Liquidity Policy Consultation Paper – 31 October 2008

Contents

Consultation on Liquidity Policy for Registered Banks

The Reserve Bank has been reviewing its prudential liquidity rules for banks. As part of the review we are now consulting on a draft Liquidity Policy. The consultation paper, including the draft Liquidity Policy, is attached.

Events in world financial markets have emphasised the importance of robust liquidity-risk management by banks, and have underscored our long-standing concerns about the liquidity and refinancing risks in the New Zealand banking system. The current review of our prudential liquidity rules comes about as part of our ongoing work to ensure that banking supervision in New Zealand continues to make its best contribution to our statutory objectives: the soundness and efficiency of the financial system, and avoiding the damage that the system might incur should a registered bank fail.

Our existing rules require banks to publish information about their risk-management policies, and require that those responsible for governing banks attest to the adequacy of those policies. Liquidity risk is one of the types of risk that must be addressed in such disclosure and attestations. As the attached draft Liquidity Policy makes clear, our analysis suggests a need to supplement the existing approach with rules and guidelines as to how the Reserve Bank expects registered banks to address liquidity-risk management.

The aim of the proposed policy is to ensure that banks: maintain robust liquidity positions as measured over both short and longer terms; have robust internal arrangements for managing liquidity risk; and provide clear and useful information to the public and the Reserve Bank about liquidity risk and the management thereof. Those objectives are reflected in the nature of the proposed Liquidity Policy, whose main components are:

- limits on a bank’s mismatch positions over one week and one month;
- a minimum “core funding” ratio;
- identification of some required elements in banks’ internal liquidity-risk management arrangements;
- greater specificity on the required content of public disclosure; and
- required reporting to the Reserve Bank on a limited set of important indicators of liquidity and liquidity risk.

The proposed approach aims to ensure that banks meet some minimum standards, while still allowing flexibility in the detail of how banks meet the requirements. Our emphasis would continue to be on bringing market discipline and self discipline to bear through public disclosure. However, the nature of liquidity and liquidity risk means that some prescription will be needed in certain areas to ensure satisfactory outcomes.

The requirements proposed in this policy are the “steady state” requirements that would exist under the policy. We understand that registered banks will need a period of time to achieve compliance with some of the requirements, especially in the current environment. Consequently some form of adjustment period will be needed for the proposed quantitative requirements (and possibly for some parts of the proposed qualitative rules). In contrast, we would expect banks to be able to meet the reporting and disclosure requirements from the inception of the Liquidity Policy as they are very similar to the existing disclosure requirements applying to registered banks.

The Reserve Bank will continue to monitor market developments in assessing a realistic transition period to full compliance with the Liquidity Policy, as well as taking into account discussions with your bank on the transition period. Once a satisfactory path has been determined, conditions of registration would be put in place requiring your bank to meet the target date for compliance and any identified milestones along the way. Subject to the consultation and analysis of the transition period, we expect that banks should be able to be compliant with all requirements by the end of 2010 (as well as with required milestones during the transition period).

We invite comments on all elements of the draft Liquidity Policy, although Appendix A to this Consultation Paper sets out specific questions for consideration by banks when responding to our consultation.

The Reserve Bank invites submissions on the Consultation Paper by 31st of December 2008. Submissions and technical enquiries about the consultation should be addressed, in the first instance, to:

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Following the consultation period, and having made any amendments to the Policy in light of submissions, the Reserve Bank aims to issue a finalised Liquidity Policy early in 2009. Upon issuing the Policy, the Reserve Bank will commence discussions with individual banks about the application of the Policy's conditions of registration and any particular issues in those banks' paths to compliance.

RESERVE
BANK
OF NEW ZEALAND

DRAFT Liquidity Policy

Prudential Supervision Department
Document BS13

Issued: [Month] [Year]

A. INTRODUCTION

Liquidity policy and the Reserve Bank's objectives

1. This Liquidity Policy sets out the Reserve Bank of New Zealand's (Reserve Bank's) policy on the management of liquidity risk by registered banks.

2. The Reserve Bank has powers under Part 5 of the Reserve Bank of New Zealand Act 1989 (the Act) to register banks and undertake prudential supervision of registered banks.

3. Section 68 of the Act requires the powers under Part 5 of the Act to be exercised for the purposes of:

    (a) promoting the maintenance of a sound and efficient financial system; or

    (b) avoiding significant damage to the financial system that could result from the failure of a registered bank.

4. Section 68A of the Act requires that the Reserve Bank, when exercising its part 5 powers, must support Australian authorities in pursuit of Australian financial stability and where reasonably practicable avoid actions that might be detrimental to Australian financial stability.

5. Bank liquidity is essential to the functioning of the financial system. Liquidity problems at a registered bank can harm confidence and cause liquidity problems to spread through the financial system. In the case of minor disruptions, this could inhibit smooth operation of the financial system and make daily business more costly and less certain. Larger disruptions impose material costs on the wider economy as well as financial system participants, and could even give rise to the failure of other banks.

Conditions of registration

6. Section 74 of the Act permits the Reserve Bank to impose conditions of registration that relate to, among other things, the matters referred to in the following sections of the Act:

    (a) 73A;

    (b) 73B; and

    (c) 78(1)(f) and 78(1)(fa);

7. The matters referred to in section 73A of the Act apply to the case where a registered bank operates or a proposed registered bank would operate as a branch of an overseas person. Those matters are:

    (a) the law and regulatory requirements of the applicant's home jurisdiction that relate to –

        (i) the recognition and priorities of claims of creditors or classes of creditors in the event of the insolvency of the applicant; and

(ii) the disclosure by the applicant of financial and other information of the kind that a registered bank must disclose under section 81 [of the Act]; and

(iii) the accounting and auditing standards applicable to the applicant; and

(iv) the duties and powers of directors of the applicant; and

(v) the licensing, registration, authorisation, and supervision of the applicant; and

(b) the nature and extent of financial and other information disclosed to the public by the applicant.

