POLICY STATEMENT ON THE

PRUDENTIAL ASPECTS OF BANK LIQUIDITY

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1) INTRODUCTION

1.1 The Reserve Bank of Malawi (RBM) regards the maintaining of an adequate level of bank liquidity to be, along with solvency, an essential aspect of overall bank soundness. In its role as the supervisory authority, the RBM is issuing this policy statement to guide commercial banks as to considerations for their own liquidity policy, as well as to inform banks of supervisory standards for bank liquidity. It should be noted that this policy statement is confined to liquidity for prudential purposes, i.e. safety and soundness, and is not intended to address monetary policy aspects.

1.2 While the Banking Act, 1989 authorizes the RBM to issue a directive for liquidity, a policy statement has been chosen in lieu of a directive. The latter would normally contain a specified liquid assets requirement expressed in the form of a balance sheet ratio. The thinking behind this choice of a policy statement instead of a mandatory liquid asset ratio in the form of a directive is that liquidity is a complex facet of banking, so much so that it cannot be adequately measured in any single ratio. The dynamics of effective liquidity management must take into account: cash flow analysis, maturity profile, funding and off-balance-sheet commitments , and back-up sources of funding. Thus unlike capital adequacy and profitability, ratio analysis alone cannot reveal the full extent of a bank's liquidity. Thus while banks are not called upon to meet a liquid assets requirement, per se, the RBM will make use of certain ratios as indicators to monitor the trend of bank liquidity, and when such indicators show an unfavourable pattern, an on-site examination is likely to follow. An explanation of the use of ratios as indicators for the RBM is given in part 4 of this policy statement.

2) SUPERVISORY PERSPECTIVE ON BANK LIQUIDITY

2.1 Bank supervision operates under the objectives of enhancing economic growth through a stable banking system and protection of depositors' funds. While bank soundness covers a wide variety of areas, the two most fundamental aspects are solvency (adequacy of capital) and liquidity. For prudential purposes liquidity can be defined as "the ability to fund at reasonable cost all contractual obligations of the bank, notably lending and investment commitments, deposit withdrawals, and liability maturities, in the normal course of business".[1]

2.2 In considering proper liquidity management, the "reasonable cost" element is crucial. Banks can often raise liquidity quickly if they are willing to sell or otherwise dispose of assets at a huge loss/discount or to acquire funds quickly at a very high price.

1 Definition taken from "Bank Supervision Guidelines (G10) - Asset and Liability Management" prepared by the Financial Policy and Systems Division of the World Bank.

In turn, banks which take a very cautious approach to liquidity may do so at an opportunity cost to profits. Thus it must be recognized that there is a close relationship between liquidity and profitability.

2.3 It is for the above reasons that the RBM feels its policy should be to encourage banks to properly "manage" liquidity rather than have banks simply meet a "measured" liquidity requirement. Sound liquidity management takes into account all the elements of banking that affect liquidity, including: maturities of assets and liabilities; core deposits as opposed to volatile sources of funding; commitments to lend and other off-balance-sheet contingencies; and secondary and/or back-up sources of liquidity to be used under unforeseen circumstances. As stated above, these multifaceted aspects cannot be captured in a single ratio, though the RBM will continue to use ratios as indicators to monitor the trend of liquidity.

2.4 It is the view of the RBM that sound liquidity management begins with written policy, approved by the bank's Board of Directors, for liquidity/funds management. The next section of this policy statement outlines the areas the RBM feels should be included in such a written policy.

3) BOARD APPROVED POLICIES FOR LIQUIDITY AND FUNDS MANAGEMENT

3.1 It is the view of the RBM that commercial banks should manage their liquidity (and applicable funds management aspects such as interest rate risk) using a formal policy. Such a policy should be written by senior management, approved by the Board (annually with amendments/changes as needed), and fully enforced through controls and reporting and by means of written exception reports when limits and/or guidelines are exceeded.

3.2 Effective policy for liquidity and funds management is dependent on the availability, timeliness, and accuracy of data made available to management with regard to assets, liabilities, and off-balance-sheet items. The RBM believes that commercial banks must have in place modern management information systems (MIS) to support written liquidity and funds management policies.

