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Joint Industry Trade Associations' Response to the

FSA CP 08/22: Strengthening Liquidity Standards

4th March 2009

The Joint Trade Association's (JTA) welcome the proposed FSA rules outlined in its Consultation Paper (CP) 08/22 "Strengthening Liquidity Standards." The Association of Foreign Banks has also been fully involved in formation of the JTA response. The qualitative elements of the FSA's proposals sit well alongside the recent Basel Committee for Banking Supervision (BCBS) *"Principles for Sound Liquidity Risk Management and Supervision"*, which themselves reflect many of the recent improvements which large firms have put in place to better manage liquidity risk today.

The industry fundamentally agrees that liquidity risk needs to be given a higher profile within a firm's systems and controls and where appropriate be reflected by the strengthening of adequate liquidity buffers. The industry is also in favour of appropriate reporting (provided it meets the use test) in order to assist the benchmarking of liquidity metrics and providing early warning systems for future liquidity stresses.

In particular we urge the FSA to create a new liquidity regime that predominantly focuses on systemically significant firms supervised by the FSA while offering a proportionate approach for simpler firms. The new liquidity regime should not dissuade the diversity of firms in the UK financial markets from continuing to be active here. We believe that firms should be granted waivers wherever a significant proportion of their core funding is provided from an overseas parent and they are not significant participants in the UK retail deposit market. We are keen to work with the FSA to identify the conditions under which this would be possible.

We hope that our following detailed comments will be considered helpful in further strengthening and finalising the FSA's new liquidity standards. We provide an overview of our key messages in the section below and give answers to the questions set out in the CP and comments on the draft handbook text in the annex below.

Key Messages

International Context

We are keen to encourage greater international consistency and coordination, thus avoiding the potential for complex and conflicting requirements on firms. We are concerned that the FSA proposals may lead to issues of reciprocity with other international jurisdictions. At an aggregate international level we believe that there could be macro effects of the FSA's policy proposals that have not been assessed or quantified.

A major hurdle for internationally active firms' liquidity risk management is the inconsistent nature of national liquidity standards and the disparate range of liquidity reports that internationally active firms supply to the home and host regulators. A "one size fits all" nationally focussed and prescriptive approach needs to stand up to close international scrutiny, especially in the context of improving the management of liquidity globally, where the methodology will vary from country to country, and may not exist at all in others.

This CP is important as it may influence the requirements of other liquidity regimes under development around the world. We therefore urge the FSA and other regulators to discuss their proposed reporting requirements with the BCBS, CEBS and other major regulators in order to reduce the reporting burden on large financial groups and avoid excessive and repeated duplication of liquidity reporting the world over.

Achieving a well developed and harmonised reporting framework is an important first step in achieving common international liquidity standards. Not only would it ease the burden for cross-border firms by eliminating the duplication of liquidity reports but it would also facilitate the group supervision, under the auspices of the consolidated regulator and encourage the development of harmonised liquidity risk requirements i.e. for stress testing, liquid asset metrics, Contingency Funding Plans (CFPs) and eligibility of collateral at the world's central banks.

Currently the FSA's proposals are more detailed, and potentially more constraining than liquidity regimes in overseas jurisdictions. We are concerned that this proposed regime could therefore trigger regulatory retaliation, in which each jurisdiction seeks to ring fence more and more liquidity within its own borders in more and more prescriptive ways. This will undoubtedly complicate the operation of international firms at a time when the political and regulatory agenda is calling for more simplicity and may render their current universal cross-border banking model as unviable to the detriment of the UK financial system. An immediate effect could be a reduced competitiveness of the UK marketplace. We therefore urge international dialogue between regulators in Europe and abroad to develop a harmonised approach to liquidity regulation that can be applied globally to fulfil the needs of regulators, industry and consumers. This would include the scope and application of waivers for certain types of business models where appropriate. Furthermore, it is important to address how cross-border liquidity risks will be mitigated by jurisdictions working together to prevent and resolve liquidity crises.

