MFSA

MALTA FINANCIAL SERVICES AUTHORITY

BANKING UNIT

BANKING RULES

LIQUIDITY REQUIREMENTS OF CREDIT INSTITUTIONS AUTHORISED UNDER THE BANKING ACT 1994

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INTRODUCTION

1. In terms of article 4 of the Banking Act 1994 ('the Act') the competent authority ('the authority') as appointed under article 3(1) of the Act may make Banking Rules as may be required for carrying into effect any of the provisions of this Act. The authority may amend or revoke such Banking Rules. The Banking Rules and any amendment or revocation thereof shall be officially communicated to banks and the authority shall make copies thereof available to the public.

2. The Liquidity of Credit Institutions Rule ("the Rule") is being made pursuant to article 18 of the Act which requires that:

   "The competent authority shall issue a banking Rule specifying what shall constitute the specified liquid assets and the deposit liabilities of a credit institution and laying down the minimum holding of specified assets as a proportion of deposit liabilities which a credit institution must hold."

SCOPE AND APPLICATION

3. The Rule applies to all credit institutions licensed under the Banking Act 1994.

4. The authority recognises the fact that continuous liquidity monitoring is vital for the prudential operation of credit institutions. The objective of liquidity monitoring is for credit institutions to be capable of meeting their obligations when they fall due. Such obligations mainly comprise all amounts owed to customers and banks such as sight and term deposits, commitments to lend including unutilised overdraft facilities, off-balance sheet commitments and undrawn standby facilities.

5. The scope of this Rule is therefore to provide the basis for assessing the adequacy of continuous liquidity of all credit institutions through the establishment of a liquidity maturity ladder and a minimum liquid-asset requirement.

CONTINUOUS LIQUIDITY

6. In order to maintain and monitor continuous liquidity, the authority expects that every credit institution establishes an active treasury management operation whose functions should include the monitoring of the maturity structure of the institution's receivables and payables as well as its assets and liabilities taking into account the type, scope and risks of the institution's activities.

7. A credit institution is expected to maintain continuous liquidity by:

   (i) holding sufficient available cash or liquefiable assets, subject to the qualification that marketable assets vary in quality in terms of the prices at which they are capable of being sold;

(ii) securing an appropriately matching future profile of cash flows from maturing assets, subject to the qualification that in practice there may be shortfalls if borrowers are unable to repay;

(iii) maintaining an adequately diversified deposit base in terms both of maturities and range of counterparties (bank and non-bank) which, depending importantly on the individual credit institution's standing and on the general liquidity situation at the time, may provide the ability to raise fresh deposits without undue cost;

(iv) maintaining the Minimum Liquid-Asset Requirement as specified in paragraph 15 of this Rule.

8. The authority expects that credit institutions' management policies apply a prudent mix of the different forms of liquidity mentioned in (i) to (iii) above appropriate to the circumstances of the credit institution and that these policies are sustained at all times. The authority regards a prudent mix as one which offers security of access to liquidity without undue exposure to sudden rising costs from liquefying assets or bidding for deposits/loans.

9. The responsibility for ensuring the liquidity of a credit institution rests with its own Board of Directors and management. Credit institutions should have prudent and adequate management systems to ensure that the policies set are followed. Consequently this Rule apart from establishing the minimum holding of specified assets as a proportion of deposit liabilities, establishes a framework for the measurement of liquidity applicable to credit institutions in general. It serves as a first step towards a qualitative assessment of the adequacy of the liquidity of individual credit institutions taking account of their particular circumstances.

THE BASIS OF MEASUREMENT

(i) Liquidity Maturity Ladder

10. For internal purposes a credit institution, because of its particular circumstances or its internal management policies, in measuring liquidity may make a distinction between the position in Maltese Lira - denominated business and that in other currencies. If this is the case such distinctions shall only apply to the relative institution's own monitoring. The authority through this Rule wishes to assess the liquidity of each institution's total business, undifferentiated as to currency denomination, since in principle, through the foreign exchange markets, obligations in one currency may be met by the availability of liquid funds in another.

