Financial services bulletin

PRICEWATERHOUSECOOPERS

Liquidity Risk – New requirements get clearer and closer

December 2003

Between 2004 and 2006 most companies in the financial services sector will become subject to aspects of a new liquidity risk regime. The Systems and Controls chapter of the liquidity section of the Prudential Sourcebook comes into force in the fourth quarter of 2004, while the expected implementation date for the second, Quantitative Requirements, chapter is the summer of 2006. Both chapters mandate rigorous quantitative analysis, a factor not fully recognized by many: we have found a number of instances where firms have assumed that the quantitative elements of the proposed Systems and Controls chapter (e.g., scenario analyses) would become effective at the same time as the quantitative chapter – summer 2006, not fourth quarter 2004. This misconception could leave companies exposed to the risk of non-compliance with one, and possibly two, of FSA's evidential provisions. Firms need to assess the likely liquidity and/or systems costs for them, lobby where they can, and plan for implementation.

Introduction

As a further part of the development of a unified Prudential Source Book (PSB) applying to the whole UK Financial Services market, on 31 October, 2003 the FSA issued a discussion paper (DP24), which completes the liquidity chapter of the PSB. DP24 proposes a framework of quantitative requirements for liquidity risk in a variety of firms. DP24 covers **banks**, **building societies** and a subset of **investment firms** (limited to larger dealing firms whose principal positions exceed 150% of their Tier 1 capital before deductions). Excluded from DP24 are other investment firms (e.g., CIS firms) and insurance companies, but these are still subject to the stress and scenario testing required by the near-final text on Liquidity Systems and Controls. The framework will provide a common minimum standard for evaluating liquidity adequacy. It brings quantitative requirements in relation to liquidity risk more closely into line with those for other forms of risk. Feedback, including detailed data to support arguments, comments and issues, is requested by February 27, 2004. The FSA proposes to consolidate responses into a CP by autumn 2004. As usual, this is a tight timescale.

Chapter of Liquidity Module and Implementation Date

	Systems & Controls (4Q 2004)	**Quantitative Requirements (2nd half 2006)**
Applicability[1] to:		
Banks	Yes	Yes
Building Societies	Yes	Yes
Principal Dealers	Yes	Yes (limited to those with significant dealing activity)
Asset Managers and other Investment Firms	Yes	No
Insurance Firms	Yes	No

[1] Branches are addressed later in this Bulletin.

The main focus of DP24 is to ensure that firms are able to maintain short-term stability under adverse internal or external circumstances. It proposes a liquidity mismatch approach with one week and one month time bands. The FSA sees the benefits arising from this approach as placing all firms with significant liquidity risk on an even footing, while also addressing obsolete or inconsistent aspects of the predecessor regimes. Rather than being a "one size fits all approach", the FSA has endeavoured to create a flexible regime, which among other things, would provide certain concessions to firms that it views to have robust systems and controls.

However, a unique and controversial aspect of the proposed approach is that it has taken a liquidity measurement regime, generally applied to banks, and imposed it on principal trading **investment firms** with significant trading, but no banking, activity. The effect of the proposed approach on such institutions is unclear. In addition, the FSA is considering a requirement that has the potential to increase liquidity costs for the major UK clearers by excluding from the calculation a portion of the collateral that they already have pledged to support payments and settlement activity. The FSA's counter argument is that used in Basel II that some firms will pay more and some less, but, overall, costs will remain constant for the industry as a whole.

What is the quantitative standard and why is it necessary?

The quantitative standard is intended to address the FSA's concern about the potential for a liquidity crisis at one firm to spread to other firms and therefore undermine market stability. The rationale underlying the quantitative approach is to ensure that firms have sufficient liquidity to withstand "temporary serious stress". The FSA has defined this as a firm- or group-specific stress lasting two weeks with an initial severity of impact broadly equivalent to a two-notch rating downgrade. This is not intended to represent a liquidation or "worst case" scenario as it assumes that that the firm will still be capable of meeting its business obligations without jeopardizing its franchise. The Systems and Controls requirements, on the other hand, are designed to cover liquidity under both normal and the most extreme situations.