8. The matters referred to in section 73B of the Act apply where a registered bank operates or a proposed registered bank would operate as a subsidiary of an overseas person. Those matters are:

(a) the law and regulatory requirements of the home jurisdiction of the overseas person that relate to –

(i) the disclosure by the overseas person of financial and other information of the kind that a registered bank must disclose under section 81 [of the Act]; and

(ii) the accounting and auditing standards applicable to the overseas person; and

(iii) the duties and powers of directors of the overseas person; And

(iv) the licensing, registration, authorisation, and supervision of the overseas person; and

(b) the nature and extent of financial and other information disclosed to the public by the overseas person.

9. The matters referred to in section 78(1) of the Act that are of interest here are, respectively:

(f) internal controls and accounting systems or proposed internal controls and accounting systems; and

(fa) risk management systems and policies or proposed risk management systems and policies.

Guidelines

10. Under Section 78(3) of the Act, the Reserve Bank may issue guidelines for the purpose of interpreting whether a bank is carrying on business in a prudent manner with regard to the matters identified in Section 78(1) of the Act. The matters in 78(1) that are of interest here are:

(f) internal controls and accounting systems or proposed internal controls and accounting systems; and

(fa) risk management systems and policies or proposed risk management systems and policies.

Disclosure to the public

11. Under section 81 of the Act, the Governor General may, on the advice of the Minister and in accordance with a recommendation by the Reserve Bank, prescribe information or data that registered banks must publish in disclosure statements. That information may include financial, prudential and other matters relating to the business, operation and management of a registered bank.

Regulatory reporting

12. Under section 93 of the Act, the Reserve Bank may require a registered bank to provide information, data or forecasts to the Reserve Bank. A notice under section 93 may specify:

(a) the periods for which, and form in which, the information, data or forecasts must be supplied; and

(b) the time by which the information, data or forecasts must be supplied.

B. POLICY REQUIREMENTS

13. Under the Liquidity Policy, registered banks will in general be subject to conditions of registration as set out in Appendix 1 of this Liquidity Policy.

14. In addition, registered banks must report information on liquidity and liquidity risk to the Reserve Bank as set out in a notice given to registered banks under Section 93 of the Act and repeated in Appendix B of this Liquidity Policy. The nature of the reporting requirements is summarised in section E of this Liquidity Policy.

15. Registered banks must publicly disclose information about their liquidity risk and liquidity-risk management. The requirements are set out in Disclosure Orders in Council and summarised in Appendix 3 of this Liquidity Policy.

B.1 Application of conditions of registration

16. The Reserve Bank will generally seek to impose on all registered banks standard conditions of registration regarding liquidity-risk management.

17. That notwithstanding, the Reserve Bank reserves the right to consider applying conditions of registration that differ in nature among banks or among classes of banks. However, all banks will be subject to requirements that would be expected to achieve the Liquidity Policy’s objectives.

18. Variations in the application of the policy would be considered only where the circumstances of individual banks or of classes of banks give strong reasons for differences in the detail of how those conditions of registration are applied (i.e. the calibration of the policy).

19. In particular, the Reserve Bank might in certain cases consider alternative treatment for branches of foreign banks under the Liquidity Policy. This might be considered where:

(a) the overseas-incorporated New Zealand registered bank does not have a related party operating in New Zealand as a large New Zealand-incorporated registered bank (where "large" is defined as in the January 2006 Reserve Bank of New Zealand document entitled "Outsourcing Policy – Financial Stability Department Document BS11");

and

(b) the international banking group's policies are robust and would give rise to liquidity-risk management for the New Zealand branch consistent with achieving the outcomes sought by this Liquidity Policy; or

(c) the home-country supervision applying to the international banking group would give rise to liquidity-risk management for the New Zealand branch consistent with achieving the outcomes sought by this Liquidity Policy.

20. The rest of this document:

- sets out the method of calculation for the quantitative requirements;
- sets out the conditions of registration and related guidelines for banks' liquidity-risk management;
- provides guidelines on how a registered bank could apply the qualitative requirements to its operations; and
- summarises the nature of the required public disclosures and directors' attestations under the Liquidity Policy, and the nature of reporting to the Reserve Bank.

C. QUANTITATIVE REQUIREMENTS

21. The specific application of the Liquidity Policy's quantitative requirements to a registered bank will be set out in a registered bank's conditions of registration. The standard Conditions of Registration are set out in Appendix 1 of this Liquidity Policy.

22. Under the Reserve Bank's disclosure requirements, directors of a registered bank, and the New Zealand Chief Executive Officer for a registered bank incorporated overseas, must attest that the registered bank has, at the reporting date and over the accounting period, complied with the registered bank's conditions of registration including the quantitative liquidity requirements set out here.

23. A registered bank must also disclose information to the public and report to the Reserve Bank about the registered bank's performance against the quantitative requirements. The nature of the disclosure and reporting requirements is set out in section E of this Liquidity Policy.

24. Except where a registered bank's conditions of registration state otherwise, the registered bank must calculate its position against the Liquidity Policy's quantitative

requirements by the approach set out in the remainder of Section C. The definitions and "haircuts" to be used in the calculations are defined in Section C.4.

C.1 One-week mismatch ratio

25. The one-week mismatch ratio must be maintained at greater than or equal to zero per cent at the end of each business day.

26. The one-week mismatch dollar amount for the purposes of calculating the one-week mismatch ratio is defined as follows, with the components defined in section C.4.

One-week mismatch dollar amount =

	primary liquid assets after accounting for haircuts
plus	contractual inflows due within one week
plus	25 per cent of committed lines granted to the bank available within one week
minus	100 per cent of wholesale funding withdrawable at sight or with residual contractual term within one week
minus	10 per cent of retail funding withdrawable at sight or with residual contractual term within one week
minus	15 per cent of the gross balance of committed lines granted by the bank drawable within one week

27. The one-week mismatch ratio is defined as follows, with the components defined in section C.4.

One-week mismatch ratio =
100 x (One-week mismatch dollar amount / Total funding)

C.2 One-month mismatch ratio

28. The one-month mismatch ratio must be maintained at greater than or equal to zero per cent at the end of each business day.

29. The one-month mismatch dollar amount for the purposes of calculating the one-month mismatch ratio is defined as follows, with the components defined in section C.4.