Timing of Implementation

While the industry recognises that there are lessons to be learnt from on-going market turmoil, it believes that better, more targeted and globally coordinated regulation including the regulation of liquidity is the answer. The industry however cautions that the introduction of tighter liquidity standards and restrictive cross-border flows should be carefully timed not to counteract any possibility of economic recovery in the UK. Ideally, the FSA's proposals would be considered more carefully over a longer timeframe and in the light of a better understanding of the likely impact to the UK economy, allowing more time for markets to stabilise and some form of 'new normality' to begin.

When implementation does commence, once conditions in the money markets have returned to a 'new' normality it should be phased in over a suitable period of time with quantitative liquid buffer requirements being applied first to the largest and most systemically important firms.

What is a liquid asset?

In terms of market related liquidity factors, the paper fails to mention central bank eligibility as a key consideration. At times of stress, knowing that an asset is eligible with a central bank as part of regular open market operations will increase its liquidity value in the market. Thus, it is essential to make reference to central bank eligibility in both stressed and normal times. In extremis central bank eligibility may be the only criterion that matters, where an institution is holding assets which are eligible at a central bank to which it has access. The Bank of England's current list is much shorter than those of other EU countries. This list should for example consider including other EEA, G20 and AAA rated bank debt for both normal and stressed conditions.

Furthermore, the FSA should acknowledge that small firms are disadvantaged in this area as they are not usually active in the repo markets so may fail the market use test. Although many of our smaller members may hold government bonds, setting up a repo desk would be costly and an inefficient use of resources for them and so not necessarily in their commercial interests. Also, small firms may be disadvantaged by not being able to include bank CD holdings in their buffer to the detriment of the interbank market as a whole.

Impact on simpler firms and overseas branches

Whilst we recognise that those larger firms with experience reporting under the current Liquidity Risk Profile (LRP) regime will have an easier transition to the new framework, the majority of firms have no practical working knowledge or experience of such a regime. This means foreign firms with Global Liquidity Concessions (GLCs), as well as small and medium sized firms will be starting from scratch, with a pressing need to build up the relevant internal liquidity risk management infrastructure, developing IT systems, and training personnel to deliver the required Individual Liquidity Adequacy Assessment (ILAA). Some recognition of the fact that not all firms will be starting from the same position would be helpful. We believe some regulated entities may need a period of time to invest in and implement additional systems to meet the new liquidity reporting standards, making the proposed implementation at the end of Q3 2009 (at the earliest) difficult to achieve.

Thus, we urge the FSA to give additional time to simpler firms so that the constraints under which they operate may be properly addressed. Also guidance on the “default” state would be constructive, as to what these firms would have to achieve whilst awaiting the Transitional CP and approval of a waiver.

We are concerned that the current proposed liquidity regime appears to have been drawn up with a clear focus on complex systemic firms and ignores a whole range of firms’ operating simpler banking models with reduced risk and less systemic importance compared to larger firms. Whilst the principle of proportionality is implied and specifically mentioned in some areas, we feel it needs to be made more explicit throughout, in particular as regards the application of evidential provisions being regarded as tending to establish contravention of a rule.

The proposals appear disproportionate to the risks the simpler firms face and that they in turn represent to the FSA’s objectives. These firms will face significant challenges in meeting the proposed requirements in particular they lack access to central bank facilities. The cost of implementation of the current proposals for small firms, in terms of human, financial and IT resources - although marginal in the bigger scheme of things - is significant for small firms, placing them at a competitive disadvantage to larger firms, and would be detrimental to their business model.

We therefore propose that the scope for simple firms be widened so that small simple firms with for example a retail or trade finance focus and/or only limited reliance on wholesale funding have the option to either perform a simplified ILAS, apply the standardised buffer or be classified as “non-ILAS”.

Furthermore, CP08/22 extends the proposals originally flagged in DP07/07 "Review of the liquidity requirements for banks and building societies" to all full scope BIPRU firms, including securities trading houses and investment management firms. As the thrust of those proposals is to mitigate the liquidity risks associated with the maturity transformation activities of the credit markets we believe that it is appropriate to concentrate the scope of the regime solely on firms whose business model is based on maturity transformation and not on small securities trading activities. In the interests of proportionality we urge the FSA to treat these firms as non-ILAS firms except where their failure could have a major systemic impact on UK financial stability.

