

# NATIONAL RESERVE BANK OF TONGA

## Prudential Statement No.5 *Revised 2012*

### LIQUIDITY

#### Introduction

1. This statement is issued in terms of Section 15(3) of the Financial Institutions Act, 2004.
2. It is the responsibility of the board of directors and management of a licensed financial institution (LFI) to implement and maintain a liquidity management strategy that ensures that the LFI has sufficient liquidity to meet its obligations as they fall due under a range of operating conditions.
3. In developing a management strategy there should be no presumption that the Reserve Bank will provide support through release of required reserves to overcome a LFI's liquidity shortfall.
4. To fulfil its responsibilities for effective management of liquidity risk a LFI must have:
  - documented liquidity and funding policies which have been approved by the Board of Directors, in the case of LFIs incorporated in Tonga, or the appropriate senior offshore executive(s), in the case of a foreign bank branch;
  - arrangements for ongoing monitoring of liquid assets and funding requirements, including management information systems that provide timely and comprehensive data in a suitable format on at least a daily basis;
  - a formal contingency plan for dealing with a liquidity crisis.
5. A financial institution should inform the Reserve Bank immediately of any concerns it has with its current or future liquidity profile and its ability to comply with requirements as well as its plans to rectify the problem(s).

#### Liquidity Policies

6. Documented liquidity policies should articulate the importance placed on liquidity and the LFI's liquidity goals. As well as policies to limit risks to acceptable levels, the documented policies should cover issues such as the diversification of liabilities, the approach to managing liquidity in different currencies, reliance on standby facilities and the liquidity and marketability of assets.
7. A LFI's liquidity management strategy should cover both the domestic and overseas operations of a Tongan incorporated LFI, as well as all related entities which have an impact on the LFI's liquidity. Where a LFI manages liquidity on a group

basis (i.e. an LFI and its approved financial subsidiaries), the strategy should cover both the LFI and the group as a whole. The strategy should cover all on- and off-balance sheet activities of the LFI and, where relevant, the group as a whole across all currencies. A LFI shall adhere to its liquidity management strategy at all times and review it regularly (at least annually) to take account of changing operating circumstances.

8. Liquidity policies should describe the minimum daily holding that the bank will permit having regard to its capacity in the Tongan market to acquire sufficient eligible liquid assets to comply with the minimum liquid assets ratio in paragraph 10. below.

9. The Reserve Bank expects a LFI's policy to incorporate the following two basic approaches:

*(a) Maintenance of a stock of Liquid Assets*

10. All LFIs are required to maintain a minimum holding of 5% of liabilities in specified eligible liquid assets at all times. (Liquid Assets Ratio (LAR)) In the normal course assets required to meet minimum requirements are not available to satisfy liquidity needs and LFIs need to maintain a working buffer above the minimum level. The working buffer would cater for any unexpected liquidity pressures or fluctuations under both normal and adverse operating conditions.

11. Liabilities, for the purpose of this requirement, are defined as all liabilities (other than capital) which are invested in Tongan pa'anga assets within Tonga. For convenience of measurement, the LAR will be calculated on the basis of each LFI's total Tongan pa'anga assets within Tonga less the LFI's capital base

12. To be eligible the assets must be held in the name of the LFI. The assets must be unencumbered by any pledge or restriction on access and be readily transferable and convertible into cash.

Subject to the restrictions in paragraph 10 eligible liquid assets are:

- a. Notes and coins (cash holdings);
- b. Balances with the NRBT (other than Statutory Reserve Deposits);
- c. NRBT Notes;
- d. Government securities (Government bonds and Treasury Bills);
- e. Net Domestic Inter-bank overnight lending (inter-bank lending less inter-bank borrowing) and net domestic inter-bank deposits with maturities of less than 30 days (deposits with other domestic banks with maturities of less than 30 days less deposits by other domestic banks with maturities of less than 30 days);
- f. Net foreign currency working balances (nostro less vostro)

For domestic inter-bank term deposits with maturities of less than 30 days which are included in the eligible liquid assets, in the event where a bank (Bank A) who has lodged deposits with another bank (Bank B) experiences liquidity difficulties/deficiencies, Bank B shall release the deposit funds without penalty or due consideration to Bank A. In addition, in the event that Bank B is unable to pay on

demand by Bank A of its deposits and if domestic liquidity is not sufficient, then Bank B has to source liquidity from its head office and/or shareholders.

