Liquidity Regulations at Banks

نظام السيولة لدى البنوك
Circular No.: 30/2012
Date : 12 / 07 /2012
To : All Banks
Subject: Liquidity Regulations at Banks

Introduction:
Following consultation with banks operating in the UAE and after reviewing international best practices in the area of liquidity risk management and regulations, the Central Bank has decided to enact these regulations for controlling and monitoring of liquidity at banks. All banks must abide by the provisions of these regulations and the accompanying manual at all times.

Objective:-
The objective of these regulations is to ensure that liquidity risks are well managed at banks operating in the UAE and are in line with the Basel Committee for Banking Supervision (BCBS) recommendations and international best practices.

Overview of the regulations
These regulations are set in three sections:
1) Qualitative requirements
2) Quantitative requirements
3) Reporting requirements

These sections cover the key requirements of liquidity risk management at banks.
Article (1) Qualitative Requirements

A Liquidity Risk Management Framework is an integral part of risk management within all banks. The framework should ensure that liquidity risk is well managed to minimize the likelihood of a liquidity stress occurring at a bank and its impact when it occurs.

The Central Bank believes that liquidity risk governance, measurement and management is equally important and complements the quantitative requirements.

When reviewing the liquidity framework, the Central Bank will apply a proportionate approach which will take into account the size of the bank, scope of operations, interconnectedness, and its possible impact on the UAE financial system.

A robust Liquidity Risk Management Framework should incorporate the following requirements:

1. Banks are responsible for managing their liquidity risk in a prudent manner using all available liquidity management tools at their disposal.

2. The bank’s Board of Directors bears ultimate responsibility for liquidity risk management within the bank.

   The bank’s Board should clearly articulate liquidity risk tolerance for the bank in line with the bank’s objectives, strategy and overall risk appetite.

3. Board members should familiarize themselves with liquidity risk and how it is managed.

   At least one board member should have a detailed understanding of liquidity risk management.

4. The bank’s Board of Directors must ensure that the bank’s liquidity risk management framework is adequate to manage liquidity risk.

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4. Senior management is to develop strategies, policies and practices to manage liquidity risk in accordance with the board of directors' approved risk tolerance and ensure that the bank maintains sufficient liquidity.

The bank's liquidity management strategy should be continually reviewed and compliance should be reported to the board of directors on a regular basis.

5. A bank must incorporate liquidity costs, benefits and risks into the product pricing and approval process for all significant business activities.

6. A bank must have sound processes and systems for identifying, measuring, monitoring and controlling liquidity risk in a timely and accurate manner.

7. A bank must establish a forward-looking funding strategy that provides effective diversification in the sources and tenor of funding.

8. A bank must establish a liquidity risk management framework including limits, warning indicators, communication and escalation procedures. The framework should be shared with the Central Bank upon request.

9. A bank must conduct its own internal liquidity stress tests on a regular basis for a variety of institutions specific and market wide stress scenarios (individually and in combination). The scenarios should be based on the individual bank specific circumstances and business model.

A bank should use its internal stress testing outcomes to adjust its liquidity risk management strategies, policies and position and develop effective contingency funding plans.

The scenarios and results of the stress tests should be shared with the Board of Directors on a regular basis and the Central Bank upon request.
10. A bank must have a formal contingency funding plan (CFP) that clearly sets out the strategies for addressing liquidity shortfalls in emergency situations. The CFP should be shared with the Central Bank upon request.

11. A bank must maintain an adequate cushion of unencumbered, high quality liquid assets to be held as insurance against a range of liquidity stress scenarios.

12. A bank is required to develop a transfer-pricing framework to reflect the actual cost of funding. The sophistication of the framework should be commensurate with the bank’s liquidity risk tolerance and complexity.

**Article (2) : Quantitative requirements**

A minimum level of liquid assets should be held at banks to ensure its ability to sustain a short term liquidity stress (both bank specific and market wide).

Banks should also structure their funding profile to limit the impact of long term market disruptions and avoid cliff effects (A large amount of liabilities maturing at the same time).

To achieve these two objectives, the Central Bank requires banks to comply with four ratios of which two are interim ratios until the Basel III Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR) come into effect.

The Central Bank will set up a liquidity task force to ensure a smooth implementation of the LCR and NSFR by its implementation date. The team will visit banks and request a “road map” with clear milestones explaining how the bank will meet the LCR and the NSFR by their respective due dates as per the format in attachment number (1). The team will then assess the plan and provide guidance. The team will also monitor the progress of the bank against its internally set milestones.
The four liquidity ratios are as follows:

A) Liquid Assets Ratio
   (Interim until 31 December 2014)

This is an interim ratio until the LCR ratio in (C) below takes effect.