One-month mismatch dollar amount =

	primary liquid assets after accounting for haircuts
plus	secondary liquid assets after accounting for haircuts
plus	contractual inflows due within one month
plus	25 per cent of committed lines granted to the bank available within one month
minus	100 per cent of wholesale funding withdrawable at sight or with residual contractual term within one month
minus	15 per cent of retail funding withdrawable at sight or with residual contractual term within one month
minus	15 per cent of the gross balance of committed lines granted by the bank drawable within one month

30. The one-month mismatch ratio is defined as follows, with the components defined in section C.4.

One-month mismatch ratio =
100 x (One-month mismatch dollar amount / Total funding)

C.3 One-year core funding ratio

31. The one-year core funding ratio must be maintained at greater than or equal to 70 per cent at the end of each business day.

32. The core funding dollar amount for the purposes of calculating the one-year core funding ratio is defined as follows, with the components defined in section C.4.

One-year core funding dollar amount =
wholesale funding with residual maturity longer than one year
plus retail funding with residual maturity longer than one year
plus 80 per cent of retail funding withdrawable at sight or with residual maturity shorter than one year
plus total shareholders' equity

33. The one-year core funding ratio is defined as follows, with the components defined in section C.4.

Core funding ratio =
100 x (One-year core funding dollar amount / total assets)

C.4 Definitions: components of the quantitative ratio requirements

34. Section C.4 defines the variables that are to be used in the calculation of the quantitative requirements under this Liquidity Policy.

35. **Primary liquid assets** are those that are eligible for use in the Reserve Bank's Domestic Market Operations, with the exceptions of bank-issued Registered Certificates of Deposit (RCDs), Residential Mortgage Backed Securities (RMBSs), and Asset Backed Securities (ABSs). The contribution of primary liquid assets to meeting mismatch requirements will be subject to the same haircuts as apply for the purposes of the Reserve Bank's Domestic Market Operations.

36. **Secondary liquid assets** contain the following classes of assets, which will be subject to the stated haircuts when calculating their contribution to the one-month mismatch requirement.

(a) Bank-issued Registered Certificates of Deposit issued by another bank, subject to the haircut that applies for the purposes of the Reserve Bank's Domestic Market Operations.

The total contribution of RCDs to the dollar-amount mismatch calculation, after applying the haircut, must not exceed two percent of the registered bank's total assets.

(b) Residential Mortgage Backed Securities and Asset Backed Securities issued by another institution and eligible for use as "two-name" securities in the Reserve

Bank's Domestic Market Operations, subject to the haircut that applies for the purposes of the Reserve Bank's Domestic Market Operations.

The total contribution of RMBSs to the dollar-amount mismatch calculation, after applying the haircut, must not exceed two percent of the registered bank's total assets. Similarly, the total contribution of ABSs to the dollar-amount mismatch calculation, after applying the haircut, must not exceed two percent of the registered bank's total assets.

(c) New Zealand Dollar-denominated debt securities with a short-term credit rating of A1+ (by Moody's or Standard and Poor's) or F1 (by Fitch), or a long-term credit rating of AAA for such securities with residual maturity greater than one year, subject to the haircut applying to those securities of such types that are eligible for the Reserve Bank's Domestic Market Operations for the purposes of those Operations.

(d) Foreign currency-denominated debt securities issued by governments with credit ratings of AAA, subject to a five percentage point margin over the haircut applying to those securities of this type that are eligible for the Reserve Bank's Domestic Market Operations for the purposes of those Operations.

37. The following table summarises the acceptable securities and haircuts in the Reserve Bank's Domestic Markets operations as at 28 August 2008. At any given time, the fully-detailed list of such securities is set out on the Domestic Markets section of the Reserve Bank's website.

<table>
<tr><th rowspan="2">Rating</th><th rowspan="2">Eligible Security</th><th colspan="2">Haircut

Residual maturity</th></tr>
<tr><th>< 3 years</th><th>≥ 3 years</th></tr>
<tr><td rowspan="4">AAA</td><td>NZ Government
- Treasury bills
- Bonds
- Inflation-Indexed Bonds</td><td>1%</td><td>3%</td></tr>
<tr><td>Acceptable Kauri issues (NZ$)</td><td>3%</td><td>5%</td></tr>
<tr><td>Bank paper (NZ$) - NZ Registered Banks only
Local Authorities (NZ$)
State Owned Enterprises (NZ$)
Corporate Paper (NZ$)</td><td>8%</td><td>10%</td></tr>
<tr><td>Residential Mortgage Backed Securities (RMBS) (NZ$)
Asset Backed Securities (ABS) (NZ$)</td><td colspan="2">19%</td></tr>
<tr><td>AA- to AA+</td><td>Bank paper (NZ$) - NZ Registered Banks only
Local Authorities (NZ$)
State Owned Enterprises (NZ$)</td><td>10%</td><td>15%</td></tr>
<tr><td>BBB to A+</td><td>NZ Registered Bank RCDs
(Maturity date less than 365 days)</td><td>10%</td><td>15%</td></tr>
</table>

38. **Committed lines granted to the registered bank** are defined as [see comment in Appendix A to the Consultation Paper] any line:

(a) that is legally binding;

(b) whose commitment agreement will remain valid for at least 6 months;

(c) that is not unconditionally cancellable; and

(d) of which the bank judges that no covenants or adverse change clauses are likely to be breached.

39. **Committed lines granted by the registered bank** are defined as [see comment in Appendix A to the Consultation Paper] committed credit card limits and all unused committed credit limits, including overdrafts and mortgage limits.

40. **Wholesale funding** is defined as [see comment in Appendix A to the Consultation Paper – proposed definition still under consideration]

41. **Retail funding** is defined as [see comment in Appendix A to the Consultation Paper – proposed definition still under consideration]

42. **Total funding** is the sum of wholesale and retail funding.

43. **Total assets** is the total balance sheet.

44. **Total shareholders' equity** is as defined for accounting purposes.

D. QUALITATIVE REQUIREMENTS

45. Standard conditions of registration require that a registered bank must have an internal process for liquidity-risk management that meets the Reserve Bank's qualitative requirements for liquidity-risk management. This section sets out the Conditions of Registration and associated guidelines.