11. The measure described in this Rule is based on a cash flow approach, normally taking assets and liabilities in all currencies together, although for internal purposes as explained in paragraph 10 above, it can also be applied to assets and liabilities in one or a group of currencies. In this approach, assets and liabilities are inserted in a "maturity ladder", with the net positions in each time period being accumulated. In the first maturity bands the ladder will compare cash and assets capable of generating

cash immediately with demand and quasi-demand liabilities. Marketable assets are placed at the start of the maturity ladder, rather than according to their maturity date, but account needs to be taken of limitations on their marketability and their susceptibility to price fluctuations. Commitments are recognised by being included as liabilities or as agreed in specific cases. The measure is thus a series of accumulating net mismatch positions in successive time bands.

12. The measurement incorporates the following particular features:

(a) *<u>Assets</u>*

(i) Assets are measured by reference to their maturity, unless, as in the case of overdrafts, they are repayable on demand or unless they are marketable, or are known to be of doubtful value. In case of lending repayable on demand the authority may exceptionally allow a credit institution to treat some proportion of the total as generating an immediate cash flow or to treat it as repayable in instalments over a period.

(ii) The treatment of marketable assets takes account of the extent to which they can be sold for cash quickly (or used as security for borrowing), incurring little or no cost penalty; and of any credit or investment risks which may make their potential value less predictable. It is important that the market for the asset should be sufficiently deep to ensure a stable demand for it. An important factor in this is the willingness of the Central Bank to use the asset in its normal market operations. These considerations are recognised in the measurement by applying varying discounts normally against the market value of marketable assets, all of which, as indicated in paragraph 11 above, are included at the start of the maturity ladder.

(iii) Discounts for the majority of assets are set out in *Annex 1* to this Rule. Assets not covered in *Annex 1* will be a matter for agreement, on a common basis, arising out of discussions by the authority with individual credit institutions.

(iv) Assets known to be of doubtful value are normally excluded from the measurement. However these may be treated by the authority for inclusion on a case-by-case basis, on application by the respective institution.

(v) Contractual standby facilities made available to the credit institutions by other credit institutions provide support which should be recognised, and they are therefore included as equivalent to a sight asset. Due regard, however, will be paid to their remaining term and the possibility that they may not be renewed.

Standby facilities provided by a credit institution to other credit institutions are treated in the same way as commitments to lend at some uncertain future date.

(b) *<u>Liabilities</u>*

(i) All types of amounts owed to banks or non-bank customers are included according to earliest maturity. Deposits which are pledged against a specific asset could be netted off against the specific asset and therefore excluded from the calculation. As a prerequisite however, credit institutions are expected to take into consideration the matching of the maturity of the currency of both the asset and the liability. The authority expects credit institutions to match-up such pledged deposits to the relative counter-asset value. In reporting as per paragraph 18 of the Rule, credit institutions are expected to submit details of such deposits/assets which have been excluded from the calculation.

(ii) Known firm commitments to make funds available on a particular date are included in the appropriate time band at their full value.

(iii) Commitments which are not due to be met on a particular date, for example undrawn overdraft and other facilities, are unlikely to have to be met in full and cannot be treated precisely. The extent to which undrawn facilities should be included as a liability will vary with their nature. This imprecision will be reflected by the inclusion of only a proportion of outstanding commitments in the first maturity band, the remainder being excluded. In this respect the authority expects that as a minimum 50% of such commitments are to be included. A different proportion for each credit institution may however be determined by the authority following discussions with the relative credit institution having regard to its past and prospective draw-down experience.

(iv) Contingent liabilities are not included in the measurement, unless there is a reasonable likelihood that the conditions necessary to trigger them might be fulfilled.

(c) <u>Other items</u>

(i) Where items in course of transmission or collection are material, credits in course of collection are deducted from debits in course of collection and the net balance included at the start of the maturity ladder.

(ii) Any other liabilities are to be treated on a gross basis.

