Islamic Republic of Afghanistan
Da Afghanistan Bank

Summary

Da Afghanistan Bank (DAB) is issuing for public comment a regulation on liquidity measurement and management. The circulation of the regulation for comment is consistent with Article 3 of the Decree Law of Banking in Afghanistan (Banking Law), which requires that a regulation be published in the manner "best calculated to bring the regulation to the attention of the domestic banking industry." If the DAB determines that the delay in issuing a regulation that would be caused by circulating the regulation for public comment would be a "serious threat to the interests of the banking system" it may forego this requirement. In the case of this regulation, the DAB chooses to circulate the regulation for public comment.

Purpose of rule

The purpose of the regulation is to set forth what DAB, at a minimum, expects of banking organizations in the measurement and management of their liquidity positions. It also establishes two minimum required liquidity ratios that banks must observe[1], in addition to any internal limits they may adopt.

The adoption and full implementation of this rule is generally in keeping with Principles 13, 17, and 18 of the Core Principles of Effective Banking Supervision of the Basle Committee.

Background and summary of rule

Liquidity management is one of the most important tasks of the overall management of banking risks. If a bank does not properly manage its liquidity, it may find itself unable to immediately meet depositors' demands for withdrawals or repay other borrowed

[1] A minimum ratio of certain "liquid" assets to certain liabilities that is established for prudential reasons is superficially similar to, but fundamentally distinct from, a reserve requirement for monetary policy purposes and the two should not be confused. Minimum liquidity ratios are designed to help ensure that ***each individual bank*** has enough liquid assets to meet temporary, unexpected cash outflows. The reserve requirement for monetary policy purposes, also expressed as a ratio of certain assets to certain liabilities, is designed to influence ***the aggregate liabilities of the banking sector as a whole*** and thus the supply of money and credit in the economy. The numerators and denominators of the "quick" and "broad" liquidity ratios are defined in this regulation to be substantially different from the numerator and denominator of the reserve requirement, so that for most banks there will be some correlation but not enough to make any of the three ratios redundant.

money; it may also be unable to meet borrowers' demands to fund worthwhile new credits, thereby depriving the bank of profitable assets and future business. Too much liquidity, however, and the bank's profitability will suffer.

This regulation requires banks to have a comprehensive liquidity management program, including oversight by the Board of Supervisors and Board of Management; policies and procedures including quantitative guidelines and internal limits; management information systems; measuring and monitoring activities; contingency planning; and diversification of funding sources. Minimum standards for all of these activities are indicated.

As an added prudential measure, the regulation specifies two minimum required liquidity ratios that are to be calculated and observed by banks on a monthly average basis. These two ratios reflect a "tiered" approach to liquidity: a "quick" liquidity ratio, consisting of a narrow measure of "high-liquid" assets in the numerator and a narrow measure of "volatile" liabilities in the denominator is complemented by a "broad" liquidity ratio, consisting of a broader measure of liquid assets as a required percentage of all attracted funds and certain off-balance sheet items that pose liquidity risk. Reflecting higher overall risk, the minimum quick liquidity ratio – 20 percent – is higher than the minimum broad liquidity ratio, 15 percent.

It is acknowledged that liquidity management is complex, involving constant monitoring of cash flows and projections thereof, and cannot be accomplished only with reference to static, numerical balance sheet ratios. Nevertheless, minimum ratios of assets to liabilities are essential, especially in emerging banking markets where there are not many sources of secondary liquidity or access to wholesale funds. As with all minimum regulatory ratios, banks are expected to operate well above the required minimums.

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Article Five: Liquidity Measurement and Management

<u>Part A — General.</u>

§ 5.1.1. Authority

This regulation on liquidity measurement and management is pursuant to the authority granted to DAB by Articles 32.3 and 35.2.1 of the Decree Law of Banking in Afghanistan (Bank Law).

