



FSA consultation on strengthening liquidity standards

The regulation of liquidity has taken a back seat in recent years as the focus has been firmly on adequacy of capital. However, on 4 December 2008 the Financial Services Authority (FSA) published a consultation paper on changes to its rules governing liquidity, following its discussion paper on the issue in December 2007. The proposals contemplate a major overhaul of the current regime. This briefing outlines the main elements of the FSA's proposals and considers their implications.

Introduction

The importance of liquidity has been graphically illustrated by the recent collapses and rescues of banks and investment firms around the world. For some of these firms the crisis was brought on by concerns about their asset quality or other exposures, for others by their funding models, for others by the freezing up of credit and other markets or combinations of these problems. In almost all cases the problems manifested themselves most immediately and acutely in a liquidity crisis. These liquidity crises often developed extremely quickly, sometimes in the course of a few days. Once confidence in a firm has gone, no amount of liquidity is likely to save it. But proper liquidity management and regulation may buy the firm and the authorities a breathing space to find an alternative to allowing the firm to collapse.

The fact that regulation of liquidity has taken a back seat in recent years can, in part, be attributed to the difficulty of the problem: liquidity risks are difficult to assess and quantify, and are not very susceptible to rule-based regulation. But in the last few months, the attention of international standard-setters has returned to this area. In September 2008 the Basel Committee on Banking Supervision updated its Principles for Sound Liquidity Risk Management and Supervision and the Committee of European Banking Supervisors published its final response to the European Commission's call for evidence on this issue.

The Financial Services Authority (FSA) has now published its own consultation paper on changes to its rules

governing liquidity. This follows the FSA's discussion paper on the issue in December 2007. The proposals contemplate a major overhaul of the current regime for all FSA-regulated firms subject to the FSA's BIPRU rules (ie banks, building societies and other investment firms) and UK branches of European Economic Area (EEA) and third country banks. For all of these firms there are to be new requirements governing systems and controls, stress-testing, contingency funding plans and management responsibility. In addition, for the more complex firms (ie not including BIPRU limited licence and BIPRU limited activity firms) there will be an entirely new regime of 'individual liquidity adequacy standards'.

Comments on most aspects of the consultation are invited by 4 March 2009. Comments on the new reporting proposals (which are published as a pre-consultation at this stage) are invited by 6 January 2009. The FSA expects to finalise the new rules by April 2009 and to bring them into force in October 2009 (possibly subject to any transitional rules that may be consulted on in Q1 2009).

The elements of the new regime

The main elements of the FSA's proposed new regime are described below.

High-level standards

The basic high-level provisions of the current regime are to be retained. The main ones are Statement of Principle 3 ('A firm must take reasonable care to organise and control its affairs responsibly and effectively, with

adequate risk management systems'), Statement of Principle 4 ('A firm must maintain adequate financial resources') and Threshold Condition 4 ('The resources of the person concerned must, in the opinion of the [FSA], be adequate in relation to the regulated activities that he ... carries on').

General systems and controls requirements

The existing FSA rules and guidance on systems and controls for liquidity are to be replaced. The new requirements include overarching requirements to have in place sound, effective and complete processes, strategies and systems to identify, measure, monitor and control liquidity risk and liquidity resources. These requirements are backed up by guidance, which indicates measures that tend to show that the firm is complying with them. These include having a robust framework for cash flow projections, compliance with the firm's liquidity risk tolerance, having early warning indicators of potential liquidity problems and systems for providing information to senior management and the board.

Stress tests and contingency funding plans

The FSA is strengthening its requirements for firms to carry out stress testing. The FSA believes that many firms have failed sufficiently to consider difficult scenarios and that their assumptions have in some cases been inadequately researched. Some specific new FSA rules are to be introduced, supported by evidential provisions relating to the frequency of testing and the factors to be considered. There is also a new requirement for firms to have in place an appropriate contingency funding plan, approved by the board. Again, the pattern is that some specific new rules on the requirement for the plan and its contents are backed up by evidential provisions.

Responsibility and oversight

In line with its general approach to principles-based regulation, the FSA places ultimate responsibility for the firm's liquidity risk with its board of directors. The board will be required to establish the firm's liquidity risk tolerance, which must be appropriate to its business strategy and reflect the firm's financial condition and funding capacity. The firm's senior management must then review the firm's liquidity position continuously and report appropriately to the board. Although ultimate responsibility is placed with the board, the way it

discharges this responsibility will be reviewed by the FSA. In fact, the FSA says that it expects to review these matters and the firm's systems and controls arrangements more rigorously than before.

Individual liquidity adequacy standards

The FSA is to retain quantitative liquidity requirements in addition to the qualitative requirements referred to above. However, whereas the three current quantitative regimes are each based on a one-size-fits-all calculation, the new requirements are to be more tailored to the particular circumstances of the firm. This is to be achieved through the use of Individual Liquidity Adequacy Standards (ILAS), a framework similar to the Individual Capital Adequacy Assessment Process used by the FSA to set individual capital requirements for banks. These requirements will apply to all banks, building societies and 'full scope' firms that are subject to the FSA's BIPRU rules (except as described below).

The concept is that a firm must have sufficient liquidity resources to be able to withstand the liquidity stresses specified in the FSA rules. These stresses are: a stress specific to the firm itself, a market-wide stress and a combination of these two. The firm-specific stress is that, for a two week period, the market and/or retail depositors perceive the firm to be unable to meet its liabilities as they fall due, and that this is followed by a longer-term stress equivalent to a multi-notch credit rating downgrade that results in liabilities linked to the firm's credit crystallising. The market-wide stress is an unforeseen short-term market-wide dislocation that gradually evolves into a long-term market-wide liquidity stress – it involves widespread concerns about the solvency of financial sector firms and uncertainty about the value of financial assets leading to illiquidity in many financial markets.

