Financial Regulator Issues Circular on Management of Liquidity Risk

Banks in Luxembourg and around the world have prioritized liquidity risk and risk exposure and have taken steps to improve the quality of their risk management. Risk in a banking context covers not only credit risk, market risk, operational risk and interest rate risk, but also liquidity risk.

The Committee of European Banking Supervisors (CEBS), composed of high-level representatives from the banking supervisory authorities and central banks of the European Union, was established in 2004 in order to advise the European Commission on banking policy issues and to promote cooperation and convergence of supervisory practice across the European Union. In June 2008 the CEBS published the second part of its advice to the European Commission on liquidity risk management, including 30 recommendations on liquidity risk management and supervision.(1)

National Supervisory Framework

Articles 5 and 17 of the Financial Sector Law require that credit institutions have effective processes to identify, manage, monitor and report the risks to which they are or may be exposed. The supervision of liquidity risk is shared between the Financial Sector Supervisory Authority and the Central Bank of Luxembourg. According to Article 45 of the law, the authority, being the competent entity of the host EU member state, is also responsible for supervising the liquidity of Luxembourg branches of credit institutions authorized in another member state, in cooperation with that state's competent authorities. The Central Bank of Luxembourg is responsible for supervising general market liquidity, as well as the liquidity of individual financial market operators. The law provides that coordination and cooperation in this task are subject to agreements between the Central Bank of Luxembourg and the authority. On April 29 2009 the Central Bank of Luxembourg issued Regulation 4/2009 on liquidity supervision,(2) which states that it is responsible for supervising general market liquidity and assessing market participants. Article 3(3) states that it must apply the regulation in cooperation with other supervisory authorities in the financial sector pursuant to cooperation agreements.

The regulation primarily covers credit institutions that are monetary policy counterparties, but also applies on a case-by-case basis to other operators, such as:
- collective investment undertakings;
- insurance companies;
- pension funds;
- risk capital investment companies;
- securitization undertakings;
- issuers of payment instruments; and any other operators identified by the Central Bank of Luxembourg as monetary policy counterparties.
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Market participants must establish an appropriate liquidity management framework and provide the Central Bank of Luxembourg with all relevant information. The authority must cooperate with the Central Bank of Luxembourg and the other authorities responsible for prudential supervision at national, EU and global level in order to ensure financial stability, primarily through its participation in the committees set up for this purpose.

In May 2009 the authority issued a new circular on the management of liquidity risk. Circular 09/403 amends the Circular on the Internal Capital Adequacy Assessment Process 07/301.

Scope of New Circular

Circular 09/403 applies to credit institutions and investment firms incorporated in Luxembourg and to branches of EU and non-EU firms and institutions in Luxembourg. Where a credit institution is a branch or a subsidiary, its establishment in Luxembourg must be taken into account in order to ensure sound consolidated risk management. In practice, institutions in Luxembourg must be able to manage their local liquidity risks, conduct liquidity stress tests and manage liquidity crises. They must also have sufficient reserves to prepare for and deal with a liquidity crisis. Potential liquidity risk in respect of a group of institutions must be distinguished from risk in respect of one entity in the group. Luxembourg subsidiaries must be able to manage their liquidity risks internally and adequately, even if the group of companies benefits from preferential treatment in accordance with prudential regulations.

Implementation of CEBS Principles

Circular 09/403 implements the 30 CEBS principles on sound liquidity risk management which complete the rules issued by the CEBS on January 25 2006 and reflected in Circular 07/301. Circular 07/301 requires credit institutions to (i) assess whether their internal capital is adequate to cover all risks to which they are or could be exposed, and (ii) hold adequate internal capital. The structure of the assessment process described in Chapter II of the circular is identical to that adopted in Circular 09/443, requiring internal processes for (i) identifying, measuring, managing and reporting risks to which the institution is exposed, and (ii) capital planning and capital management so as to allows the institution to ensure internal capital adequacy on an ongoing basis.

The supervisory review process described in Chapter III of Circular 07/301 applies to all risks, including liquidity risks. At least once a year the authority must evaluate the risks to which institutions may be exposed and assess the extent to which existing internal processes ensure adequate management and coverage of such risks. The institutions must supply the authority with all necessary information to this end. The first 18 recommendations are intended to ensure that adequate liquidity risk management provisions are in place, whereas the final 12 recommendations relate to the prudential supervision of liquidity risk. The proportionality principle requires the authority to check that credit institutions have established adequate and effective strategies, policies and procedures for normal periods and periods of financial stress. It is also required to coordinate closely with other supervisors.

Circular 09/443 provides that liquidity risk management must be monitored by a sufficient number of competent staff with the necessary technical infrastructure at their disposal. A bank's risk control function must operate as a separate unit within the organization and this role may not be delegated or outsourced. The supervisory process also applies to intra-group operations. Pursuant to Article 47 of Circular 07/301, the authority can limit intra-group operations which are contrary to sound and prudential liquidity management principles with respect to the entity's establishment in Luxembourg.

Amendments to Circular 07/301

Circular 09/443 amends Circular 07/301 on the following points:
- The bank's management team must appoint one of its members to be directly in charge of the risk management function and must inform the authority of the name of the person and of any change in the role;
- If the board of directors discovers that risks are no longer adequately covered by internal risk management systems, it must implement corrective measures and charge of the risk management function and must inform the authority of the name of the person and of any change in the role;
- If the board of directors discovers that risks are no longer adequately covered by internal risk management systems, it must implement corrective measures and inform the authority; and
- The management must immediately inform the board of directors and the authority if internal risk management systems or internal capital management systems do not adequately support the development of incurred risks.

Definition of Liquidity Ratio

Circular 09/403 does not change the liquidity ratio to be observed by credit institutions, as defined in Circular 93/104. Circular 93/104 applies to all credit institutions incorporated or established in Luxembourg and to branches of banks whose head office is in the European Union. Such institutions must permanently maintain their liquidity ratio on an individual, nonconsolidated basis, ensuring that existing liabilities are covered by liquid assets at all times.

However, Chapter V(15) of Circular 9/403 highlights that the ratio and Reporting Requirement B1.5 will soon be amended because:
- they do not allow for correct prudential supervision of liquidity risk;
- the CEBS recommendations state that credit institutions should maintain adequate liquidity reserves, which requires changes to the prudential requirement in Requirement B1.5; and
- they penalize credit institutions that give assets as guarantees to central banks against non-drawn credit lines, since such operations - although advantageous from a prudential perspective - reduce their liquidity ratio under Requirement B1.5. The authority intends to exempt banks from deducting these assets in future.

Directors' and Managers' Responsibilities

The board of directors must establish the main principles and objectives of risk management and entrust the application of its liquidity strategy, policies and practices to the institution's authorized management.

The management must:
- take into account all kinds of liquidity risk (Recommendations 4, 6, 8 and 13);
- prepare plans to deal with a liquidity crisis (Recommendation 15);
- adequately manage all concentration risks relating to liquidity (Recommendation 17); and regularly conduct liquidity stress tests and check that its methodology adequately covers all foreseeable cash inflows and outflows (Recommendations 13, 14 and16).

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(1) For further details please see www.iasplus.com/crunch/0809cebsadvice.pdf.
(2) See page 1527 of Memorandum A-102, published on May 18 2009.

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