§ 5.1.2. Definitions.

a) *Attracted funds* -- a subset of liabilities, meaning the sum of: demand deposits of banks; time deposits of banks; deposits of other financial institutions; demand deposits by nonfinancial institutions and other clients; time deposits by nonfinancial institutions and other clients; savings deposits by nonfinancial institutions and other clients; borrowings under securities repurchase agreements; short-term borrowings from DAB; short-term borrowings from banks; other short-term borrowings; long-term borrowings; subordinated debt; and debt/equity hybrid instruments.

b) *Broad liquidity ratio* – liquid assets, expressed as a percentage of the sum of attracted funds and designated off-balance sheet items.

c) *Designated off-balance sheet items* – designated off-balance sheet items mean the sum of: unused commitments to lend; commercial letters of credit; financial standby letters of credit; performance standby letters of credit; and other guarantees and credit substitutes.

d) *High-liquid assets* – a subset of liquid assets, meaning the sum of: cash in vault; current account with DAB; and demand deposits with banks.

e) *Liquid assets* -- liquid assets mean the sum of: cash in vault; current account with DAB; demand deposits with banks; time deposits with banks; loans to banks; other receivables from banks; loans to other financial institutions; claims under securities repurchase agreements; foreign securities – securities issued by category A counterparts in the trading account; foreign debt securities – securities issued by category A counterparties in the held-to-maturity account; foreign debt securities – securities issued by category A counterparties in the available-for-sale account.

f) *Quick liquidity ratio* – high-liquid assets, expressed as a percentage of volatile liabilities.

g) *Volatile liabilities* – a subset of attracted funds, meaning the sum of: demand deposits of banks; deposits of other financial institutions; borrowings under securities repurchase agreements; short-term borrowings from banks; and other short-term borrowings.

§ 5.1.3. General goals and objectives.

a) This regulation aims at the following:
   1. To set forth DAB's expectations regarding liquidity measurement and management by banks.
   2. To establish two absolute minimum liquidity ratios – quick and broad – below which banks must never operate.

b) The objectives of this regulation:
   1. Banks will be required to have a comprehensive liquidity management program, including: oversight by the board of supervisors and board of managers; policies and procedures including quantitative guidelines and internal limits; management information systems; measuring and monitoring activities; contingency planning; and diversification of funding sources.
   2. Banks will be required to maintain minimum ratios of high-liquid assets to volatile liabilities and liquid assets to attracted funds.

c) Adherence by banks to the standards set by this regulation will be monitored by DAB through on-site examinations and off-site analysis of data.

Part B — Liquidity Measurement and Management

§ 5.2.1. Liquidity Measurement and Management -- General.

a). Every banking organization must have a written strategy for the day-to-day management of liquidity. The liquidity strategy should define the bank's

general approach to managing liquidity, including various quantitative and qualitative targets. The strategy should cover specific policies on the composition of assets and liabilities, the use of interbank funding, and strategies for addressing temporary and longer-term liquidity disruptions.

b). Banks with deteriorating financial condition, deteriorating CAMELS ratings, or both must increase attention to liquidity management and contingency planning.

§ 5.2.2. Oversight by the Board of Supervisors and Management Board.

The Board of Supervisors (Supervisors) and Board of Management (Management) must exercise oversight of the bank's liquidity management program. Supervisors and Managers must understand their oversight responsibilities and carry them out diligently.

a) *Supervisors* -- Supervisors must establish the bank's tolerance for liquidity risk, including quantitative limits, and approve significant policies related to liquidity management, on at least an annual basis. Supervisors must also ensure that Managers take the necessary steps to monitor and control liquidity risk. Supervisors must understand the nature and level of the bank's liquidity risk.

b) *Management* – Management must establish policies, procedures, and guidelines for managing and monitoring liquidity, including internal controls. They must review the bank's liquidity position on a regular, frequent basis, monitor internal and external factors and events that could affect liquidity, and prepare contingency funding plans. Management must also inform Supervisors regularly of the liquidity position of the bank.

§ 5.2.3. Policies and Procedures.

