4 March 2009

Our ref: ICAEW Rep 23/09

Your ref:

David Morgan
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Dear David

CONSULTATION PAPER 08/22 STRENGTHENING LIQUIDITY STANDARDS

The Institute of Chartered Accountants in England and Wales (the ICAEW) is pleased to respond to your request for comments on the *Consultation Paper 08/22: Strengthening Liquidity Standards (CP08/22),* and is also very grateful to you personally for the time you spent clarifying a wide range of points, and updating us on how FSA thinking has developed.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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ICAEW Representation

ICAEW REP 23/09

CONSULTATION PAPER 08/22 STRENGTHENING LIQUIDITY STANDARDS

Memorandum of comment submitted in March 2009 by The Institute of Chartered Accountants in England and Wales, in response to the Financial Services Authority *Consultation Paper 08/22: Strengthening Liquidity Standards (CP08/22)* published in December 2008.

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the ICAEW) welcomes the opportunity to comment on *Consultation Paper CP08/22: Strengthening Liquidity Standards* from the Financial Services Authority.

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 132,000 members in more than 160 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 750,000 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

4. We support an overhaul of the UK liquidity rules, which are outdated, inconsistent and inappropriate: eg in their treatment of non-sterling positions, derivatives, marketable instruments and 'sticky' deposits.

5. As such we think that the ILAS approach is the right way forward, although further steps need to be taken to specify the size of the shocks against which firms are expected to protect themselves, in order to show that this is done in a risk-based fashion and to demonstrate consistency across firms in the results of the subsequent supervisory reviews. We expand on these points later in this paper.

6. We support the idea that 'simple' firms should have a 'simple' approach available to them, though we have significant reservations about the particular model suggested, and on whether this approach should be mandatory.

7. We do not believe that it is feasible to have the new regime fully operational by October, or even January (as we understand is now the intention). This point has several aspects:
   - The position of those firms (such as investment firms) that have not previously been subject to a detailed liquidity regime.
   - Issues over the frequency and granularity of reporting for all firms – recognised in part by the FSA.
   - The appropriate quantity of liquid assets to be held when we are in the middle of the most serious funding crisis for many years. (We understand that this point is accepted by the FSA, and that it is common ground between us that stocks of these assets should in consequence be below their 'steady state' level).
   - The need to decide on whether or not to grant waivers for international firms and groups in an expeditious fashion, to avoid them having to spend

time and money both on a waiver application and on the possibility that this may not be successful.
- The fact that the proposed qualitative standards are set well above current industry practice and that firms therefore need time to bring their systems and controls up to scratch.

As such the transitional provisions will be of crucial importance, and it is highly desirable for these to be available soon, and to recognise each of these points separately.

8. While supporting the ILAS approach, we believe that there is inevitably a tendency for a lack of transparency in a model review process, with the details of the supervisory review transmitted on a private and bilateral basis. This can (and should) be an issue that is addressed via structured feedback, and this should go rather wider than that proposed in this paper.

9. We support the FSA in its view that the qualitative standards for liquidity risk supervision are of great importance, and should be based on the Basel Committee paper. It would therefore be helpful if greater detail could be provided on the read-across from the Basel standards to the detailed provisions in the FSA paper, and on how the FSA expects to monitor others' compliance with these standards in considering waivers from overseas groups (eg through the Basel Committee's own compliance exercise). More generally, it is highly desirable for the standards to be interpreted in a consistent fashion across the globe.

10. As we make clear in the body of this note, we find the presentation of the regime for branches deficient in two respects – first, that in some areas the FSA has not followed its own edict that legal entities matter, and has confused the position of branches and subsidiaries, and second that there is too little consideration of what the host supervisor can (or more particularly cannot) do to protect UK depositors in the event of failure of the whole bank. These proposals therefore run the risk of misleading depositors as to their effectiveness.

11. In addition, there is a real worry among some foreign banks with substantial subsidiaries in the UK that a tough new policy on central group liquidity functions could make their UK operations unviable. In particular, some of the conditions that have been set for a waiver (not least a de facto guarantee by the parent) seem unlikely to be met: we would not expect a responsible UK regulator or parent agreeing to them for a foreign subsidiary of a UK bank. While we appreciate the recent cases that have led to the FSA's concerns, we believe that a more risk-sensitive and less rules-based approach would cause less damage to the UK's competitive position.

12. More generally, we think that these proposals should be subject to a separate cost-benefit analysis for branches, and for foreign-owned subsidiaries, to demonstrate that they are proportionate and cost-effective.

13. We also believe that the cost-benefit work in the paper is too "micro" in its focus. There needs to be more consideration as to the overall effects of these policies on the relative prices of assets (eg via an increased demand for government paper) and on other 'macro' effects, not least given recent interest in macro-prudential issues.

14. Some sectors – such as Islamic banks – may have particular difficulties with aspects of these proposals. We hope that the FSA is prepared to look at these

with its desired ‘outcomes’ in mind, and allow firms some flexibility in the manner in which the requirements are met.

15. While the deadline has passed for comments on reporting issues, we are concerned that the FSA is still insisting that mismatch numbers drawn up to its own specifications (which are rarely those that firms believe best capture their own risk management needs) should be reported in a way that does not allow processing by the firm in an overnight batch job. In our view this is an excellent case of the best being the enemy of the good, and we very much doubt that such a provision could be justified on CBA grounds.

