THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

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Your ref: DP 07/7

Financial Services Authority
25 The North Colonnade
Canary Wharf
London
E14 5HS

By email dp07_07@fsa.gov.uk

Dear Sirs

DISCUSSION PAPER 07/7 - REVIEW OF THE LIQUIDITY REQUIREMENTS FOR BANKS AND BUILDING SOCIETIES

The Institute of Chartered Accountants in England and Wales is pleased to respond to your request for comments on *Review of the Liquidity Requirements for Banks and Building Societies.*

Please contact Michelle Logan, Manager, Risk and Regulation, (michelle.logan@icaew.com or 020 7920 8432) in the first instance 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 37/08

FSA - REVIEW OF THE LIQUIDITY REQUIREMENTS FOR BANKS AND BUILDING SOCIETIES.

Memorandum of comment submitted in March 2008 by The Institute of Chartered Accountants in England and Wales in response to the Financial Services Authority Discussion Paper 07/7 *Review of the liquidity requirements for banks and building societies,* issued in December 2007.

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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 *Review of the Liquidity Requirements for Banks and Building Societies,* issued by the Financial Services Authority in December 2007.

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.

4. The Financial Services Faculty draws together members from all areas of the financial services industry. It is responsible for the Institute's policy, representational and thought leadership activity on financial services related issues. It also provides a focus to the Institute's support to members working in and associated with the financial services industry.

MAJOR POINTS

Support for the initiative, but with some reservations

5. We welcome the FSA's initiative in reviewing current liquidity requirements. We believe that the Discussion Paper is a good, thought-provoking document and the lessons learned section is of particular value. This is useful as a means of both educating firms and allowing them to challenge any conclusions that they feel are not supported by what they have seen in practice. However, there is a need to recognise that there may have been material differences in the degree that firms were affected in various markets by the recent turmoil. In addition, whilst not wanting to minimise the importance of stress testing, we believe that a major cause of this crisis from a liquidity perspective was insufficient identification and understanding of liquidity risk related to complex products.

6. In our view the objectives of liquidity policy are slightly understated as drafted. Another important objective is to assist contingency planning both for firms and regulators in the event of financial crises. In addition the gathering of accurate and reliable information for the Tripartite should be explicitly acknowledged as a benefit of such a policy.

Balance between principles and detailed rules

7. We also agree that, given the different business models, legal structures and risk profiles of the range of businesses impacted by this Discussion Paper liquidity policy should be principles-based, although there may need to be some minimum quantitative standards within the FSA regime to supplement any set of qualitative principles. These need to be very carefully drawn up so as to encourage effective risk management. We understand why the Discussion Paper proposes a set of rules for liquidity at shorter maturities, but these are not self-evidently principles-based, even though they are linked to certain fundamental principles.

8. Many regulated firms 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 and capabilities better and is, therefore, more appropriate than a one size fits all approach . This view was recently expressed in the Institute of International Finance Paper on Principles of Liquidity Management (IIF Report) issued in March 2007. We believe that much can be achieved by modelling, as we discuss in greater detail below, and that different firms may well be able to justify material differences in how they wish to structure their liquidity management. Through reviews and benchmarking regulators should be able to challenge firms on their methodologies and assumptions used, thereby allowing a range of approaches to meet any particular minimum standard.

The use of internal models

9. 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.

10. Stress testing will be important but firms will need guidance in relation to the type and size of shock that they are meant to guard against, and the extent to which particular modelling techniques are acceptable. The guidance needs to explicitly recognise that firms will have to engage in a balancing exercise between risks and the costs of any mitigation. We believe that the focus of stress testing should be for the firms to identify points of failure in more extreme but plausible scenarios, and use the results to decide on mitigating action, if any: in some cases there may be little scope for such action. We also note that it may not be appropriate to use the same assumptions for all firms in reviewing liquidity mismatches and stocks of liquid assets as these measures are partial and would result, in practical terms, in a framework being applied that is not risk-based.

11. It is unclear that allowing models only for longer horizons (as is implied in the Discussion Paper) is, in fact, the best approach. Behavioural assumptions (for example on maturing loans) are not always more conservative than the contractual position, and disallowing modelling of short-term flows may, in fact, give rise to a less prudent outcome. The future consultation paper will need to make clear in this context whether ‘short term’ is a week or a month or three

months. We also doubt the assumption in the Discussion Paper that all firms that are subject to the mismatch requirement need to hold a stock of highly liquid assets and believe that this issue needs to be addressed further in the consultation paper.

