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Guidelines on the application and approval process concerning internal liquidity risk measurement and management systems pursuant to section 10 of the German Ordinance on Liquidity (*Liquiditätsverordnung*)

Introduction

Pursuant to section 10 (1) of the ordinance on the liquidity of institutions (Ordinance on Liquidity; *Liquiditätsverordnung*), which entered into force on 1 January 2007, institutions may, at their discretion on a permanent basis and with the prior consent of the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, hereinafter referred to as BaFin), use internal liquidity risk measurement and management systems (for short: liquidity models¹) in place of sections 2 to 8 of the Ordinance on Liquidity. A liquidity model thus requires approval from BaFin. The adequacy of a liquidity model is assessed on the basis of an audit performed jointly by BaFin and the Deutsche Bundesbank pursuant to section 44 (1) sentence 2 of the German Banking Act (*Kreditwesengesetz*).

These guidelines provide forthcoming applicants with information on the application and approval process.

Basic principles

The institution must submit an application for approval of a liquidity model in writing. The application must include meaningful written documentation concerning the liquidity model (see "Documentation" below).

¹ Liquidity models are not necessarily stochastic models. Hereinafter, the simpler term "liquidity model" will be used in place of "liquidity risk measurement and management procedure". It implies basically a broader context and captures not only the aspect of risk measurement but also the more extensive requirements regarding the management of risk and how risk measurement is embedded in the overall risk management context.

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If an institution intends to use the “opening clause” under the Ordinance on Liquidity, supervisors will be involved in the pre-application phase, too. As with the procedures for other approval examinations, it may make sense, in practice, to arrange meetings in order to exchange information prior to submission of the actual application either at the request of the institution itself or at the supervisors’ suggestion.

Such meetings give institutions an opportunity to present the basic features of their liquidity model. Supervisors usually obtain an initial impression of the conceptual and organisational maturity of the model. However, at this stage they will not come to any final judgement on its approvability. On the other hand, such discussions give supervisors the opportunity to provide guidance on the application and approval procedure as well as on the required documentation.

The approval process

The approval process basically begins when an institution submits an application for approval to BaFin. Supervisors determine whether they can adequately prepare for the examination based on the documents submitted and, if necessary, demand that additional documentation (the extent of which varies from one institution to the next) be provided prior to the on-site examination.

The on-site examination is conducted in order to assess compliance with the requirements of section 10 (3) of the Ordinance on Liquidity. The examination starts with the institution’s liquidity risk strategy and continues covering the methodology of risk measurement as well as all processes for measuring, monitoring, reporting and managing liquidity risk.

The decision on whether or not to grant the approval is based on the findings of the on-site examination and, in the case of section 10 (4) sentence 1 of the Ordinance on Liquidity, also on the findings regarding the entities within the group of institutions or the financial holding group. BaFin sends the examination report to the applicant institution. In addition, supervisors offer the institution the possibility of a meeting to discuss the result of the examination.

The applicant institution must bear the costs of the approval process, including the costs of the examination. Costs arise from the moment the application is submitted.

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BaFin notifies the institution once the model has been approved. Upon delivery of the notification, the applicant institution may use the liquidity model for prudential purposes and is exempt from applying sections 2 to 8 of the Ordinance on Liquidity. The approval may be subject to specific terms and conditions. The approval letter will also determine the content and form of the individual monthly reporting requirements pursuant to section 11 (2) of the Ordinance on Liquidity.

Following approval, the requirements of the Ordinance on Liquidity and any conditions issued with the approval notice must be complied with. This, as well as the permanent compliance with the preconditions for approval, will be checked by supervisors in follow-up examinations. Modifications to the models are to be communicated properly to supervisors. Major changes to the model require renewed approval, although this does not necessarily require a renewed on-site examination.

Preconditions for approval

If the applicant institution submits an application including the supplementary documentation, BaFin orders an on-site examination to be conducted at the institution.

The preconditions for approval derive from section 10 of the Ordinance on Liquidity. They are not listed in detail here.

Components of the application

(a) Application

The institution has to submit, in triplicate, a written application for the use of an internal model to BaFin. It must be submitted in German. The accompanying documents must be submitted electronically in triplicate. Conventional file formats and data media are to be used. In case of doubt about the compatibility of certain file formats, prior coordination of the modalities is recommended.

If a group of institutions or a financial holding group submits an application for approval of a liquidity model at group level, the application must state which institutions belonging to the group and, as appropriate, which other firms belonging to the group will be

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incorporated into the liquidity risk model of the group of institutions or financial holding group for which an application for approval has been submitted, and which institutions or enterprises will not be included.

Furthermore, the application must also stipulate features specific to each institution as well as a central point of contact and an alternate.

b) Documentation

The documentation to be appended to the application should enable supervisors to perform a fundamental assessment of the liquidity risk model and contain an adequate and comprehensible description of the liquidity risk measurement and management systems, especially of its assumptions. The supervisors reserve the right to request the submission of additional and/or improved documentation. The documentation must usually be submitted in German.²

The documentation to be submitted includes, above all:

- the liquidity risk framework, liquidity risk strategy or policy, including a list of responsibilities in the risk management process in the broader sense, ie the identification, measurement, monitoring and management of liquidity risk (eg the interplay between risk controlling on the one hand and treasury, asset/liability management or also the asset/liability committee or the like on the other).
- a list of the key institution-specific circumstances arising from the institution's business structure and business policy.
- organisational charts detailing the institution's internal operational structure, primarily outlining which units are responsible for liquidity risk management.
- a description of the underlying assumptions of the liquidity model, eg
 - assumptions of the liquidity risk measurement system, broken down, as appropriate, by business line, product or also (balance sheet) item and taking into account the

² If the banking supervisors are in agreement, it may also be possible to submit the documentation in English in justified exceptional cases.

special features of specific products or items, eg with uncertain cash flows regarding amounts and times;

- reasons for simplifying (or omitting) the modelling of products or positions (due to IT restrictions, for instance), as well as other simplifications, with a materiality analysis if possible;
 - model assumptions regarding funding capacities and the possibility to sell assets in normal and crisis scenarios as well as a description of other regularly conducted scenario analyses.
- a description of the internal validation processes and the results thereof.
 - a description of the limit system, especially limits based on stress scenarios.
 - a list of liquidity risk measurement ratios used by the institution to identify insufficient liquidity on an aggregated level and reasons for the choice of these ratios.
 - with reference to the aforementioned liquidity risk measurement ratios, a list of the thresholds at which the institution regards itself as being exposed to a significant, medium or high risk of insufficient liquidity, as well as the remedial actions that the institution will take once one of the mentioned threshold levels has been reached.
 - an explanation of the use of the liquidity model and the internal limit system for the institution's liquidity risk management and general business management.
 - an explanation of the IT implementation of the liquidity model including the interfaces with the IT systems that provide the data, as well as an explanation of data flows in the model and system interfaces, including coordination and control steps, as well as other control processes to ensure data quality.