

Annex- IV: Basel Principles for Liquidity Risk Management

Broad principles for sound liquidity risk Management by banks as envisaged by BCBS

Fundamental principle for the management and supervision of liquidity risk	
Principle 1	A bank is responsible for the sound management of liquidity risk. A bank should establish a robust liquidity risk management framework that ensures it maintains sufficient liquidity, including a cushion of unencumbered, high quality liquid assets, to withstand a range of stress events, including those involving the loss or impairment of both unsecured and secured funding sources. Supervisors should assess the adequacy of both a bank's liquidity risk management framework and its liquidity position and should take prompt action if a bank is deficient in either area in order to protect depositors and to limit potential damage to the financial system.
Governance of liquidity risk management	
Principle 2	A bank should clearly articulate a liquidity risk tolerance that is appropriate for its business strategy and its role in the financial system.
Principle 3	Senior management should develop a strategy, policies and practices to manage liquidity risk in accordance with the risk tolerance and to ensure that the bank maintains sufficient liquidity. Senior management should continuously review information on the bank's liquidity developments and report to the board of directors on a regular basis. A bank's board of directors should review and approve the strategy, policies and practices related to the management of liquidity at least annually and ensure that senior management manages liquidity risk effectively.
Principle 4	A bank should incorporate liquidity costs, benefits and risks in the internal pricing, performance measurement and new product approval process for all significant business activities (both on- and off-balance sheet), thereby aligning the risk-taking incentives of individual business lines with the liquidity risk exposures its activities create for the bank as a whole.
Measurement and management of liquidity risk	

Principle 5	A bank should have a sound process for identifying, measuring, monitoring and controlling liquidity risk. This process should include a robust framework for comprehensively projecting cash flows arising from assets, liabilities and off-balance sheet items over an appropriate set of time horizons.
Principle 6	A bank should actively monitor and control liquidity risk exposures and funding needs within and across legal entities, business lines and currencies, taking into account legal, regulatory and operational limitations to the transferability of liquidity.
Principle 7	A bank should establish a funding strategy that provides effective diversification in the sources and tenor of funding. It should maintain an ongoing presence in its chosen funding markets and strong relationships with funds providers to promote effective diversification of funding sources. A bank should regularly gauge its capacity to raise funds quickly from each source. It should identify the main factors that affect its ability to raise funds and monitor those factors closely to ensure that estimates of fund raising capacity remain valid.
Principle 8	A bank should actively manage its intraday liquidity positions and risks to meet payment and settlement obligations on a timely basis under both normal and stressed conditions and thus contribute to the smooth functioning of payment and settlement systems.
Principle 9	A bank should actively manage its collateral positions, differentiating between encumbered and unencumbered assets. A bank should monitor the legal entity and physical location where collateral is held and how it may be mobilised in a timely manner.
Principle 10	A bank should conduct stress tests on a regular basis for a variety of short-term and protracted institution-specific and market-wide stress scenarios (individually and in combination) to identify sources of potential liquidity strain and to ensure that current exposures remain in accordance with a bank's established liquidity risk tolerance. A bank should use stress test outcomes to adjust its liquidity risk management strategies, policies, and positions and to develop effective contingency plans.
Principle 11	A bank should have a formal contingency funding plan (CFP) that clearly sets out the strategies for addressing liquidity shortfalls in emergency situations. A CFP should outline policies to manage a range of stress environments, establish clear lines of responsibility, include clear invocation and escalation procedures and be regularly tested and updated to ensure that it is operationally robust.

Principle	A bank should maintain a cushion of unencumbered, high quality liquid assets to be held as insurance against a range of liquidity stress scenarios, including those that involve the loss or impairment of unsecured and typically available secured funding sources. There should be no legal, regulatory or operational impediment to using these assets to obtain funding.
Public disclosure	
Principle 13	A bank should publicly disclose information on a regular basis that enables market participants to make an informed judgment about the soundness of its liquidity risk management framework and liquidity position.

Thus, a sound liquidity risk management system would envisage that:

- (i) A bank should establish a robust liquidity risk management framework.
- (ii) The Board of Directors (Board) of a bank should be responsible for sound management of liquidity risk and should clearly articulate a liquidity risk tolerance appropriate for its business strategy and its role in the financial system.
- (iii) The Board should develop strategy, policies and practices to manage liquidity risk in accordance with the risk tolerance and ensure that the bank maintains sufficient liquidity. The Board should review the strategy, policies and practices at least annually.
- (iv) Top Management/ ALCO should continuously review information on bank's liquidity developments and report to the Board on a regular basis.
- (v) A bank should have a sound process for identifying, measuring, monitoring and controlling liquidity risk, including a robust framework for comprehensively projecting cash flows arising from assets, liabilities and off-balance sheet items over an appropriate time horizon.
- (vi) A bank's liquidity management process should be sufficient to meet its funding needs and cover both expected and unexpected deviations from normal operations.

- (vii) A bank should incorporate liquidity costs, benefits and risks in internal pricing, performance measurement and new product approval process for all significant business activities.
- (viii) A bank should actively monitor and manage liquidity risk exposure and funding needs within and across legal entities, business lines and currencies, taking into account legal, regulatory and operational limitations to transferability of liquidity.
- (ix) A bank should establish a funding strategy that provides effective diversification in the source and tenor of funding and maintain ongoing presence in its chosen funding markets and counterparties and address inhibiting factors in this regard.
- (x) Senior management should ensure that market access is being actively managed, monitored, and tested by the appropriate staff.
- (xi) A bank should identify alternate sources of funding that strengthen its capacity to withstand a variety of severe bank specific and market-wide liquidity shocks.
- (xii) A bank should actively manage its intraday liquidity positions and risks.
- (xiii) A bank should actively manage its collateral positions.
- (xiv) A bank should conduct stress tests on a regular basis for short-term and protracted institution-specific and market-wide stress scenarios and use stress test outcomes to adjust its liquidity risk management strategies, policies and position and develop effective contingency plans.
- (xv) Senior management of a bank should monitor for potential liquidity stress events by using early warning indicators and event triggers. Early warning signals may include, but are not limited to, negative publicity concerning an asset class owned by a bank, increased potential for deterioration in bank's financial condition, widening debt or credit default swap spreads, and increased concerns over the funding of off- balance sheet items.
- (xvi) To mitigate the potential for reputation contagion, a bank should have a system of effective communication with counterparties, credit rating agencies, and other stakeholders when liquidity problems arise.

- (xvii) A bank should have a formal contingency funding plan (CFP) that clearly sets out the strategies for addressing liquidity shortfalls in emergency situations. A CFP should delineate policies to manage a range of stress environments, establish clear lines of responsibility, and articulate clear implementation and escalation procedures.
- (xviii) A bank should maintain a cushion of unencumbered, high quality liquid assets to be held as insurance against a range of liquidity stress scenarios.
- (xix) A bank should publicly disclose its liquidity information on a regular basis that enables market participants to make an informed judgment about the soundness of its liquidity risk management framework and liquidity position.