46. Under the Reserve Bank's disclosure requirements, directors of a registered bank, and the New Zealand Chief Executive Officer for a registered bank incorporated overseas, must attest that the registered bank has, at the reporting date and over the accounting period, complied with the registered bank's conditions of registration including the qualitative requirements set out here.

D.1 Requirements

47. Except where a registered bank's conditions of registration provide otherwise, the registered bank's internal framework for liquidity-risk management must:

(a) be clearly documented and communicated to all those in the organisation with responsibility for managing liquidity and liquidity risk;

(b) identify responsibility for approval, oversight and implementation of the framework and policies for liquidity-risk management;

(c) identify the principal methods that the bank will use for measuring, monitoring and controlling liquidity risk;

(d) consider the material sources of stress that the bank might face, and prepare the bank to manage stress through a contingency funding plan;

(e) overall, be adequate for managing the bank's liquidity risk at a prudent level.

D.2 Guidelines

48. Guidelines, issued under Section78(3) of the Act, s follow on factors that a registered bank should consider when deciding how to meet the requirements set out in section D.1.

49. Subject to complying with the requirements set out in the registered bank's conditions of registration, a registered bank may determine the detailed nature of its arrangements for liquidity-risk management. The directors should satisfy themselves that the detailed arrangements both comply with the requirements of the Liquidity Policy and are appropriate to the nature of the bank's business and risks.

50. In determining the detailed nature of a registered bank's arrangements for liquidity risk management, the registered bank should take account of the guidelines provided by this Liquidity Policy and of the implications of the particular nature of the registered bank's business and risks.

D.2.1 Organisational structure for liquidity-risk management

51. Where relevant to the bank, given its nature and risks, the bank should apply the guidelines given in Section D.2.1 when devising the organisational structure for managing liquidity risk.

52. The overall framework and structure should be approved by the Board of the bank (for a New Zealand-incorporated bank) or by the Board and the New Zealand Chief Executive Officer (for a branch of a foreign-incorporated bank).

53. The principal elements in the organisational structure for liquidity-risk management are:

(a) the application of the framework through the organisation; and

(b) the arrangements for governance, oversight and implementation of the framework.

(a) Application through the organisation

54. The registered bank's policies should apply to all parts of the business that have a material influence on the registered bank's liquidity position and liquidity risk. The policies should be communicated to all those with responsibility for managing liquidity and liquidity risk.

55. The policies should address the terms on which liquidity or liquidity risk may be transferred across business lines or with other members of the banking group. Where appropriate, this should address the appropriate pricing of any liquidity or risk transferred.

(b) Roles and responsibilities in liquidity-risk management

56. The framework should identify where responsibility lies in the registered bank for oversight, control and implementation of liquidity-risk management.

57. The framework should identify the necessary process for approval of the registered bank's policies for liquidity risk management, and for any changes to or exceptions to those policies.

58. The framework should identify the nature, recipients and frequency of the main internal reporting on liquidity risk and on the management of liquidity risk.

59. Those responsible for governing, overseeing and controlling liquidity-risk management should have independence from, and authority to challenge, those responsible for implementing liquidity management and for executing funding plans.

60. Provision should be included for periodic review, by internal audit or by an external independent party, of liquidity management and of the liquidity-risk management framework.

61. The Board should take responsibility for ensuring that the registered bank has and implements an effective structure and liquidity-risk management framework for the bank, including contingency planning, so as to achieve the bank's objectives for liquidity-risk management in normal times and in periods of stress.

62. Senior management should take responsibility for the operational implementation of the registered bank's liquidity-risk management framework, including contingency planning, and of the structures, strategy, policies and practices that comprise the framework.

D.2.2 Methods for measuring, monitoring and controlling liquidity risk

63. Where relevant to the bank, given its nature and risks, the bank should apply the guidelines given in Section D.2.2 when devising and applying the analytical framework and tools for liquidity-risk management.

(a) Internal strategy and communication of the strategy

64. The strategy for liquidity-risk management should identify how the bank will manage liquidity risk in line with its risk tolerance and with any other stated objectives. This should include identification of the analytical framework and tools that the bank will use to measure, monitor and control liquidity risk.

65. The analytical framework and tools should be documented and communicated clearly to all those in the bank who are required to carry out the measurement, monitoring, control and management of liquidity risk.

66. The bank should identify its risk tolerance and objectives for liquidity risk management. In general, the bank's risk tolerance and objectives should reflect:

- the nature of the bank's business;
- potential demands from off the bank's balance sheet and from business with connected parties;

- the environment and markets in which the bank operates; and
- the nature of the bank's relationship with the owner or with related parties.

(b) Coverage of the bank's operations

67. The bank's approach to measuring, monitoring and controlling liquidity risk should enable the bank to meet demands for liquidity, in the form of cash outflows in a given period, with a margin of certainty consistent with the bank's risk tolerance. The approach should address liquidity risk and liquidity positions over a range of time horizons, from intra-day payment and settlement needs in Real-Time Gross Settlement systems out to the long term, and for all material sources of liquidity risk.

68. The processes and systems for measuring, monitoring and controlling liquidity risk should apply both to transactions with third parties and to activity within the bank or its group. They should also address risk stemming from off the balance sheet and from contingent exposures.

69. All elements of the bank's framework for measurement, monitoring, and control of liquidity risk and for management of liquidity should take account of cashflows in all currencies. Where there is not a material risk to the convertibility of a currency, positions in that currency may be converted into a home currency or principal currency of analysis for the purposes of analysing and managing liquidity risk.

70. Those in the bank undertaking activities that affect the bank's liquidity and liquidity risk should face controls and incentives reflecting their contributions to liquidity and liquidity risk.

(c) Cashflow management and liquid-asset stocks

71. The bank should have a method for projecting cashflows and positions under both normal conditions and stress scenarios. This analysis should be performed both the bank as a whole and for business units that contribute significantly to liquidity or liquidity risk. The flows considered should include flows driven by correspondent relationships and off-balance-sheet business.

72. Internal cashflow projections should take account of the expected behaviour of assets and liabilities, making appropriate assumptions where contractual maturities are unlikely to be a useful guide. The bank should also consider the risk of calls for support from off-balance sheet vehicles, from requirements to post additional collateral in derivatives positions, or from other contingent demands on liquidity.