Under this ratio banks are required to hold an amount equivalent to 10% of their liabilities in high quality liquid assets defined as

- Cash at the Central Bank and
- Physical cash at the bank,
- Central Bank Certificates of Deposit (CDs),
- UAE Federal Government Bonds,
- Reserves Requirements and other account balances at the Central Bank.
- UAE Local Governments and Public Sector Entities (PSEs) publicly traded debt securities provided they have 0% Risk Weighted under Basel II standardized approach and that securities of this category, with a credit rating of “A” or below, do not exceed 2% of the liquid assets ratio.

This ratio will become effective on 1 January 2013 and will remain in force until 31 December 2014 after which the below mentioned LCR ratio becomes effective.

B) Uses (of funds) to Stable Resources Ratio
   (USRR) (Interim until 31 December 2017)

This ratio is an amended version of the current “Advances to Stable Resources Ratio” Circular Number 394 dated 12 July 1986. It aims to prepare banks for the implementation of the Basel III Net Stable Funding Ratio (NSFR) outlined in section (D) below. This ratio will become effective on 1 June 2013.

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The ratio identifies key uses of funds as well as the different types of funding sources used by banks. It assigns stability factors to the sources of funds and required stable funding (usage) factors to asset classes.

After applying the relevant factors, the net uses of funds is divided by the net sources of funds and the result should be less than 100%.

The Banking Supervision Department within the Central Bank is required to issue a guidance manual that specifies the key sources and uses of funds as well as the stability factors and the uses factors to be applied to them.

C) Liquidity Coverage Ratio (LCR) (Effective 1 January 2015)

The LCR is taken from Basel III requirements. It represents a 30 day stress scenario with combined assumptions covering both bank specific and market wide stresses that the bank should be able to survive using a stock of high quality liquid assets.

The LCR requires that banks should always be able to cover the net cash outflow with eligible liquid assets at the minimum LCR determined by the Central Bank (Please see the guidance manual paragraph 119 page 27). Basel III accord requires that this minimum is 100%.

\[
\text{Required LCR} < \frac{\text{Eligible Liquid Assets}}{\text{Net Cash outflow over the next 30 days}}
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Eligible liquid assets are strictly defined in the LCR to ensure that these assets remain liquid under severe stress scenarios both firm specific and market wide. Please note that assets that are usually liquid under normal conditions might not be liquid under a severe stress scenario.

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Eligible liquid assets are strictly defined in the LCR to ensure that these assets remain liquid under severe stress scenarios both firm specific and market wide. Please note that assets that are usually liquid under normal conditions might not be liquid under a severe stress scenario.
Eligible liquid assets are separated into two categories, Tier 1 and Tier 2 liquid assets. Tier 1 liquid assets are allowed in the LCR with no haircuts and no cap applied to them given their superior liquidity at all times. These assets are:

- Cash at the Central Bank and physical cash at the bank.
- Cash Reserve Requirements and account balances at the Central Bank.
- Central Bank CDs and all debt issued or explicitly guaranteed by the UAE Federal Government or local governments.
- Debt issued by multilateral development banks and the International Monetary Fund.
- Foreign, Sovereign or Central Bank, debt or debt guaranteed by them which receive 0% Risk Weight under Basel II Standardized approach.
- UAE Public Sector Entities or Government related entities debt securities which receive 0% Risk Weight under Basel II Standardized approach.

Tier II eligible liquid assets are also highly liquid assets even under a market wide or a bank specific liquidity stress. Nevertheless, the realizable market value under a liquidity stress might be lower than the normal market value and therefore are allowed to be used in the LCR at a haircut. Tier II assets are allowed up to 40% of eligible liquid assets.

The following assets, after being reduced by haircuts (as outlined in the guidance manual paragraph 122 page 28), are eligible as Tier II liquid assets.

- Claims issued or guaranteed by Sovereigns, Central Banks, PSEs receiving 20% risk weight under Basel II standardized approach.
- Corporate bonds and Sukusks rated (AA- or higher) provided it is not issued by a financial institution or any of its affiliates.
- Covered bonds rated (AA- or higher) provided it is not issued by the bank itself or any of its affiliates.