A bank must have clearly defined policies and procedures for managing liquidity. The Supervisors have ultimate responsibility for the adequacy of policies and procedures; Management has responsibility for their design and implementation. Policies and procedures must include the following:

a) *Delineated lines of responsibility.* Individuals or committees responsible for managing and monitoring liquidity risk must be identified.
b) *Overall liquidity strategy.* The liquidity strategy must define the general approach the bank will follow in managing liquidity, including various quantitative and qualitative targets. The strategy must cover specific policies on the composition of assets and liabilities, including the use of interbank funding. There must also be a written strategy for addressing temporary and long-term liquidity disruptions.
c) *Process for measuring and monitoring liquidity.* Banks must measure and monitor their liquidity through the use of cash flow projections that forecast

cash inflows and outflows over different planning periods to identify cash shortfalls and surpluses in future periods. Other methods may be used to supplement cash flow projections, but the use of cash flow projections is mandatory.

d) *Quantitative guidelines and limits*. Although cash flow projections are subjective and imprecise, banks must make efforts to define the maximum cash flow shortages they are willing to tolerate. Banks should also set internal minimums for the quick liquidity ratio and broad liquidity ratio; these minimums must be at least equal to the regulatory minimums described below.

e) *Internal controls.* Banks must adopt internal controls that include: procedures for approvals of exceptions to policies, limits, and authorizations; a schedule for the periodic review of liquidity policies and procedures; and review of reporting and compliance with laws, regulations, and internal policies.

f) *Management information systems.* Banks must have a management information system that provides the Management accurate and timely information on the bank's current and prospective liquidity position. The reports must clearly define the assumptions used in the cash flow projections so that Managers can evaluate the appropriateness and validity of the projections. The reports must also enable Management to determine compliance with internal limits and regulatory requirements.

g) *Contingency planning.* Banks must have contingency plans for handling unexpected, significant erosions in their liquidity positions. The contingency plans must identify all back-up facilities (such as asset sales or collateralized interbank borrowing) and the circumstances under which the bank might use them. Management must periodically test all sources of its contingency funding with the goal of ensuring that there are no unexpected impediments or complications to their use. Responsibilities and decision-making must be defined, so that all personnel understand their role during a problem situation.

h) *Diversification of funding sources.* Banks must build and maintain relationships with a broad range of depositors and other funding sources. Over-reliance on individual sources of funds (for example, greater than 20 percent of total attracted funds) is to be avoided.

i) *Scenario Analysis*. A bank's liquidity management strategy should, where appropriate, include scenario analysis to ensure that the bank can operate under a wide range of operating conditions. At least two scenarios should be addressed: a "likely scenario" with the normal behavior of cash flows in the ordinary course of business; and a "crisis scenario" with the behavior of cash flows in adverse operating circumstances where the bank has significant difficulty in rolling over or replacing its liabilities. The underlying assumptions of this scenario analysis should be examined periodically. Contingency planning, which is discussed under this same section, should be in place to address these difficulties.

Part C — Minimum Regulatory Liquidity Ratios.

§ 5.3.1. Minimum quick liquidity ratio.

Banks must maintain their quick liquidity ratio at or above **20 percent.** A bank with no volatile liabilities automatically meets the requirement, even though its ratio cannot be calculated.

§ 5.3.2. Minimum broad liquidity ratio.

Banks must maintain their broad liquidity ratio at or above **15 percent.**

§ 5.3.3. Calculation of compliance with minimum ratios.

Banks must calculate the minimum ratios on a monthly basis as a monthly average of daily ratios and report these monthly averages to DAB within five business days of the end of each month. Banks are in violation of this regulation if the monthly averages fall below the required percentages. Banks must maintain sufficient information to enable DAB's on-site examiners to verify the banks' calculations.

Part D — Effective date of regulation.

§ 5.4.1. Publication in the Official Gazette.

This regulation will become effective one calendar month following its publication in the Official Gazette.