73. Assumed behaviour of cashflows and available liquidity should take account of any material practical obstacles to obtaining needed funds and realising liquidity.

74. In the event of stress, an important way of meeting funding gaps can be through the sale or pledging of a stock of liquid assets held as a backstop against such events. However, such a stock should be treated as backstop for difficult conditions rather than as the usual primary means of meeting net outflows. The holding of liquid assets is addressed in further detail below in Section D.2.2 (h) on management of funding and liquid assets.

(d) Internal limits and targets

75. Based on its analysis of liquidity and liquidity risk, and to provide for operation in line with the bank's risk tolerance and other objectives, the bank should set internal limits and targets for use in the day-to-day management of liquidity and liquidity risk. Where needed to ensure effective liquidity-risk management, these should be set in addition to the Reserve Bank's quantitative requirements set out in Section C of this Liquidity Policy.

76. Limits and targets should be set for the bank as a whole. Where appropriate, they should also be set for individual business lines and in line with the comments above in Section D.2.2 (b) should address risks from positions and flows in all currencies.

(e) Breaches of internal limits and targets

77. Clear procedures should be implemented for reporting on and responding to breaches of internal limits and targets, or of regulatory requirements. Any allowance of exceptions to internal limits and targets, or *ex post* approval of breaches, should be approved at an appropriate level in the organisation.

78. Any breaches of internal limits or targets, and of regulatory requirements, should be reported to an appropriate level in the bank. A remedial plan should then be identified, and regular reports provided on progress until such time as the remedial action is satisfactorily completed and the bank has returned to a position consistent with its risk tolerance and other objectives.

(f) Scenario analysis

79. To support the bank's understanding of its liquidity risk and position, the bank should regularly undertake analysis of its liquidity position under a range of scenarios that are appropriate to the bank's business and risks. This should entail, at least, analysis of the bank's cashflow position and ability to meet outflows over a range of time horizons.

80. The outcomes of scenario analysis should inform the bank's liquidity and liquidity-risk management, and any deficiencies indicated by the analysis should be addressed promptly. As noted below (Section 2.4), the scenarios analysed should also be reflected in the bank's planning for contingency management.

(g) Analysis of other types of risk

81. Liquidity risk can be exacerbated by and contribute to the manifestation of other types of risk to which banks are exposed. Analysis of risk should thus take account of the interaction of liquidity risk with other types of risk, including those risks coming from off the bank's balance sheet.

(h) Management of funding and liquid assets

82. Consistent with the bank's risk tolerance, objectives and internal analysis of liquidity risk, the bank's liquidity-risk management framework should identify the approach to managing the composition and nature of the bank's funding and its liquid assets. This should include a funding plan. There should be associated internal targets and limits.

83. The composition of funding and liquid assets should reflect the bank's liquidity needs. Equally, the bank's business should not be allowed to develop in ways that cannot be prudently supported by its funding and liquid-asset holdings.

84. Consistent with Section D.2.2 (b) above, decisions on the composition of funding and liquid assets should address risks from positions and flows in all currencies.

Managing the composition of funding

85. The composition of funding should reflect the bank's liquidity needs and risks. Two important dimensions of funding composition are: the diversity (of the source and form) of funding; and the term of funding. The bank should have policies, including internal targets and limits, to ensure that the diversity and term of funding are prudent for the bank's needs.

86. The bank's funding position and policy should be one of the important inputs to the bank's analysis of liquidity risk and to scenario analysis.

87. Where funding sources are diverse in source and form – so that their risks are not highly correlated – there is a lesser chance that the bank will face a reduction in access to, or increase in demands to repay, a number of sources at the same time. Important elements of diversity can include, though are not necessarily limited to: the identity of the provider, including whether the funding is wholesale or retail in nature; the currency of denomination; the jurisdiction of origin; the markets through which funding is raised; and the legal structure of the funding instrument. Diversity is important for promoting the continued provision and renewal of funding, the issuance of new funding, and the mobility of funds within the bank or within the group of which the bank is a part.

88. The term of funding determines the point in time at which, under normal conditions, the bank will face the requirement to renew funding or obtain funding from another source. If the term of funding and of the assets funded is more closely matched, there will be less risk of difficulties in obtaining funding to support those assets or in realising inflows from the assets to repay funding.

89. It is important not to allow excessive concentrations in the term of funding. Such concentrations can be a source of difficulty when large quantities of funding of a given term need to be renewed within a short space of time. The bank is responsible for adopting policies that ensure adequate diversity in the term of funding, and should not rely solely on compliance with the Reserve Bank's quantitative requirements (set out in Section C, above).

Management and monitoring of market access

90. The bank should actively monitor and promote its access to its important funding sources. The bank should also have a way of assessing its funding capacity both in normal times and in stressed circumstances.

Buffer of liquid assets

91. Effective management of the bank's mismatch position and balance sheet composition should be the principle means of avoiding shortfalls in liquidity. Nonetheless, as a backstop measure the bank should hold a buffer of high-quality liquid assets against the risk of liquidity shortfalls. This buffer should both allow the bank to meet the Reserve Bank's quantitative requirements of liquid-asset holdings and take account of the full range of risks and liquidity demands facing the bank.

92. These liquid assets should be available permanently and should be eligible for realisation by sale or pledging even in stressed circumstances. The composition and quantum held in the portfolio should be appropriately diversified by source and term in light of the bank's risk tolerance, the bank's potential liquidity needs under a range of relevant scenarios, and the available facilities for realising the liquidity value of the assets. Among the demands to be considered are the intra-day needs for collateral stemming from the bank's operation in payment and settlement systems.

93. Practical factors influencing the bank's needs and ability to realise liquidity value should also be considered when structuring the portfolio, including the currency of denomination and location in which assets are held.

94. It is important that the bank should not excessively concentrate its liquid assets in particular asset classes simply for reasons such as minimising the cost of holding liquid assets. Because liquid assets are held as a buffer against the risk of unforeseen events, the portfolio composition should take account of the risk to the liquidity of each asset type in the kinds of circumstances in which the bank might need to liquefy the portfolio.

D.2.3 Planning for contingency management

95. Where relevant to the bank, given its nature and risks, the bank should apply the guidelines given in Section D.2.3 when preparing, maintaining and implementing plans for contingency management.