Specific questions

16. Our answers to the specific questions raised by the FSA are set out in the Appendix below. We make no comments on questions 65-82, for which the deadline for responses was 6 January, or on questions 88, 89, 93 and 95, since these relate to the impact on ‘your firm’.

RESPONSES TO SPECIFIC QUESTIONS/POINTS

Chapter 1 – Overview

Q1: To what extent should the reduction of ‘moral hazard’ be a key objective of liquidity regulation?

A1.1 We agree that the reduction of moral hazard is legitimately a key objective of liquidity regulation. But it is not the only objective. Regulation should also protect depositors in cases where they will not be ‘rescued’ (ie where there is no moral hazard) but where managers and shareholders have taken insufficient account of these risks, and consumers do not have the knowledge or information to appreciate that fact.

Q2: Do you agree that central bank policies and frameworks and supervisors’ views of liquidity risk are intrinsically linked?

A2.1 We agree that they are closely linked. However, liquidity risk can be mitigated not just by holding assets against which the central bank will lend, but by other means, such as altering the tenor and structure of funding itself, and indeed by holding other assets which even in a crisis are ones against which some liquidity can be raised.

Q3: To what extent is the reputation of, and creditors’ confidence in, a firm the key to that firm’s liquidity position?

A3.1 It is hugely important, and ‘a’ key factor. But it is not the only one. It needs to be supported by some objective factors; ie it is a necessary but perhaps not sufficient condition.

A3.2 In addition, a system-wide problem (such as a major IT failure) might affect the ability of a firm to meet its liabilities as they fell due, without affecting its reputation (the liquidity problem in this case preceding any loss of confidence). More recently we have seen similar issues arise as a result of the endemic system-wide shortage of liquidity which has persisted for many months.

A3.3 There is also a trade-off in this area. To maintain a firm's reputation and investor confidence, an appropriate balance must be reached between the level of liquidity risk a firm is exposed to and its cost of mitigation. Accessing too much liquidity at a very high cost will impair a firm's reputation and investor confidence.

Q4: Do you agree that a buffer of liquid assets alone cannot protect against the consequences of liquidity stress?

A4.1 It is a matter of degree – a firm that held billions of the highest-quality paper would be very well protected against nearly all liquidity stresses for a lengthy period. But the stock of such assets would, of course, eventually be depleted, and what is 'highest-quality' is not always easy to determine in advance. For this reason, other concepts should also be considered, such as term funding, unused funding capacity to the extent that it is likely to be reliable at an appropriate confidence level, and maturing assets with little credit risk.

Q5: Do you believe that legal entities are an important consideration for the purpose of liquidity regulation?

A5.1 We do. As a result we are concerned by the apparent confusion in thinking of the FSA in this area, so far as the supervision of branches is concerned. It is odd to refer, in a section called 'Legal entities matter', to the liquidity position of the locally incorporated entity or local branch as if the two were indistinguishable. Precisely because legal entities <u>do</u> matter, there is a fundamental distinction to be made between the two. After discussion, we believe that this may be at least in part a drafting infelicity rather than a genuine confusion. But the table on page 16 shows that this is not entirely the case; formally speaking, the requirements it sets out for branches and subsidiaries are pretty much identical, in the absence of a waiver.

A5.2 If a legal entity has insufficient liquidity worldwide, there is nothing that the host supervisor can do to rectify the situation locally (eg by setting requirements on the branch), unless it uses so-called anti-terrorist legislation to freeze assets in the UK. If that is the intention, the FSA needs to spell this out.

A5.3 We do accept that local requirements set beforehand may hinder the growth of a UK retail deposit base that is then 'upstreamed' to head office, and that the FSA may have legitimate information requirements in this area (although these need to be spelt out, and subject to cost/benefit analysis). We also accept that there are certain legal obligations placed on the FSA to monitor the liquidity of a branch, either itself or via others, and that these need to be met, whatever their theoretical merit or otherwise.

A5.4 By contrast, local requirements can provide some protection to depositors in a separately capitalised subsidiary, even if the group is in difficulty, so long as the subsidiary is rigorously ring-fenced from its parent. Such an approach brings with it considerable problems of its own, but it is intellectually coherent.

A5.5 That said, a more risk-based approach for subsidiaries would be to request tailored changes to practices or structures as needed, not changing the liquidity risk regime for all such firms on a 'one size fits all' basis. Forcing units to 'stand alone' causes consolidated balance sheet, capital, leverage and funding inefficiencies, higher funding costs and increased third party credit exposures, all of which may affect a firm's reputation and investor confidence.

Q6: Do you agree that firms tend to underestimate the potential severity of liquidity stresses in their stress testing and CFPs?

A6.1 It is clear that this has been the case over the past 18 months. What is less clear is whether this is a regular feature of these arrangements, or whether these events have been a '1 in 200 year event' that neither firms nor regulators typically guard against. But even if this stress is unusually severe, there is evidence that stress events as such are not that rare.

Q7: What role do you believe models have to play in liquidity regulation?