The firm must itself carry out an Individual Liquidity Adequacy Assessment (at least annually) to consider the effects of these stresses on its liquidity position. In doing so, the firm must consider, in particular, a number of specified ways in which these stresses might affect the firm (including effects on its various sources of funding and its ability to realise assets). Once the firm has completed its individual liquidity assessment, that assessment will be reviewed by the FSA. The FSA will then issue 'individual liquidity guidance' to the firm. This

will include a number of metrics relevant to the firm, including the minimum level of liquid assets the FSA will expect the firm to hold. Liquid assets for this purpose will mean highly liquid, high-quality debt instruments issued by the UK government or rated at least Aa3 and issued by the governments of EEA countries or of Canada, Japan, Switzerland and the US. Reserves held with the central banks of these countries will also qualify.

The FSA believes that the full rigours of the ILAS process may not be appropriate for those banks, building societies and full scope investment firms with comparatively simple business models. It is therefore consulting on two proposals for these firms: a standardised buffer ratio for simpler mortgage banks and building societies and a phased introduction of supervisory reviews for smaller wholesale-only banks and full scope BIPRU investment firms.

Self-sufficiency of legal entities

In light of recent experience, the FSA believes that a more rigorous approach is necessary in regulating the liquidity of UK branches of foreign firms and legal entities forming part of a wider group. At present, some UK branches of overseas firms rely on a 'global liquidity concession', under which many aspects of liquidity regulation of the branch are performed by the home state regulator. Many legal entities rely on the provision of liquidity from other parts of the group. A new, more formal, regime is proposed for both these cases. The starting point will be that, in the absence of a formal waiver or modification, a firm or a UK branch of a foreign entity will need to be self-sufficient in terms of liquidity adequacy. The FSA will consider any application for a waiver or modification against the statutory criteria. Before granting it, the FSA will need to be satisfied as to the effectiveness of the home state regulator's regime of liquidity regulation. Among other things, the FSA will need to be satisfied that it complies with the Basel Committee's principles for liquidity regulation and does not favour domestic or other creditors to the detriment of those in the UK.

Liquidity reporting

The FSA is also pre-consulting on a new regime for liquidity reporting by firms. A formal consultation on this will be published in Q1 2009. The FSA wants firms to provide a greater amount of data and to provide it

more frequently than is currently required. The new requirements will be based on what the FSA considers it would need in a crisis situation. It recognises that these requirements will be onerous for firms.

The implications of the proposals

The FSA sees its proposals as far-reaching and believes that many institutions will need to reshape their business model significantly over the next few years as a result. It anticipates that the main changes for firms will be:

- enhanced liquidity risk management capabilities, including greater use of stress testing and improvements to contingency funding plans;
- less reliance on short-term wholesale funding, including wholesale funding from foreign counterparties;
- greater incentives for firms to attract a higher proportion of retail time deposits;
- a higher amount and quality of stocks of liquid assets, including a greater proportion of those assets held in the form of government debt; and
- a check on unsustainable expansion of bank lending during favourable economic times.

It is also clear that the cost implications will be significant and will fall mainly on the larger and more complex firms. The FSA estimates that the requirement for a greater proportion of assets to be government bonds will result in a diminution of revenues across the sector in the order of between £1bn and £5bn per annum. There may also be costs arising from the need for more funding to be at longer maturities and inevitably IT and other costs. The need for a greater proportion of assets to be government bonds will necessarily restrict a firm's ability to lend to business and to individuals and will therefore have an impact on the wider economy.

Commentary

This consultation is the first major FSA policy paper since the systemic crisis reached its peak severity in September 2008. The new ILAS regime proposal shows that principles-based regulation has survived this test and is here to stay. There will be no return to a system based primarily on detailed prescriptive rules. The reliance on principles and high-level rules gives the FSA much more

flexibility to adapt its requirements to the particularities of individual firms and (in practice) to change its requirements over time without the need for formal rule changes.

The proposals give firms' boards of directors and senior management an important role, but this is essentially to carry responsibility. Their power to set liquidity standards for the firm is, in reality, only a power to be more prudent than the FSA thinks is necessary. The important discretionary power under the new regime, namely the power to determine the lowest permissible liquidity standards for the firm, will lie with the FSA – notwithstanding that the results of ILAS will theoretically be only individual liquidity 'guidance'. This is an important shift of power. However, firms will probably not object too strongly if they feel that the FSA understands their business and that they are being treated fairly in comparison with their peers. But this begs two important questions.

First, are FSA personnel capable of understanding the subtleties of the liquidity risks of the various complex businesses they regulate and can they assess how these risks can be adequately mitigated? The difficulty of this task should not be underestimated. In the short term, this may not matter too much as firms themselves are now extremely conscious of liquidity risk and are no doubt taking a very cautious approach. But in the longer term, as the FSA itself recognises, management's incentives to build in sufficient resilience to liquidity stress may well prove insufficient.

The second question is can UK banks and other complex investment firms face competitive disadvantage in relation to foreign firms? There seems little reason to suppose that international standards for liquidity regulation will become aligned with the quantitative standards of the FSA in the foreseeable future. In the meantime, competitive disadvantage could be a real issue.

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