It should be noted that the LCR in the UAE has a qualitative risk weight component. Tier I liquid assets are allowed in the LCR with no haircuts and no cap applied to them given their superior liquidity at all times. These assets are:

- Cash at the Central Bank and physical cash at the bank.
- Cash Reserve Requirements and account balances at the Central Bank.
- Central Bank CDs and all debt issued or explicitly guaranteed by the UAE Federal Government or local governments.
- Debt issued by multilateral development banks and the International Monetary Fund.
- Foreign, Sovereign or Central Bank, debt or debt guaranteed by them which receive 0% Risk Weight under Basel II Standardized approach.
- UAE Public Sector Entities or Government related entities debt securities which receive 0% Risk Weight under Basel II Standardized approach.

Tier II eligible liquid assets are also highly liquid assets even under a market wide or a bank specific liquidity stress. Nevertheless, the realizable market value under a liquidity stress might be lower than the normal market value and therefore are allowed to be used in the LCR at a haircut. Tier II assets are allowed up to 40% of eligible liquid assets.

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- Claims issued or guaranteed by Sovereigns, Central Banks, PSEs receiving 20% risk weight under Basel II standardized approach.
- Corporate bonds and Sukusks rated (AA- or higher) provided it is not issued by a financial institution or any of its affiliates.
- Covered bonds rated (AA- or higher) provided it is not issued by the bank itself or any of its affiliates.
The Banking Supervision Department within the Central Bank is required to issue a guidance manual that specifies the scenario assumptions and the liquid assets eligibility criteria and update it as necessary. The assumptions and definitions used will follow Basel III LCR assumptions.

D) Net Stable Funding Ratio (NSFR) (Effective 1 January 2018)

This is a structural ratio that aims to ensure that long term assets on the banks’ balance sheets are funded using a sufficient amount of stable liabilities. It also requires an amount of stable funding to cover a portion of the contingent liabilities. The NSFR mirrors the Basel III NSFR standard.

The NSFR identifies the key uses of funds and the different types of funding sources used by banks. It assigns Available Stable Funding (ASF) factors to the sources of funds and Required Stable Funding (RSF) (usage) factors to asset classes and the off balance sheet contingent exposures.

The assigned ASF factor depends on the term of funding and the perceived stability of the funding source. The assigned RSF factor will depend on the liquidity of the asset being funded under a market wide stress. Both factors will follow the Basel III NSFR standard.

Under Article 6 below, the Banking Supervision Department within the Central Bank is required, to issue a guidance manual that specifies the stability factors to be assigned to funding sources and the required stable funding (Usage) factors of various asset classes.

Article (3) : Reporting Requirements

From time to time, banks will be required to complete a liquidity report to enable the Central Bank to monitor effectively the liquidity positions at banks and to take appropriate and timely action at early signs of a liquidity stress.

The report should be based on contractual data with no behavioral assumptions made.
The Central Bank will apply homogeneous assumptions to the data to perform its liquidity analysis on both micro and macro prudential levels.

Banks are required to use the liquidity reporting template provided as part of the liquidity guidance manual attached to this circular.

**Article (4): Commencement of these Regulations**

The qualitative requirements commences on 1 January 2013. It is expected that banks shall be compliant with the rules at the commencement date.

The Liquid Assets Ratio will take effect from 1 January 2013 until 31 December 2014, after which the LCR comes into effect.

The USRR will take effect from 1 June 2013 until 31 December 2017, after which the NSFR comes into effect.

The LCR will come into effect on 1 January 2015.

The Net Stable Funding Ratio will take effect from 1 January 2018.

**Article (5): Cancellation of Previous Regulations**

When the Uses to Stable Resources Ratio (USRR) come into effect on 1 June 2013, Circular Number 394 “Advances to Deposits Ratio” dated 12 July 1986 shall be cancelled.

**Article (6): Guidance/Clarification Manual**

The Central Bank will issue a guidance manual which includes: standardized assumptions for the LCR and NSFR calculation which will follow the standards set out in Basel III.
The manual will also include a liquidity reporting template, and a more detailed explanation of what is expected from banks under the qualitative rules.

The manual will be updated with any changes to Basel III liquidity standards that might take place between the date of these regulations and the respective implementation date.

**Article (7) Interpretation**

Banking Supervision Department is responsible for interpreting and enforcing these regulations.

**Article (8) Notification and Publication**

These regulations shall be communicated to all concerned parties for implementation and will be published in the Official Gazette in both Arabic and English.

Issued in Abu Dhabi on 12/07/2012

صدر في أبو ظبي بتاريخ 12/07/2012

خلاص محمد شريف فولادي

رئيس مجلس الإدارة

Khalil Moh'd Sharif Foulathi

Chairman