APPENDIX "2"

Cayman Islands Monetary Authority

PRIVATE SECTOR CONSULTATION

Rules and Guidelines on
Liquidity Risk Management for Banks

A. <u>Introduction</u>

1. Section 34(1)(a) of the Monetary Authority Law (2016 Revision) (as amended) ("MAL") states that –

"After private sector consultation and consultation with the Minister charged with responsibility for Financial Services, the Authority may –

(a) issue or amend rules or statements of principle or guidance concerning the conduct of licensees and their officers and employees, and any other persons to whom and to the extent that the regulatory laws may apply;".

2. Requirements specific to the private sector consultation are outlined in section 4(1) of the MAL as follows:

"When this Law requires private sector consultation in relation to a proposed measure –

(a) the Authority shall give to each private sector association a draft of the proposed measure, together with –
   i. an explanation of the purpose of the proposed measure;
   ii. an explanation of the Authority's reasons for believing that the proposed measure is compatible with the Authority's functions and duties under section 6;
   iii. an explanation of the extent to which a corresponding measure has been adopted in a country or territory outside the Islands;
   iv. an estimate of any significant costs of the proposed measure, together with an analysis of the benefits that will arise if the proposed measure is adopted; and
   v. notice that representations about the proposed measure may be made to the Authority within a period specified in the notice (not being less than thirty days or such shorter period as may be permitted by subsection (3)); and

(b) before proceeding with the proposed measure, the Authority shall have regard to any representations made by the private sector associations, and shall give a written response, which shall be copied to all the private sector associations."

3. The Cayman Islands Monetary Authority ("the Authority" or "CIMA") seeks consultation and comment from the private sector associations concerning the proposed *Rules and Guidelines on Liquidity Risk Management for Banks* (see appendix 1). The proposed measures will be applicable to banks incorporated in the Cayman Islands under the Banks and Trust Companies Law (2018 Revision) ("BTCL")

B. <u>Background/History</u>

4. The 2007/2008 global economic and financial crisis reaffirmed the importance of liquidity to the functioning of financial markets and the banking sector. The deterioration in market conditions illustrated how quickly liquidity can be eroded over a relatively short period of time and the resulting destabilising effects.

5. The Basel Committee on Banking Supervision ("BCBS") published a paper titled *Liquidity Risk Management and Supervisory Challenges* in February 2008. The paper emphasised that the arising difficulties at the time were largely as a result of banks failing to take account of a number of the basic principles of liquidity risk management ("LRM"), outlined in the BCBS *Sound Practices for Managing Liquidity in Banking Organisations* that was issued in 2000.

6. Consequently, in order to account for the financial market developments and lessons learned from the crisis, the BCBS conducted a comprehensive review of its *Sound Practices for Managing Liquidity in Banking Organisations* and issued enhanced *Principles for Sound Liquidity Risk Management and Supervision* in September 2008.

7. The enhanced principles/guidance were significantly expanded in a number of key areas. In particular, more detailed guidance was provided on:

    a) The importance of establishing a liquidity risk tolerance;
    b) The maintenance of an adequate level of liquidity, including through a cushion of liquid assets;
    c) The necessity of allocating liquidity costs, benefits and risks to all significant business activities;
    d) The identification and measurement of the full range of liquidity risks, including contingent liquidity risks;
    e) The design and use of severe stress test scenarios;
    f) The need for a robust and operational contingency funding plan;
    g) The management of intraday liquidity risk and collateral; and
    h) Public disclosure in promoting market discipline.

8. Subsequent to these developments, the BCBS took further steps to strengthen global capital and liquidity rules with the goal of promoting a more resilient banking sector. In 2010, the BCBS issued *Basel III: A Global Regulatory Framework for more Resilient Banks and Banking Systems* and *Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring* (together constituting the *Basel III: International Regulatory Framework for Banks,* "Basel III") to achieve this objective.

9. The latter Basel III component was replaced in 2014 and 2013 respectively by the following issuances, *Basel III: The Net Funding Stable Funding Ratio* and *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools.* The BCBS

liquidity standards are a fundamental component of the Basel III framework and represent an important foundation for improved financial institution and system wide liquidity and management of liquidity risk, particularly in times of stress and/or crisis.

10. The introduction of the net stable funding ratio ("NSFR") created the requirement for internationally active banks to maintain a stable funding profile in relation to the composition of their assets and off-balance sheet activities.