ILAA and SLRP – A two way process

For the Individual Liquidity Guidance (ILG) to be effective, it is essential that the Individual Liquidity Adequacy Assessment (ILAA) and Supervisory Liquidity Review Process (SLRP) as with the Internal Capital Adequacy Assessment Process (ICAAP) and Supervisory Review and Evaluation Process (SREP) under Basel II is a two way process. While the ILAA can reveal useful benchmarks it must be understood that each firm operates a unique business model and will have to rely on its own internal analysis to derive its appropriate stress tests, CFPs and liquid asset buffer. We therefore suggest that the FSA adopt a “comply or explain” process as suggested in the IIF proposals, where a firm can set its own liquidity buffer and defend its decision based on historical and behavioural evidence.

Group management of Liquidity and Waivers

We have a number of questions with respect to waivers which we request to be addressed fully by the planned FSA CP on waivers and transitional arrangements. Our questions/concerns are touched under the heading of Chapter 7 in the annex but relate to:

- matters of timing
- what preparation would be needed
- how could comfort be gained by the FSA where not all requirements relating to the home state regulation are met
- how does it fit with ILAS review
- scale of implied costs of compliance/ and a probable lack of a use test.

We strongly urge the FSA to explore these questions in the planned Transition CP. Unfortunately, for the vast majority of our members who have operations based in the UK, the waiver process and its likely impact on group wide management is the crucial component of the FSA's proposals, and without gaining better insight into some of the outstanding concerns above, it is very difficult to comment on the merits or otherwise of the FSA's new rules.

Macroeconomic Implications

The FSA’s requirement for a greater proportion of a firm’s funding to be held in retail deposits may have some unintended consequences for the UK economy. A lot of firms who are affected by the new regime have no deposits at all as they are not banks. Thus, a greater number of firms taking deposits may have a crucial impact on the business models of many firms. It is difficult to predict with any certainty what the cumulative effects of these changes might be.

We suggest the FSA complete a thorough quantitative and qualitative analysis of the proposed new framework and how it will affect the broader UK economy before finalising and implementing the rules.

As part of this analysis the FSA may consider the impact on the following:

- Supply and stickiness of retail deposits
- Interest rates and savings ratio
- Cost of wholesale funding and availability of credit

Annex 1- Answers and Comments to CP Questions

Chapter 1 – Overview

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

Yes, we agree, but we do not think that the reduction of moral hazard should be the sole objective.

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

We believe that close cooperation between UK regulators and central banks and their overseas counterparts plays a key role in the crisis management and resolution of liquidity shortcomings in the market. A clear framework needs to be established for communications and contingency funding planning between all stakeholders.

Further, the central bank eligibility of assets and the understanding of marketable assets and "core" liquid assets is a key consideration for FSA policy on the liquid asset buffer. At times of stress, knowing that an asset is eligible with a central bank as part of regular open market operations will increase its liquidity value in the market. Thus, it is essential to make reference to central bank eligibility when talking about liquid assets. Central bank eligibility may be the single criterion that needs to be satisfied, where an institution is holding assets which are eligible at central banks to which it has access.

We see considerable differences in central bank eligibility in normal day-to-day operations. The Federal Reserve Bank (FRB) or European Central Bank (ECB), for example, will accept a much wider range of collateral than the Bank of England including, for example Residential Mortgage-Backed Securities (RMBS). RMBS - particularly over the past year - have failed most of the tests proposed by the Bank of England but nevertheless would provide liquidity in stressed circumstances for those banks with access to the FRB or ECB. We urge central banks and regulators to work together to establish a common list of criteria for eligible central bank collateral and agree between themselves on the level of haircuts to be applied.

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

Reputation and confidence are key elements affecting a firm's liquidity. The right balance must be reached between the level of liquidity risk a firm is exposed to, and its cost of mitigation, as holding too much liquidity at too high a cost will ultimately impair a firms' reputation and investor confidence. However, there are limits on how to measure reputational risk and conservatism for liquidity stress tests.

