

## FSA update - March 09



### FSA LIQUIDITY REQUIREMENTS

#### Introduction

Back in Dec 08, the FSA published a consultation paper proposing major changes to the liquidity requirements for banks, building societies and investment firms.

The new rules are based on international liquidity standards, in particular the Basel Committee on Banking Supervision's Principles for Sound Liquidity Risk Management and Supervision and are designed to take into account the difficulties faced by global economies over the last two years.

There are four main elements to the consultation paper.

- A new quantitative framework for liquidity risk management which places greater emphasis on firm's abilities to assess liquidity risks and develop policies to tackle them
- A strengthened qualitative framework for liquidity risk management with an increased focus on firm's stress testing and contingency fund plans
- New liquidity reporting requirements
- A new approach to firms operating in the UK which are part of a wider UK or international group

The consultation ended on 4<sup>th</sup> March

and the new regulations are due to be introduced by October 2009.

The FSA have published their timetable for the implementation of the new requirements and this is shown in Appendix 2.

#### Design and Scope of New Regime

The requirements cover all BIPRU Firms and UK branches of certain EEA and non EEA banks.

The scope of the proposed policy is similar to the current regime, with the notable exception that quantitative standards for liquidity are being broadened to cover full scope investment firms.

The table in Appendix 1 shows the application of the various parts of the new policy to each type of firm.

The FSA still believe that their principle based approach will remain and have not departed from this view when preparing the new requirements regarding liquidity management.

In addition to the principles that:

- a firm must hold adequate financial resources
- a firm must conduct its business with due skill, care and diligence
- a firm must take reasonable steps to organise and control

its affairs responsibly and effectively with adequate risk management systems

The new proposals introduce two key further considerations to the general principles:

- Adequate liquidity resources
- Self sufficiency

#### Adequate liquidity resources

The FSA wish to ensure that a firm's liquidity resources are adequate at all times, both as to amount and quality to ensure a firm can continue to meet its liabilities as they fall due, both in normal and stressed conditions.

They state that liquidity resources are not limited to assets which are marketable or otherwise realisable, but also a firm's ability to generate unsecured funding of appropriate tenor in a timely manner.

#### Self Sufficiency

The FSA are proposing that all firms are self sufficient for liquidity purposes, and that reliance on a parent or another related entity for liquidity purposes will be prohibited unless express permission is granted.

This measure has arisen from the experiences over the last year or so, where reliance on a parent or the wider group has proved counterproductive for the purposes of sound liquidity risk management.

The FSA have however recognised that in some circumstances self sufficiency may not be appropriate and they are willing to consider waivers and modifications of this principle.

### Overall Liquidity Adequacy Rule

The two new principles of adequate liquidity resources and self sufficiency are combined to form the overall liquidity adequacy rule which is stated in the new draft handbook text as follows:

- A firm must at all times maintain liquidity resources which are adequate, both as to the amount and the quality, to ensure that there is no significant risk that its liabilities cannot be met as they fall due.
- A firm may not include any liquidity resources that can be made available by other members of its group;
- A firm may not, in relation to its UK branch, include liquidity resources other than those which are located in the UK and under the control of the branch's senior management;
- A firm may not include liquidity resources that may be made available through emergency liquidity assistance from a central bank (including the European Central Bank).

### Assessment Process

For ILAS firms, the assessment process will be similar to that for capital adequacy.

Each firm will carry out an individual liquidity adequacy assessment (ILAA) and the FSA will undertake their supervisory liquidity review process (SLRP).

Also, all ILAS firms will be required to hold an adequate buffer of high quality, unencumbered assets. The aim here is to ensure that if stresses occur, a firm can realise some of

these assets and maintain their business as a going concern.

## New Rules to be covered in BIPRU 12

The new rules will be added to the BIPRU handbook as chapter 12. This section gives a brief outline of the rules in each section of the new chapter.