Scope of the proposals

12. We have not attempted to comment in relation to those questions in the Discussion Paper where the FSA has sought specific information from firms relating to their recent experiences as we believe that it would be inappropriate to do so. Our comments are confined to the more general points that have been raised.

13. The FSA needs to reflect carefully on the scope of these proposals. In particular, we note that paragraphs 1.10 and 3.12 in the Discussion Paper refer to firms other than banks and building societies. We believe strongly that if it is the intention that this type of regime should be applied, for example, to broker/dealers and insurers, it is imperative that they are separately consulted. We agree that, at a conceptual level, there may be little difference between a broker/dealer and a small wholesale firm, but we believe it would be inappropriate for other firms to be included without formally extending the consultation process to ensure that any possible changes have been sufficiently understood and are the subject of an appropriate degree of scrutiny.

14. We also believe that the subsequent consultation paper will need to make clear how far these proposals affect overseas firms, particularly branches, and the cost benefit analysis behind this interpretation.

OTHER CONCERNS

15. Liquidity measurement and supervision is a particularly difficult area. This is demonstrated by the fact that there is currently no international consensus on the details of how this should be implemented, beyond some work on sound practices. Liquidity regimes have historically developed along national lines reflecting a number of practical and cultural differences between countries (for example eligible collateral rules of each national central bank). In addition there are different regulatory approaches.

16. We believe that one of the most important questions raised by this Discussion Paper is whether, in the absence of international consensus, the UK should take the lead by implementing a new approach on its own. There is precedent for this in a number of areas, most recently evidenced by the capital adequacy rules for the UK insurance market that are widely regarded as having been necessary and implemented successfully in the UK. The difficulty in terms of liquidity is that some firms manage their liquidity risk on a global basis and, therefore, it is inefficient from a cost perspective to have to apply a series of different rules across national boundaries. As such there is a strong preference from the industry for co-ordinated action in this area.

17. The Basel Committee on Banking Supervision (BCBS) published in February 2008 a report entitled 'Liquidity Risk: Management and Supervisory Challenges' which proposes that the BCBS should take action aimed at strengthening banks' liquidity risk management in relation to the risks they hold. It is intended that the 'Sound Practices for Managing Liq uidity in Banking Organisations' will be updated later this year. We believe that any proposals

from the FSA should take account of this work, particularly at the level of qualitative standards.

18. At quantitative and political levels we understand why the FSA believes it may be more appropriate to make changes now rather than waiting for international consensus, although this may result in unnecessary technological change and duplication of effort for member firms if progress is faster than expected, or a competitiveness issue if it is not. Nonetheless, timing is clearly a key issue given the potentially significant costs and one that the proposed consultation paper should deal with at some length.

19. We recommend that the impact on liquidity management should be analysed in more detail from an international perspective ie the effect on global groups, branches of an EU firm and branches of a non EU firm, since the cost-benefit calculation might be different from that for a UK-only firm.

20. We recommend that the FSA should explicitly raise the issue of firms having satisfactory systems and controls in place in relation to liquidity management. We believe that it is important that firms are required to demonstrate at a practical level the steps that they have taken to assure themselves that policy has been effectively applied, and, in addition, that their underlying data is materially accurate.

ANSWERS TO DETAILED QUESTIONS

Chapter 2 - Liquidity risk - context

Question 1: Have we established the right objectives for liquidity policy? If not, what alternatives would you suggest?

21. We agree with the general approach used here but it is important that any definition can be used operationally. Once the appropriate risk appetite for firms and the FSA has been established, the definition of the objectives should be re-examined, and if necessary broadened, to ensure that they are compatible with that appetite. In addition we believe that the objectives of liquidity policy are understated as drafted. It is important to state that a key objective of liquidity policy is to assist contingency planning both for firms and regulators in the event of financial crises. In addition gathering accurate and reliable information for the tripartite should be explicitly acknowledged as a benefit of such a policy.

22. It should also be noted that subject to certain minimum quantitative standards referred to earlier in the response, firms should be able to determine their own risk appetite for liquidity risk as for all other risks. Firms should then be required to justify this not only to regulators but also to other third party stakeholders such as rating agencies, analysts, investors and auditors. It also needs to be explicitly recognised that a firm's risk appetite is not static and is likely to change.

Question 2: How well is the role of central bank standing facilities in firms' liquidity risk management understood? Should all UK firms be required to sign up to these facilities, or (if they do not have access) have an agreed alternative in place?