LFI's can borrow short term under the Repurchase Agreement facility.

13. The Reserve Bank may, where it is not satisfied with the adequacy of a LFI's liquidity management strategy, or where it has particular concerns about a LFI's liquidity, direct the LFI to hold specified amounts of eligible liquid assets above the minimum requirement defined above.

*(b) Limits on Maturity Mismatching*

14. A liquid assets ratio is not sufficient in itself to manage liquidity because of its static nature and inability to take account of off-balance sheet flows. A LFI should monitor and control the gaps between maturing assets and liabilities in various time bands as well as off-balance sheet cash flows.

15. The construction of such maturity profiles relies heavily on assumptions and these assumptions will vary under different scenarios and according to the business profile of the LFI. In practice the LFI 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 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.g. the inter-bank market or foreign funding markets);
- (e) the convertibility of foreign currencies; and
- (f) access to standby facilities and intra-group funding.

16. A LFI should document in its liquidity 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.

17. Control over maturity gaps in the shorter time periods obviously needs particular attention as this is the area in which a LFI has least room to manoeuvre. At anyone point in time the Reserve Bank will expect to see positive net assets in the next five business days and no more than a modest net cumulative deficit out to one month.

18. An LFI can reduce the volatility of its balance sheet by maintaining a diversified funding base and establishing strong and lasting relationships with depositors and other liability holders. A LFI should establish limits on the concentration of sources of funding so as to avoid excessive reliance on any one counterparty (including related entities) or any one product or market. It should also conduct regular statistical analysis of liabilities to detect any signs that the deposit

base is becoming more volatile. A stable core of deposits and avoidance of reliance on large and potentially volatile deposits are significant components in successful liquidity management.

19. The ability to obtain funds in the inter-bank market or other wholesale markets can be an important source of liquidity but access may be substantially reduced or delayed in crises conditions. As well as meeting maturing obligations there may also be calls for early repayment or denial of access to funding lines in terms of “material adverse change” clauses. LFIs should estimate their “normal” borrowing capacity in such markets and establish a policy regarding reliance on these markets accordingly.

20. Where a LFI has significant foreign currency funding (i.e. more than 5% of total funding) its liquidity policy should address the measurement and monitoring of liquidity in foreign currencies. For example, a LFI needs to assess the convertibility of individual currencies, the timing of access to funds, foreign currency mismatches, the impact of potential disruptions in foreign exchange markets and exchange risks.

21. Policies should be reviewed by the board, or the appropriate offshore executive(s) in the case of a foreign bank branch, as circumstances change such as the introduction of new products or variations in existing products. In any case there should be documented reviews, at least annually, of the continuing appropriateness of policies and the assumptions underlying the behaviour of liabilities and undrawn funding commitments.

22. A LFI should provide the Reserve Bank with a copy of its Liquidity Policy and inform the Bank immediately of any changes. Annual reviews of the Liquidity Policy will be examined during on-site visits conducted by the Reserve Bank in terms of S25 of the *Financial Institutions Act 2004*.

### **On-going Monitoring**

23. As with other elements of risk management, a LFI should have a management structure in place to execute effectively, and ensure observance of, the liquidity strategy, policies and procedures. The responsibility for managing the overall liquidity of the LFI should be placed with an identified officer such as the Manager of the treasury function and/or a group such as an Asset/Liability Committee. Whatever structure is used, it is critical that there be close links between those responsible for liquidity and those monitoring market conditions (e.g. loan sales team), as well as other individuals with access to critical information such as credit managers.