11. A sustainable funding structure is intended to reduce the likelihood that disruptions to a bank's regular sources of funding will erode its liquidity position in a way that would increase the risk of its failure and potentially lead to broader systemic stress. The NSFR limits overreliance on short-term wholesale funding, encourages better assessment of funding risk across all on- and off-balance sheet items and promotes funding stability.

12. The Liquidity Coverage Ratio ("LCR") was introduced to promote the short-term resilience of the liquidity risk profile of internationally active banks. It does this by ensuring that banks have an adequate stock of unencumbered high-quality liquid assets ("HQLA") that can be converted easily and immediately in private markets into cash to meet their liquidity needs for a 30 calendar day liquidity stress scenario. The intention of the LCR is to improve the banking sector's ability to absorb shocks arising from financial and economic stress, thus reducing the risk of spill-over from the financial sector to the real economy.

13. In keeping with these international developments, and in complement to the ongoing implementation of the Basel [1] II framework in the Cayman Islands, the Authority is seeking to effect Basel III liquidity enhancements to the regulatory framework. This will be achieved with the issuance of the proposed *Rules and Guidelines on Liquidity Risk Management for Banks* (replacing the *Statement of Guidance – Liquidity Risk Management* and the November 2006 *Rule on Liquidity Risk Management for Banks* issued by the Authority) which set out a LRM framework for banks. The LRM being proposed for Cayman banks mirrors the Basel III requirements very closely and makes adjustments in cases where applicability is limited.

14. Broadly, and particularly relevant to CIMA's current undertaking to achieve an internationally comparable LRM regulatory framework, comprehensive LRM embodies the promotion of a bank's ability to meet cash flow obligations, which are uncertain as they are affected by external events and other agents' behaviour. Effective LRM is of paramount importance because a liquidity shortfall at a single institution can have system-wide repercussions and financial market developments have increased the complexity of liquidity risk. The absence of deposit insurance or lender of last resort arrangements in the Cayman Islands further strengthens the case for the implementation of a comprehensive liquidity risk management.

15. All Category "A" Retail Banks will be required to adhere to the minimum requirements of the LCR and NSFR. Additionally, the Authority took the decision to expand this framework to ensure that there is a minimum regulatory requirement for all banks licensed in the Cayman Islands, as such all Category "A" Non-retail

[1] Basel III reforms not yet implemented in the Cayman Islands are improved quality of regulatory capital; minimum capital requires revised risk-weighted capital framework; leverage ratio requirements; and macroprudential elements.

banks and Category "B" banks are required to meet the minimum requirements of the Minimum Liquidity Ratio (MLR). The requirements of the MLR include a refined definition of liquid assets. The MLR differs from the requirements of the LCR as it does not have a tier structure for these liquid assets.

16. Additionally, the LRM reporting requirements have not been included in the proposed Rules and Guidelines, but will be included in guidance notes which will be developed by the Authority to accompany liquidity related prudential forms and implemented in due course. Banks are however required to ensure calculation and recording of the ratios as of the implementation date.

C. <u>Purpose of Proposed Measure and Consistency with Authority's Functions</u>

17. Pursuant to section 6(1)(b) of the Monetary Authority Law (2016 Revision) ("the Law"), one of the principal functions of the Authority is:

"*b) regulatory functions, namely -*
- *(i) to regulate and supervise financial services business carried on in or from within the Islands in accordance with this Law and the regulatory laws;*
- *(ii) to monitor compliance with the money laundering regulations; and*
- *(iii) to perform any other regulatory or supervisory duties that may be imposed on the Authority by any other law*;"

18. Section 6(3) of the MAL provides that in performing its regulatory functions, the Authority shall, *inter alia*:

i. endeavour to promote and enhance market confidence and the reputation of the Islands as a financial centre;
ii. recognise the international character of financial services and markets and the necessity of maintaining the competitive position of the Islands, vis a vis both consumers and suppliers of financial services, while conforming to internationally applied standards insofar as they are relevant and appropriate to the circumstances of the Islands;
iii. recognise the principle that a burden or restriction which is imposed on a person or activity should be proportionate to the benefits, considered in general terms; and
iv. recognise the need for transparency and fairness on the part of the Authority.

19. The proposed *Rules and Guidelines on Liquidity Risk Management for Banks* will enhance the regulatory function of the Authority in line with Sections 6(1) and 6(3) of the MAL, as stated above. The proposed Rules and Guidelines will reflect the international enhancements in the area of liquidity risk management; and support the Authority's objective to maintain the competitiveness of the Cayman Islands' financial sector through, *inter alia*, establishing relevant international standards for its licensees.

