TERMS OF REFERENCE

Project: Enhancing Banks' Liquidity Risk Management

Project Owner: **Mr. Indrit Bank, Bank of Albania, Supervision Department.**

Project Manager: **Mrs. Miranda Ramaj, Bank of Albania, Supervision Department.**

Deputy Project Managers: **Banking Community**

Technical Anchor (TAN): **One pier reviewer from Central Banks in the region**

Project Working Group: **BoA – BoA Supervision Department and representatives of all banks**

I. - Background - Problem Identification

Liquidity is the ability of a bank to fund increases in assets and meet obligations as they come due, without incurring unacceptable losses. The fundamental role of banks in the maturity transformation of short-term deposits into long-term loans makes banks inherently vulnerable to liquidity risk, both of an institution-specific nature and that which affects markets as a whole. Virtually every financial transaction or commitment has implications for a bank's liquidity. Effective liquidity risk management helps ensure a bank's ability to meet cash flow obligations, which are uncertain as they are affected by external events and other agents' behavior. Liquidity risk management is of paramount importance because a liquidity shortfall at a single institution can have system-wide repercussions. Financial market developments in the past decade have increased the complexity of liquidity risk and its management.

In Albania, banks' liquidity management is governed by the regulation "On the liquidity of the bank" no. 04 dated 19.01.2003 and amended with the decision no. 08 dated 12.02.2003 of the Supervisory Council of the Bank of Albania. The regulation provides only principles for the liquidity management. According to these guidelines, banks are given proper independence to adjust the liquidity level based on criteria set by the Bank of Albania.

Some of these criteria include:

- Diversification of funding sources according to maturity, type of bank instrument and bank's clientele;
- The degree of bank's integration into the money market, short-term bonds issued and traded in the market;
- Formulation of its commercial policy alongside with financial planning in order to avoid any potential deficiency in resources necessary for its developmental plans, and to reduce any structural asset and liability shortcomings resulting from differences between the maturity dates agreed and the actual ones.

Based on this general regulatory framework, with no quantitative prudential ratios (thresholds) provided, the liquidity level differs from bank to bank.

The financial crisis that originated in USA in 2008 is spreading in the whole world. Public officials, analysts and many others in Albania have declared in the media that the country will not be immune to the crises and that measures have to be taken in order to prevent bad consequences. Albeit the banks' current good levels of liquidity, it is expected that Albania will start feeling the consequences of the world crisis through decreased level of remittances. Therefore, Bank of Albania is considering the enhancement of the regulatory provisions on liquidity risk management, by introducing minimum/prudential liquidity levels.

The necessity of improving the liquidity management is also related to tight conditions on liquidity in the international markets, a factor that might influence the activity of the banking system in Albania as well. Although it is an issue for each banks' management, it could also have systemic implications.

Not only the current financial crisis demands for tighten liquidity risk management, but also the need to align the Albanian regulations to the international ones. Looking at the experience of other countries in the region, many Central Banks have adopted in their regulations and guidelines quantitative indicators for ensuring the necessary liquidity level. Such countries include: Serbia, Byelorussia, Poland, Romania and Slovenia.

In order to account for financial market developments as well as lessons learned from the turmoil, the Basel Committee has conducted a fundamental review of its 2000 Sound Practices for Managing Liquidity in Banking Organizations and issued in September 2008 Principles for Sound Liquidity Risk Management and Supervision.

Guidance has been significantly expanded in a number of key areas. In particular, more detailed guidance is provided on:

- the importance of establishing a liquidity risk tolerance;
- the maintenance of an adequate level of liquidity, including through a cushion of liquid assets;

- the necessity of allocating liquidity costs, benefits and risks to all significant business activities;

- the identification and measurement of the full range of liquidity risks, including contingent liquidity risks;
- the design and use of severe stress test scenarios;
- the need for a robust and operational contingency funding plan;
- the management of intraday liquidity risk and collateral; and
- public disclosure in promoting market discipline.

Guidance for supervisors also has been augmented substantially. The guidance emphasizes the importance of supervisors assessing the adequacy of a bank's liquidity risk management framework and its level of liquidity, and suggests steps that supervisors should take if these are deemed inadequate. The principles also stress the importance of effective cooperation between supervisors and other key stakeholders, such as central banks, especially in times of stress.

This guidance focuses on liquidity risk management at medium and large complex banks, but the sound principles have broad applicability to all types of banks. The implementation of the sound principles by both banks and supervisors should be tailored to the size, nature of business and complexity of a bank's activities. A bank and its supervisors also should consider the bank's role in the financial sectors of the jurisdictions in which it operates and the bank's systemic importance in those financial sectors.

