CENTRAL BANK OF SOLOMON ISLANDS
Financial Market Supervision Department

Prudential Guideline No. 6
Liquidity Management

Applicability

1. This Prudential Guideline is applicable to all financial institutions[1] licensed by the Central Bank of Solomon Islands (CBSI).

Purpose of Prudential Guideline

2. This Prudential Guideline outlines the approach used by the CBSI in its supervision of the liquidity of financial institutions.

3. Financial institutions engage in maturity transformation, which makes them particularly vulnerable to sudden and unexpected demands for funds. Moreover, liquidity problems with an individual financial institution may have implications for the whole of the financial system.

4. It is the responsibility of a financial institution's board and management to ensure that the financial institution has sufficient liquidity to meet its obligations as they fall due as well as policies to limit risks to acceptable levels. Financial institutions are expected to have appropriate liquidity measurement and information systems and clearly defined management responsibilities for managing liquidity. These policies should be reviewed as circumstances change, but at least annually, and should not assume that CBSI will provide support if a financial institution is facing problems.

5. As well as establishing policies which deal with the "normal" behavior of cash flows in the ordinary course of business, CBSI expects financial institutions to have contingency plans to deal with a worst case "name crisis" arising out of real or perceived problems and adverse rating changes. CBSI expects that a financial institution will have sufficient liquidity to continue operating for a period of at least five (5) business days in a name crisis situation. This period should provide sufficient time to address underlying problems.

6. For foreign banks operating in the Solomon Islands as branches a name crisis could be restricted to local operations or affect the bank's global operations. CBSI expects contingency policies to cover both these scenarios.

7. A financial institution should inform CBSI immediately of any concerns it has with its current or future liquidity profile and of its plans to rectify the problem(s).

[1] As defined in the Financial Institutions Act 1998, a financial institution "includes any body corporate doing banking business" in the Solomon Islands.

Liquidity Management Requirements

8. **Stock of Liquid Assets -** Financial institutions are required by the CBSI to maintain a minimum liquid asset ratio (LAR) based on a percentage of their deposit liabilities as measured from time to time. In the normal course of operations, liquid assets used to meet the minimum LAR should not be used or relied upon by a financial institution to meet normal demands for the payment of funds. Rather, financial institutions are expected to maintain a "working buffer" above the LAR to meet day-to-day clearings and other demands for funds. Accordingly, the CBSI expects each financial institution to have a board-approved written liquidity policy which, among other things, establishes target liquidity ratios such as:
    i. a minimum short term liquid asset-to-deposit ratio, with short term liquid assets clearly defined in the liquidity policy; and
    ii. a maximum loan-to-deposit ratio.

9. **Limits on Maturity Mismatching** – Financial institutions are expect to measure, monitor and control on a regular and frequent basis the gaps between maturing assets and liabilities in various time bands (maturity gap analysis). The maturity profile should also take into consideration off-balance sheet cash flows. As part of the liquidity policy, financial institutions should establish maximum negative maturity gap positions (i.e., the maximum difference whereby maturing deposits and other funding sources can exceed maturing assets) for various time bands and document the assumptions used in determining the appropriateness of those limits. The appropriateness of the maturity gap positions and assumptions should be reviewed and revised, as appropriate, to take into consideration changing economic and market conditions but at least annually.

10. **Diversification of Liabilities** – Financial institutions are expected, as part of the liquidity policy, to establish policies and procedures that address funding concentration in or excessive reliance on any single source (including related entities) or type of funding. The financial institution should undertake regular written statistical analyses of liabilities to detect any signs that the deposit base is becoming more volatile.

11. **Interbank Transactions** - Financial institutions are expected, as part of the liquidity policy, to outline the circumstances under which borrowings through the interbank market are to be accessed and the maximum duration of interbank borrowings. Generally, the CBSI will expect financial institutions to fund their long term earning assets, such as loans and other advances of credit, from deposits. The purchase of funds from other financial institutions in the interbank market should be restricted to short term liquidity support needs.

12. **Foreign Currency** – The liquidity policy of financial institutions should clearly define those foreign currencies in which the financial institution is authorized to conduct business, establish target liquidity measures and parameters and minimum monitoring requirements.

13. **Intra-group Liquidity** - Where liquidity is managed on a group basis (i.e. for a financial institution and its subsidiaries) liquidity management strategies should address any regulatory or legal impediments to group members accessing liquidity. CBSI will want to ensure that any commitment of funding support for subsidiaries is appropriately

captured in the measurement of liquidity of the financial institution itself and may wish to place limits on that funding.

Contingency Planning

14. A financial institution should establish a formal contingency plan approved by its board (or an appropriate senior officer from outside the Solomon Islands in the case of foreign bank branches) for dealing with major liquidity problems, including a name crisis. The contingency plan should, among other things:
    (a) Name who would assume responsibility for identifying crises, instituting crisis management and notifying CBSI;
    (b) Provide procedures to ensure that all necessary information is available to enable senior management to make quick decisions;
    (c) Specify what early warning signals might be used as signs of an impending crisis and time frames within which action should be taken. They should spell out clearly the sources of fall-back funding; their expected reliability and the priority in which they will be accessed.
    (d) Outline courses of action for altering asset and liability behavior, e.g. plans to raise deposits and/or restrict growth in assets;
    (e) Assess the likely impact of particular courses of action on the market's perception of the financial institution;
    (f) Provide procedures for determining the priority of customer relationships, e.g. the order in which lines of credit would be withdrawn from specific customers;
    (g) Detail plans for dealing with the staff and public, key market participants and the media.

Reporting

15. Each financial institution will submit returns in respect of the gap of maturity assets and liabilities in the form and frequency as the CBSI may prescribe.

Enforcement and Corrective Measures

16. A financial institution which fails to comply with the requirements contained in this Prudential Guideline or submits reports to the Central Bank of Solomon Islands which are materially inaccurate will be considered as following unsound and unsafe practices as provided in Section 16 (1) (a) of the Financial Institutions Act 1998.

17. The Central Bank of Solomon Islands may pursue any or all corrective measures as provided in Section 16 of the Financial Institutions Act 1998 to enforce the provisions of this Prudential Guideline including:
    (a) issuance of an order to cease and desist from the unsound and unsafe practices and
    (b) action to replace or strengthen the management of the financial institution.

Effective Date

18. The effective date of this Prudential Guideline is 1 January 2010.

Issued this ***4th*** day of ***September***, 2009

____

Governor Denton Rarawa
Central Bank of Solomon Islands