A7.1 Our views were set out in our response to DP 07/7, where among other things we said:
"The Discussion Paper is overly negative on the use of internal liquidity models although we accept that there is currently no consensus on any comprehensive liquidity model. There is however agreement in the industry on the factors that should be considered when using models, as evidenced by the forty four specific recommendations in the IIF report. Partial modelling of behavioural cash flows is widely used in practice in the UK. We believe that internal models have a fundamental role to play in the effective regulation of liquidity, as they can be used to focus the attention of senior management on the key assumptions underpinning the firm's liquidity, given its specific business."

A7.2 We therefore agree that models can play a very useful role in liquidity risk management, even though we accept that they are not the only tool that a firm should use – in particular a firm should look at what 'could' go wrong in this area, rather than basing its views solely on what 'has' gone wrong in the past. So we think the conclusion that models are 'necessary but not sufficient' is, as things stand at present, a fair one, although it is not one that the FSA itself appears always fully to endorse.

A7.3 In that context we agree that a fully reliable stochastic model for liquidity risk management does not exist at present, not least because much of the best data is firm-specific and hence less publicly observable. Instead, what firms make use of are judgments as to the reliability or otherwise of various methods of funding the firm, which are in themselves simple models. This applies in a variety of areas – eg the stickiness of retail deposits; the discount on certain 'marketable' assets in a crisis; the likelihood of an asset being repaid in full and on time at its maturity date. The ILAS process should be run in a way that encourages the development of good practice in this area, and rewards those with strong risk management practices rather than putting them on the same basis as those that are not in this group.

Q8: Do you agree that strong liquidity regulation, in the long run, enhances the international competitiveness of the UK financial services sector as a whole?

A8.1 We agree with the proposition as stated, in theory. But this does not mean that <u>all</u> forms of 'strong' regulation have that effect.

A8.2 Indeed, if this were the case the cost/benefit analysis should show a plus for the industry, quite apart from the benefit for consumers. We cannot find such a figure in the paper. It is also inconsistent with para 9.31, which suggests that the impact on competitiveness will depend on the reaction of other countries, and that if others implemented less stringent requirements this might disadvantage UK-domiciled firms. So it would appear that the FSA does not agree with the proposition set out in Q8.

A8.3 More generally, in the long run, effective and efficient liquidity regulation enhances competitiveness, but a 'one size fits all' approach has the opposite effect. It remains to be seen how far the FSA will allow firms the necessary flexibility in this area, to meet the relevant standards in a variety of different ways. This would be consistent with CEBS Principle 25 and some other international regulatory practices.

A8.4 We nevertheless accept that in the past, cost/benefit analysis may have focussed too much on the short-term costs of the insurance provided by tough regulation, rather than on the long-term benefits it provides for firms, consumers and the taxpayer.

Q9: What is your opinion of the priorities for the international and European forward agendas on liquidity?

A9.1 We welcome the thrust of these developments, and believe it would be desirable if these were accompanied by the sort of action on quantitative standards proposed by the UK, not least because of the competitiveness issues referred to above, and the interconnectedness of the global banking system in areas such as funding. Indeed, it would be better if a globally-coordinated approach was adopted in this area: and we hope that this can be agreed as a medium-term objective.

Chapter 2 – Design and scope of the new regime

Q10: What is your view on our principle of adequate liquidity resources? Do you agree that quality, nature and behaviour of the asset are as important to determine its liquidity value as its amount and face value?

A10.1 We agree all of these factors are important (though amount is possibly the most crucial). One particular feature of the present crisis is how best to judge 'quality' in advance – will this endure or not?

Q11: What is your view on our principle of self sufficiency? Do you agree that it constitutes a prudent approach to liquidity risk management?

A11.1 We understand the factors that have led the FSA to this position. But in considering the concept it is important to differentiate between those that can be self-sufficient and those that cannot.

A11.2 The line on subsidiaries and other separately-capitalised UK firms is a tough one – and its impact will depend on how willing the FSA is to grant waivers. It would be helpful if some indication of this were to be given relatively soon – otherwise firms will need to go to the expense of putting in new systems which may in the event prove unnecessary.

A11.3 Steps that may appear sensible at a national level may be counter-productive if they weaken the overall strength of international firms and international stability. The ability to manage liquidity centrally and move it among subsidiaries can be an important source of strength. Put another way, if other jurisdictions follow the FSA's approach (especially if no waivers are granted) then more liquidity will be trapped in other companies, and will not be available to support the UK firm if it got into trouble.

A11.4 The proposals on branches seem to us not to be well thought through. A branch cannot be 'self-sufficient': even if it has adequate liquidity in the UK this will not stop its default if on a global basis it has inadequate liquidity. So at first sight this proposition appears to be based on a misunderstanding of the legal basis of a branch, that is unless the UK proposes to adopt a 'separate entity' approach to branch liquidation, as practiced in the US. If it is planning to do this, it should say so. We believe that this is not the intention.

A11.5 It is possible, of course, that the intention is to give all branches liquidity waivers. If so this should be made clear, to avoid unnecessary costs being incurred in the meantime. We return to the issue of the appropriate conditions for such a waiver later in this note.

A11.6 We also note that even if local liquidity requirements do not protect depositors in the event of insolvency, that may on occasion be helpful in introducing 'grit in the wheel' to hinder the rapid growth of a business which is in other respects imprudently run, and that this is a particular factor in cases where the host supervisor has no other powers (eg an 'inwardly passporting' firm). This point, however, needs to be elucidated more carefully, and given more thought, to guard against unintended consequences.