24. A strong management information system is integral to making sound decisions related to liquidity. The management information system should provide the board of directors, senior management and other appropriate personnel with timely and accurate information on the liquidity position of the LFI. The management information system should capture all relevant information, including cash flows associated with off-balance sheet activities, and produce reports on compliance with the LFI’s established policies, procedures and limits as well as enable management to evaluate trends in the LFI’s liquidity backwards and forwards. At a minimum, the management information system must be able to:

- a. report the composition and market values of a bank’s liquid holdings;

- b. and construct maturity profiles of a bank's cash flows to identify cumulative net funding positions at selected maturity dates.

25. Future funding requirements should be analysed on the basis of projected fund inflows and outflows. These projections should be prepared on a rolling basis for each day out to one week, then weekly out to at least 1 month and monthly thereafter. This maturity profile ladder will have different assumptions to the repricing gap calculations done for measurement of interest rate risk.

26. The expectation is that Liquidity Policies will be observed at all times. Any deviations from the approved Liquidity policy and limits – that do not involve a breach of the requirement in paragraph 10 above – should be subject to prior approval from the authorised nominated responsible officer **and** reported to the Board at least on a quarterly basis in the case of a Tongan incorporated LFI, or those responsible offshore in the case of foreign bank branches. Exceptions should be rare and result in prompt corrective action in accordance with previously agreed strategies.

### **Contingency Plans**

27. As well as establishing policies which deal with the behaviour of cash flows in the ordinary course of business, the Reserve Bank expects LFIs to have contingency plans to deal with a worst case “name crisis” arising out of real or perceived problems and adverse rating changes. Deposit retention in particular is likely to become more problematic in a “name crisis” and require active management.

28. For branches and subsidiaries of foreign banks contingency plans need to cover not only a crisis precipitated by local factors but also a crisis affecting the global group. The Reserve Bank expects contingency policies of foreign bank branches to cover both these scenarios.

29. Plans should:

- Name the officer who would assume responsibility for identifying a crisis, instituting crisis management and notifying the Reserve Bank.
- Provide procedures to ensure that all necessary information is available to enable senior management to make quick decisions;
- Specify what early warning signals might be used as signs of an impending crisis and time frames within which action should be taken. They should spell out clearly the sources of fall-back funding; their expected reliability and the priority in which they will be accessed.
- Outline courses of action for altering asset and liability behaviour e.g. plans to raise deposits, restrict growth in assets;
- Assess the likely impact of particular courses of action on the market's perception of the LFI;
- Provide procedures for determining the priority of customer relationships – e.g. the order in which lines of credit would be withdrawn from specific customers
- Detail plans for dealing with the staff and public, key market participants and the media. Astute public relations management can help a LFI counter rumours that can result in significant run-offs by retail and commercial depositors.

30. A LFI should review and update its contingency plan regularly (at least annually) to ensure that it remains robust over time and reflects the bank's changing operating circumstances. A bank 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.

31. The Reserve Bank expects that an LFI will be capable of operating for at least five business days under "name" crisis conditions.

32. The "name crisis" scenario should be covered in the Liquidity Policy submitted to the Reserve Bank and the LFI's maturity profile under the "name" crisis scenario should be submitted to the Reserve Bank each quarter along with the maturity profile for "normal" operating conditions.

### **Reporting Arrangements**

33. The holding of the eligible assets are to be reported in the FID 2 Weekly Liquidity Reports no later than 1 business day from the end of the week reported (Attachment 1). The Reserve Bank may require less frequent reporting when a LFI's liquidity is at a more comfortable level or less "tight". A LFI must also provide the Reserve Bank each month (or more frequently if required by the Reserve Bank) with a maturity GAP report under FID 1\_4 (Attachment 2).

### **Compliance with Prudential Statement No. 5**

34. This statement is effective from 1 May 2012. Non-compliance with the requirements of this Prudential Statement will be subject to corrective actions as provided under section 33 of the Financial Institutions Act 2004 and the administrative penalties outlined in Prudential Statement No.3 Administrative Penalties.