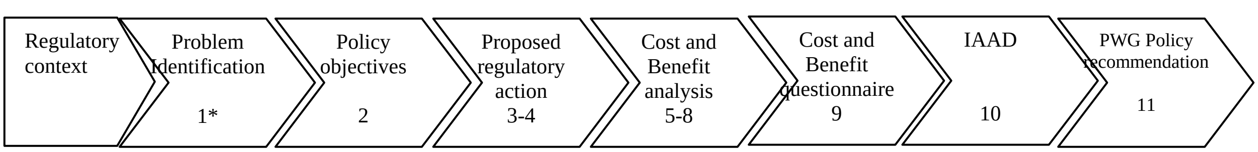
The Albanian regulatory framework should also be aligned to the revised Basel Committee guidelines.

II. - Project Objective

To enhance banks' liquidity risk management by reviewing the current regulatory framework according to international guidelines and best practice, including introduction of quantitative prudential ratios, in order to prevent the occurrence of systemic liquidity difficulties.

III.- Intended Strategy-Description of the Better Regulation

=====Scoping of Problem========‖====Analysis== =‖= Policy‖=Conclusion=
Of Impact Consultation



The project management group (Project Owner, Project Manager, Deputy Project Manager), supported by the SPI Secretariat will act based on the mandate received from the SPI Committee to review the liquidity management regulation in order to introduce quantitative prudential ratios and to align it with the international practices.

The project working group (PWG), with the support of SPI Albania Secretariat, will consult and analyze the international guidelines and practices and other countries' experience in setting up quantitative ratios, in order to understand and apply them in the current Albanian regulatory framework.

Planned steps to achieve project's objective:

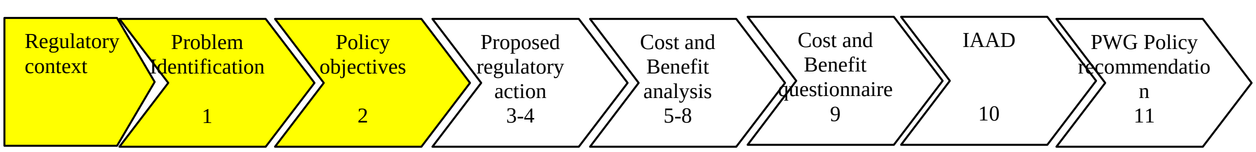
1. To identify the current legal framework that regulates the liquidity management for banks;
2. To acquire a clear understanding on the 2008 Principles for Sound Liquidity Risk Management and Supervision of the Basel Committee and international guidelines and on experiences in other European Countries in using quantitative ratios for liquidity management.
3. Based on the analyzed documents, to formulate the amendment proposals in order to enhance the liquidity management;
4. To assess the possible impact of introducing quantitative prudential ratios and run consultations on the proposed amendments.

IV- Methodology: from kick off to the accomplishment of the project

The Project Owner will appoint PM and DPM. SPI Secretariat will draft the invitation letter. The project working group members will be appointed by PM and by banks, following the invitation sent through AAB.

A. First PWG meeting

Preparation of PWG 1st meeting (PM/DPM and SPI Secretariat)



Preparatory works

PMG and SPI Secretariat to prepare: a. a background note on current regulatory framework; b. a note on international experience (2008 Basel Committee guidelines and experience in European countries).

For drafting the note on international experience, PWG members representing banks will be asked to provide SPI Secretariat with the experience in regulating liquidity of their parent banks.

After PMG clearance and before the 1st meeting, SPI Secretariat will send to PWG members the following documents:

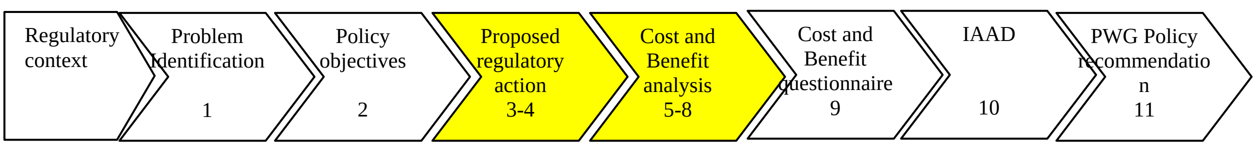
1. Draft TORs;
2. Draft of "Scoping of Problem" document;
3. Background note on current regulatory framework;
4. Note on international experience

Objectives: To understand the current context and the policy goals
To get acquainted with international guidelines
To acquire knowledge on other European countries' experience in regulating liquidity management

Outputs: Final ToRs
Final "Scoping of Problem" document
Approved note on international experience

SPI Secretariat will prepare the minutes of the meeting

B. PWG 2nd meeting



Preparatory works

PWG members will send to SPI Secretariat the description of their internal methodologies and policies for liquidity management. SPI Secretariat will collect individual inputs and will present them in a structured approach.

A core of the PWG, with SPI Secretariat support, will prepare a proposal for potential PWG recommendations to amend the current regulatory framework.

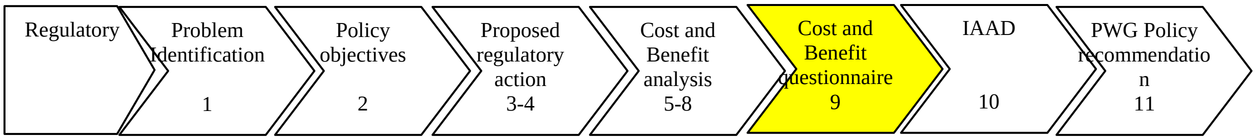
SPI Secretariat will prepare the draft qualitative analysis of the potential PWG amendment proposals.

Objectives: To formulate recommendations on policy implementation;
To analyze the qualitative impact for users and regulators.

Output: Proposed regulatory action (amendments)
Approved IAAD document up to qualitative impact assessment

SPI Secretariat will prepare the minutes of the meeting

C. PWG 3rd meeting



Preparatory works

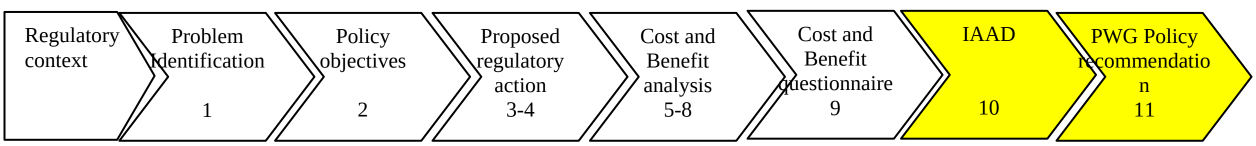
SPI Secretariat, with PMG support, will draft the questionnaire for data collection. SPI Secretariat will base its approach on the very clear understanding of the current banks' practices and of the changes brought in the methodology by the amendment proposals.

Objective: To discuss and agree on the cost and benefit questionnaire for assessing the quantitative impact of the regulatory amendments

Output: Final questionnaire.

SPI Secretariat: will prepare the minutes of the meeting.

D. PWG 4th meeting



Preparatory works

SPI Secretariat will collect data from PWG participating banks and will summarize questionnaire results, preparing the draft "summary impact assessment" for PWG discussion and endorsement. PMG and SPI Secretariat: to draft PWG recommendations on regulatory amendment proposals.

Objectives: To endorse Impact Assessment Analysis Document including "Summary Impact Assessment";
To finalize PWG recommendations..

Output: IAAD
Final PWG recommendations .

Following PWG 4th meeting:

Preparation of the SPI Committee paper that will be approved by PMG.

VI - Project Team

The team is composed of:

- Bank of Albania
- Banks – all banks will be invited to appoint PWG members

Consulted documents:

1. Regulation "On the liquidity of the bank" no. 04 dated 19.01.2003 and amended with the decision no. 08 dated 12.02.2003 of the Supervisory Council of the Bank of Albania
2. Experiences of other countries in the region: Serbia, Byelorussia, Poland, Romania and Slovenia.
3. Principles for Sound Liquidity Risk Management and Supervision, Basel Committee, 2008.

Attachment

The EU Better Regulation Approach	
Steps	**Purpose**
	Scoping of problem
1. Problem identification	To understand if a market/regulatory failure creates the case for regulatory intervention.
2. Definition of policy objectives	To identify the effects of the market /regulatory failure to the regulatory objectives.
3. Development of "do nothing option"	To identify and state the status quo.
4. Alternative policy options	To identify and state alternative policies (among them the "market solution").
	Analysis of impact
5. Costs to users	To identify and state the costs borne by consumers
6. Benefits to users	To identify and state the benefits yielded by consumers
7. Costs to regulated firms and regulator	To identify and state the costs borne by regulator and regulated firms
8. Benefits to regulated firms and regulator	To identify and state the benefits yielded by regulator and regulated firms
9. Data Questionnaire	To collect market structure data to perform a quantitative cost and benefit analysis
	Consultations
10. Policy Document	To learn market participant opinions on various policy options
	Conclusion
11. Final Recommendations	Final report to decision-makers, based on Cost Benefit Analysis and market feedback

Source: CESR-CEBS-CEIOPS 3L3 Guidelines, adjusted by the Convergence Program based on experience.