23. We believe that the facilities are well publicised and clearly explained, but that firms should not be compelled to sign up to the facilities. As is recognised in the question, some are ineligible under present rules, as they are not Cash Ratio Deposit payers. Some are branches or subsidiaries of overseas firms and may be able to obtain access to facilities from their home central bank. Moreover for the FSA to insist on sign-up strongly suggests rules-based regulation. Firms that do not sign up to these facilities would of necessity face a regime which reflects this absence, and as such would be required to put appropriate alternatives in place.

Question 3: How should the wider banking reform work influence the reform of liquidity policy?

24. We do not believe that the wider banking reform work will have a large impact on the reform of liquidity policy. Better arrangements for liquidity supervision should mean that there are fewer cases in which firms need to close. The arrangements governing their orderly resolution are in that sense a separate matter. However, to the extent that failure for any reason is made less disorderly, there may be a somewhat greater appetite to countenance a small possibility of liquidity risk, even if it results in the closure of a firm.

Chapter 3 - Market failure and cost-benefit analysis

Question 4: Are there other market failures or cost benefit issues that we should consider?

25. We believe that reporting requirements should be justified with reference to cost-benefit analysis. This is particularly relevant for branches that manage their liquidity on a global basis. The benefits of gathering such information from the UK branch for foreign currencies, either for the supervision of that firm or for the wider oversight of liquidity pressures in the UK, are unclear. We agree that there might be a case for collecting market-wide data on sterling, since most of these positions would be held within the UK.

26. We do not believe that there are any other market failures or cost benefit issues that need to be considered.

Chapter 4 - Lessons learned from recent events

Question 5: How did your liquidity planning address (I) both firm-specific and market-wide scenarios and (ii) both “chronic and “shock” plausible liquidity stresses?

27. We have no detailed comments in respect of this question as the Institute is not a regulated firm. However, we agree that for most firms there was little planning for systemic issues, especially for disruptions to markets that persisted for some time. This assumption needs to be revisited in the light of recent events.

Question 6: How did your market-wide stress tests take account of disruptions both in the unsecured funding markets and in the secured funding markets (and both at the same time)? What were your assumptions on the correlation between short-term funding and long-term funding markets and on the effectiveness of diversification across sources of funding during a liquidity stress? Do you plan to revise your assumptions?

28. We have no comments in respect of this question as the Institute is not a regulated firm.

Question 7: How far were contingent exposures arising from both on balance sheet and off-balance sheet activities incorporated into your liquidity planning? How did your behavioural and correlation assumptions compare with recent events? How will you revise your assumptions?

29. We have no comments in respect of this question as the Institute is not a regulated firm.

Question 8: To what extent have constraints in cross-border liquidity (e.g. trapped pools of liquidity, time zone differences, freezing of FX swap markets) and regulation (e.g. large exposure limits on intra group lending and other rules and legal restrictions) impacted on your liquidity management during the market turmoil?

30. We have no detailed comments in respect of this question as the Institute is not a regulated firm. We note however that some of these constraints are unavoidable (time zone), some are predictable (intra-group rules) and some reflect unexpected market conditions (swap freezing). The policy implications of each may differ.

Question 9: In light of recent events, how would you improve the stress testing for retail deposits, including the behavioural assumptions used in stress scenarios?

31. We have no comments in respect of this question.

Question 10: How severe was your firm's experience of the market turmoil? Describe how your firm was exposed to a drying up of interbank funding and a flight to quality.

32. We have no comments in respect of this question as the Institute is not a regulated firm.

Question 11: In what ways do you think stress testing – including the assumptions used to build stress scenarios - could be strengthened in light of recent events? How has the output from your stress testing informed and challenged your ongoing liquidity management? Please provide some examples.

33. We have no comments in respect of this question as the Institute is not a regulated firm.

Question 12: To what extent have your 'treasury assets' been affected by the liquidity freeze in the asset markets? What assets, in your opinion, can be considered consistently liquid?

34. We have no comments in respect of this question as the Institute is not a regulated firm.

Question 13: in your experience, what has been the role of liquidity promises and liquidity facilities in your liquidity management during the recent market-wide liquidity stress? How well did liquidity promises perform when and if called upon and did 'committed' lenders invoke material adverse change or market disruption clauses to refuse lending?

35. We have no comments in respect of this question as the Institute is not a regulated firm.

Question 14: Which of the courses of action contained in your contingency funding plans have been more useful in ensuring enough liquidity to remain operational? At what point and for what reason did you activate your contingency funding plans?