Conceptually akin to the current Liquidity Mismatch Approach for banks, the proposed framework is a maturity gap approach that looks at cash inflows and outflows arising from various business activities. In contrast to the current regime for banks that requires firms to calculate gaps over a variety of time bands, the proposed approach focuses only on one-week and one-month periods. As outlined in DP 24, the cash flows would be weighted by stress factors, which under the "Standard Approach", are set by the FSA. However, firms that the FSA considers to have robust systems and controls would be eligible to apply their own factors using an "Advanced Adjustments" approach. Firms would be required to calculate maturity gaps (net cash flows) for each "material currency" with the opportunity to offset negative gaps in one currency against positive gaps in another, subject to currency haircuts to compensate for adverse movement in the rates between calculation and the projected inflows/outflows.

The FSA proposes default gap ratio limits of 0% (mismatch expressed as a percentage of non-capital liabilities) in one-week and one-month periods. Firms would be required to meet the gap ratio limits at the end of each day, but not necessarily to calculate them with the same frequency. The one-week period would cover eight calendar days, including the day following the calculation date, plus five working days. **These explicit limits represent a departure from the FSA's existing approach to bank liquidity, under which it sets liquidity limits on a firm-by-firm basis, although the proposed approach addresses the potential for such customisation through annual Individual Liquidity Adequacy Reviews (ILAR).**

The proposed quantitative approach is notably different from the predecessor regime for **investment firms,** which focuses on ensuring an orderly wind-down and has no separate liquidity framework. Under the current regime, investment firms are required to deduct significant illiquid assets directly from capital. The FSA has not yet determined whether the proposed regime would maintain the illiquid assets deduction. However, the FSA has stated that it only intends to apply the quantitative regime to larger dealing firms—those whose principal positions exceed 150% of their Tier 1 capital (before deductions). How the FSA proposes that firms calculate their principal positions is not explained.

The proposed requirements also mark a significant departure for **building societies** that, under the predecessor regime, are subject to a marketable assets requirement. Through an evidential provision, they are currently required to maintain a minimum of 3.5% of their share and deposit liabilities in 8-day liquidity. The proposed approach, however, is likely to be perceived as being more complex than that presently in place, and may have broader implications for the types of systems that such firms will need to satisfy the requirements.

Benefits of the proposed regime from the perspective of the FSA

In the view of the FSA, the framework is an improvement over prior regimes, with sufficient flexibility and granularity to avoid being considered a "one size fits all" approach. A key element of this flexibility would be in the form of "Advanced Adjustments" to the Standard Approach, which would apply to firms that can demonstrate (to the FSA) that they have robust liquidity systems and controls, although the FSA is still thinking through the specifics of how this will be achieved (e.g., waiver, notification). The FSA proposes that firms meeting certain conditions might use their own discount factors, rather than those prescribed in DP24. The main effects of this treatment would be reduced floors, or, where appropriate, ceilings. Additionally, in exceptional cases, the FSA has indicated that it may consider allowing firms to use their internal liquidity models.

Similar to the Global Liquidity Concession provided to banks under the Liquidity Mismatch Approach, the FSA would exempt certain firms (e.g., deposit taking branches of firms incorporated elsewhere in the EEA that are authorised as Banking Consolidation Directive credit institutions) from complying with the substantive requirements of the module, provided they satisfy a number of qualifying conditions. These would include ensuring that the branch is fully integrated with the firm's overall liquidity risk management, and obtaining consent from the home country regulator. The FSA also envisages applying the liquidity framework to integrated groups and subgroups, provided certain conditions are met.