96. The bank should be prepared to respond promptly and decisively to periods of liquidity stress. As part of such preparedness, the bank must establish a contingency funding plan. The contingency funding plan must be documented and communicated to those who would be affected by its execution.

97. The contingency funding plan should seek to achieve operation within the bank's risk tolerance where that is possible. In the eventuality of stress and the invocation of the contingency funding plan, the plan should be designed to return the bank to a robust position, in line with its risk tolerance, as quickly as possible.

98. A contingency funding plan should include policies, procedures and plans for responding to disruptions to the bank's ability to meet its funding needs, enabling prompt and effective decision making and execution of contingency measures.

99. The plan should address all of the bank's business lines, and take account of any off balance sheet and contingent risks that exist. The plan should reflect the nature of the risks that the bank faces and the bank's liquidity-risk tolerance. The scenarios considered by the contingency funding plan, and the assumptions therein, should relate to the bank's scenario analysis and take account of the lessons from scenario analysis.

100. The contingency funding plan should be consistent with any wider business continuity plan (BCP) of the bank.

101. The contingency funding plan should identify clear triggers – quantitative and qualitative as appropriate – and procedures for invocation of the plan, and for escalation of the level of alert. There must be scope for the plan to be invoked and

escalation initiated based on judgement about risk, even if none of the identified triggers has been hit.

102. To support internal control of liquidity risk, the bank should be capable of producing, analysing and responding to additional information during periods of stress. This must include the ability to meet the requirements for additional reporting to the supervisor (see Section E). The bank should be able to quickly assess its position and available liquidity sources, taking account of any practical matters involved in realising liquidity. The plan should also consider means of prioritising payments and controlling outflows where possible.

103. The contingency funding plan should include consideration of how to manage both internal and external communications to promote the markets' and the wider public's confidence in the bank.

104. The plan should be tested for effectiveness and operational feasibility.

E. REQUIREMENTS FOR PUBLIC DISCLOSURE AND REGULATORY REPORTING

E.1 Public disclosure

105. A registered bank must comply with the Reserve Bank's requirements for public disclosure and for regular reporting to the Reserve Bank about liquidity. Further, directors of a registered bank, and the New Zealand Chief Executive Officer for a registered bank incorporated overseas, must attest in disclosure statements that the registered bank has, at the reporting date and over the accounting period, complied with the requirements set out in the bank's conditions of registration.

106. The precise requirements for public disclosure, together with associated guidance on the content of disclosure, are set out in the Disclosure Orders in Council. The quantitative disclosure requirements specifically relating to liquidity-risk management are summarised in Appendix 3 of this Liquidity Policy. Qualitative disclosure requirements are summarised in Appendix 4 of this Liquidity Policy.

107. In addition to the liquidity-specific requirements summarised in this Liquidity Policy, registered banks must comply with other disclosure and attestation requirements set out in the Disclosure Orders in Council.

E.2 Reporting to the Reserve Bank

108. A registered bank must report monthly to the Reserve Bank on its liquidity position and risk. The registered bank must also be able to provide the same information weekly should the Reserve Bank request such reporting.

109. The details that must be reported and the precise timing of reporting are set out in [reference to reporting form, to be provided when the final policy is issued]. In general the reporting details and definitions will be standardised for all registered banks. The requirements are summarised below.

110. Except where the contrary is stated, all variables should be reported:

(a) as at the reporting date;

(b) as the maximum over the period;

(c) as the minimum over the period; and

(d) as the average over the period

111. **Wholesale funding maturity profile** on a contractual basis. Where a registered bank uses behavioural assumptions in its internal management, the registered bank should also provide the information on that behavioural basis.

(a) On a face-value basis as measured by the residual time to maturity; divided into the following time buckets.

i. Overnight

ii. 1 – 7 days

iii. 8 – 14 days

iv. 15 days – 1 month

v. 1 – 2 months

vi. 2 – 3 months

vii. 3 – 6 months

viii. 6 months – 1 year

ix. 1 – 2 years

x. 2 – 3 years

xi. 3 – 5 years

xii. 5 – 10 years

xiii. 10 years and over

(b) Average maturity

112. **Mismatch positions**

(a) One week ahead, calculated according to the Reserve Bank's requirements

(b) One month ahead, calculated according to the Reserve Bank's requirements

(c) Daily out to one week according to the bank's own assumptions, where the bank calculates such data for internal management purposes

113. **Core funding ratio**

(a) At one year, calculated according to the Reserve Bank's requirements

114. **Retail funding composition**. Where a particular market or source of funding exceeds 25 per cent of a class of funding, then this should be separately listed under that class of funding.

(a) Short term (residual contractual maturity under 1 year) as a percentage of total retail funding

i. Domestic – NZD

ii. Domestic – non-NZD

iii. Offshore – NZD

iv. Offshore – non-NZD

v. Total (face-value basis)

vi. Total (discounted basis)

(b) Long term (residual contractual maturity over 1 year) as a percentage of total retail funding

i. Domestic – NZD

ii. Domestic – non-NZD

iii. Offshore – NZD

iv. Offshore – non-NZD

v. Total (face-value basis)

vi. Total (discounted basis)

115. **Wholesale funding composition**. Where a particular market or source of funding exceeds 25 per cent of a class of funding, then this should be separately listed under that class of funding.

(a) Short term (residual contractual maturity under 1 year) as a percentage of total wholesale funding

i. Domestic – NZD

ii. Domestic – non-NZD

iii. Offshore – NZD

iv. Offshore – non-NZD

v. Total (face-value basis)

vi. Total (discounted basis)

(b) Long term (residual contractual maturity over 1 year) as a percentage of total wholesale funding

i. Domestic – NZD

ii. Domestic – non-NZD

iii. Offshore – NZD

iv. Offshore – non-NZD

v. Total (face-value basis)

vi. Total (discounted basis)

116. **Liquid assets** measured in each of: NZD; as a percentage of retail deposits and short-term wholesale funding; and as a percentage of total funding

(a) Cash

(b) Primary liquid assets as defined for the Reserve Bank's mismatch requirements

(c) Secondary liquid assets as defined for the Reserve Bank's mismatch requirements

(d) Total liquid assets

Appendix 1 – Standard conditions of registration

In general, registered banks will be subject to the following conditions of registration.