D. <u>International Standards</u>

20. Liquidity standards are core to the *Basel III: International Regulatory Framework for Banks*. The importance of liquidity is further evidenced in the Basel Core Principles ("BCP").

21. *BCP 24 Liquidity* states *"The supervisor sets prudent and appropriate liquidity requirements (which can include either quantitative or qualitative requirements or both) for banks that reflect the liquidity needs of the bank. The supervisor determines that banks have a strategy that enables prudent management of liquidity risk and compliance with liquidity requirements. The strategy takes into account the bank's risk profile as well as market and macroeconomic conditions and includes prudent policies and processes, consistent with the bank's risk appetite, to identify, measure, evaluate, monitor, report and control or mitigate liquidity risk over an appropriate set of time horizons. At least for internationally active banks, liquidity requirements are not lower than the applicable Basel standards."* The specific criteria of the BCP are outlined in Table I.

Table I: International Standards on Liquidity Risk Management for Banks

BCP 24: Liquidity Risk	***<u>Essential Criteria</u>*** *1. Laws, regulations or the supervisor require banks to consistently observe prescribed liquidity requirements including thresholds by reference to which a bank is subject to supervisory action. At least for internationally active banks, the prescribed requirements are not lower than, and the supervisor uses a range of liquidity monitoring tools no less extensive than, those prescribed in the applicable Basel standards.* *2. The prescribed liquidity requirements reflect the liquidity risk profile of banks (including on- and off-balance sheet risks) in the context of the markets and macroeconomic conditions in which they operate.* *3. The supervisor determines that banks have a robust liquidity management framework that requires the banks to maintain sufficient liquidity to withstand a range of stress events, and includes appropriate policies and processes for managing liquidity risk that have been approved by the banks' Boards. The supervisor also determines that these policies and processes provide a comprehensive bank-wide view of liquidity risk and are consistent with the banks' risk profile and systemic importance.* *4. The supervisor determines that banks' liquidity strategy, policies and processes establish an appropriate and properly controlled liquidity risk environment including:* *a. clear articulation of an overall liquidity risk appetite that is appropriate for the banks' business and their role in the financial system and that is approved by the banks' Boards;* *b. sound day-to-day, and where appropriate intraday, liquidity risk management practices;* *c. effective information systems to enable active identification, aggregation, monitoring and control of liquidity risk exposures and funding needs (including active management of collateral positions) bank-wide;*

   d. *adequate oversight by the banks' Boards in ensuring that management effectively implements policies and processes for the management of liquidity risk in a manner consistent with the banks' liquidity risk appetite; and*

   e. *regular review by the banks' Boards (at least annually) and appropriate adjustment of the banks' strategy, policies and processes for the management of liquidity risk in the light of the banks' changing risk profile and external developments in the markets and macroeconomic conditions in which they operate.*

5. *The supervisor requires banks to establish, and regularly review, funding strategies and policies and processes for the ongoing measurement and monitoring of funding requirements and the effective management of funding risk. The policies and processes include consideration of how other risks (e.g. credit, market, operational and reputation risk) may impact the bank's overall liquidity strategy, and include:*

   a. *an analysis of funding requirements under alternative scenarios;*

   b. *the maintenance of a cushion of high quality, unencumbered, liquid assets that can be used, without impediment, to obtain funding in times of stress;*

   c. *diversification in the sources (including counterparties, instruments, currencies and markets) and tenor of funding, and regular review of concentration limits;*

   d. *regular efforts to establish and maintain relationships with liability holders; and*

   e. *regular assessment of the capacity to sell assets.*

6. *The supervisor determines that banks have robust liquidity contingency funding plans to handle liquidity problems. The supervisor determines that the bank's contingency funding plan is formally articulated, adequately documented and sets out the bank's strategy for addressing liquidity shortfalls in a range of stress environments without placing reliance on lender of last resort support. The supervisor also determines that the bank's contingency funding plan establishes clear lines of responsibility, includes clear communication plans (including communication with the supervisor) and is regularly tested and updated to ensure it is operationally robust. The supervisor assesses whether, in the light of the bank's risk profile and systemic importance, the bank's contingency funding plan is feasible and requires the bank to address any deficiencies.*