The FSA also is proposing that firms undertake an annual Individual Liquidity Adequacy Review to determine whether the stress factors contained in the Standard Approach are "sufficiently prudent" estimates of the potential impact of a serious liquidity stress and whether any "Advanced Adjustments" remain appropriate. The ILAR would be subject to supervisory review with the FSA on occasion proving firm-specific guidance where warranted. Again, this is an area where further clarity will be necessary.

Conclusion

The proposed implementation date of mid 2006 for the quantitative requirements may seem a long way off but firms should not be complacent, since the FSA still intends to implement its liquidity Systems and Controls Requirements by the fourth quarter of 2004. Given the linkages between the two liquidity chapters in the areas of currency limits, contingency funding plan and stress testing, and the importance for firms to have robust processes in place, firms should begin assessing and documenting their existing liquidity risk management infrastructure. They should also consider the implications of these changes for their market activity.

While the requirements for 2004 and 2006 may seem daunting for some firms that have not been subject to similar regulation in the past, it should be remembered that the FSA expects firms to have systems and controls that are in keeping with the nature and size of their business. The key is to have properly documented and robust systems (whether manual or computerised), to have effective setting and management of limits, and to have considered and planned for the needs of the firm to operate under stressed and adverse scenarios.

PricewaterhouseCoopers LLP

If you would like to discuss any of these issues arising from the proposals, please speak with your usual contact at PricewaterhouseCoopers, or one of the people listed below:-

John Tattersall
020 7212 4689
john.h.tattersall@uk.pwc.com

Emily Ludwick
020 7804 1731
emily.ludwick@uk.pwc.com

Patrick Fell
020 7212 5273
patrick.w.fell@uk.pwc.com

Ian Clark
020 7804 2120
ian.j.clark@uk.pwc.com

PwC's UK Financial Services Regulatory Practice comprises 120 partners, directors, managers, and staff dedicated to providing pro-active regulatory advice to authorised firms and other financial institutions within the UK, Europe, and elsewhere. Our team blends the experience of former senior regulators, compliance managers, industry personnel and staff with an assurance/client facing background, to provide clients with an unparalleled knowledge of the regulatory rules, codes of conduct and the prudential supervisory framework

This bulletin is produced periodically to address important issues, affecting the financial services industry. If you wish to receive it by e-mail or if any of your colleagues would like to be added to the mailing list or if you do not wish to receive further editions, please write to

Jackie Dowsett
PricewaterhouseCoopers
Southwark Towers
32 London Bridge Street
London SE1 9SY

Or send an email to:
jackie.m.dowsett@uk.pwc.com

PricewaterhouseCoopers (www.uk.pwc.com) is the world's largest professional services organisation. Drawing on the knowledge and skills of more than 124,000 people in 142 countries, we build relationships by providing services based on quality and integrity.

("PricewaterhouseCoopers" refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

Appendix 1 Some Additional Requirements…

In addition to the above, the FSA is considering a requirement for firms that it views as being primary sources or providers of liquidity to the financial system. As envisaged, "core firms"—defined as members of the Clearing House Automated Payment System (CHAPS) sterling payment system would be subject to a core marketable assets requirement under which they would need to hold a prescribed amount of high quality assets as part of their overall liquidity resources. The mechanics of such a requirement have yet to be determined and will be the subject of ongoing dialogue with firms likely to be directly affected. Related to this proposal is one that would impact firms participating in the payments systems more broadly. This requirement, which is a departure from the approach undertaken by Sterling Stock regime, would disallow firms that post collateral to support their payment systems activities from applying the entirety of the collateral to satisfy their liquidity requirements. The rationale underlying this shift in its current position is that a portion of the assets would be required to meet normal operating needs and therefore not available to mitigate a stress to the firm's liquidity.