### BIPRU 12.1 – Application

BIPRU 12.1 sets out the scope of application and gives information on which firms the new rules will apply to.

### BIPRU 12.2 – Adequacy of Liquidity Resources

BIPRU 12.2 gives the overall liquidity adequacy rule definition and emphasises that the new rules apply on a solo basis (i.e. a firm cannot rely on group liquidity to meet these requirements).

It also sets out that a firm must hold sufficient liquidity resources to withstand a range of severe stress events and that this doesn't simply mean having an adequate liquid assets buffer.

### BIPRU 12.3 – Liquidity Risk Management

BIPRU 12.3 sets out the new systems and controls requirements, including requirements for the governing body and senior management of firms.

This section also sets out specific rules on:

- Pricing liquidity risk
- Intra day management of liquidity
- Management of collateral
- Management of liquidity across legal entities, business lines and currencies
- Funding diversification and market access

### BIPRU 12.4 – Stress testing and contingency funding

BIPRU 12.4 sets out the requirements to conduct regular stress tests to ensure that:-

- Sources of potential liquidity strain are identified
- Current liquidity exposures continue to confirm to the liquidity risk tolerance agreed by the governing body and
- The effects on that firm's assumptions about pricing are identified

This section also sets out the requirement for firms to analyse the separate impact of possible future liquidity stresses on cash flows, liquidity position, profitability and solvency.

BIPRU 12.4 also sets out the requirement for firms to ensure that the results of its stress testing are reviewed regularly by management and then reported to the FSA in a timely manner. It should be noted however, that at present the FSA have produced no standardised reporting forms for this requirement.

A further key requirement set out in this section is that a firm must have formally documented contingency plans in place which have been approved by the governing body, to deal with liquidity crises.

These contingency plans should set out a firm's strategies for addressing liquidity shortfalls in emergency situations and the section also details the specific topics that the contingency plan should contain.

### BIPRU 12.5 – Individual Liquidity Adequacy Standards

BIPRU 12.5 sets out the requirement for ILAS firms to undertake an Individual Liquidity Adequacy Assessment (ILAA).

When undertaking the ILAA, firms must consider the impact of:-

- Market wide liquidity stresses
- Name specific liquidity stresses
- A combination of the above

Firms must also assess the impact of the above stresses on the 10 specified sources of risk:-

- Wholesale funding risk
- Retail funding risk
- Intra-day liquidity risk
- Intra-group liquidity risk
- Cross-currency liquidity risk
- Off-balance sheet liquidity risk
- Franchise- viability risk
- Marketable assets risk
- Non-marketable assets risk
- Asset diversification risk

The ILAA will then be used by firms to establish an appropriate liquid assets buffer and to ensure they comply with the overall liquidity adequacy rule.

### **BIRPU 12.6 – Simplified ILAS**

BIPRU 12.6 contains details of the simplified ILAS approach under which certain firms can calculate their liquid assets buffer in a different way to larger firms.

The simplified ILAS approach applies to firms where:-

- A majority of the firm's total assets are accounted for by loans secured on residential property
- Their assets and liabilities are denominated exclusively in sterling and
- No less than 70% of their total liabilities are accounted for by retail deposits

If these conditions are met, then a firm can calculate its liquid assets buffer as the sum of:-

- The wholesale net cash out-flow component
- The retail deposit component and

- The credit pipeline component

### **BIPRU 12.7 – Liquid Assets Buffer**

BIPRU 12.7 describes the nature of the assets that would be eligible for inclusion in the liquid assets buffer.

### **BIPRU 12.8 – Cross-border and intra-group management of liquidity**

BIPRU 12.8 sets out the waivers available for liquidity requirements and the conditions needed for the waivers to be granted.