7. *The supervisor requires banks to include a variety of short-term and protracted bank-specific and market-wide liquidity stress scenarios (individually and in combination), using conservative and regularly reviewed assumptions, into their*

	stress testing programmes for risk management purposes. The supervisor determines that the results of the stress tests are used by the bank to adjust its liquidity risk management strategies, policies and positions and to develop effective contingency funding plans. *8. The supervisor identifies those banks carrying out significant foreign currency liquidity transformation. Where a bank's foreign currency business is significant, or the bank has significant exposure in a given currency, the supervisor requires the bank to undertake separate analysis of its strategy and monitor its liquidity needs separately for each such significant currency. This includes the use of stress testing to determine the appropriateness of mismatches in that currency and, where appropriate, the setting and regular review of limits on the size of its cash flow mismatches for foreign currencies in aggregate and for each significant currency individually. In such cases, the supervisor also monitors the bank's liquidity needs in each significant currency, and evaluates the bank's ability to transfer liquidity from one currency to another across jurisdictions and legal entities.* ***Additional Criterion*** *The supervisor determines that banks' levels of encumbered balance-sheet assets are managed within acceptable limits to mitigate the risks posed by excessive levels of encumbrance in terms of the impact on the banks' cost of funding and the implications for the sustainability of their long-term liquidity position. The supervisor requires banks to commit to adequate disclosure and to set appropriate limits to mitigate identified risks.*

E. Jurisdictional Comparisons

22. The developed jurisdictions reviewed, Australia, Canada, United States and United Kingdom, all have comprehensive Basel II/Basel III frameworks. The Bank of International Settlements ("BIS") website also has the status of Basel II, Basel 2.5 and Basel III adoption in Argentina, Australia, Brazil, Canada, China, France, Germany, Hong Kong, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, The Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, United Kingdom, United States and the European Union, as at October 2016.

23. Notably, Bermuda, representing a Caribbean counterpart, has made significant strides in implementing the Basel III liquidity standards. In 2015, the Bermuda Monetary Authority ("BMA") issued the *Basel III for Bermuda Banks – Final Rule*[2] which effectively represented the jurisdiction implementation of Basel III. Basel III Liquidity requirements, within this new framework, apply to all Bermuda licensed banks and deposit companies and include LCR and NSFR expectations, which came into effect in January 2018.

[2] The Rule was updated in November 2017.

Implementation of Alternative Approach

24. The decision taken by the Authority to implement an alternative approach for certain banks, the MLR, within the LRM framework is not unique, as similar undertakings were introduced in Australia, Hong Kong and Singapore, amongst others.

Australia

25. An Authorized Deposit-taking Institution, determined by the Australian Prudential Regulatory Authority, is required to maintain a portfolio of liquid assets (referred to as minimum liquidity holdings (MLH)) of nine per cent of its liabilities in specified liquid assets, absent a situation of financial stress.

Hong Kong

26. The Liquidity Maintenance Ratio of an institution that is permitted to use alternative method is a ratio, expressed as a percentage, of the amount of the institution’s liquefiable assets to the amount of the institution’s qualifying liabilities (after deductions). The Hong Kong Monetary Authority requires that the institution must maintain a Liquidity Maintenance Ratio of not less than 25% on average in each calendar month.

Singapore

27. Monetary Authority of Singapore adopted a two-tiered approach for implementation of LCR. Banks deemed systemically important to Singapore are required to meet the LCR requirements which are closely aligned to the Basel III framework, but all other banks could choose to comply with the LCR regime or remain on the previously implemented Minimum Liquid Assets framework. Under the previously existing liquidity regime, banks must maintain eligible assets to cover a specified proportion of their qualifying liabilities

F. Scope of Application and Rationale for Issuing the Proposed Rule Guidelines on Liquidity Risk Management for Banks

28. The BCBS remains the globally recognised and respected standard-setter for international banking activity. Compliance with Basel standards, particularly its capital standards and core principles, represents a hallmark of prudent and sound operations. As the Cayman Islands seek to maintain its standing as a world leading financial centre, alignment with international best practice is crucial.

29. More specifically, the Basel III liquidity standards aim to promote banks’ ability to meet cash flow obligations during both normal and stressed conditions and prevent liquidity shortfalls which may result in system-wide repercussions affecting financial sector stability locally and at the global level.

30. The *Rules and Guidelines on Liquidity Risk Management for Banks* applies to all banks, except those operating in the Cayman Islands as a branch, regulated by the Authority under the Banks and Trust Companies Law (2018 Revision) (“BTCL”) and allows the Authority, in its discretion, to set liquidity requirements on a case-by-case basis. Within the documents, the Authority proposes variations in the

approaches used and requirements set for banks based on type of licence and the nature of the business.

