overview of the Commission's Approach to Behavioural Adjustments

- 2.1 The Commission requires a bank to have a prudent liquidity policy and appropriate systems in place to measure and monitor liquidity, and to ensure that the policy is adhered to. The policy should reflect Commission requirements and may take into account any prudent level of behavioural adjustments agreed between the Commission and the bank.
- 2.2 When establishing what is a "prudent level", it is important to take into account the fact that liquidity limits exist to ensure that a bank has a sufficient pool of available funds or liquid assets to enable it to meet its obligations in times of liquidity stress or disruption. As banks' business and risk profiles differ enormously, it is necessary to examine a number of different issues as they may relate to individual banks during a period of liquidity distress before agreeing a prudential level of behavioural adjustment.
- 2.3 It should also be noted that the Commission analyses banks on an ongoing basis and that they might not always consider it appropriate for behavioural adjustments to be granted to a bank. Additionally, in some instances, the Commission may

issue Directions requiring a bank to maintain a stock of liquidity with, or issued by, third party banks.

3. **Deposit Liabilities - The Commission's Requirements**

- 3.1 Banks applying for behavioural adjustments are required to analyse their deposit base into the following broad classifications:

Wholesale

Incorporating deposits from banks and building societies (including non-committed funding from other group companies), and "commercial" deposits from international life companies, central and national governments and their agencies (or equivalent bodies). Money market interest rates are likely to be paid on these deposits, and they are likely to be the first to be subject to repayment in the event of liquidity disruption. The Commission will not consider behavioural adjustments on wholesale deposits.

Corporate

Including deposits from, or introduced by, small and medium sized enterprises, trust companies, corporate service providers, collective investment schemes, investment managers, accountants and lawyers etc. This represents the large "grey area" between wholesale and retail deposits. Typically, these deposits will be substantially "stickier" and less price sensitive than wholesale, but as the business is directed through a fiduciary intermediary, the deposits cannot be regarded as stable as retail deposits. The Commission will consider limited behavioural adjustments on up to half of corporate deposits.

Retail

Deposits placed by individuals in their own name. Deposits from investment companies and other incorporated bodies that have been established as a SPV should normally be regarded as "Corporate" deposits. Retail deposits tend to be most stable and therefore may attract a higher behavioural adjustment.

- 3.2 Further analysis of deposit books should be undertaken in order to provide supporting evidence to the Commission. In particular, the following areas should be examined and details presented:

a) ***Deposit Profile***

- Deposit mix – retail/corporate/wholesale? (See above for definitions).
- Deposit concentration by depositor (and connected parties), sector, industry, or geographic classification.

b) ***Product Profile***

Identifying the bank's core products and its contractual liquidity profile.

c) ***Deposit analysis***

The analysis should evidence:

- i) The "stickiness" of deposits by product.

- ii) Numbers and values of new and closed accounts.

4. Behavioural Adjustments to Assets

4.1 Full details of the reporting requirements may be found "***Form SR-3A – Liquidity Risk – Notes to Assist Completion***".

4.2 Behavioural adjustments to the following assets do not require the prior approval of the Commission.

- Overdrafts
Although technically available on demand, overdrafts should be reported in the one to three month maturity band.
- Certificates of Deposit and Floating Rate Notes issued by, and Bills of Exchange accepted by third party banks.

These instruments qualify for behavioural adjustment to the sight to less than 8 days maturity band subject to the following discounts:

Under 1 year to maturity:	5%
1 to 5 years to maturity or floating rate:	10%

Where an active secondary market does not exist for an issue or issuer, the Commission may either disallow or reduce the behavioural adjustment pertaining to the asset.

4.3 Prior approval of the Commission is required before applying behavioural adjustments to the following assets:

- Certificates of Deposit and Floating Rate Notes issued by, and Bills of Exchange accepted by other group entities.

Behavioural adjustments will not normally be considered unless the assets are highly liquid and capable of being independently sold in the secondary market. Banks should obtain the prior agreement from the Commission before applying behavioural adjustments to such assets.

- Deposit Bonds Incorporating Embedded Options

To qualify for any behavioural adjustment, a bank must have the sole right to exercise an option for repayment prior to final maturity, or a liquid secondary market for the instrument must exist. The prior agreement of the Commission must be sought before making such adjustments.

- Government Bonds Purchased

Bonds issued by, United Kingdom and other “Zone A” governments, Isle of Man, Jersey, and Guernsey may be subject to a behavioural adjustment to the sight to less than 8 days maturity band subject to the following discounts:

Under 1 year to maturity or floating rate	3%
1 to 5 years to maturity	7%
Over 5 years to maturity	16%

The prior agreement of the Commission must be sought before making such adjustments.

Bonds issued by “Zone B” governments should be reported according to contractual maturity.

- Syndicated Loans

Syndicated loans should generally be reported by contractual maturity. However, where it can be shown that an active secondary market exists for the issuer’s debt, a behavioural adjustment to the maturity profile may be appropriate, and will be considered by the Commission on a case by case basis.

- Other Investments

All other investments should be reported by contractual maturity date. In some cases, such as corporate bonds and commercial paper, behavioural adjustments may be appropriate, and will be considered by the Commission on a case by case basis.

5. Methodology

5.1 The Commission will assess banks’ applications for behavioural adjustments on a case by case basis.

5.2 When determining the level of adjustment, the Commission will, in addition to the above, examine a number of areas, including, but not limited to the following:

a) Ownership.

- Degree of likely parental support in a liquidity disruption.
- Parent’s standing
- Parent’s country of domicile

b) Independent liquidity.

- Level and quality of independent liquidity held.
- c) Business rationale.
- Nature of business.
 - Business strategy.
 - Asset mix.
- d) Pricing policy – how aggressive is the bank’s pricing strategy?
- 5.3 The Commission will then meet with the bank to discuss the analyses and to ascertain the level of adjustment sought by the bank.
- 5.4 A recommendation will then be made to a Commission Validation Panel, and a Recommendation/Direction will be issued to the bank detailing the levels of adjustments that may be made to deposit liabilities.
- 5.5 The agreed levels will represent the percentage of deposits classified as “Corporate” and “Retail” maturing in the sight to eight days, and eight days to one month maturity bands that may be factored out of the contractual maturity bands, and be placed in the one to three month maturity band. It should be noted that, in most circumstances, different levels of adjustment will be allocated to “Retail” and “Corporate” deposits.
- 5.6 In certain circumstances, e.g. during a period of liquidity disruption, the Commission reserves the right to vary levels of behavioural adjustments.

6. Procedures and Systems

- 6.1 The levels of behavioural adjustments agreed with the Commission should eventually be reflected in the bank’s LMP.
- 6.2 The bank should maintain ongoing analysis of the deposit base to support their case for behavioural adjustments to their deposit liabilities. Such analysis, should, on request, be made available to the Commission.
- 6.3 Should the analysis show that the bank’s deposit profile has undergone material change, the bank should notify the Commission immediately, giving full details of the change.
- 6.4 Banks may, at any time, apply to the Commission to alter the levels of behavioural adjustments previously agreed. Any request for an increase in the levels should be supported by empirical evidence.

Liquidity mismatch positions should be reported on Form SR-3A on a contractual basis, and then allowance made for behavioural adjustments. Please refer to Form SR3-A – Liquidity Risk - Notes to Assist Completion for full details.

Appendix 3 – Glossary

“bank” is the Isle of Man incorporated bank (part 1), or the head office, or otherwise as applicable, of the branch (part 2).

“branch” means a branch in the Isle of Man of a bank incorporated outside the Isle of Man