BANKA QENDRORE E REPUBLIKËS SË KOSOVËS
CENTRALNA BANKA REPUBLIKE KOSOVA
CENTRAL BANK OF THE REPUBLIC OF KOSOVO

Prishtina, January 2009

TO THE MANAGING DIRECTORS OF ALL KOSOVO FINANCIAL INSTITUTIONS

Dear Sir/Madam

As you have been informed earlier, CBK will continue the method of communication in the form of Advisory Letters.

These letters are intended to provide assistance and clarity with issues impacting the Kosovo financial sector. As examples, we will discuss new developments in the industry, especially in these times of global financial concerns.

We hope this continued series of Advisory Letters will provide guidance and clarity to you.

Attached herewith is our sixth issuance, Advisory Letter 2009-1, concerning Minimum Standards for Liquidity Risk Management.

Best Regards,

Nexhat Kryeziu
Deputy Governor

Shkendije Himaj
Chief Supervision Officer

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Advisory Letter 2009-01 **January 2009**

MINIMUM STANDARDS FOR LIQUIDITY RISK MANAGEMENT

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PURPOSE

In the course of performing its supervisory activities, CBK has noted that liquidity risk management is a systemic issue that needs the attention of banks' governing bodies. In general, bank lending in Kosovo is growing faster than the deposit base. Also, as the banking sector is becoming more sophisticated as to financial products offered, the CBK will play its role supervisory role proactively by issuing general guidance to banks on the management of their liquidity

.As such the contents of this letter should be viewed as guidance. It is written in the context of the banking sector as it exists in Kosovo at present and will be revised as the sector evolves. It. incorporates those aspects or overriding principles of liquidity risk management that CBK supervision views as essential. It represents the standards that CBK will use in its on-site examinations as to evaluating how well each bank manages its liquidity risk. CBK expects that banks will, on their own, develop or revise their liquidity risk management policies, practices and systems in order to substantively conform to these at all times.

ONGOING LIQUIDITY MANAGEMENT

A. Developing a Structure for Managing Liquidity Risk

I. **Each bank should have an agreed strategy for the day-to-day management of liquidity, in the form of written policies**

As with managing other types of risk, sound liquidity risk management first involves <u>setting a strategy</u> for the bank ensuring effective board and senior management oversight, as well as operating under a sound process for identifying, measuring, monitoring and controlling liquidity risk. The formality and sophistication of the liquidity management process should be appropriate for the overall level of risk incurred by the bank and the sophistication of its banking activities.

Banks need to place a high priority as to their liquidity strategy. A main activity of banks is raising and maintaining adequate liquidity. Many banking activities depend directly on a bank's continual ability to provide liquidity to customers. As highly leveraged businesses, banks are particularly vulnerable to liquidity problems, both of an institution-specific nature and those external events which affect markets as a whole. Virtually every financial transaction or commitment has implications for a bank's liquidity. In view of this, banks need put in place a liquidity strategy, policies, and management approach. The liquidity strategy should set out the general approach the bank will have to liquidity, including various quantitative aspects and qualitative (specific) targets.

The liquidity strategy should address the bank's goal of protecting financial strength and the ability to withstand stressful events in the marketplace.

A bank's liquidity strategy should articulate specific policies on particular aspects of liquidity management, such as the composition and quantity of liquid assets, the volatility and/or stability of liabilities (especially funding from deposits and other sources), the level of credit commitments made, the relative reliance on the use of certain financial instruments, and sources of back-up funding for liquidity needs. To a lesser extent in Kosovo, it should also include an approach to managing liquidity in different currencies. There should also be an agreed strategy for dealing with the potential for both temporary and long-term liquidity disruptions.

The strategy for managing liquidity risk should be communicated throughout the organization, particularly in light of the fact that in many banks, managing liquidity is no longer purely the responsibility of the treasury function. A breakdown in operating systems can also have a substantial impact on liquidity risk. All businesses units within the bank that conduct activities having an impact on liquidity should be fully aware of the liquidity strategy and operate under the approved policies, procedures, and limits.

Senior management and the appropriate personnel should have a thorough understanding of how other risks, including credit, market, and operational risk, impact on the bank's overall liquidity strategy. For example, credit problems with specific counterparties may affect the amount of anticipated cash inflows and necessitate alternative actions by the bank.

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

Because of the critical importance of liquidity management to the viability of any bank, the board should approve the bank's strategy for managing liquidity risk. The board should approve significant policies that govern or influence the bank's liquidity risk. The board should also approve policies and procedures that identify lines of authority and responsibility for managing liquidity exposures.

The board of directors should ensure that senior management provides clear guidance on the level of acceptable liquidity risk in order to comply with the bank's liquidity strategy. The board should also ensure that senior management has the policies and procedures in place to effectively monitor and control liquidity risk.

The board should monitor performance and liquidity risk profile of the bank and periodically review information that is timely and sufficiently detailed to allow them to understand and assess the liquidity risk facing the bank's key portfolios and the bank as a whole. Banks holding