Further consideration needs to be given to factors that can enhance and diminish confidence. For example depositor guarantee schemes can help build confidence while some disclosure of liquidity information can have a negative impact. We caution that too much transparency of liquidity information could endanger a firm's liquidity position as it may expose a firm to misinterpretation of its liquidity position.

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

Yes, a liquidity buffer alone is not sufficient.

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

Applying liquidity regulation to each legal entity, by definition will reflect the business done by that entity, but it does not help provide insight into the liquidity of the group.

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

We agree that this has historically been the case, however we have been observing more and more appetite for severe stress tests at all levels. It must be cautioned though that stress testing is not the only way to measure risk. For instance senior management experience is a further essential component in assessing and managing liquidity risk. Firms accept that there need to be improvements in risk management and also in senior management oversight. However, there are also roles to be played by other actors – whether central banks or other regulators – which must also be taken into account.

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

We see there being merit in the regulator accepting firms' individual models for liquidity risk as being valid, subject to supervisory assessment and informed judgement of the assumptions on which the model is based and whether the mechanics of the model work as intended. We do not believe that a model for assessing liquidity risk that is designed by the regulator would be viable in the context of liquidity risk as it would need to be so very complex if it were to take account of the range of institutions to which it would have to apply

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?

Yes, efficient liquidity regulation can contribute to enhanced competition. However, if UK policies are more restrictive or costly than competitor centres, UK firms could be significantly disadvantaged and London's position as global financial centre may be threatened as this regime will prompt re-location and limit the activities and profitability of international banking in the UK. We therefore urge the FSA to pursue international cooperation in aligning its liquidity proposals with other overseas regulators.

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

In our opinion the following areas should be addressed as a matter of priority by international policy makers:

1. Common liquidity reporting language and standards
2. An international understanding of what constitutes a Liquid Asset
3. Cross-border cooperation and supervision through colleges of supervisors for home/host requirements
4. Reliance on internal models (if they meet minimum standards; and co-ordination of host/home requirements)

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?

The ability to monetise an asset may vary from institution to institution depending on the depth of their repo market access and their ability to participate in open market operations/special facilities with various central banks. Currently institutions are clearly trying to get access to the ECB in preference to central banks with more restrictive eligibility criteria. Some assets will be more liquid in different markets as they are for example more readily accepted by the ECB than by the Bank of England.

In normal circumstances firms can use a range of assets as collateral to raise funds (e.g. through sale or repo), they can also use a range of assets as collateral to support their collateral and margin calls. Furthermore, in normal circumstances, firms' primary marginal liquidity source is, of course, their ability to borrow, unsecured, from the markets. It is only where these sources of funding become unobtainable that the firm looks to its liquidity buffer for cash.

The circumstances under which a firm is unable to borrow unsecured or is unable to use its marketable assets as collateral fall into the two categories - a firm specific event and a market event (and, of course, the two may occur together).

In a firm specific event, as the markets continue to work normally, it is not unreasonable to assume that the range of assets which a firm could regard as "marketable" will be wider than those it would consider marketable in a market event. It is true that haircuts/margins/collateral thresholds may all be increased but this is a reflection of the increased credit risk on the firm and not a reflection of the value of the underlying security.

In a market event, however, the liquidity value of the underlying securities maybe called into question and then the firm will need to look to a much narrower range of assets as its liquidity buffer.

Regulators therefore need to make very clear the distinction between the ultimate reserve (let us call it the "core" liquidity buffer) and the more general liquidity buffer (let us call this the "marketable assets portfolio" of which the "core" liquidity buffer forms part). There is then scope to recognise that the marketable assets portfolio contains a range of instruments which can be used, over a range of time horizons and with a range of haircuts, to raise cash in a range of stress events, whereas the core liquidity buffer is available under ALL circumstances to raise cash with minimal forced sale risk. By making this distinction, the need for the core liquidity buffer to consist of the most high quality assets is satisfied, whilst allowing firms to recognise value of the rest of the marketable asset portfolio in more normal times.