1. The registered bank must comply with the Reserve Bank's quantitative requirements for liquidity-risk management, and in particular must maintain at the end of each business day:

   (e) a one-week mismatch ratio of at least zero per cent;

   (f) a one-month mismatch ratio of at least zero per cent;

   (g) a one-year core funding ratio of at least 70 per cent; and

   For the purposes of these requirements, the calculation of the ratios identified is set out in the [Date] Reserve Bank of New Zealand document entitled "Liquidity Policy – Prudential Supervision Department Document BS13.

2. The registered bank must have an internal process for liquidity-risk management that is consistent with the Reserve Bank's qualitative requirements for liquidity-risk management. In particular, the registered bank's internal framework for liquidity-risk management must:

   (h) be clearly documented and communicated to all those in the organisation with responsibility for managing liquidity and liquidity risk;

   (i) identify responsibility for approval, oversight and implementation of the framework and policies for liquidity-risk management;

   (j) identify the principal methods that the bank will use for measuring, monitoring and controlling liquidity risk;

   (k) consider the material sources of stress that the bank might face, and prepare the bank to manage stress through a contingency funding plan;

   (l) overall, be adequate for managing the bank's liquidity risk at a prudent level.

   Where relevant to the bank, given its nature and risks, the bank should apply the guidelines given in the [Date] Reserve Bank of New Zealand document entitled "Liquidity Policy – Prudential Supervision Department Document BS13" when determining its approach to liquidity risk management.

Appendix 2 – Sample Section 93 notice setting out reporting requirements

SECTION 93 NOTICE issued to [name of registered bank]

With effect from [date], the Reserve Bank of New Zealand hereby requires [name of bank] to provide the Reserve Bank with the information specified in this Notice, to the Reserve Bank of New Zealand, no later than [date in each month] in the form specified. [name of bank] must also be capable of providing such information weekly, should the Reserve Bank of New Zealand request weekly reporting.

The required information/data and the form in which the information/data is required is set out below:

[List of information, as set out in Section E.2 of this Liquidity Policy]

This notice is issued pursuant to Section 93 of the Reserve Bank of New Zealand Act 1989.

Head of Financial Stability
Reserve Bank of New Zealand

Appendix 3 – Summary of quantitative disclosure requirements

1 This Appendix summarises the requirements for disclosure of quantitative material that apply under this Liquidity Policy. A sample template at the end of this Appendix provides the same information in an alternative form. The complete disclosure requirements are set out in the Disclosure Orders in Council.

2 The majority of variables should be reported as at the end of the accounting period.

3 Particular variables must be reported on each of the following bases: as at the reporting date; as the maximum over the period; as the minimum over the period; and as the average over the period. Those variables are:

(a) one-week mismatch ratio;

(b) one-month mismatch ratio;

(c) core-funding ratio;

(d) total primary liquid assets;

(e) total secondary liquid assets;

(f) total short-term wholesale funding (face value);

(g) total long-term wholesale funding (face value);

(h) total short-term retail funding (face value); and

(i) total long-term retail funding (face value).

Maturity profile of assets and liabilities

4 Maturity profile at face value of assets and liabilities on a contractual basis. Where a registered bank uses behavioural assumptions in its internal management, the registered bank should also provide the information on that behavioural basis.

5 Information on the total position should also be provided at each of face value and discounted value.

6 The information should be provided for the following classes of assets and liabilities for each of the terms listed below in paragraph 6 below.

Wholesale

(a) Domestic – NZD

(b) Domestic – non-NZD

(c) Offshore – NZD

(d) Offshore – non-NZD

(e) Total – face value

(f) Total – discounted

Retail

(a) Domestic – NZD

(b) Domestic – non-NZD

(c) Offshore – NZD

(d) Offshore – non-NZD

(e) Total – face value

(f) Total – discounted

Financial liabilities

(a) Deposits from other banks

(b) Other money market deposits

(c) Amounts owed to other depositors

(d) Certificates of deposit

(e) Promissory notes and other liabilities evidenced by paper

(f) Other borrowed funds

(g) Fair value held for trading

(h) Related parties

(i) Subordinated debt

(j) Total – face value

(k) Total – discounted

Financial assets

(a) Cash and demand balances with central banks

(b) Treasury bills and other bank bills eligible for rediscounting with central bank

(c) Government and other securities held for trading

(d) Placements with, and loans to and receivables from other banks

(e) Other money market placements

(f) Financial assets designated at fair value other than those held for trading

(g) Other securities

(h) Available for sale assets

(i) Held to maturity investments

(j) Loans to and receivables from customers

(k) Due from related parties

(l) Investments in related parties

(m) Total – face value

(n) Total – discounted

Liquid assets

(a) Cash

(b) Primary liquid assets

(c) Secondary liquid assets

(d) Total – face value

(e) Total – discounted

7 The information on the above classes of assets and liabilities should be provided on each variable for the following term structure.

(a) Overnight

(b) 1 – 7 days

(c) 8 – 14 days

(d) 15 days – 1 month

(e) 1 – 2 months

(f) 2-3 months

(g) 3 – 6 months

(h) 6 months – 1 year

(i) 1 – 2 years

(j) 2 – 3 years

(k) 3 – 5 years

(l) 5 – 10 years

(m) 10 years and over

(n) Average maturity

(o) Total – face value

(p) Total – discounted basis

Mismatch positions

8 One week ahead, calculated according to the Reserve Bank's requirements

9 One month ahead, calculated according to the Reserve Bank's requirements

10 Daily out to one week according to the bank's own assumptions, where the bank calculates such data for internal management purposes

11 One year ahead, where the registered bank calculates such information for internal management purposes

Core funding ratio

12 At one year, calculated according to the Reserve Bank's requirements.

Average maturity of wholesale liabilities

13 Measured in years.

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Liabilities maturity profile