36. We have no comments in respect of this question as the Institute is not a regulated firm.

Question 15: In what ways do you think contingency funding plans could be strengthened in light of recent events? Do you think that a necessary component of a contingency funding plan is to have access to central bank's standing facilities?

37. We refer you to our response to Question 2.

Chapter 5 - Review of existing regimes

Question 16: What other comments would you like to make on the operation of the sterling stock regime? How could the regime be refined if it were to continue?

38. We refer to some of our initial observations. To focus only on the next five day period is too short a timeframe, and there is too great a contrast between disallowed marketable assets and CDs, although the regime needs to reflect the constraints on significant sales during a period of stress in terms both of quantum allowed and discount applied. There should also be more rigorous modelling of retail outflows and more consideration of behavioural adjustments, for example, to loan maturities, as well as a consideration of non-sterling liabilities (possibly currency by currency where significant) and off balance-sheet items.

Question 17: What is your experience of applying the mismatch regime? How well does it address core liquidity risk? In what ways could it be improved?

39. We do not understand what is meant by 'core' liquidity risk.

40. As is recognised in the paper, the regime does not deal well with behavioural issues; for example, for retail deposits. Firms need to adopt an approach that is more granular (i.e. not just covering one week and one month, but the

periods in between) and covers a longer time period. They also need to consider more carefully the possibility of delays in settlement of sales of marketable assets – i.e. the asset may need not only to be heavily discounted, but might not generate any cash immediately. Finally, positions in material currencies need to be monitored separately, unless there are strong arguments to the contrary.

Question 18: How successful, in your experience, is the building society regime in regulating societies' liquidity?

41. We note that at present that the 3.5% floor does not often bite in practice, with most societies holding much more liquidity.

Chapter 6 - A more principles-based way forward

Question 19: How effective do you think our high-level standards are? Do they make sufficiently clear that liquidity remains the responsibility of the firm and its board/senior management?

42. We believe that the FSA's high level standards are unambiguous. All market participants, whether consumer, provider, market counterparty, analyst, or credit ratings agency should, and most do, understand that liquidity is the responsibility of the firm and its senior management. In our view it makes sense to develop this responsibility further through the strengthening of qualitative standards in the manner that has been utilised for the ICAAP process, which emphasises this as a practical message rather than something that is more philosophical in tone.

Question 20: What are your views on the correct risk appetite? Should the same 1 in 200 one year risk appetite that applies for capital also be applied to liquidity, if necessary converted to the equivalent for a shorter time horizon?

43. We consider that while conceptually the idea is laudable, it may not be possible to make it operational. It is, therefore, more useful as a statement of the exceptional nature of the stress, rather than a benchmark that can be used to produce a measure of risk exposure. We are also unclear as to why it is necessary to explain that 200 years are equivalent to 800 quarters.

44. We have considered at a conceptual level whether it is better for a firm to fail for reasons of lack of liquidity rather than capital. In the first case, the answer is potentially yes in that ultimately all stakeholders would potentially obtain a full recovery. Nonetheless once it became known in the marketplace that a particular firm was in difficulty for reasons of liquidity, the potential for erosion in its capital value should not be underestimated.

Question 21: How should we apply our risk appetite to our stress-testing requirements? Which assumptions should be applied and over which periods? How should we develop what we mean by 'forward looking' in SYSC 11.1.11R?

45. We believe that the focus of stress testing should be for the firms to identify points of failure in more extreme but plausible scenarios, and use the results to decide on mitigating action, if any: in some cases there may be little scope for such action. We also note that it may not be appropriate to use the same assumptions for all firms in reviewing liquidity mismatches and stocks of liquid assets as these measures are partial and would result, in practical terms, in a

framework being applied that is not risk-based. See also our remarks above on modelling contained in paragraph 10 of this response. This ties in closely with Q20 – indeed it is important to spell out clearly the difference (if any) in the risk appetites envisaged between Q20 and 21.

Question 22: Are the proposals for amplifying our qualitative requirements sufficient to improve the robustness of firms' liquidity management?

46. Whilst we welcome these proposals, they may not be sufficient in themselves to improve the robustness of firm's liquidity management. For this reason there is a case for a quantitative standard, either expressed in terms of risk appetite or something more prescriptive. We believe, however, that such a standard should be outcomes-based: ie it should be able to be met via a number of different approaches, so as to encourage firms to build their capacities and capabilities in this area. Firms need to invest in this area and they are more likely to do so if they are able to gain a competitive advantage by, for instance, having proven access to alternative markets and stronger controls, with regulatory standards reflecting these facts rather than treating them identically to competitors who have not taken these steps.

