THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

27 July 2008

Our ref: ICAEW REP 87/08

Your ref:

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

By email: baselcommittee@bis.org

Dear Sirs

PRINCIPLES FOR SOUND LIQUIDITY RISK MANAGEMENT AND SUPERVISION

The Institute of Chartered Accountants in England and Wales is pleased to respond to your request for comments on *Principles for Sound Liquidity Risk Management and Supervision*.

Please contact me or Iain Coke, Head of the Financial Services Faculty, should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

ICAEW Representation

ICAEW REP 87/08

BCBS – PRINCIPLES FOR SOUND LIQUIDITY RISK MANAGEMENT AND SUPERVISION

Memorandum of comment submitted in July 2008 by The Institute of Chartered Accountants in England and Wales in response to the BCBS discussion paper.

Contents | **Paragraph**

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the Institute) welcomes the opportunity to comment on the Discussion Paper *Principles for Sound Liquidity Risk Management and Supervision,* issued by the Basel Committee for Banking Supervision in June 2008.

WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 130,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.

MAJOR POINTS

Support for the initiative, in so far as it goes

4. We welcome the paper, which we see as a helpful attempt to tackle an area that is both difficult and important. We are aware that previous attempts to do so by the Committee have proved difficult, and that all that has been possible is to produce statements of good practice that have had limited impact internationally. It is important to ensure that the latest paper does not suffer the same fate. We return to this issue later.

5. Rather than going through the recommendations one by one, we have concentrated on four key points, with additional comments on two of the principles in an appendix.

6. The key points are as follows:

- the role of quantitative limits, and how far these are amenable to non-standard methodologies;
- to understand the constraints on the roles of home and host supervisors, and how these differ in the case of branches as opposed to subsidiaries;
- to understand in more detail the difficulties and benefits posed by additional transparency and disclosure, in normal and stressed circumstances; and
- to find ways to make the principles effective, not just now but going forward;

Quantitative limits (Principles 14 and 15)

7. Given the different business models, legal structures and risk profiles of international banks, we agree that an effective liquidity policy should be principles-based, with flexibility for limits to be set to reflect the differing risk characteristics of each organisation. However, in the longer-run there may need to be some minimum quantitative standards to supplement any set of qualitative principles. These need to be very carefully drawn up so as to encourage effective risk management. Many banks question the need for detailed quantitative reporting rules and believe that the regulatory emphasis should be on internal modelling and qualitative standards. In their view this forces them to understand their underlying capacities better and is therefore more appropriate than a one size fits all approach. This view was expressed in the Institute of International Finance Paper on *Principles of Liquidity Management (IIF Report)* issued in March 2007.

8. We believe that much can be achieved by using elements of 'modelling' of cash flows and discounts on marketable assets. To be clear, we accept that full-scale stochastic modelling is not yet in place in most, perhaps all, firms, and given the particular characteristics of liquidity risk that this may be an unattainable goal. Instead, what we have in mind is the systematic capture of all potential cashflows, whether these relate to business that is on or off balance-sheet at present, and the prudent and thoughtful assessment of how these flows could alter in a variety of stressed circumstances. Capturing these 'behavioural' effects is crucial: to the extent that this is done in a rigorous and conservative fashion, less of the measured 'gap' would need to be covered by liquid assets than if the shortfall had been assessed in a less systematic and prudent fashion, and in consequence seemed smaller. Through reviews and benchmarking regulators should be able to challenge firms on their methodologies and assumptions used, and allow a range of approaches to meet any particular minimum standard. Such modelling can be used to focus the attention of senior management on the key assumptions underpinning the firm's liquidity, given its specific business.

9. All that said, we believe that some form of quantitative requirements, agreed with the regulator, are a necessary part of an effective liquidity regime, rather than an optional extra. Moreover it is undesirable for too great a range of regimes to persist across countries, if these produce materially different results for firms with the same risk profile but of different nationality. At the same time, it is desirable that there is not a vast array of reporting requirements between countries – but rather than propose an expansion of common reporting templates this could perhaps be addressed through the use of information that is already produced by the firm for liquidity management information purposes.

Home/host supervisors (Principles 3 and 6)

10. Principle 6 emphasises the need for firms to take account of legal, regulatory and operational limitations to the transferability of liquidity within and across legal entities. In doing this it may be helpful to be rather more explicit about the distinction between a branch operation, and that of a subsidiary.

11. In countries that do not follow the 'separate entity' liquidation doctrine, it is not possible to shield a branch from a shortage of liquidity at head office, but this

point is not fully reflected in current supervisory orthodoxy. By contrast, such a policy is possible in the case of a subsidiary.

