INSTRUCTION CPO/B-2000/3
ON BANK LIQUIDITY
I. AUTHORITY

In carrying out its responsibility to establish the liquidity requirements for banks licensed in East Timor pursuant to Sections 23.2, 26.2(a), 35.1, and 46 of UNTAET Regulation No. 2000/8 on Bank Licensing and Supervision, the Central Payments Office of East Timor, hereinafter referred to as CPO, provides this instruction on liquidity.

II. GENERAL

The purpose of this instruction is to provide for an adequate balance between a bank invested funds (assets) and its financial resources (liabilities) and to ensure that a bank is at all times able to fund its operations under any conditions and at a reasonable cost. This instruction establishes the requirements for the minimum amount of liquid resources that a bank must maintain, and sets forth the basic principles for effectively managing liquidity.

Sound liquidity management must be closely inter-related with both interest rate risk management and asset and liability management. Each of these areas significantly impact a bank formal business planning process as well as day-to-day operations.

III. DEFINITIONS

A. **Asset and Liability Management** - The process of effectively managing a bank portfolio mix of assets, liabilities, and when applicable, off-balance sheet contracts. This process involves the management of two primary financial risks, interest rate and foreign exchange, and directly relates to sound overall liquidity management.

B. **Interest Rate Risk** - The exposure of a bank financial condition to adverse movements in interest rates. Changes in interest rates can have significant impact on a banks earnings as well as the underlying economic value of a bank assets, liabilities, and off-balance sheet items.

C. **Liquidity** - The ability to fund all contractual obligations of the bank, notably lending and investment commitments and deposit withdrawals and liability maturates, in the normal course of business, that is the ability to fund increases in assets and meet obligations as they come due.

D. **Liquidity Management** - An on-going process to ensure that cash needs can be met at reasonable cost in order for a bank to maintain the required level of reserves at the CPO and to meet expected and contingent cash needs. Required reserves at the CPO should not be considered to be a routine source of liquidity. Good management information systems, analysis of net funding requirements under alternative scenarios, diversification of funding sources, and contingency planning are crucial elements of sound liquidity management.

E. **Liquidity Risk** - The risk of loss to a bank resulting from its inability to meet its needs for cash or from inadequate liquidity levels, which must be covered by funds, obtained at excessive cost.

F. **Net Funding Requirements** - The liquid assets necessary to fund a bank cash obligations and commitments going forward determined by performing a cash flow analysis, all cash inflows against all cash outflows, to identify potential net shortfalls.

IV. PRINCIPLES OF LIQUIDITY MANAGEMENT

The following principles, from Publication No. 69, dated February 2000, of the Bank for International Settlements' Basel Committee on Banking Supervision, details the key elements for effectively managing liquidity. Banks should formally adopt and implement these principles for use in the overall liquidity management process.

A. Banks must develop a structure for liquidity management.

1. Each bank should have an agreed strategy for day-to-day liquidity management. This strategy should be communicated throughout the organization.

2. A bank Governing Board should approve the strategy and significant policies related to liquidity management. The Governing Board should also ensure that senior management of the bank takes the steps necessary to monitor and control liquidity risk. The Governing Board should be informed regularly of the liquidity situation of the bank and immediately if there are any material changes in the bank current or prospective liquidity position.

3. Each bank should have a management structure in place to effectively execute the liquidity strategy. This structure should include the ongoing involvement of members of senior management. Senior management must ensure that liquidity is effectively managed, and that appropriate policies and procedures are established to control and limit liquidity risk. Banks should set and regularly review limits on the size of their liquidity positions over particular time horizons.

4. Banks must have adequate information systems for measuring, monitoring, controlling and reporting liquidity risk. Reports should be provided on a timely basis to the banks Governing Board, senior management and other appropriate personnel, and to the CPO as required by this instruction (Section VI).

B. Banks must measure and monitor net funding requirements.

1. Each bank should establish a process for the ongoing measurement and monitoring of net funding requirements.

2. Banks should analyze liquidity utilizing a variety of what if scenarios.

3. Banks should frequently review the assumptions utilized in managing liquidity to determine that they continue to be valid.