47. We would also recommend that the FSA should explicitly raise the issue of firms having satisfactory systems and controls in this context. We believe that it is important that firms are required to demonstrate at a practical level the steps that they have taken to assure themselves that policy has been effectively applied and that in addition their underlying data is accurate.

Question 23: What changes, if any, are you planning to make to your liquidity policies and liquidity risk management practices in response to the recent market turmoil?

48. We have no comments in respect of this question as the Institute is not a regulated firm.

Question 24: What role do you think models should play in regulating liquidity?

49. We believe that for risk management to be effective it is essential that firms manage their business against a set of explicit guidelines and assumptions, which are often helpfully brought together in a model. Stress testing will also be important, though firms may need some 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 or are not acceptable. We believe that the focus of stress testing should be for the firm to identify points of failure in the more extreme scenarios, and on whether or not there is scope for mitigation, although in some cases there might not be. See also paragraphs 9-11 above.

50. We are conscious that there are many forms of model – some have simpler parameters than others. Judging how easy it would be in practice to receive 100% of a due cash flow, what the eventual recovery will be, and how long any recovery might be delayed are all examples where simple models can be effective. The issue is how far these can be estimated from empirical data, particularly since the answer might well depend on a variety of institution-specific factors.

Question 25: Do you agree that quantitative requirements are a necessary component of our liquidity regime? Do you agree that we should aim for a single quantitative regime to replace the three existing ones?

51. On balance, we tend to agree with both questions posed, though within the unified regime the particular quantitative requirement needs to reflect the business and risk management processes of the firm rather than being the same for all firms, regardless of these risk-related factors.

Question 26: Would the mismatch approach, suitably refined, provide an effective framework for quantitative requirements for all firms? Should most/all firms be required to hold a survival stock of high-quality assets, as in effect the quantitative requirement at the short term end of a mismatch-based regime?

52. We agree that in general this is the case, although as indicated earlier the position of branches needs to be analysed separately. We believe that the requirement to hold a stock of assets is not the sole quantitative requirement of a mismatch-based regime; the size of the mismatch itself is relevant in that context. As earlier noted, we can also envisage cases where it would not be appropriate to require a firm to hold a stock of such assets.

Question 27: Have we captured the most important differences between firms? Are there other criteria relevant to liquidity risk? Do you agree that these do not justify the continuation of different quantitative regimes?

53. We agree that the most important differences between firms have been captured and that these are insufficient to justify the continuation of different quantitative regimes. There is no reason why there cannot be one framework with sets of differing requirements depending on the type and risk profile of the firm, rather than on its classification for example as a building society.

Chapter 7 - Supervisory information

Question 28: What information would, in your view, help the FSA obtain a clear picture of the liquidity position of the markets as a whole and understand the liquidity positions of individual firms and their implications? What information should, in your opinion, be considered as part of an Early Warning System on liquidity?

54. The remark about 'the liquidity position of the markets as a whole' needs further amplification. It is important to justify obtaining such a picture on cost-benefit grounds, particularly for the branches of firms that manage their liquidity on a global basis, and to consider what exactly needs to be collected to provide such a picture. Does the requirement extend beyond sterling? If so why? We are also sceptical whether the aggregation of liquidity positions from different firms will always result in the production of meaningful data.

55. In addition we recommend that consideration is given to the significant amount of available market data that will be held by the UK authorities, for example in relation to money market instruments, that could be utilised to complement the data from individual firms referred to above whilst recognising of course that not all such instruments will be held by regulated firms.

56. There is a wide range of potential early warning indicators that could be utilised for liquidity but none are fail-safe. Some are potentially more effective for

problems across the system as a whole; some for individual institutions. It is important not to ignore the latter particularly if the organisation itself is considered to be a potential source of systemic risk. Examples of the former would include a variety of spreads (for example LIBOR versus government; secured versus unsecured). Examples of the latter would include the sorts of measures set out in this Discussion Paper, including indications of any problems with currency convertibility, any unusual reliance of the firm on asset sales and recent data on retention and replacement of retail deposits. The cost to firms of maintaining pools of liquid assets (against their cost of funding) is a key indicator of risk appetite and therefore any significant change in policy could be indicative of a shift in risk profile and should be questioned.

57. In terms of individual reporting requirements of particular firms we would recommend that the FSA liaise closely with the relevant trade bodies and consult widely in terms of determining the appropriate measures/frequency/granularity. We would note however that regulators may want to see data that is not unduly influenced by month end and period end effects.

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