Chapter 3 – Systems and controls requirements

Q12: Do you agree with our intention to align closely our systems and controls requirements with international developments, specifically the BCBS Principles for Sound Liquidity Risk Management and Supervision?

A12.1 We strongly agree with this. It would therefore be helpful to provide a key setting out how each of these requirements have been translated across into the FSA's rules, not least since the FSA is asking home supervisors to demonstrate compliance ('give legal effect to, and supervises in accordance') with these rules. We assume this will be rather straightforward, since presumably such a map will need to be supplied to the Basel Committee as part of its monitoring process. In that context, the closer different jurisdictions interpret these precepts, the better.

Q13: Do you agree with the approach taken in BIPRU 12.3 & BIPRU 12.4 in relation to systems and controls requirements?

A13.1 The overall approach seems reasonable. It is for consideration as to whether it is too "solo" focussed, at least in the context of a UK group.

Q14: Do you agree with the proposed overarching systems and controls requirements for liquidity risk management?

A14.1 Again the approach seems sensible. We would caution, however, whether the requirement for a firm to minimise the risk of falling below its ILG will always be appropriate if, as now, conditions are stressed. Liquidity should be able to be used in such cases, not frozen as a 'minimum requirement' that can never be breached. We think the FSA is sympathetic to this point so it is important that the rules reflect this shared understanding.

Q15: Do you believe that the requirements placed on firms' governing bodies and senior management deliver the right degree of oversight?

A15.1 It is important that the requirements in this area are proportionate, and do not deter well-qualified non-executive directors from undertaking their tasks. It will also be important to clarify whether these are 'whole bank' requirements in the case of branches, and if so how these can be met without an inappropriate element of extra-territoriality.

Q16: In your view, are the proposed requirements adequate to ensure that firms quantify the liquidity costs, benefits and risks arising from their business activities?

A16.1 We hope these requirements are implemented in a manner that fully reflects materiality and proportionality. On the basis of the information in the CP it is difficult to come to a judgment on this matter.

Q17: Do you believe that we have adequately addressed firms' requirements in relation to intra-day management of liquidity?

A17.1 Intra-day liquidity management is as much the domain of operational risk and credit risk managers as that of liquidity risk managers. There should be flexibility for firms to choose what is covered by liquidity policies and what by other risk policies.

A17.2 Management of this risk varies materially in complexity and materiality depending on whether a firm does its own cash/securities settlements or uses another firm as agent.

Q18: What are your views on our proposals for ensuring that firms are able to manage their collateral positions proactively?

A18.1 The proposals seem comprehensive but are wide-ranging and complex, and may need to be implemented on a phased basis.

Q19: What are your views on our proposal for ensuring that firms actively monitor and control liquidity risk exposures across legal entities, business lines and currencies?

A19.1 We consider that the proposals are sensible, and are pleased to see that there is no requirement to do this across geographies – ie at least this part of the proposals reflects the reality that a branch is legally indistinguishable from Head Office. Moreover, to the extent that there is comprehensive legal entity coverage, we question what value there is in insisting in addition on business line monitoring and control, although we accept it can usefully play a role as an additional control in cases where firms are still working to improve group-wide and legal-entity systems.

Q20: In your view, are the proposed requirements sufficient to ensure that firms establish an adequate funding strategy?

A20.1 Funding diversification, capability and capacity should be rewarded when setting a firm's liquidity risk tolerance and limits, and measuring, analyzing and comparing risk. In many cases, unused funding capacity can serve as a buffer against unplanned cash outflows, and those firms that have built such capacity need to have this appropriately recognised. That said, the requirement to 'Regularly test their capacity to raise funds of all tenors' may not be a desirable course of action in some circumstances, and could have unintended negative consequences.

Q21: Are there any further requirements that may be necessary to improve the quality and effectiveness of firms' stress tests?

A21.1 We are rather surprised that the concept of 'reverse stress testing' as high-lighted in CP08/24 is not mentioned explicitly here.

Q22: Do the proposals go far enough to improve the quality and effectiveness of firms' CFPs sufficiently?

A22.1 We believe so, but would add that CFPs should not be positioned as a follow on to stress testing, since both are linked and deal with crisis management preparation in different yet equally important ways. CFPs have a broader perspective, covering organisational, governance and operational structures that need to be in place irrespective of stress test results and types of crisis.

Q23: What are your views on our approach to reviewing firms' compliance with our qualitative requirements?

A23.1 We are supportive, but are conscious that these approaches by their nature are not necessarily as transparent as the drafting of a large number of published rules. As such we believe there should be structured feedback from the FSA, both on what they have found on their visits, and on the benchmarks and approaches that they are developing as they learn by doing. Making such material available via the FSA website would be one possibility, so long as any updates were flagged clearly and prominently. Similar information contained in the lessons learned section (chapter 4) of DP 07/7 was widely viewed as being very helpful.

A23.2 Key to the success of the approach will be for the FSA to have access to experts that are seen to be knowledgeable about how liquidity risk is managed in practice.

A23.3 In addition, it might be appropriate to have a formal review of the system once it has been up and running two years – say at end-2011.