	Overnight $m	<7 days $m	<14 days $m	< 1 month $m	< 2 months $m	< 3 months $m	< 6 months $m	< 1 yr $m	< 2yr $m	< 3yr $m	< 5yr $m	≤ 10yr $m	> 10yr $m	Total (face value) $m	Total (discounted) $m	Average maturity (years)
Retail																
Domestic - NZD																
Domestic - non-NZD																
Offshore - NZD																
Offshore - non-NZD																
Total (face value basis)																
Total (discounted basis)																
Wholesale																
Domestic - NZD																
Domestic - non-NZD																
Offshore - NZD																
Offshore - non-NZD																
Total (face value basis)																
Total (discounted basis)																
Financial liabilities																
Deposits from other banks																
Other money market deposits																
Amounts owed to other depositors																
Certificates of deposit																
Promissory notes and other liabilities evidenced by paper																
Other borrowed funds																
Fair value held for trading																
Related parties																
Subordinated debt																
Total (face value basis)																
Total (discounted basis)																

Assets maturity profile

	Overnight $m	<7 days $m	<14 days $m	< 1 month $m	< 2 months $m	< 3 months $m	< 6 months $m	< 1 yr $m	< 2yr $m	< 3yr $m	< 5yr $m	≤ 10yr $m	> 10yr $m	Total (face value) $m	Total (discounted) $m	Average maturity (years)
Retail																
Domestic - NZD																
Domestic - non-NZD																
Offshore - NZD																
Offshore - non-NZD																
Total (face value basis)																
Total (discounted basis)																
Wholesale																
Domestic - NZD																
Domestic - non-NZD																
Offshore - NZD																
Offshore - non-NZD																
Total (face value basis)																
Total (discounted basis)																
Financial assets																
Cash and demand balances with central bank																
Treasury bills and other bills eligible for rediscounting with central bank																
Government and other securities held for trading																
Placements with, and loans to and receivables from other banks																
Other money market placements																
Financial assets designated at fair value other than those held for trading																
Other securities																
Available for sale assets																
Held to maturity investments																
Loans to and receivables from customers																
Due from related parties																
Investments in related parties																
Total (face value basis)																
Total (discounted basis)																
Liquid assets																
Cash																
primary liquidity																
secondary liquidity																
Total (face value basis)																
Total (discounted basis)																

Mismatch positions	Overnight $m	2 days $m	3 days $m	4 days $m	5 days $m	1 week $m	1 month $m	1 year $m
Period minimum								
Period maximum								
Period average								
End of period								
Core funding ratio at one year								
Period minimum								
Period maximum								
Period average								
End of period								

Average wholesale liabilities maturity

Period minimum	years
Period maximum	years
Period average	years
End of period	years

Appendix 4 – Summary of qualitative disclosure requirements

1 This Appendix summarises the requirements for disclosure of qualitative material that apply under this Liquidity Policy. The complete disclosure requirements are set out in the Disclosure Orders in Council.

2 A bank must disclose publicly information about the following matters.

(a) A summary of the bank's main liquidity-risk management framework and the main policies underlying the framework.

(b) The scope of application of the main liquidity-risk management framework through the business units of the group, including exceptions (areas that do not operate under the bank's general framework) and reasons for those.

(c) The influence of group policies and home country requirements on the New Zealand bank's liquidity-risk management.

(d) The governance / authority structure for the development, oversight and implementation of the framework for liquidity-risk management.

(e) A summary of the internal reporting framework.

(f) A summary of the main elements of the framework for analysing liquidity risk and the performance of liquidity-risk management, including:

i a summary of the main tools used in internal analysis, and the important assumptions therein; and

ii the nature and important assumptions of the scenarios that the bank regularly considers.

(g) A summary of the internal structure of limits and targets for controlling liquidity risk.

(h) A summary of internal policies for the composition and term of funding and liquid-assets.

(i) The essential elements of the bank's contingency management plan, including the objective, the structure of responsibility, the nature of any scenarios explicitly considered, and the approach taken to preparing for managing stress.

(j) The fact of and nature of any breaches of Reserve Bank requirements during the accounting period, and the remedial actions / plans.

Appendix to Consultation Paper

Appendix A – detailed questions

This Appendix poses some specific questions. The Reserve Bank would welcome responses to these questions in particular, to enable us to refine and finalise the proposals. Please note however that comments are invited on all elements of the proposed Liquidity Policy, and not solely on the detailed questions identified in this Appendix.

Calculation of the quantitative requirements

We invite information from banks on the values of the proposed three quantitative ratios – the one-week and one-month mismatch ratios, and the one-year core funding ratio – based on their current businesses, with as much detail as possible on the components of the calculation and any assumptions made. This may assist us in refining our draft requirements. Where a bank's calculated ratio does not meet the proposed minimum, we would welcome comments on the nature of adjustment that would be required to meet the requirements.

Any such information provided will, of course, be treated as confidential and protected under section 105 of the Reserve Bank of New Zealand Act 1989.

Definitions

We invite information from banks about how they define the following concepts for their own internal and reporting purposes, and on what would be a meaningful definition for the purposes of the Liquidity Policy. Some comment follows on the matters that might be considered in identifying the definitions.

Distinction between retail and wholesale liabilities

By way of background, some commonly-used definitions internationally, for a range of policy purposes, are based on criteria that include the following:

- size of liability;
- counterparty type (such as "households" and "businesses");
- nature of contract (such as standard advertised terms as opposed to individually agreed terms); and
- which part of the bank manages the account.

Contractual inflows due

This aims to capture un-discounted cash amounts due contractually in a nominated period. It should include repayments of principal and interest payments, and possibly fee and commission payments due. We suggest that the definition should exclude outstanding balances on overdraft lending and loans that are not performing according to contract.

Committed lines granted to the registered bank

This should capture the value of lines that will be available with as high a degree of certainty as possible within the relevant period (i.e. both contractually and practically available, where the latter might refer to the capacity of the lender to provide the funds), and on which repayment cannot be demanded within the relevant period. Covenants and adverse change clauses should be considered.

Committed lines granted by the registered bank

This should capture the value of committed facilities that may be drawn within the relevant period.

Disclosure and reporting requirements

The requirements that we propose should be considered against the background of the Reserve Bank's existing data collection and disclosure requirements. Where possible any new requirements to provide data to the Reserve Bank will be integrated with the existing framework. Similarly, disclosure requirements will be designed to efficiently provide a coherent and complete set of information.