The debate can then move on to what is eligible in the portfolio as a whole, and what proportion of the portfolio should be in the form of core liquidity. Associated with this are the respective haircuts and the respective time periods over which cash can be raised (in some cases the haircuts will vary dependent upon the time horizon over which an institution looks to realise the asset). Having made the distinction it becomes apparent that only government securities, central bank deposits and cash are likely to fulfil the definition required to count as core liquidity. However, we would point out that the central bank's definition of collateral in its normal open market operations will have an effect here.

Current Best Practice and Firm Definition of Liquid Assets vs Liquidity Buffer

In deriving a firm's liquidity position and maturity ladder one starts with the contractual position. For liquid assets that are held long, the contractual position is clearly the maturity date of the asset. The liquidity of assets depends wholly on the time horizon being considered.

Under normal conditions, a "liquid" asset will be given a "behavioural" overlay that enables its liquidity value to be recognised in the maturity ladder by reducing the contractual maturity to, let us say, overnight but with a haircut to recognise sale risk. Thus a Gilt with a mark-to –market (MTM) of £100 and maturity 5 years hence is moved from the 5 year bucket to overnight with, say, a 2% haircut i.e. a value of £98. The remaining £2 is left in the 5 year bucket.

Any asset can be considered for its liquidity value and can therefore be moved down the liquidity ladder. The haircut taken will represent the degree to which the asset is considered liquid. A completely illiquid asset has a 100% haircut.

In undertaking stress tests any asset which has been brought forward should be reviewed. Dependent upon the stress scenario, in simple terms, the haircut will be increased the more severe the stress event being considered.

Notice that this applies to any asset. If we now turn to a firm's liquidity buffer, a firm is looking for the assets in the buffer to be robust under all stress conditions with the haircuts being applied changing little, irrespective of the type of stress scenario being considered. For this buffer, therefore, there will be a very restricted list of assets that are considered liquid. But that does not rule out other assets being given liquidity value under normal or less stressful conditions.

It is also possible that a liquidity buffer may consist of a range of types of assets which are held to protect against different stress events.

Supervisors and central banks should recognise that the only assets which are sufficiently liquid in all conditions will be those that are acceptable at the central bank given that the most stressful condition envisages an institution having no access to the market, even for secured trades. In less severe stress events - with market or systemic problems - we have seen that counterparties look to their own liquidity position and, again, it is those assets which are eligible at the central bank which are the most desirable.

The liquidity risk appetite will take into account that the buffer assets are the most expensive, so there will be pressure to minimise this type of asset compared with others.

A list of characteristics of a liquid asset which a UK firm currently uses:

a) Prices being regularly quoted in the market for the asset;
b) The asset being regularly traded, both by the market and by the firm;
c) The asset's value being marked to market regularly;
d) The asset being readily saleable, including by repo, either on an exchange, or in a deep and liquid market for payment in cash; and
e) Settlement being according to a prescribed timetable, rather than a negotiated timetable;
f) The frequency that the marketable assets are marked to market;
g) Proportion of an issue held by the firm;
h) Central Bank discount window support and access to that support by units within the financial group;
e) Discounts/haircuts applied by respective central banks;

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

We agree with the principle of self sufficiency where it fits the business models of a banking group. However, we also welcome the FSA's proposed flexibility and look forward to see how this will be applied in practice.

Self-sufficiency is a top-down process. First, the group, then the legal entity, then the branch. If the group cannot demonstratively support the entities below it, then the next lowest entity will need to prove self sufficiency. However, if a level can demonstrate its ability to support lower levels, this should be sufficient – the relevant legal framework permitting.

Further, it may be worth considering whether more guidance around the term "self-sufficiency" would be useful. For example, can a firm build a positive mismatch position by taking term liabilities from its Head Office? What happens if its excess cash balances are held centrally - do they have to be excluded? Are there any implications for operations in terms of for example interlinked back offices and settlement functions?

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?

We support the FSA's intentions to align its policies for systems and control requirements with the BCBS Principles for Sound Liquidity Risk Management and Supervision but are not sure that the current proposals reflect the intentions of the BCBS and CEBS.