3.3 The Board approved liquidity policy should begin with clearly stated objectives. A main objective should be to ensure the bank has sufficient liquidity for expected and most unforeseen and/or contingent needs. Such liquidity needs are to be above the RBM's liquidity reserve requirement (LRR) set for monetary policy purposes. The objectives should also including ensuring that cash needs can always be met at a reasonable cost, i.e. avoidance of penalty rates or selling assets at a loss.

3.4 While this policy statement is mainly concerned with liquidity management, the RBM would encourage banks to write comprehensive asset and liability management (ALM) policy. The other objective in an ALM policy would concern interest rate risk, foreign exchange risk, and for profitability as affected by pricing management.

3.5 Such policies should have quantitative elements. These would usually be shown as target ratios for key liquidity components. Examples of target ratios would be for minimum coverage of the LRR (an example being a target to always maintain 110 percent of the LRR with the RBM). Other targets may cover: secondary liquidity, advances to deposits ratios, and liquid assets to deposits/borrowings, etc. The policy should also take into account targets based on cash flow and/or maturity profiles so as to reflect the on-going dynamics of bank liquidity as opposed to reliance on "point-in-time" ratios.

3.6 The written policy should also call for regular analysis of maturity structures of both assets and liabilities to reasonably take into account all funding obligations, especially deposits and borrowings. Included in this analysis should be a determination of core deposits (usually savings and a percentage of demand deposits) as compared to more volatile funding such as time deposits and borrowings. Normally banks with heavy reliance on volatile funding should have higher levels of liquid assets.

3.7 In writing a liquidity policy, management should closely analyze the level of normal and/or anticipated funding commitments, especially unused overdraft lines and undrawn lending commitments. Limits as to the amount of such contingents or commitments should be set and effectively communicated to all lending personnel and closely monitored for compliance.

3.8 The policy should also take into account economic aspects, especially seasonal factors which affect liquidity in Malawi's banks. Contingent plans for obtaining needed liquidity during certain times of the year should be specified in the policy.

3.9 Finally, the policy should set out responsibilities for the management of liquidity, including the Board of Directors, senior management (perhaps through a funds management or ALCO committee), line managers (especially lending officers), and a support group primarily responsible for timely and accurate date for policy makers. The flow of information should be made clear in the policy, and it should also include exception reports for times when limits are exceeded or targets not met. Such exception reports should not only be promptly reviewed and acted upon by senior management but should also be brought to the attention of the Board at the earliest possible time.

3.10 It is the view of the RBM that liquidity management is far more effective when done through a formal Board approved written policy. As such, the RBM will be calling for such policies to be written and will be reviewing them for completeness and effectiveness as part of its on-site examinations of banks.

4) RBM MONITORING OF BANK LIQUIDITY

4.1 While the RBM expects banks to properly manage their liquidity by means of written policies as called for above, it will, through its off-site surveillance efforts, monitor bank liquidity through a number of measurements.

4.2 As stated above, bank liquidity is too complex a topic to be fully analyzed through a single ratio. However, liquidity ratios can serve as indicators as to the level and especially the trend of liquidity within a bank. The RBM wishes to make clear to banks how this monitoring will take place and what ratios will be emphasised.

4.3 The first liquidity indicator will be bank compliance with the LRR. Failure to meet RBM's LRR will, of course, be seen as a serious liquidity shortfall and full scale efforts will be undertaken to determine the underlying causes of such a shortfall.

4.4 Beyond compliance with the LRR, the RBM will be monitoring bank's daily cash position at each month end for level and trend taking into account seasonal factors. The ratio of total liquid assets (defined as notes and coins, cheques in the course of collection, net balances with RBM, Malawi Government Treasury Bills, RBM Day Bills, Short-term Investments with other financial institutions and Local Registered Stocks [excluding Special Local Registered Stocks]) to deposits (defined to cover deposits of the private sector, statutory bodies, and non-residents but excluding inter-bank deposits) will also be calculated and analyzed on a regular basis. While again taking some seasonal factors into account, a declining trend and/or low ratios will be seen by the RBM as an indicator of a liquidity problem.

