

Managing Funding and Liquidity

The resilience of the financial services industry depends a great deal on funding and liquidity. Recent history, such as the circumstances that led to the financial crisis in 2007, underlined the importance of funding and liquidity. In fact, it is just as vital as capital and yet, unlike for capital, there were no internationally agreed standards for liquidity. Then came Basel III, which included provisions to strengthen the funding and liquidity risk management of banks. Its goal was to promote resilience in a bank's short-term and long-term liquidity risk profile. This was achieved through the Liquidity Coverage Ratio (LCR), and the Net Stable Funding Ratio (NSFR), which came into effect in 2015 and 2019, respectively. In addition to the conventional Statutory Liquid Assets Ratio, these measures are geared to prevent banks from relying excessively on short-term wholesale funding to support long-term assets.

The Bank accords as much importance to funding and liquidity as it does to capital, ensuring that it has sustainable sources of funding and maintains adequate levels of liquidity at all times, never compromising on liquidity in its drive to generate returns for investors. This contributed greatly towards public trust in the Bank.

To actively monitor the funding and liquidity requirements and pricing of assets and liabilities, the Assets and Liabilities Committee (ALCO) of the Bank meets fortnightly. It extensively deliberates on the developments such as market liquidity, current and perceived interest rates, changes in policy rates, credit growth and facilities in the pipeline, capital market developments etc. that affect funding and liquidity.

Encouraging the use of electronic cash and cards to reduce cash holdings and establishing credit lines with strong overseas counterparties, enabling it to access foreign currency funds at attractive prices the Bank has further strengthened its funding and liquidity.

Stable funding sources of the Bank for onward lending include:

- Retail deposits through the branch network
- Low-cost foreign currency borrowing (provided the interest and swap cost attached to such borrowing is cheaper as compared to the cost of wholesale deposits)
- Selected long-term wholesale deposits

With a substantial portion of retail customer deposits likely to remain with the Bank for the medium to long term, such deposits are considered more stable than wholesale funding sources.

Objectives

Objectives of the Bank's funding and liquidity management efforts include:

- Honouring customer deposit maturities/ withdrawals and other cash commitments efficiently under both normal as well as stressed operating conditions
- Compliance with the regulatory requirements
- Maintaining internal funding and liquidity targets which are more stringent than the regulatory requirements
- Optimum usage of liquid assets for maximum profitability thereby meeting the expectations of investors
- Funding future business expansion at optimum cost
- Supporting desired credit rating
- Ensuring smooth transition to Basel III funding and liquidity requirements

The year under review witnessed shortages in market liquidity thus prompting the CBSL to reduce the Statutory Reserve ratio from 7.50% to 6.00% from mid November 2018, releasing Rs. 90 Bn. to improve market liquidity.

Progress in 2018

Throughout the year, the Bank maintained optimum levels of funding and liquidity, with guidance from ALCO under normal as well as stressed conditions. This is evident from the indicators in Graph 49 on page 339. Maintaining such optimum levels of liquidity allowed the Bank to earn higher fund-based income.

Plans for contingency funding and liquidity requirements in the event of any stressed conditions are also in place.

Of the Bank's assets, 75% were funded by customer deposits, while of the Bank's liabilities, 83% were made up of customer deposits as at December 31, 2018. Sufficiently diversified by type and maturity, the funding portfolio represented stable sources of funding. At 239%

(for all currencies), the LCR was well above the minimum requirement of 90%, as at December 31, 2018.

The NSFR, which became a prudential requirement with effect from January 1, 2019, was at 139% as at December 31, 2018 based on the test computations done.

Movement of liquidity ratios over the past four years is given in Graph 49 on page 339.

At year end, the Bank's FVOCI assets portfolio stood at Rs. 176.506 Bn. (compared to the AFS portfolio of Rs. 154.714 Bn. as at December 31, 2017), being available for use to meet any funding requirements as the need arises in the normal course of business or due to market stress.

Movement of the liquidity coverage ratio and net stable funding ratio are given in Figure 2 on page 9.

Periodic tests were conducted at varying degrees of risk thresholds revealed that liquidity strains could be withstood with the resources at disposal and contingency plans in place even during a severe stress scenario.

2019 and beyond

The Bank will continue to migrate short-term reliance for funding towards medium to long-term tenors. This takes on greater significance in light of the LCR and the NSFR. It also prepares the Bank for any potential liquidity tightness in the region. The Bank will also gradually reduce its dependence on low liquidity value deposits such as interest sensitive wholesale funding. Improving its funding profile further will be another focus for the Bank. It will continue evaluating broad-basing its funding sources to other multilateral lending institutions and also by diversifying borrowing currencies.