Application to Groups

The FSA also has introduced group liquidity requirements that would apply to Integrated Liquidity Groups (ILG) and Integrated Liquidity Subgroups (ILSG). Regarding the former, provided certain conditions were met, the ILG would be required to maintain gap ratios calculated on an equivalent basis to the solo requirements. While the solo firm would still be expected to remain within the gap ratio limits, such limits would not be explicitly prescribed, but rather subject to confirmation between the firm and the FSA. The FSA has proposed various conditions for meeting ILG treatment. These include that:

- All the undertakings are members of a group which is subject to the FSA's group risk assessment;
- The group is managed and controlled as a single group with the integrated liquidity risk management executed from within the group subject to the FSA's assessment;
- Each entity has an explicit policy to provide liquidity support to the others, subject to not endangering its own position; and
- The group has stress testing and contingency funding planning in the event that funding cannot be obtained by the UK entities from the overseas entities

The conditions applied to ILSGs would be broadened to include a condition requiring the regulator responsible for assessing the group's global liquidity risk management is satisfied with the arrangement. In addition, the second condition listed above for ILGs would be amended appropriately.

Is This a "One Size Fits All" Approach?

The FSA maintains that while its approach is intended to apply to a variety of firm types, it provides enough detail and flexibility to be customisable to meet the specific circumstances of firms. The FSA views this differentiation as being accommodated through a combination of means, which include the following:

Greater Delineation of Business Components

- The approach includes a fairly wide number of business activities in order to capture key areas that impact a firm's liquidity risk position. The cash flows related to these activities are key inputs into the liquidity calculation. The FSA maintains that the proposed framework distinguishes more business components than predecessor regimes. This includes a more comprehensive treatment of flows arising from derivatives than some of the predecessor regimes and is directed at capturing the following possible sources of risk:

- The net effect of adverse movements in the prices of the underlying instruments; and

- The effect of clauses in some of the firm's derivative contracts which may trigger calls for additional margin or collateral in the event of a ratings downgrade or other problem affecting the firm.

Ability to Simplify Gap Ratio Calculations

- The FSA offers scope for firms with relatively simple business or relatively low levels of liquidity risk to benefit from options for simplifying their gap ratio calculations. This would be achieved by allowing firms to exclude components of their calculations that are not considered material and/or through a "combination option" allowing firms to aggregate business components provided they applied the most conservative stress factor to the highest level of aggregation.

Inclusion of Firm-Specific Features

- In addition the FSA has in certain instances framed the approach to enable distinctions in firms' circumstances to be reflected. For example, the proposed "repo" treatment of marketable assets would be limited in extent to the amount that firms judge they would reliably find counterparties in a serious stress with the benefit accruing to those that are active participants in that market.

Option to Apply "Advanced Adjustments"

- The proposed framework envisages enabling certain firms to adjust the Standard stress factors to accommodate their firm-specific experience, provided they can demonstrate that they meet three main types of conditions, although the FSA has not yet determined the process (e.g., waiver, notification) firms would need to undertake to qualify for such adjustments. These conditions include:

    - Having highly effective systems for identifying, measuring, monitoring and controlling its liquidity risk;

    - In respect of a particular component, having an advanced risk measurement process incorporated into its overall measurement systems and used in its day-to-day liquidity risk management, subject, where appropriate to meeting certain minimum standards in relation to the data used, method of calculation etc; and

    - Having specific conditions attached to adjustments for particular components such as limits on the amount of reduction afforded by the own estimate. The FSA is currently proposing floors in the order of 65% of the Standard measures, with the intention of reviewing them after an initial consultation period.

- The FSA has proposed the following three main areas as being targets for Advanced adjustment:

    - less conservative stress factors applied to certain components

    - inclusion, within particular treatments, of classes of flow not so included under the Standard Approach (e.g., a wider range of marketable assets); and

    - to allow firms to subdivide a Standard components, and apply a less conservative stress factors to a particular subset of it.

- The FSA has not ruled out the possibility of incorporating further flexibility into this approach including waivers from Advanced Adjustments provided the firm has an internal liquidity model that passes muster with the FSA.