4.5 More specifically, the RBM will also be looking at liquidity and the impact of cheques for collection. As such net liquidity (total liquid assets less suspense account in foreign currency) will be divided by total deposits to give Liquidity Ratio I. Then net liquidity less cheques for collection will be divided by total deposits to give Liquidity Ratio II. Both the level and trend of Liquidity Ratios I and II will be analyzed monthly. In general, the RBM would expect Liquidity Ratio I to be at least 30 percent for all banks and it would expect Liquidity Ratio II to be at least 20 percent for all banks. When either of these ratios fall below these general levels and/or have declined for 3 consecutive months, the RBM will view these ratios as indicators of potential liquidity concerns and the RBM may, at its discretion, seek to determine the underlying causes or problems, most likely through an on-site examination.

5) ON-SITE REVIEW OF BANK LIQUIDITY

5.1 As part of long-term upgrading of its on-site exams, the RBM intends to include a review of liquidity management in its scope of exams for general (full scale) exams. As exam procedures and guidelines are written, banks will be informed as to the scope of such reviews. However, all reviews of liquidity will focus on overall adherence to this policy statement with special attention to review of the bank's own written liquidity (funds management or ALM) policy. The review will be for completeness, compliance, adequacy of MIS to support the policy, and overall effectiveness in implementation.

5.2 In addition to the inclusion of liquidity reviews in general examinations, the RBM reserves the right to conduct limited scope examinations when compliance with the LRR and/or the ratio indicators have shown a potentially worrisome level and/or a declining trend (as described in paragraph 4.5). Such exams will attempt to determine the underlying cause of liquidity problems. They will also include a review of the bank's own policy as described in the prior paragraph. In addition, these limited scope examinations will focus on the bank's control of off-balance-sheet commitments (especially the extent of overdraft facilities and undrawn loan commitments) as well as the deposit structure (core deposits versus volatile funding) and back-up sources of funding.

5.3 When on-site exams disclose a severe liquidity problem or poor liquidity management practices and/or policies, the RBM reserves the right, when necessary, to use any and all of its remedial measures as specified in Sections 31 and 32 of the Banking Act.

5.4 When severe remedial measures are not necessary, but some form of supervisory action is essential to ensure improved liquidity, the RBM will look to administrative sanctions as described in the next section.

6) ADMINISTRATIVE SANCTIONS WITH REGARD TO LIQUIDITY

6.1 The RBM is of the view that liquidity is a supervisory concern best dealt with through close dialogue with bank management. As such, any potential use of administrative sanctions or remedial measures under the Banking Act would not be exercised until thought to be fully necessary. In turn, when the liquidity position of a bank shows clear weakness and/or policies/practices are inadequate, the RBM will call for a written agreement with the bank's Board to include specific steps to lead to an improved liquidity position.

6.2 If such written agreements do not result in an improved liquidity position, the RBM (as would be true for any directive) may impose any or all of the following administrative sanctions:

1) Prohibition from declaring and/or paying dividends;

2) Suspension of the establishment of new branches and/or expansion into new banking or financial activities

3) Suspension of lending operations;

4) Suspension of the new off-balance-sheet commitments to include the opening of letters of credit, guarantees, and all forms of commitments to lend;

5) Suspension of acquisition of fixed assets.

7) SUMMARY

7.1 The RBM views liquidity, along with solvency, as one of its main focuses as the supervisory authority. As such, it is felt liquidity, as a complex aspect of banking, needs to be properly managed, and no single ratio or simple liquid asset requirement can fully address bank liquidity.

7.2 The RBM expects banks to manage their liquidity by a well thought out written policy approved by the bank's Board of Directors. The policy needs to be supported by effective MIS and fully implemented, with reporting to management and the Board.

7.3 The RBM will monitor bank liquidity through compliance to the LRR and with a series of ratios to be used only as indicators as to the level and, especially, the trend of bank liquidity. It is expected procedures for a review of liquidity will be made part of the scope for all general examination of banks, and the RBM may conduct limited scope exams of banks to determine the underlying causes of emerging liquidity problems.

7.4 While the RBM reserves the right to use all remedial measures available to it under the Banking Act with regard to severe liquidity problems in a bank, it prefers close dialogue with bank management. When necessary, the RBM will call for a written agreement with bank management to include specific steps to strengthen liquidity. it may also choose to impose administrative sanctions toward the same goal.

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GOVERNOR

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