FINANCING COMPANIES LIQUIDITY RISK MANAGEMENT MODULE

MODULE:	LM	Liquidity Risk Management

Table of Contents

LM-A.1 Purpose

Executive Summary

LM-A.1.1 This Module provides detailed Rules and Guidance on risk management systems and controls required for minimum liquidity requirements for <u>financing company licensees</u>.

LM-A.1.2 This Module expands on certain high-level requirements contained in various High-Level Standards Modules. In particular, Condition 5 of the Licensing Conditions (see Section AU-2.5) notes that <u>financing company licensees</u> must maintain sufficient liquid assets to meet their obligations as they fall due in the normal course of business. In addition, Principle 9 of the Principles of Business (see Paragraph PB-1.1.9) refers to the requirement to maintain adequate resources for <u>financing company licensees</u> to run their business in an orderly manner. Principle 10 of the Principles of Business (see Paragraph PB-1.1.10) also notes the requirement for <u>licensees</u> to maintain systems and controls to manage the level of risk inherent in their business and ensure compliance with the CBB Rulebook.

LM-A.1.3 This Module sets out the minimum <u>stock liquidity ratio</u> and <u>maturity mismatch ratios</u> which <u>financing company licensees</u> must meet as a condition of their licensing. In addition, it outlines the need for proper systems and controls to ensure the prudent management of liquidity and the liquidity reporting and other requirements.

LM-A.1.4 Liquidity risk is the risk of not being able to meet liabilities when they fall due, even though a firm may still be solvent. Liquidity risk in <u>financing company licensees</u> relates to the management of their cash flow and the risk to their meeting short-term liabilities due to liquidity problems. The purpose of these requirements is to ensure that <u>financing company licensees</u> hold sufficient liquid assets to meet their obligations as they fall due.

Legal Basis

LM-A.1.5 **This Module contains the Central Bank of Bahrain's ('CBB') Directive relating to the liquidity risk management of <u>financing company licensees</u>, and is issued under the powers available to the CBB under Article 38 of the Central Bank of Bahrain and Financial Institutions Law 2006 ('CBB Law'). The Directive in this Module is applicable to all <u>financing company licensees</u>.**

LM-A.2 Module History

Evolution of Module

LM-A.2.1 This Module was first issued in January 2014 by the CBB. Any material changes that have subsequently been made to this Module are annotated with the calendar quarter date in which the change was made: Chapter UG-3 provides further details on Rulebook maintenance and version control.

LM-A.2.2 A list of recent changes made to this Module is provided below:

Module Ref.	Change Date	Description of Changes
LM-1.2.1	07/2014	Clarified the requirement for the minimum stock liquidity ratio.

LM-B.1 Scope of Application

LM-B.1.1 This Module is applicable to all financing company licensees authorised in the Kingdom of Bahrain (thereafter referred to in this Module as licensees).

LM-1.1 General Requirements

LM-1.1.1

Licensees must maintain on a continuing basis an appropriate mix of high quality liquid assets in order to meet their obligations when they fall due and to address any liquidity needs and unexpected cash flow required for funding needs.

LM-1.1.2

To address the requirements of Paragraph LM-1.1.1, a minimum amount of liquid assets must be maintained by the licensee. The minimum level of liquid assets is determined by the minimum stock liquidity ratio (See Section LM-1.2) and maturity mismatch ratios (See Section LM-1.3) that must be complied with by the licensee.

LM-1.1.3

Licensees must ensure that at all times they maintain the minimum stock liquidity ratio and maturity mismatch ratios outlined in Paragraph LM-1.1.2. In the event that the licensee does not comply with these ratios, it must notify the CBB by no later than the following business day of the actual level of the ratios. When providing such notification, the licensee must:

(a) Provide to the CBB, within one week of the non-compliance, a written action plan setting out how the licensee proposes to restore its ratios to the required minimum level and describe the systems and controls that have been put in place to prevent any future non-compliance of the minimum ratios;

(b) Report to the CBB, on a weekly basis or on another timely basis as required by the CBB, the average stock liquidity ratio until such time as it reaches 30%; and

(c) Report to the CBB on a monthly basis or on another timely basis as required by the CBB, the negative cumulative maturity mismatch ratios until such time as the 3-month maturity does not exceed 15% and the 6-month maturity band does not exceed 20%.

LM-1.2 Stock Liquidity Ratio

LM-1.2.1

Licensees must maintain a minimum stock liquidity ratio of 25% on a monthly basis. Such ratio is to be calculated for Bahrain operations only.

LM-1.2.2

The CBB may require licensees to maintain an average stock liquidity ratio in excess of the 25% minimum required under Paragraph LM-1.2.1, should it have concerns regarding the licensee's liquidity and/or financial position.

LM-1.2.3

The stock liquidity ratio, expressed as a percentage, must be calculated on each business day and is the ratio of the sum of the licensee's liquid assets, net of deductions required under Paragraph LM-1.2.6, divided by the sum of qualifying liabilities.

LM-1.2.4

The average stock liquidity ratio for a calendar month is calculated by dividing the sum of the daily stock liquidity ratio calculated in accordance with Paragraph LM-1.2.3 at the close of business on each working day during a month by the number of business days during that month.

Liquid Assets

LM-1.2.5

For purposes of Paragraph LM-1.2.3, liquid assets are defined as:
(a) Cash unencumbered current accounts with financial institutions;
(b) Placements with financial institutions maturing within one month;
(c) Exchange traded financial instruments;
(d) GCC government securities;
(e) Other sovereign bonds and bills up to one year maturity, carrying a minimum rating of AA-; and
(f) Accounts receivable due within one month.