Chapter 4 – Individual Liquidity Adequacy Standards

Q24: Is the ILAS regime the right approach to address the concerns raised about our current regime?

A24.1 We believe so (while remaining sceptical as to how far current problems result from too prescriptive a regime in the past). We believe that the subsequent SLRP needs to be carried out in a way that is demonstrably consistent (at least in broad terms) and prudent, both in terms of the quantitative and qualitative standards, while giving firms leeway to meet specified standards in a way that reflects their particular circumstances.

A24.2 While supporting the approach, we also believe there is an inherent risk of a lack of transparency in a model review process, with the details of the supervisory review transmitted on a private and bilateral basis. This can (and should) be an issue that is addressed via structured feedback, and this should go rather wider than that proposed in this paper

A24.3 We remain uncertain how the extensive standardised reporting requirements, which will be relatively costly for firms to produce, will interact with the ILAS and SLRP approach.

Q25: Do you agree that we should express our risk appetite in terms of the type of stresses we expect firms to be able to withstand? If no, how would you suggest our risk appetite be articulated?

A25.1 It is crucial that the stress is specified in some detail (how firms address the issue can properly vary, but they need to be told to plan for the same eventuality). This is not "taking firms straight to the answer" (para 4.15/4.22); it is ensuring they are answering the same question. That said, the different likelihood of a firm facing a particular idiosyncratic event also needs to be reflected in the regime.

Q26: What are your views on our analysis on the benefits and drawbacks of prescriptive requirements?

A26.1 Making the question precise is different from a prescriptive requirement (which is about dictating the answer).

A26.2 It is important to make the regime broadly consistent for each player: there may be many differences in the detail, but these should be capable of being justified.

A26.3 A very non-prescriptive regime is typically opaque to others – this is arguably a bad thing. (In that context, we believe that there is a typo in the paper in para 4.11 – more prescription makes firms more (not less) able to make provisions for costs, and consumers will be clearer (not less clear) as a result.

A26.4 We strongly believe that the requirement needs to be precise in as much as firms need detailed information about the standards against which they will be measured (ie the exam question should be unambiguous). We do not think that there need be a unique answer to the question however, or even necessarily a 'model answer' against which the examiner will mark the answers, though in some areas some prescription may be required (and will over time develop in any case as the liquidity reviewers at the FSA develop some 'case law').

A26.5 We also repeat our earlier remarks about the need for the regime to reflect, appropriately, the fact that certain events (particularly related to idiosyncratic risk) are less likely to affect some firms than others.

Q27: How often do you think the ILAA should be carried out?

A27.1 The formula set out in para 4.19 seems appropriate as a general rule. In some cases, details of the assessment (eg on the stickiness of deposits) may need to be reviewed more frequently, depending on market developments.

Q28: Is two weeks sufficient as a time period for an idiosyncratic stress? Would a longer time period (such as one month) be more appropriate?

A28.1 In current circumstances we can see a case for a longer period than two weeks – it took, for instance, longer than two weeks between the initial problems at Northern Rock and the retail run on the bank.

Q29: What are your views on the level of prescription embedded within the idiosyncratic liquidity stress and on the particular parameters where specified? Should more descriptive detail on the stress be included in the Handbook?

A29.1 On balance we believe so – we see this as defining the question in detail, not prescribing the answer. So for instance the expression "multi-notch" in para 4.25 will be interpreted as two notches: the equivalent term in 12.5.11 is even vaguer ("downgrades of varying degrees of severity"). There is a risk that some firms may interpret this as one and two grade, and others as one, two, three and four. Clarity on points such as these is helpful.

Q30: What are your views on the level of prescription embedded within the market-wide liquidity stress and on the particular parameters where specified? Should more descriptive detail on the stresses be included in the Handbook?

A30.1 The scenario is not fully risk-based: different FX markets would be affected differently for different terms and a firm's ability to access these markets will also vary based on capabilities and capacities. Assuming a common impact to all FX markets and participants does not reflect past experience or in all probability likely future episodes. Firms need to adapt related assumptions to their own environment to make the stress test more meaningful and focused.

A30.2 We believe it is also important to focus on areas other than FX – basis risk such as the TED spread (or (LIBOR-base) is one such: a possible sovereign default is another.

A 30.3 Note that in annex 2 there is a typo in the heading to para 8 ("idiosyncratic" not "market-wide").

Q31: Do you agree that the stress-testing that we propose for the ILAA is the most appropriate way of applying our risk appetite in practice? Do you agree with the severity of the stress assumptions?

A31.1 There is an issue as to whether this picks up a long period of chronic stress appropriately. In some ways the proposed stresses are less severe than what we have seen recently.

Q32: Have we succeeded in striking an appropriate balance between firms retaining ownership of stress testing requirements whilst restricting the scope for an uneven implementation of our risk appetite, thereby optimising the level of prescription in the stresses?

A32.1 As set out above we believe that there should be rather more prescription in the stresses, as we believe it is important that the firms own the answers, rather than writing the questions themselves.

Q33: Do you agree that we have identified the most relevant sources of liquidity risk?

A33.1 Yes, but as noted earlier in the CP consideration should also be taken of correlation/diversification effects and how these could compound the problem in some cases, and also separately to any particular issues related to secured funding.

