

RESERVE BANK OF VANUATU

INTERNATIONAL BANK

PRUDENTIAL GUIDELINE No. 3

GUIDELINES FOR SUPERVISION OF THE ADEQUACY OF LIQUIDITY OF INTERNATIONAL BANKS

- 1 This statement outlines the reserve bank's approach to supervision of the liquidity adequacy of international banks.
- 2 The maintenance of an assured capacity to meet promptly all obligations as they fall due is fundamental to banking. It is the responsibility of an international bank's management to ensure that its internal systems and controls are adequate to ensure resources are available to cover potential funds outflows.

Liquid Assets Requirement (LAR)

- 3 Each international bank is to maintain at all times a minimum proportion of its balance sheet in specified liquid assets. The Liquid Assets Requirement (LAR).
- 4 This provides a stock of cashable, undoubted assets, which, with the Reserve Bank's approval, can be *quickly* converted into cash in extreme circumstances. Such stock is additional to the liquid assets which each international banks needs for management of its day-to-day liquidity needs.
- 5 LAR is expressed as a ratio of an international bank's liabilities.
The *numerator* of the ratio comprises:
 - notes and coin;
 - balances with any Reserve Bank or Central Bank (other than Statutory Reserve Deposits);
 - Any Reserve Bank or Central Bank and Treasury notes; and
 - other Central Government securities.
- 6 To be eligible, liquid assets must be held in the name of the international bank; they must be unencumbered by any pledge or restriction on access and be readily transferable.
- 7 The *denominator* of the LAR ratio comprises all liabilities (other than capital), which are invested anywhere. For convenience of measurement, the LAR ratio will be calculated on the basis of each international bank's total assets anywhere less:
 - the international bank's capital base; and
 - favourable overnight settlement balances.
- 8 The LAR ratio is a fixed minimum, which each international bank is required to meet at *all* times.

- 9 The minimum ratio. The Reserve Bank will review and agree with each international bank the adequacy and appropriateness of that particular international bank's liquidity management strategy, having regard to the bank's size and nature of operations. Each international bank shall consult the Bank prior to making any material changes to the agreed liquidity management strategy.
- 10 If an international bank should find itself in danger of breaching the LAR ratio – which should be a rare and exceptional situation – it must advise the Bank immediately and, in consultation with the Bank, take prompt action to correct the situation.
- 11 The Liquid Assets Requirement for each international bank may be reviewed from time to time.

Liquidity Management

- 12 In addition to LAR, each international bank should ensure that it manages its liquidity prudently and efficiently.
- 13 Prudent liquidity management should not rest on an assumption that the behaviour of depositors and borrowers will always be within predictable bounds; nor that the international bank will always be able to fund any liquidity shortfall by purchased money.
- 14 An international bank requires adequate liquidity to enable it to cover:
 - withdrawal of deposits;
 - differences in the maturity pattern of assets and liabilities;
 - increases in demand for loans, including increased usage of unused overdraft facilities;
 - shortfalls in protected cash flows; and
 - unplanned expenditures.
- 15 An international bank can use a variety of techniques to meet its liquidity needs:
 - holding adequate cash and readily liquefiable assets;
 - maintaining assured standby arrangements with other banks;
 - developing and maintaining a stable core of deposits;
 - maintaining a suitably matched maturity structure of assets and liabilities which generates a steady pattern of cash inflow and allows the refinancing of liabilities in digestible amounts; and
 - developing its capacity for asset and liability management.
16. The Bank will regularly review with international banks their policies and systems for monitoring and controlling their liquidity needs. The Bank seeks to determine that international banks are following practices, which limit liquidity risks to prudent levels, and that policies are observed and reviewed to take

account of changing circumstances.

- 17 At the core of international banks' liquidity management systems there should be a comprehensive monitoring of:
 - the maturity profile of its assets and liabilities (including off-balance sheet commitments and transactions);
 - the buffer of liquid assets, additional to LAR, to ensure that the exempted financial institution will be able to absorb day-to-day fluctuations in its liquidity;
 - potential sources of deposit volatility; and
 - concentration in sources and application of funds.
- 18 Regular evaluation of the maturity structure and related aspects of international banks' assets and liabilities is fundamental to supervision of the adequacy of liquidity.
- 19 Banks should ensure that liquid assets additional to LAR are adequate to avoid undue reliance on liability management. Liability management depends on an international bank's market status, the depth of the money markets and the general liquidity situation – factors, which can change rapidly. Undue reliance on it can risk the need for urgent sale of assets at heavy loss or the purchase of liabilities at interest rates higher than can be sustained in the medium term.
- 20 International banks are expected to hold an adequate stock of high quality liquefiable assets in suitable currencies.