The section considers 3 key waivers:-

- Intra group liquidity modification – this would allow a firm to rely on liquidity resources from elsewhere in the group where liquidity is managed on a group wide basis
- Whole firm liquidity modification – this would allow a UK branch to rely on liquidity resources from elsewhere in the firm
- Whole firm liquidity waiver – this would exempt a firm from the requirements of BIPRU 12 completely

### **Reporting Requirements**

The FSA have made it clear that the new reporting requirements (applicable in full only to ILAS firms) will be onerous and more data will be sent by firms to the FSA than is currently the case.

The FSA have not yet announced the method by which data will be submitted, although it is expected that this will be done via the GABRIEL system.

The new reporting requirements have yet to be finalised – the FSA will be issuing a separate consultation paper on these in late Q1 or early Q2 of 2009.

However, there are draft examples of

the reports and provisional reporting frequencies which can be found at:

<http://www.fsa.gov.uk/pages/About/What/International/Liquidity/reporting.shtml>

For non- ILAS firms (i.e. limited licence and limited activity firms), the only proposed new reporting requirement is a systems and controls questionnaire to ensure that they are complying with the systems and controls requirements, including stress testing and contingency fund planning.

### **Requirements for non ILAS firms**

The nature of the requirements for limited licence and limited activity firms are similar to the ICAAP requirements.

Non ILAS firms will have to document their liquidity systems and controls, evidence adequate Board oversight, produce management information in excess of what may be required from an operational perspective and perform stress tests.

They will then report their compliance to the FSA via a systems and controls questionnaire.

At present, the draft handbook text doesn't show much evidence of proportionality in the application of the new requirements and several requirements do not take into account the fact that a limited licence firm will present a different set of challenges to the FSA from a credit institution.

## Appendix I

### Scope of New Rules

Policy	Description of policy	ILAS firms				Non ILAS firms	
		UK incorporated bank	Building Society	Full Scope Investment Firm	Branches of EEA and non EEA banks	B I P R U limited licence firms	B I P R U limited activity firms
Adequate liquidity resources and self sufficiency	High level requirement to maintain adequate liquidity at all times through own resources, without relying on other parts of the group	P	P	P	P	P	P
Systems and controls requirements	Framework setting out main systems and controls requirements for liquidity risk management	P	P	P	P	P	P
Individual Liquidity Adequacy Standards (ILAS)	Quantitative standards for liquidity, resulting in the issuance of individual liquidity guidance	P	P	P	P	×	×
Simpler firms	Standardised options for certain firms	P	P	See chapter 5	×	×	×
Liquid Assets	Standards around quality and quantity of liquid assets	P	P	P	P	×	×
Cross group management of liquidity	Policy around where it may be appropriate for firms not to be self sufficient, including FSMA waiver process	P	P	P	P	×	×
Quantitative reporting	Granular and frequent liquidity data to provide a firm specific and market wide view of liquidity risk	P	P	P	P	×	×
Qualitative reporting	Systems and controls questionnaire	P	P	P	P	P	P

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## Appendix 2

### FSA Timetable for Implementation of New Requirements

Requirements	Stage of Implementation by October 09
Systems and controls	Rules will apply in full
Adequate liquidity and self sufficiency	Rules will apply in full
ILAS	ILAS will apply in full. A firm subject to ILAS will therefore be required to assess the adequacy of their liquid resources in accordance with BIPRU 12 from October 09. Consultation will occur in Q1 09 on any transitional arrangements arising from roll out of the SLRP (Supervisory Liquidity Review Process)
Simplified ILAS	It will apply in full. A firm meeting the criteria for simplified ILAS may therefore adopt that approach from October 09.
Group wide management of liquidity	A firm wishing to benefit from an intra group liquidity modification or a whole firm liquidity waiver/modification from October 09 will have to apply and received approval from the FSA by that date. A firm without an intra group or whole firm liquidity modification as at the date that our new rules come into force will therefore need to be self sufficient for liquidity purposes in line with BIPRU 12.
Reporting	Transitional arrangements will be discussed as part of the consultation on reporting requirements.

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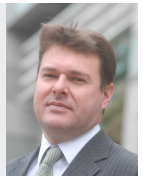
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