Q34: To what extent will the proposed methodology help the ILAA achieve its purpose?

A34.1 It may be appropriate for certain technical assumptions – eg the 'stickiness' of retail deposits – to be reviewed more frequently than annually, in the light of recent experience, the behaviour of competitors, the overall level of interest rates (at zero there is less opportunity cost in withdrawing money from the banking system etc.). It would be helpful to have this point clarified.

Q35: Are there any other factors that we should ask firms to consider as part of their assessment of wholesale funding risk?

A35.1 We note that there is no attempt to spell out what 'more' or 'less' sticky is in these cases: this we believe is appropriate so long as the judgments undertaken by firms are subject to vigorous but knowledgeable challenge by those doing the SLRP. An alternative approach would be to set 'standard' assumptions, against which variations would need to be justified, but we feel that at this stage this would be too prescriptive. It is for consideration whether, after the regime has been running for some time, publication of such data would help, particularly if it were used as a de facto yardstick by the supervisory review teams, in order to let firms know where the FSA is coming from in this area.

A35.2 An alternative divide to the retail/wholesale split would be between relationship deposits (including retail, commercial, corporate and some institutional) and wholesale deposits. Within wholesale deposits, there is a need to differentiate between those that are obtained through reverse inquiries and those that are aggressively sought in public markets. Behaviours by different types of investors will vary materially for different firms. We agree that the behaviour of liabilities is unique in each firm and should be recognised in the ILAA. We also feel that it is important to learn the lessons from the recent freezing up of wholesale market liquidity.

Q36: Are there any other factors that we should ask firms to consider as part of their assessment of retail funding risk?

A36.1 The degree to which depositors are influenced by deposit guarantees and also the relationship between maturity and stickiness is not always clear.

A36.2 Foreign deposits are not necessarily less sticky than domestic deposits, eg if issues are of a domestic nature where domestic depositors may be quicker to react.

A36.3 In that context, it is important that in its CFP a bank has proactive and effective procedures in place to deal with media interest, if it gets into difficulty.

Q37: Are there any other factors that we should ask firms to consider as part of their assessment of group risk? (NB this is Q38 in the main text and Q37 in the Annex)

A 37.1 There should be some assessment of the strength or otherwise of the parent itself.

Q38: Are there any other factors that we should ask firms to consider as part of their assessment of intra-day liquidity risk? (This is Q37 in the main text)

A38.1 See answer to Q17. There are also risks involved in settlement fails – either on a bilateral basis (as for OTC trades) or of infrastructure such as exchanges.

Q39: Are there any other factors that we should ask firms to consider as part of their assessment of cross-currency liquidity risk?

A39.1 It might be helpful to define 'major' in more detail (does this mean euro, dollar and yen, or does it mean any currency over 5% of the balance-sheet?), and to explain what – if any – difference it makes if the bank is active in exotic currencies. In any case, a firm active in these markets will be able to fund itself more easily than one with a 'structural' position that is rarely seen, and has few counterparties.

Q40: Are there any other factors that we should ask firms to consider as part of their assessment of off-balance sheet liquidity risk?

A40.1 In contrast to para 12.5.49, we believe that some of the problems in this area came from banks supporting vehicles that they were not contractually obliged to do.

A40.2 Derivatives positions can give rise to cashflow mismatches even if not 'proprietary' if the back-to-back is not perfectly matched, but has basis risk.

Q41: Are there any other factors that we should ask firms to consider as part of their assessment of franchise-viability risk?

A41.1 There are issues (see previous question) about supporting vehicles associated with the bank, for 'reputational' issues.

A41.2 A firm may also be in a 'liquidity-hungry' business that is crucial to its continuing viability. One issue is therefore for how long cash outflows to fund such a business can last.

Q42: Are there any other factors that we should ask firms to consider as part of their assessment of marketable assets risk?

A42.1 A firm should consider not only potential reductions in the value of the assets, but delays (eg from settlement problems) before any value is realised.

A42.2 The size of the position (eg in relation to typical daily trading volumes) and the inter-relationship between the value of marketable assets might also be considered.

Q43: Are there any other factors that we should ask firms to consider as part of their assessment of non-marketable assets risk?

A43.1 The issue of assets that are contractually due to mature is not dealt with in detail in the paper, but is clearly highly relevant to any bank calculating its mismatch position. It could be discussed in more detail in a number of places in the paper, including here.

Q44: Are there any other factors that we should ask firms to consider as part of their assessment of funding diversification risk?

A44.1 We believe this ignores micro-diversification – ie a firm with 100 depositors of £10k each typically has less vulnerability than one which has one depositor with £1m. This does not come out clearly either in the 'retail' or 'wholesale' sections: it needs to do so.

Q45: Do you agree with our view that firms need to maintain an adequate buffer of high-quality unencumbered liquid assets? Do you agree with our counter-cyclical approach to individual liquidity guidance in this regard?

A45.1 We do – so long as the appropriate buffer takes full account of the extent of the maturity mismatch.

A45.2 We strongly agree with the 'counter-cyclical' element in the proposal – liquidity that cannot be used is not liquidity in any meaningful sense. But more details on the extent to which regulators might allow 'buffers' to be used would be helpful, not least in considering the overall costs and benefits of the new regime.