National Reserve Bank of Tonga  
March 2012

## Attachment 1

| NRBT Weekly FID 2                         |   |                |
|---|---|----------------|
| <b>WEEKLY LIQUIDITY REPORT</b>            |   |                |
| (T\$000 on Last Business Day of the Week) |   |                |
|   |   | <u>Balance</u> |
| a   | Notes and Coins <sup>1</sup>  | -              |
| b   | Balances with NRBT <sup>2</sup>   | -              |
| c   | NRBT notes  | -              |
| d   | Government bonds  | -              |
| e   | Net domestic inter-bank overnight lending (borrowing) / deposit <sup>3</sup>  | -              |
| f   | Net foreign currency working balances <sup>4</sup>  | -              |
|   |   |                |
| g   | Total Eligible Liquid Assets <sup>5</sup>   |                |
|   |   |                |
| h   | Total Liabilities <sup>6</sup>  | -              |
|   |   |                |
| i   | <b>Liquid Asset Ratio (%)</b> <sup>7</sup>  |                |
|   |   |                |
|   |   |                |
|   | <b>MEMORANDUM ITEMS</b>   |                |
| j.i.                                      | total inter-bank deposits with other domestic banks with maturities of less than 30 days  |                |
| j.ii.                                     | total inter-bank deposits by other domestic banks with maturities of less than 30 days  |                |
|   |   |                |
|   | Notes:  |                |
| 1/  | Cash balance = FID 1 line 1.1 column (d)  |                |
| 2/  | Exchange Settlement Account excluding Statutory Required Deposits = FID 1 line 1.2.1.1.1.2 column (d)   |                |
| 3/  | Overnight inter-bank lending + deposits held with other domestic banks with maturities of less than 30 days [as reported above in Memorandum Item j.i.] less overnight interbank borrowing + deposits by other domestic banks with maturities of less than 30 days [as reported above in Memorandum Item j.ii.] |                |
| 4/  | Nostro less vostro = FID 1 line 1.2.1.2 column (c) less FID 1 line 2.1.1.6.1 column (b) and line 2.1.1.6.2 column (b)   |                |
| 5/  | Sum of 'a' to 'f'   |                |
| 6/  | Total Liabilities = FID 1 line 2 column (d) less FID 1 line 2.11 column (d)   |                |
| 7/  | Liquid Asset Ratio = total eligible liquid assets / total liabilities = 'g' / 'h'   |                |



|            |   |   |   |   |   |   |   |   |   |  |  |   |
|------------|---|---|---|---|---|---|---|---|---|--|--|---|
| 2.2        | Savings Deposits                            | - |   |   |   |   |   |   |   |  |  | - |
| 2.3        | Time Deposits                               | - | - | - | - | - | - | - | - |  |  | - |
| 2.4        | Debt Securities Issue<br>To                 | - | - | - | - | - | - | - | - |  |  | - |
| 2.5        | Borrowings                                  | - | - | - | - | - | - | - | - |  |  | - |
| 2.6        | Interbank Funds<br>Purchased                | - |   |   |   |   |   |   |   |  |  | - |
| 2.7        | Accrued Interest<br>Payable                 | - | - | - | - | - | - | - | - |  |  | - |
| 2.8        | Dividends Payable                           | - | - | - | - | - | - | - | - |  |  | - |
| 2.9        | Interest in Suspense<br>on Loans & Advances |   |   |   |   |   |   |   |   |  |  | - |
| 2.1<br>0   | Other Liabilities                           | - | - | - | - | - | - | - | - |  |  | - |
| 2.1<br>1   | Provisions for<br>Losses                    |   |   |   |   |   |   |   |   |  |  | - |
| 2.1<br>2   | Accumulated<br>Depreciation                 |   |   |   |   |   |   |   |   |  |  | - |
| 2.1<br>3   | Off-Balance Sheet<br>Liability Items        |   |   |   |   |   |   |   |   |  |  |   |
| 2.13<br>.1 | Firm<br>Commitments                         | - | - | - | - | - | - | - | - |  |  | - |
| 2.13<br>.2 | Foreign<br>Exchange                         | - | - | - | - | - | - | - | - |  |  | - |
| <b>3</b>   | <b>Maturity Gap (+/-)</b>                   | - | - | - | - | - | - | - | - |  |  | - |
| <b>4</b>   | <b>Cumulative Gap</b>                       | - | - | - | - | - | - | - | - |  |  | - |