12. There is a wider issue as to how the liquidity position of a subsidiary should be treated. This will depend crucially on the business model. Proper distinctions need to be made between the various types of firm, for example, those that:

- are funded by the parent, and thus for these purposes are in some ways analogous to a branch;
- fund the parent, with a concentration of risk on the asset side of the balance sheet; and
- have no parental concentrations on either side of the balance-sheet, and are thus more akin to a stand-alone operation.

Transparency and disclosure (Principle 13)

13. We note that Principle 13 states "*A bank should publicly disclose information on a regular basis that enables market participants to make an informed judgement about the soundness of its liquidity risk management framework and liquidity position".* We would make three observations on this.

14. First, we are not sure that much use has been made of information that has been disclosed in this area to date. In other words, as disclosures have got longer they have not always become correspondingly useful. IFRS 7 *Financial Instruments: Disclosure* already requires disclosure about an institution's liquidity risk management framework. These were only required for 2007 year ends, and it would be sensible first to evaluate their effectiveness, and how best to build on or adapt them (and the equivalent US rules).

15. Second, we note that in a crisis some consider that it is not always helpful for market participants to have an accurate view of the position – for example that a firm's liquidity position is such that it requires emergency lending assistance. In the UK changes have just been proposed that would have the effect of delaying promulgation of this fact. It is important that regulatory policy in this area is consistent and that it is made clear how Principle 13 should be interpreted in the circumstances catered for by the UK authorities. We note that as drafted the Principle applies to firms that are under pressure, as well as those in normal circumstances: and that in any case the suspension of standard disclosures is not an option if it is seen as a sign that the firm is in trouble.

16. Finally, the liquidity position of a firm can deteriorate extremely quickly. Published information on Bear Stearns (eg chart 11 in the Bank of England *Financial Stability Review* published in April 2008) suggests that it was only in the three or four days before the 'rescue' that its stock of liquid assets began to fall at all significantly. Of course, other disclosures (such as fair values) can also change rapidly.

Making the guidelines operational

17. We are acutely aware that it is much easier to monitor compliance with the implementation of quantitative rather than qualitative standards, not least because the latter will always be a somewhat subjective area. Unless

quantitative standards are agreed explicitly, alternative procedures may be needed. These might include:

- systematic benchmarking of procedures between firms in any jurisdiction (we assume that this will be the rule rather than the exception);
- benchmarking of internal or external limits within a jurisdiction;
- peer reviews by one supervisor of another's procedures, in the hope of bringing about a greater consistency of supervisory approach; and
- benchmarking of limits between countries.

18. Although these represent a set of increasingly more ambitious procedures, unless some progress is made along this route, there is a danger that these guidelines will prove no more effective than those promulgated by the Committee back in 2000.

APPENDIX: COMMENTS ON SPECIFIC PRINCIPLES

Principle 4: A bank should incorporate liquidity costs, benefits and risks in the product pricing, performance measurement and new product approval process for all significant business activities (both on- and off-balance sheet) thereby aligning the risk-taking incentives of individual business lines with the liquidity risk exposures their activities create for the bank as a whole.

While we agree with the sentiment behind this observation, and are aware of instances in the public domain that may have triggered interest in these issues, we believe it is important to apply the concepts of materiality and proportionality to a firm's activities in this area. Most of the benefits will be achieved if higher risk and illiquid assets (both) attract significantly higher internal funding rates than do assets that are held to provide liquidity for the firm as a whole. Developing a full-scale in-house industry to refine this approach, and apply it to activities of very limited size, is unlikely to be justifiable on cost/benefit grounds and it would be helpful if regulators were rather more explicit in stating that they share this assessment.

Principle 10: A bank should conduct stress tests on a regular basis for a variety of institution-specific and market-wide stress scenarios (individually and in combination) to identify sources of potential liquidity strain and to ensure that current exposures remain in accordance with a bank's established liquidity risk tolerance. A bank should use stress test outcomes to adjust its liquidity risk management strategies, policies and positions and to develop effective contingency plans.

Stress testing is important but we believe that firms will need guidance in relation to the type and size of shock that they are meant to guard against, and on how far particular modelling techniques are acceptable. We also believe that the focus of stress testing should be for the firms to identify points of failure in the more extreme scenarios, and use these to decide on mitigating action, if any: in some cases there may be little scope for such action.

In our view it is important that a firm takes account not only of institution-specific issues, and problems across the financial system as a whole, of the type listed in the paper, but also lessons from business continuity planning more generally. These often focus on widespread disruption, including physical dislocation, relating to operational incidents that are economy-wide, such as an incident that affected a key settlement system, under which a marketable asset might not realise any of its value until after a delay of several days.

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