A45.3 We agree that liquidity cushions should be built in normal course of business not during stressed conditions.

A45.4 Because funding capacity cannot always be estimated with precision does not mean it should be ignored as a potential risk mitigant. It is not risk-based to assume that during stresses funding gaps can only be plugged by using liquid assets if a portion of a firm's unused funding capacity could be available at an acceptable confidence level.

Q46: What are your views on our overall approach to ILG?

A46.1 The general approach seems appropriate, including the use of eg Section 166 powers.

Q47: To what extent will the measures we propose help to ensure time consistency will be sufficient?

A47.1 We believe that the measures should be kept under review (see Q23), and should certainly include not only a review of the overall position of the industry, but more usefully feedback on good and bad practice seen, on benchmarks used by the FSA to identify outliers for further questioning, and on refinements to the FSA's approach. Such additional transparency is desirable in its own right, and allows others to share the burden of monitoring time-consistency.

Chapter 5 – Quantitative standards for simpler firms

Q48: Have we adequately addressed the challenges faced by firms with simpler business models?

A48.1It needs to be made clear how far this approach will be in practice mandatory.

Q49: Are the conditions for the use of a standardised buffer necessary and sufficient?

A49.1 It is not clear why non-mortgage banks should be ineligible for this approach, nor why a complete foreign currency ban is required. See also Q54.

Q50: Should the FSA refine the threshold for application of the standardised buffer?

A50.1 See Q49.

Q51: Have we sized the retail deposit and mortgage pipeline stresses appropriately?

A51.1 The retail deposit stress looks rather weak, for a three-month period.

Q52: What will be the impact of discouraging firms from funding long-term assets with short-term wholesale funding?

A52.1 It will raise the cost of the product over that experienced up until 2007. The issue, of course, is whether this increase is proportionate (in that it restores the cost to what it should have been all along) or whether it will be excessive. There is also a risk that if the requirements set out in this area are mandatory, and are tougher than those on other firms, it will weaken the competitive position of this group, and make the business model of – for instance – a small building society unviable.

Q53: What will be the impact of only recognising treasury bills with a residual maturity of less than three months as liquid assets for regulatory purposes?

A53.1 It is difficult to justify the exclusion of cash, gilts with less than three months to run etc. In and of itself such distinctions that do not reflect economic reality will distort markets – though in this case if the rules are applied only to tiny firms the macro-impact should not be great.

Q54: Do you agree that smaller wholesale firms have diverse liquidity business models, which mean that the development of a simple ratio would be imprudent?

A54.1 It might be inappropriate for some, but it should be an option that they could use – at their instigation but with a supervisory veto.

Q55: How practicable would it be to require smaller wholesale firms to undertake ILAS?

A55.1 If the approach is appropriately proportionate there shouldn't be an issue. It will be important, as the FSA acknowledge, that this is covered in the post-implementation review. Indeed to the extent that such an approach is overly costly for such firms it would raise some questions about its proportionality more generally.

Chapter 6 – Liquid assets buffer

Q56: Do you agree the FSA should issue individual guidance to firms on the appropriate size of the liquid assets buffer, and that this should be based on the outcome of the defined stresses under the ILAS framework?

A56.1 In general, yes. But we do not preclude the possibility of requiring firms to take action to reduce their mismatches instead.

Q57: What are your views on the appropriateness of the assets listed above for use in the liquid assets buffer?

A57.1 It would be good to have more information about why such a restrictive list has been used, in order to judge whether - for instance - other countries such as Australia should be included (subject to the rating cut-off), and whether there is a case for the inclusion of some private sector paper, albeit at a very significant discount.

A57.2 An alternative approach would be for firms to use their own internal methodology to assess the types and size of liquidity buffer they should hold. Their methodology should be integrated into their liquidity management framework. FSA subject matter experts should test the adequacy of a firm's approach using principles-based standards. Unintended consequences may arise from having a rigid definition of liquid assets (e.g., government collateral or central bank eligible collateral), and excluding other types of high quality liquid assets, irrespective of their market liquidity in secondary markets. Forcing banks to hold more of the former assets may delay the recovery of other important funding markets, which other entities rely on to reduce their dependency on bank loans.

Chapter 7 – Group-wide management of liquidity

Q58: To what extent should the FSA have regard to both going and gone concern scenarios when considering the appropriateness of a regime for group-wide management of liquidity?

A58.1 It should do this, although arguably there should be more weight on the former. The purpose of liquidity is to allow a firm itself to continue as a going concern, or if not to wind up its activities so as to pay off all its creditors in full, rapidly. Among the scenarios considered should be ones where other companies in the group have failed or are unable to continue to supply funding.

Q59: Do you agree that the management of liquidity across international groups is optimised by having equal regard for the liquidity of the group and its component entities?

A59.1 It should look at both. Whether it is 'optimal' to give both weights of exactly 50% is a different issue: in any case the thrust of these proposals is to give more weight to the solo calculation. In that context, there is a real worry among some foreign banks with subsidiaries in the UK that a tough new policy on central group liquidity functions could make their UK operations unviable. While we appreciate the recent cases that have led to the FSA's concerns, we believe that a more risk-sensitive approach would cause less damage to the UK's competitive position.

Q60: Do you agree that the FSA should implement a new regime for considering the appropriateness of group management of liquidity?

