



## **FINANCIAL SERVICES COMPLIANCE (EU) LIMITED**

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### **SPECIAL NEWSLETTER – JANUARY 2010**

#### **THE FSA's NEW LIQUIDITY REQUIREMENTS – ARE YOU PREPARED?**

Before the financial crisis that began in the summer of 2007 liquidity had been a relatively neglected area – by both banks and their regulators. At the international policy level all the focus had been on the negotiation and implementation of the “Basel 2” capital accord; at the domestic policy level an attempt to modernise the liquidity regime (do you remember the FSA's Discussion Paper 24, issued in 2003?) was quietly dropped in response to industry opposition; supervisors of commercial banks and investment banks paid too little attention to liquidity; and banks assumed that liquidity would not prove to be a major issue in a world where assets could be sold, securitised or repoed without difficulty.

Events since the summer of 2007 have changed all that. Central banks have had to make massive amounts of liquidity available to banks, individually and collectively; regulators are taking a much closer and intrusive interest in banks' liquidity positions; and banks themselves have been scrambling to secure funding in a world where wholesale funding has become much more difficult and expensive to obtain.

Part of the regulatory response has been to introduce *ad hoc* reporting requirements to collect more frequent and more granular data from a wide range of banks and building societies. Meanwhile, the FSA has been consulting on a fundamental overhaul of its liquidity regime, culminating in the policy set out in Policy Statement 09/16 in October 2009. And the Basel Committee of Banking Supervisors published a Consultation Paper in December 2009 proposing two key liquidity ratios that banks should meet.

How ready are you for this major shift in regulatory regime?



**First,** let us start with what should be the easy part – reporting to the FSA.

- Have you worked out from the seemingly endless permutations in chapter 11 of PS09/16 what type of firm you are, and thus what reports you need to send to the FSA, at a solo and group-wide level, and at what frequency?
- Have you worked out how you are going to capture the much greater granularity of data that the FSA now requires?
- Are you ready to begin reporting to the FSA at one of the three “phasing in” dates of 1 June, 1 October and 1 November 2010? And
- Could you switch to daily reporting to the FSA if required in periods of stress?

**Second,** systems and controls. Since these new requirements (as set out in the FSA's Handbook in BIPRU 12.3 and 12.4) were switched on at 1 December 2009 (unless you are a branch of a foreign bank with a Global Liquidity Concession, in which case you have until 1 November 2010), you should already have everything in place here. The FSA would no doubt take the view that events since the summer of 2007 have made it completely clear that banks should have improved their systems and controls by now.

So do you now have robust strategies, policies, processes and systems in place to:

- Identify, measure, manage and monitor your liquidity risk?
- Provide reliable management information and early warning indicators? And
- Meet FSA Individual Liquidity Guidance (more on that in a moment) at all times?

At a more detailed level, the FSA's systems and controls requirements extend to:

- ✓ Cash flow projections
- ✓ The ability to report liquidity positions daily
- ✓ The measurement of anticipated intra-day flows
- ✓ Feeding liquidity risks into product pricing
- ✓ Measuring reliance on collateral
- ✓ Assessing liquidity across legal entities, business lines and currencies
- ✓ Assessing liquidity by maturity, depositor, instrument and security/collateral.

Do you have systems and controls in place to deliver all of these requirements?



**Third**, where do you stand on the FSA's “quantitative standards” (although in practice much of this will be highly qualitative)? These will be introduced from 1 June 2010 for many banks (although for some types of firm the “switch-on” date will be slightly later, at 1 October or 1 November 2010).

The basic approach here will be familiar to banks that have already been subject to “pillar 2” capital requirements. Banks will be required to undertake an Individual Liquidity Adequacy Assessment (ILAA), including a firm-specific stress test, a market-wide stress test and a combination of the two. The FSA will then review each bank's ILAA and issue Individual Liquidity Guidance (ILG) on how much liquidity the bank should hold. In most cases this will be calibrated in terms of the stock of high quality liquid assets (government bonds) that a bank needs to hold as a “liquidity buffer”. In addition, banks will be required to trade these liquid assets regularly in private markets, and to access emergency central bank liquidity facilities on a random but regular basis.

What does this mean in practice? For the firm-specific stress, banks will need to make aggressively negative assumptions about:

- ✓ Potential retail deposit outflows
- ✓ Inability to roll over unsecured wholesale funding
- ✓ Settlement problems
- ✓ Closure of foreign exchange markets
- ✓ Implications of a ratings downgrade
- ✓ Repaying intra-group deposits at contractual maturity.

For the market-wide stress, banks will need to take account of the potential negative impact of:

- ✓ Drying up of markets
- ✓ A general loss of confidence in counterparties.



Banks will therefore be required to assess their vulnerability to a wide range of factors, including:

- ✓ Retail funding
- ✓ Wholesale funding
- ✓ Intra-group liquidity and transferability of funds
- ✓ Cross-currency exposures
- ✓ Off-balance sheet vehicles and positions
- ✓ Marketability of assets
- ✓ Concentrations of funding sources
- ✓ Correlations and diversifications of risk
- ✓ Margin calls on collateral
- ✓ Contingent claims
- ✓ Future balance sheet growth
- ✓ Access to payment systems
- ✓ Access to central bank liquidity

Simpler firms – including those that are predominantly retail deposit funded, or funded by a parent, will not be required to undertake an ILAA and will be subject to standardised stress tests, including:

- a 10% loss of “stable” retail deposits
- a 20% loss of lower-quality retail deposits
- a net cash outflow of wholesale market deposits over the next three months
- providing 25% of “pipeline” credit (for example mortgage lending commitments) to retail customers.

Do you have the ability to take account of all these factors in constructing your ILAA, or in applying the standardised stress tests?

**The Basel Committee Consultation Paper** also provides a framework for setting quantitative based on stressed conditions. It proposes that banks should have to meet both a Liquidity Coverage Ratio (to hold sufficient high quality liquid assets to meet net cash outflows for 30 days) and a Net Stable Funding Ratio (to hold sufficient medium-term and other stable funding to match non-marketable assets). The Basel paper also proposes that banks should continue to calculate and monitor their maturity mismatch, concentrations of funding, the availability of unencumbered marketable assets, and external metrics for market vulnerabilities.



**Fourth**, if subsidiaries or branches of foreign banks thought that they were exempt from these requirements, then they need to think again. The default position of the FSA is that every UK legal entity and branch in the UK must satisfy the above requirements on a “self-sufficient” basis. This is a significant change in the FSA's position. It is, however, possible for these subsidiaries and branches to apply for a waiver – if they are not a major player in the UK system, if they can demonstrate that their parent stands ready and able to provide liquidity support, and if their home country supervisor is prepared to confirm this to the FSA.

This brief overview of the FSA's new approach to liquidity makes clear that banks need to be able to:

- 1) capture and report all relevant data, for both internal purposes and reporting to the FSA;
- 2) implement internal systems and controls to identify, measure and control liquidity risks;
- 3) run stress tests and meet the FSA's quantitative requirements;
- 4) assess their vulnerability to a wide range of factors; and
- 5) set their own internal limits and controls.

The challenges here are significant, and many firms are struggling to meet them.

### [How can we help?](#)

FSC stands ready to help you in implementing all of these liquidity requirements. In particular, our team includes Clive Briault, a former Managing Director at the FSA who is uniquely placed to bring together the FSA's regulatory requirements and a bank's own individual approach to liquidity.

Please contact Ben Goh on 01908 322450 or 07954 104534 for further information.