31. The Rules and Guidelines propose that Category "A" Retail banks are required to meet the LCR and NFSR minimum requirements by 1 January 2019; and Category "A" Non-Retail banks and Category "B" banks are required to meet the MLR minimum requirements by the same date.

G. Cost-Benefit Assessment of Implementing the Proposed Rules and Guidance on Liquidity Risk Management for Banks

32. The relevant costs and benefits associated with the implementation of the *Rules and Guidelines on Liquidity Risk Management for Banks* are presented in Table II.

Table II: Costs and Benefits of Issuing a Rules and Guidelines on Liquidity Risk Management for Banks

	Costs	**Benefits**
CIMA	The Authority will incur the usual administrative costs associated with conducting industry consultation, publication and amending supervisory manuals. These costs are not deemed to be overly burdensome and represent usual costs of the Authority carrying out its mandate. More significantly, with these new and broadened liquidity rules, CIMA will need to dedicate staffing resources to ensure banks are complying with issued LRM measures. This will need to be done on an on-going basis through both on-site and off-site supervision.	CIMA will have more comprehensive insight into the operations of regulated banks. From this insight, the Authority will be better able to identify liquidity risk exposures inherent in licensees. With improvements in risk identification and mitigation, the Authority can expect a reduced regulatory burden in the future at both the entity and financial system levels. Providing clearer guidance and more comprehensive requirements to the industry on LRM, CIMA will be able to more adequately review and assess the risks, potential risks and adequacy of liquidity of its licensees and therefore apply more appropriate remedial actions to avert issues at an early stage. The Authority also stands to improve the quality of banking supervision through better compliance with the Basel Core Principles (BCPs) and an increased focus on risk-based supervision.
Cayman Islands	There are no costs to the jurisdiction as a whole with the implementation of these requirements.	As previously mentioned, compliance with Basel standards represents an important element indicative of prudent and sound banking operations. This perceived strength and safety is at the

	Costs	Benefits
		core of the stability of any financial system, including that of the Cayman Islands. Also, the improvement of system wide LRM referenced above, will holistically promote greater levels of high quality liquidity, increased confidence and a more efficient, stable and resilient financial market which is less susceptible to failures. Additionally, bank counterparts' own risks related to exposures to respective banks are reduced. This in turn reduces cost of capital and extends to widespread financial and economic stability. As the jurisdiction moves towards full Basel compliance, the implementation of LRM requirements will significantly and positively impact confidence in the Cayman Islands as a strong world leading financial centre.
Banks	Bank licensees will face costs associated with the implementation of these new measures, particularly as it relates to: 1. Upgrading LRM frameworks (possibly including technological upgrades); 2. Amending internal policies and procedures; and 3. Staff training. Beyond the direct costs of implementation above, with more liquidity comes lower risk and reduced returns. As banks divert higher earning (less liquid) assets to more liquid assets to meet new LRM requirements, this will ultimately affect revenue streams and overall profitability.	Banks will have improved LRM practices including identification, monitoring and mitigation processes. This will allow banks to be more resilient, particularly during times of stress. Additionally, banks will benefit from the positive spill-overs associated with improved LRM, a stronger financial system and heightened confidence. This may positively impact, in both separate and related ways, profitability, customer growth and satisfaction and all-encompassing bank performance.
Summary	Consequent on the above, it is determined that benefits far outweigh costs and the implementation of the *Rules and Guidelines on Liquidity Risk Management for Banks* should proceed.	

H. **Comments and Consultation**

33. The Authority seeks consultation through written comments and representations from the private sector associations concerning the *Rules* and *Guidelines on Liquidity Risk Management for Banks.*

34. The Authority must receive representations by
35. Comments and representations must be addressed to:

The Managing Director
Cayman Islands Monetary Authority
P.O. Box 10052
80e Shedden Road
Elizabethan Square
Grand Cayman KY1-1001
Cayman Islands
Tel: 345-949-7089
Fax: 345-946-5611
Email:
Consultation@cimoney.com.ky
With copy to: A.Glace@cimoney.com.ky

36. The Authority shall have due regard to any representation made by the private sector associations and industry stakeholders. The Authority shall provide a written response collating the feedback received and the Authority's position on this feedback. This response shall be copied to all relevant private sector associations only.