A60.1 We remain unconvinced by these proposals. In any case we hope this can be managed in a way that causes as little disruption as possible to present arrangements, unless this can be justified by prudential concerns.

Q61: Have we adequately described the issues that the FSA would need to address with home regulators before agreeing to modify or waive BIPRU 12?

A61.1 See Q5 and Q11. The FSA needs to explain much more clearly how far controls over branch liquidity can improve the position of UK depositors. It then needs to put these benefits against the costs implied by these changes. If there is serious concern about the liquidity of the whole bank, it is unclear why a branch operation (as opposed to a sub) should be allowed to continue, however much 'grit in the wheel' is introduced by local liquidity rules, although we appreciate the complications posed by single market legislation.

Q62: Have we adequately described the issues that the FSA would need to address with the firm and whole-firm/parent before agreeing to modify or waive BIPRU 12?

A62.1 For branches – see earlier comments. For subsidiaries, we believe that it has (with one exception, covered in our next answer).

Q63: Does the requirement for the whole-firm/parent to undertake to commit to provide liquidity support in certain events have the effect of an irrevocable and enforceable indemnity? If not, how could this be achieved and would this be desirable?

A63.1 In the case of a branch the head office has no option but to support its branch (depending on local insolvency rules). Emphasising this by such an undertaking runs the risk of appearing ignorant of this fact, but on balance we believe it is sensible.

A63.2 In the case of a subsidiary here, we doubt whether any responsible overseas parent (or indeed supervisor) would agree to a blanket assurance that liquidity would be made available to a sub come what may, if by so doing it brought down the parent. (We would be astonished if the FSA would countenance such a thing for a UK-headquartered group). As such we do not think that such applications will be forthcoming. A more risk-based approach would therefore be preferable, unless the FSA can justify why it should not grant any waivers of this type to such firms.

Q64: Have we adequately described the ongoing conditions that we would need to impose on any modification or waiver of BIPRU 12?

A 64.1 The proposals seem sensible.

Chapter 9 – Cost benefit analysis

Q83: Do you agree with our cost estimates for the increased holding of liquid assets? What do you estimate the increased costs for increasing the holding of lower yielding assets to be for your firm?

A83.1 It is difficult to judge the macro-effects of a mandated move into an asset class, as shown by pension funds and index-linked gilts: the effects can be big.

A83.2 The benefits of less risky balance sheets may come at a high cost for banks and the broader economy, especially if built in stressed not normal conditions. Reducing risk will not necessarily lead to lower funding costs if achieved by raising more term funds. Investors may focus more on expected reduced profitability, not reduced risk. Some banks may not be able to access term funding at any price, and costs will materially vary between firms.

Q84: Do you think firms will pass on the incremental costs of holding additional lower yielding assets to their customers?

A84.1 Yes – unless there are structural reasons to prevent this – depending on how far firms that do not face these requirements (eg non-banks) are a significant constraint on pricing in this market.

Q85: How do you see firms developing their risk profile in response to the introduction of the regime?

A85.1 They will reduce holdings of illiquid assets (including lending to the personal and corporate sector), and increase term funding, as well as increasing holdings of government paper. The macro-impact of these steps could be considerable. While this point is recognised by the FSA, it makes the timing of any quantitative targets peculiarly difficult.

Q86: Do you agree that firms will not be able to significantly alter central bank reserves in order to meet a liquid assets requirement?

A86.1 In regimes where banks determine how much is held at a central bank, and there is no opportunity cost in holding excess reserves, we believe that significant changes would be possible.

Q87: Do you agree with our estimates of implementation and ongoing costs?

A87.1 It is difficult to come to a judgment without seeing how the ILAS system will work in practice.

Q90: Do you have any observations about the effect of the new regime on the UK's competitiveness?

A90.1 See our detailed answer to Q8.

Q91: Do you have any comments on the likely wider economic impacts of the ILAS regime?

A91.1 See earlier comments. If banks are required to hold more liquid assets then they are likely to lend less to others, including SMEs and consumers.

Q92: Do you believe the new liquidity regime is well designed to make individual firms more resilient to liquidity stresses?

A92.1 It depends on the way in which it is implemented.

A92.2 More particularly, we believe that the FSA should take a more granular approach to considering the benefits and costs of this new approach. At the very least, a separate calculation should apply to branches, and another to the costs of the particular model of standardised reporting that is proposed here. See paras 12 and 15 for more on these subjects.

Q94: Do you believe the new regime is well designed to reduce the risk of systemic crises?

A94.1 Given our earlier comments on macro-effects, we remain to be convinced on this score: it is possible that this is an area where there is a 'fallacy of composition' – ie that what makes sense at a micro-level does not make sense system-wide.

Q96: Would other ways of designing the new liquidity regime be more cost-effective in improving the management of liquidity risk at your and other firms?

A96.1 We believe that a more risk-based approach to branches, and to subsidiaries, could produce the same benefits at significantly lower cost.

Chapter 10 – Compatibility statement with our objectives and the principles of good regulation

Q97: Do you agree that our proposed liquidity regime is compatible with our statutory objectives and principles of good regulation?

A97.1 We do not believe that important elements of these proposals produce a benefit that is proportionate to the burden that it places on the industry.

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