C. Banks should manage market access. Each bank should periodically review its efforts to establish and maintain relationships with liability holders, to maintain the diversification of liabilities, and aim to ensure its capacity to sell assets.

D. Banks should have contingency plans in place that address the strategy for handling liquidity crises and which include procedures for making up cash flow shortfalls in emergency situations.

E. Banks should manage their foreign currency liquidity.

1. Each bank should have a measurement, monitoring and control system for its liquidity positions in the major currencies in which it is active. In addition to assessing its aggregate foreign currency liquidity needs and the acceptable mismatch in combination with its domestic currency commitments, a bank should also undertake separate analysis of its strategy for each currency individually.

2. Subject to the analysis undertaken according to Section IV.E.1 above, a bank should, where appropriate, set and regularly review limits on the size of its cash flow mismatches over particular time horizons for foreign currencies in aggregate and for each significant individual currency in which the bank operates.

F. Each bank must have an adequate system of internal controls over its liquidity risk management process. A fundamental component of the internal control system involves regular independent reviews and evaluations of the effectiveness of the system and, where necessary, ensuring that appropriate revisions or enhancements to internal controls are made. The results of such reviews should be available to the CPO upon request.

G. Each bank should have in place a mechanism for ensuring that there is an adequate level of disclosure of information about the bank in order to manage public perception of the organization and its soundness.

V. LIQUIDITY REQUIREMENTS

A. Liquidity Ratio

1. Banks must maintain a Liquidity Ratio of at least 15%, calculated as follows:

$$\frac{\text{Highly Liquid Assets}}{\text{Total Liabilities not including equity}} \times 100$$

2. Highly Liquid Assets eligible for inclusion in the numerator of the ratio include the following unencumbered assets:

   a. Vault Cash
   b. Precious metals (Gold)
   c. Deposits with the CPO
   d. Deposits in other financial institutions
   e. Readily Marketable securities
   f. Net inter-bank lending and borrowing with a remaining maturity period of up to one month.

B. Limits on Cumulative Cash Flow Mismatches

Each bank should adhere to the limits established by its Governing Board on the cumulative cash flow mismatches, that is the cumulative net funding requirement as a percentage of total liabilities, over the following periods: next day, up to seven days, 8 days to one month.

VI. REPORTING

Each bank shall submit to the CPO a report as of each month-end in the format prescribed by the CPO showing the calculation of the Short-Term Liquidity Ratio and the cumulative cash flow mismatches in accordance with this Instruction.

VII. RESPONSIBILITIES FOR MONITORING COMPLIANCE

Direct responsibility to determine that the bank has in place at all times a comprehensive risk management process rests with the Governing Board of the bank or the committee(s) cited in Section 16.1 and 19.3 of UNTAET Regulation No. 2000/8 on Licensing and Supervision of Banks. This requires, at a minimum, specific written policies and procedures that address each item contained in parts IV and V of this instruction.

26 October 2000
Fernando De Peralto, General Manager

REPORT ON LIQUIDITY

Name of Bank:
CPO Identification Number:
Report for Month Ended:

I . LIQUIDITY RATIO

1.	Vault Cash	
2.	Precious metals (Gold)	
3.	Deposits with the CPO	
4.	Deposits in other financial institutions	
5.	Readily Marketable securities	
6.	Net inter-bank lending and borrowing with a remaining maturity period of up to one month	
7.	**Total Highly Liquid Assets** 7 = (1 + 2 + 3 + 4 + 5 + 6)	
8.	**Total Liabilities**	
9.	**Liquidity Ratio** [(7/8) x 100]	

II – LIMITS ON CUMULATIVE CASHFLOW MISMATCHES

Liquid Assets	Maturity at/up to		
	next day	seven days	a month
Vault Cash Precious metals (Gold) Deposits with the CPO Deposits in other financial institutions readily Marketable securities Net inter-bank lending and borrowing			
Liquid Assets/Total Liabilities x 100			
Limit of LA/TA established			

Signature of Authorized Officer / Date: