Deposit Guarantee Corporation of Manitoba
La Société d’assurance-dépôts du Manitoba

Guideline

Subject: Systemic Liquidity Risk (CUCM)

Effective Date: July 1, 2022

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1.0 Overview

On July 1, 2022, DGCM issued new Prudential Standards pursuant to s. 159.2 of *The Credit Unions and Caisses Populaires Act*. Credit Union Central of Manitoba (CUCM) must comply with the Prudential Standards (s. 159.2).

The Prudential Standards are available at this link:

https://web2.gov.mb.ca/laws/regs/annual/2022/090.pdf

The purpose of these Systemic Liquidity Risk Guidelines is to further describe CUCM's obligations under Part 3 of the Prudential Standards which require CUCM to establish a robust liquidity risk management framework.

2.0 Systemic Liquidity Risk

CUCM is jointly owned and governed by Manitoba credit unions. CUCM plays a significant role in the management of Manitoba credit union and the Caisse (cu/caisse) liquidity risk. Liquidity risk, for CUCM, is the potential failure of CUCM or any cu/caisse to meet day-to-day cash commitments including payment and settlement obligations.

CUCM's role is mandated under Section 165 of the Act which states that:

> ***165(1)*** *The purposes of the central are*
> *to manage and receive the liquidity reserves of credit unions;*
>
> ***165(2)*** *In addition to the purposes set out in subsection (1), the central must receive and manage the liquidity reserves of the caisse populaire if requested to do so by the caisse populaire.*

CUCM is responsible for managing a substantial portion of cu/caisse liquidity reserves. These reserves are placed in a single system Liquidity Pool that is owned and controlled by CUCM.

CU/Caisse funds are held on deposit with CUCM, aggregated in the Liquidity Pool, and are used primarily to:

- Ensure the exchange, clearing, and settlement of payment obligations of the cu/caisse
- Support daily cash flow management
- Support emergency liquidity events

Given CUCM's role as the manager of the Systems' liquidity reserves in a mandatory liquidity pool, CUCM must mitigate liquidity risk at the systemic level and ensure that all cu/caisse can meet member demand for withdrawals in both normal and stressed conditions.

CUCM's role in managing systemic liquidity risk is supported by its Liquidity Pool investment strategy. In investing cu/caisse liquidity reserves, CUCM must prioritize liquidity needs over all other factors. A prudent person approach should be followed to mitigate all associated risks while obtaining a reasonable return.

Under the Prudential Standards**,** CUCM must adhere to policies, standards, and procedures that a reasonable and prudent person would apply to a portfolio of investments and loans to avoid undue risk and to obtain a reasonable return. Refer to the **Prudent Person Guidelines (CUCM)** for more details.

3.0 Liquidity Principles

In order to manage systemic liquidity risk and prudently manage the Liquidity Pool, CUCM must follow the Liquidity Principles set out in this Section.

3.1 Liquidity Risk Management Framework

Principle 1
CUCM 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.

CUCM's liquidity risk management framework should include:

- Liquidity risk tolerances, approved by the Board of Directors, reflected in liquidity and funding policies, business strategies, reporting frameworks, risk management and control functions.

- A robust framework for the identification, measurement, management and monitoring of cu/caisse and CUCM liquidity requirements, including:

    - The capacity to conduct hypothetical analyses of changes to funding requirements under identified stress scenarios

    - The maintenance of a cushion of high quality, unencumbered liquid assets.

- Contingency funding plans that reflect outcomes generated from systemic liquidity risk stress testing programs.

- A funding strategy that assures diversification of funding sources.

- Active participation in risk management and information sharing between CUCM and cu/caisse.

3.2 Governance and Risk Tolerances

Principle 2
CUCM should establish liquidity risk tolerances that are appropriate for its business strategy and its role as manager of the Liquidity Pool.

CUCM's Board of Directors is responsible for determining CUCM's liquidity risk tolerances. Tolerances should align with CUCM's business objectives and overall risk appetite. Established tolerances should also represent a baseline for operationalizing CUCM's liquidity strategies, policies, risk management and controls.

CUCM's Board should regularly review its tolerances.

Principle 3
CUCM's Board of Directors should review and approve the strategy and policies for management of liquidity risk and ensure that senior management manages liquidity risk effectively. Senior management should develop those strategies, policies, and practices and ensure the Board receives appropriate reports.

Senior management is responsible for establishing and implementing well documented, sound, and prudent liquidity management and funding policies and strategies. Policies should be recommended by senior management to the Board of Directors for its approval.

CUCM's liquidity policies, which collectively articulate the importance the Board and senior management places on liquidity and its use in achieving business objectives and its strategy, should be communicated and understood at all relevant levels of the organization. In particular, these policies should capture decisions around:

- asset, liability and off-balance sheet instrument composition
- funding source diversification
- regulatory compliance
- the use of stress test scenarios and related assumptions
- the size and composition of a stock of liquid assets that is available to generate cash in a stress environment
- interjurisdictional risks and impacts to cu/caisse system liquidity from participation in group clearing arrangements

- contingency funding plans
- management of collateral including pledging and apportionment
- limit setting, the process for escalating exceptions and review of applicability.

Senior management should ensure that CUCM has adequate internal controls and practices that ensure compliance with policy. CUCM's overall liquidity strategies should be well understood at the Board level and throughout the organization.

The governance and oversight of liquidity risk at CUCM must be supported by an experienced and well-resourced Asset-Liability Committee (ALCO) led by management.

Regular reporting to the Board, including reporting on stress test results, is required so that it can fulfill its oversight role.

3.3 Measuring, Managing, and Monitoring

Principle 4
CUCM should actively monitor and control liquidity risk exposures and funding needs.

CUCM has a unique role as manager of the Liquidity Pool. CUCM must manage systemic risk and interjurisdictional liquidity risk through participation in a group clearing arrangement. To actively monitor and control systemic liquidity risk exposures and funding needs, CUCM should:

- actively monitor cu/caisse's daily liquidity positions in relation to established policy limits and consult with cu/caisse to determine their funding needs
- ensure effective processes are in place to allocate and transfer liquidity within the system, and meet collateral requirements for clearing and settlement
- assess liquidity risk on a system-wide basis and undertake stress-testing to assist in identifying, measuring and controlling liquidity risk
- assess liquidity sufficiency at CUCM, system-wide, and interjurisdictional levels (e.g. understand requirements to comply with the group clearing arrangement)
- assess the availability of CUCM's stock of liquid assets

Regular communication with cu/caisse and other stakeholders and effective communication when liquidity problems arise, is of vital importance. CUCM is expected to be actively engaged with cu/caisse and have appropriate communication plans and procedures documented in advance.

When assessing the availability of funds, CUCM should fully consider all potential constraints on the movement of liquidity and collateral. CUCM should also consider the operational arrangements needed to transfer funds and collateral and the time required to complete such transfers.

<u>Principle 5</u>

CUCM 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.

A sound process for identifying, measuring, managing and monitoring liquidity risk should include:

- a rigorous and comprehensive liquidity measurement program that is integrated within the liquidity management strategy and contingency funding plans of CUCM. Components of such a program should include the combination of:
    - projecting cash flows
    - maintaining liquid assets that can be liquidated under stress conditions without incurring undue losses

- a contingency funding plan that addresses stress testing results

- processes around:
    - internal limit setting and controls consistent with CUCM's risk tolerances
    - appropriate incentives for Liquidity Pool managers
    - access to a diversified set of funding sources

- systems, resources, and personnel to ensure timely measuring, monitoring, and reporting to senior management, Board, and system stakeholders

The work of measuring, managing, and monitoring liquidity risk should be undertaken by or with the support of an experienced and highly effective ALCO.

3.4 Stress Testing

Principle 6
CUCM should regularly conduct systemic liquidity stress tests to identify sources of potential liquidity strain and to ensure that exposures remain within its liquidity risk tolerances. CUCM should use stress test outcomes to influence its liquidity risk management strategies, policies, and positions and to develop effective contingency plans.

CUCM should develop a comprehensive liquidity stress testing program that considers multiple scenarios with varying degrees of stress. Evaluating liquidity sufficiency depends on the behaviour of cash flows under different conditions.

An effective stress testing program should include extreme but plausible scenarios that review:

- specific events impacting one or more cu/caisse, CUCM, or the Systems
- market-wide disruptions (e.g. events that might cause a mass flight to quality assets or re-pricing or a change in investor risk appetite)
- combinations of the above items

The outcomes of stress test exercises should:

- be compared against CUCM's risk tolerances
- be integrated into management decisions including limit setting
- influence the design of contingency funding plans

Liquidity stress tests should assess the impact of contingent liquidity risks to CUCM or cu/caisse. CUCM stress tests should also consider the reputational impact of CUCM or a cu/caisse failing to meet current or contingent liquidity obligations or consumer demands (e.g. member loans that would be funded in the ordinary course of business).

CUCM should consider potential funding shortfalls including:

- size and timing of any shortfall relative to total funding
- current level of actual stress (whether name-specific or market-wide) relative to the modelled level of stress

- diversity of funding sources available to meet the shortfall
- stock of high-quality, unencumbered liquid assets relative to the shortfall
- information from key stakeholders including cu/caisse that can be used to model cu/caisse funding shortfalls

Assumptions

Cash flow assumptions in stress scenarios are often low probability events with potentially large funding implications. An extra degree of conservatism should be applied to these assumptions (e.g., assigning later dates to cash inflows and earlier dates to cash outflows).

CUCM should make assumptions about each funding source as to whether each liability with a contractual maturity must be repaid or partially or fully rolled over. For other liabilities including those without contractual maturities, CUCM should test run-off assumptions.

When CUCM relies on secured funding, assumptions should be made about capacity for the funding market to continue to roll over when CUCM's creditworthiness may be in question or wider market disruptions have an impact.

For off-balance sheet instruments subject to contingent liquidity risks, additional assumptions are critical and should be unique to the business funding model. Other contingent funding obligations that might arise under stress that should be considered include but are not limited to:

- the funding impact of a multi-notch rating downgrade on collateral requirements
- irrevocable and revocable credit lines to other legal entities or persons
- potential funding obligations arising from issued bankers' acceptances, other guarantees and trade finance
- possible implications of market volatility or credit deterioration impact on margining agreements

3.5 Stock of Liquid Assets

Principle 7
CUCM should maintain a stock of unencumbered, high quality liquid assets to be held as cushion against a range of systemic liquidity stress scenarios.

CUCM's stock of liquid assets should provide CUCM with a source of available funds to meet normal and contingent cash flow needs in identified stress scenarios. A stock of liquid assets are assets that can be traded in broad and active secondary markets and can be liquidated, or pledged through a repurchase agreement, to a wide range of counterparties without incurring a substantial discount.

This stock of liquid assets should provide CUCM with the necessary time to:

- access alternative sources of funding
- survive identified liquidity stress events until other longer term measures can take effect

The existence of counterbalancing capacity (e.g., the ability to raise unsecured funds, draw on commitments, call loans or access new secured funding sources in the short term) is not a sufficient substitute to maintaining an adequate stock of liquid assets.

The following factors should be considered to determine the adequacy of the stock of liquid assets:

- stability of funding sources
- cost and diversity of funding
- short-term funding requirements
- contingent funding needs
- degree of integration of liquidity management with cu/caisse
- liquidation values

The liquidation values include an estimated discount to sell or borrow against a liquid asset in a period of stress. The discount should be more conservative than the discounts for collateral pledged to meet margining requirements. Liquidation values should be regularly re-assessed.

The following factors should be considered when determining liquidation values:

- The quality of the asset; instruments that are more easily liquefiable or repoable during stress scenarios will have a higher liquidation value.
- The structure of the market for the asset; an active number of market participants with transparent pricing enhances the liquidation value of an asset.
- Diversity within the stock of liquid assets; concentration in a stock of liquid assets should result in lower liquidation values.

CUCM must obtain DGCM approval with respect to its investment policies: see the **Prudent Person Guidelines (CUCM)** for more details.

Principle 8
CUCM should actively manage its collateral positions, differentiating between encumbered and unencumbered assets.

For an asset to be considered unencumbered, there should be no legal, regulatory or operational impediment to using it to obtain funding.

CUCM should consider the existence of encumbrances to determine which assets can be included in a stock of liquid assets. Assets that are pledged to clearing and settlement organizations to secure specific obligations should not be included. CUCM should actively monitor assets pledged to clearing and settlement organizations as part of its ongoing liquidity management practices.

3.6 Contingency Funding Plan

Principle 9
CUCM 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.

The focus of the CFP should be on systemic liquidity events that impact CUCM and one or more cu/caisse. CUCM's CFP represents its strategy for handling a liquidity stress event with the goal of maintaining market confidence and financial stability.

An effective CFP should consist of several components including:

- early warning indicators to identify the emergence of increased liquidity risk or vulnerabilities to CUCM and the Systems' liquidity position;
- triggers for senior management to assess, respond, and actively mitigate the liquidity risk – if necessary, activate the CFP.
- options for dealing with cu/caisse Systems and market-wide stress events
- procedures and reporting requirements to ensure timely information flows to the Board, cu/caisse, DGCM, the Registrar, and other stakeholders with potential for escalation
- clear division of roles and responsibilities within management.

The CFP should include procedures for making up cash flow shortfalls. This includes:

- action plans for management of the liquidity pool to ensure stable funding and altering balance sheet assets and liabilities and use of off-balance sheet sources
- plans to engage cu/caisse to explore their options
- identification of alternative sources of funds and procedures for accessing those alternative funds
- plans and procedures for communicating with the providers of funding, the media and public and other stakeholders.

The development and maintenance of CFPs should be integrated with CUCM's program for stress testing liquidity risk.

CFPs should be reviewed and tested regularly to ensure effectiveness and operational feasibility, with the results of such tests reported to the Board of Directors as required.

3.7 Managing Market Access

Principle 10
CUCM should employ a funding strategy that provides effective diversification of funding sources. It should maintain an ongoing presence in funding markets and strong relationships with funds providers.

Diversification of funding sources will enhance CUCM's capacity to survive liquidity stress events. Diversity strategies can include:

- Establishing strong relationships with providers of funding
- Establishing a presence in different funding markets and monitoring market developments
- Assessing the level of reliance on individual funding sources by instrument type, provider of funds, and geographic market
- Establishing internal limits on the maximum funds CUCM will accept in the normal course from any one counterparty or any one funding market
- Developing markets for asset sales or exploring arrangements under which CUCM can borrow against assets