13. The system of measurement is illustrated in *Annex 2* to this Rule.

14. How far into the future it is desirable to measure liquidity profiles depends very much on the circumstances of each credit institution. The point of maximum excess of liabilities over assets normally occurs within the first twelve months, although it can be later. In this respect *Annex 2* places greater emphasis on the first twelve months, however also including later years.

(ii) Minimum Liquid-Asset Requirement

15. Every credit institution is required to maintain a minimum liquid-asset proportion of 30% of the total deposit liabilities net of deductions which for the purposes of the Rule are specified in *Annex 3*. For the purposes of this Rule, liquid assets held are deemed to be the total assets specified in *Annex 4.* The authority may, if appropriate and necessary, set different proportions for credit institutions depending on their activities.

16. When a credit institution has opted to exempt pledged deposits under paragraph 12 (b) (i) of the Rule, the relative liabilities and assets could be treated as specified in the said paragraph for the purpose of the minimum liquid-asset requirement.

BRANCHES OF OVERSEAS INSTITUTIONS

17. The provisions of this Rule shall also apply to local branches of overseas institutions.

However circumstances may lead to a situation whereby the overseas credit institution would want to assume the ultimate responsibility for the branch liquidity. In such circumstances if the authority is satisfied with the internal arrangement of the parent credit institution for monitoring and controlling its world-wide liquidity needs, the authority may exempt the local branch from any of the provisions of this Rule.

SUBMISSIONS TO THE AUTHORITY

18. The authority requires that the liquidity structure (Maturity Ladder per *Annex 2*) and the Liquid-Asset Ratio Requirement (per *Annex 5*) be submitted by all credit institutions on a monthly basis. Submissions are to be accompanied by the Declaration under *Annex 6*.

OFFENCES AND PENALTIES

19. The authority draws the attention of all officers of a credit institution or a Malta branch, agency or office of an overseas institution particularly to article 33 (b) of the Act.

20. Any person who commits an offence in terms of this Rule as provided for under article 35 of the Act is liable to such penalties or may be prescribed pursuant to the said article.

LIQUIDITY MATURITY LADDER ASSET DISCOUNTING

1. The authority considers that assets for inclusion in the maturity ladder should be discounted in relation to their remaining term to maturity. In this respect the following discounts will be applied:

0% discount

- Cash and balances with the Central Bank of Malta including excesses on Reserve Deposit Requirements as defined in Annex 4;
- Cheques in course of collection;
- Treasury bills and similar security eligible for refinancing with the Central Bank of Malta;
- Zone A Government issued or guaranteed marketable securities with twelve months or less remaining term to maturity;
- Bank balances repayable or withdrawable on demand, overnight or within seven days;
- Other negotiable securities issued or guaranteed by international institutions or by foreign official institutions or by other first class institutions in currencies which are freely convertible and with twelve months or less remaining term to maturity.

5% discount

- Other bills and bank balances (including CD's) with six months or less remaining term to maturity;
- Other Zone A Government issued or guaranteed marketable securities with five years or less remaining term to maturity;
- Other negotiable securities issued or guaranteed by international institutions or by foreign official institutions or by other first class institutions in currencies which are freely convertible and with five years or less remaining term to maturity.

Note that the definition of 'Zone A countries' is provided under Banking Rule BR/04 Appendix 1, Article 1.1.0

10% discount

- Other bills, bank balances (including CD's) with five years or less remaining term to maturity;
- Other Zone A Government issued or guaranteed marketable securities with more than five years remaining term to maturity;
- Other marketable securities issued or guaranteed by international institutions or by foreign official institutions or by other first class institutions of Zone A countries and with more than five years remaining term to maturity.

25% discount

- Investments in collective investment schemes[1].

Discount to be Determined

- All other marketable assets *(upon application to the authority).*

2. For the purpose of discounting other marketable assets the authority will also consider instruments and/or banks of countries outside Zone A on application by the reporting institution on a case-by-case basis.

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[1] *To be reported in the "Over Two Years" band*