LM-1.2.6

The liquid assets noted under Paragraph LM-1.2.5 must also meet the following requirements to be included in the calculation of the stock liquidity ratio. They must be:
(a) Free from encumbrances; and
(b) Freely available and payable.

LM-1.2 Stock Liquidity Ratio (continued)

Qualifying Liabilities

LM-1.2.7

For purposes of Paragraph LM-1.2.3, qualifying liabilities are defined as:
(a) Liabilities due within one month; and
(b) Irrevocable commitments to provide funds within one month.

LM-1.2.8

For purposes of Subparagraph LM-1.2.7 (b), irrevocable commitments include facilities:
(a) With a known date of drawdown within one month; and
(b) Without a known date of drawdown but carrying a notice period of within one month (including where the drawdown is on demand, i.e. requiring no notice period) except where conditions attached to the drawdown cannot be met in practice within one month.

LM-1.2.9

Potential commitments relating to credit card facilities, which may be cancelled at any time are excluded from qualifying liabilities.

LM-1.3 Maturity Mismatch Ratios

LM-1.3.1 **Licensees must maintain positive cumulative maturity mismatch ratios for 3-month and 6-month maturity bands. Where negative cumulative maturity mismatch ratios occur, the negative cumulative maturity mismatch ratios, as a percentage of total liabilities, must not exceed 20% for a 3-month maturity band and 25% for a 6-month maturity band. These ratios are to be calculated on a unconsolidated basis.**

LM-1.3.2 A mismatch occurs when differences exist between the receipts from cash inflows (assets) and cash outflows (liabilities). A positive mismatch is one where the expected cash inflow, generated by revenues and assets, exceeds the expected cash outflow, from the payment of expenses and liabilities. A negative mismatch occurs when the expected inflow of cash is less than the expected outflow of funds. The amount of the mismatch is measured in cash.

LM-1.3.3 **In measuring maturity bands, cash inflows from assets and cash outflows from liabilities are slotted into time bands. The maturities used are based on a worst case scenario. Specifically, cash inflows are included based on their latest maturity and cash outflows are based on their earliest maturity.**

LM-1.3.4 **A net mismatch figure is obtained by subtracting cash outflows from cash inflows for each time band. Mismatches are then calculated on a net cumulative basis.**

LM-1.3.5 **The maturity mismatch ratio is calculated using the net cumulative mismatch figure obtained under Paragraph LM-1.3.4 as a percentage of total liabilities.**

LM-2.1 Liquidity Policy

LM-2.1.1

Prudent liquidity management is the primary responsibility of senior management based on the authority and limits approved by the licensee's Board of Directors. Senior management must continuously review information on the liquidity developments and report to the board of directors on a quarterly basis.

LM-2.1.2

Licensees must ensure that they have in place systems and controls to ensure the prudent management of liquidity. Licensees must identify and manage their liquidity risk across all their operations, and document their policies and procedures for achieving this in a liquidity risk policy.

LM-2.1.3

On annual basis, a licensee's board of directors must review and approve the structure, strategy, policies and practices related to liquidity management (including contingency planning) and must also ensure that senior management manages and monitors liquidity risk effectively.

LM-2.1.4

Licensees must formulate a statement of their liquidity management policies that is to be reviewed and discussed with the CBB. The objective of this review is to agree to minimum liquidity standards for the licensees. The policy statement must be properly documented, reviewed annually and approved by the Board of Directors to ensure that it remains valid under changing circumstances. While specific details of the policy statement will differ, at a minimum, it must refer to the liquidity management strategy, responsibilities, systems and contingency planning.

LM-2.1 Liquidity Policy (continued)

Stress Testing

LM-2.1.5 Licensees are encouraged to carry out stress testing to assess the resilience of their financial resources to any identified areas of material liquidity risk. This stress testing may take into account the general characteristics, and licensee's experience, and any mitigating factors that it considers relevant such as the ability to sell assets quickly and the options available to re-schedule the payment of liabilities.

LM-2.1.6 Where the licensee considers that the nature of its assets or liabilities and the matching of its liabilities result in no significant liquidity risk exposure, it will not be expected to carry out stress testing. The CBB will expect it to document the reasons for its decision and be prepared to discuss these during an on-site visit.

LM-2.1.7 When assessing liquidity risk, the licensee should consider the extent of mismatch between assets and liabilities and the amount of assets held in highly liquid, marketable forms should unexpected cash flows lead to a liquidity problem. The price concession of liquidating assets is a prime concern when assessing such liquidity risk and should be built into any assessment of liquidity risk management.

LM-3.1 Contingency Planning

LM-3.1.1

Licensees must have in place a formal contingency plan that clearly sets out their strategies for addressing liquidity shortfalls in emergency situations. The results of stress tests should also play a key role in shaping the licensee's contingency planning and in determining the strategy and tactics to deal with events of liquidity stress.

LM-3.2 Liquidity Reporting Requirements

LM-3.2.1 Licensees must report their stock liquidity ratio and maturity mismatch ratios on a quarterly basis to the CBB, in accordance with the requirements outlined in Chapter BR-1.3.

LM-3.3 Bonds Issued by Licensee

LM-3.3.1 In accordance with Article 141 of the Bahrain Commercial Companies Law, licensees must comply with the statutory requirement whereby the total value of existing bonds issued by the licensee must not exceed the issued and fully paid up capital and the undistributed reserves according to the latest balance sheet approved at the annual general meeting. This statutory requirement does not apply to bonds guaranteed by the state or by one of the public entities and bonds issued by financial institutions regulated by the CBB, and with the approval of the CBB.