Also, we remain uncertain whether other regulators share the FSA's view on the interpretation of the principles for sound liquidity risk management. It is doubtful that other regulators will take on the same level of prescription in their policy and for this reason we are concerned that it will be difficult to implement effective group wide policies.

The industry is concerned that if the current approach by the FSA as outlined in CP 08/22 is adopted by all other overseas regulators cross-border flows of capital would dry up and the European single market and global capital markets would be severely constrained. Therefore, we urge the FSA and other regulators to view their liquidity proposals in the international context and to seek international coordination on liquidity policy formulation.

We also note that in issuing its Principles, the BCBS intended to promote international consistency of liquidity risk management and eliminate barriers for cross-border liquidity flows.

In our view a significant contribution to achieving greater international consistency can be achieved by focusing efforts on defining a common language for liquidity reporting, collateral management, stress testing and CFPs. Establishing a common language, in particular, with other regulators is the first step in achieving mutual trust and recognition that can enable group supervision through colleges of supervisors or home supervisors by the extension of waivers. We recognise that there could be substantial hurdles to this objective but we are very ready to assist the regulators in any way that we can.

Furthermore, the timing and impact of the liquidity proposals on the UK as a global financial centre needs to be considered in order not to disadvantage the UK should markets recover and contribute to economic growth in the future. The requisite costs and changes introduced by the FSA's new regime are substantial and will be taken into account by firms in their location and relocation decisions as necessary, even though it is accepted that firms will be unlikely to make any final decisions until it is clear how other jurisdictions will react.

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

There are reservations about whether the scope of the approach outlined in 12.3 and 12.4 is appropriate to many firms. More elaborate models in response to the failure of earlier ones may not materially be better predictors of market-wide liquidity than their predecessors. Reviewing individual firms in isolation may give a false sense of wellbeing, where a market-wide aggregate metric – for example a consistent month-on-month fall in M4 money supply – would indicate that market liquidity is coming under strain. The FSA's requirement for firms to monitor their own liquidity should be proportionate to the size and importance of the firm's importance to the UK market as a whole. A monitoring by the central bank of the liquidity of the banking system and firm assets in total would also provide an early warning system of problems, and where liabilities are held at any given time.

We would be happy to work with the FSA on its proposed Handbook Text at a workshop or meeting with experts and representatives of our member firms.

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

With regard to the third bullet in paragraph 3.19 on limiting exposures across business lines and legal entities we are concerned with the FSA viewing the group as whole in absolute numbers at any given time. Specifically we feel that while observing limits and thresholds across business lines and entities it is perhaps more important to observe and assess the trends and materiality of exposures before triggering action based on absolute values. Thus, in paragraph (3) of the proposed BIPRU 12.3.34 text we would like to suggest replacing the word "limits" with "taking account of".

Furthermore, we seek clarification with regard to the application of waivers on the point of controlling exposures across group single entities and business lines.

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

We generally support the governance responsibilities of senior management in setting the risk tolerance of the firm. However, we feel that more guidance on FSA expectations in the area of a firm's risk tolerance would be helpful.

Also, we would very much welcome the "comply or explain" approach.

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?

The industry supports the quantification and reflection of liquidity risk in its business and product pricing. However, the issue is highly complex and the FSA needs to acknowledge that there may be significant costs and degrees of practicality involved depending on the level of granularity the FSA is seeking and the associated business/product lines. The explicit cost of liquidity is not straightforward to assess. For example, retail accounts might require a liquidity buffer, as might undrawn commitments, but term assets will require some degree of term funding. It is not clear how all these dimensions could be reflected deal-by-deal, product-by-product. Liquidity risk is best captured at portfolio level.

We therefore propose that a firm has flexibility in formulating its own model based on cost and benefits. These could be discussed in the SLRP dialogue based on the "comply or explain" model. The application of the proportionality principle for simple firms is essential.

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

We agree that managing intraday liquidity is an important task and challenge for firms, however we are not sure that the requested information will be helpful to the FSA. We believe that a qualitative analysis of a firm's management of intraday management would be more appropriate, as it would be difficult to derive any meaningful information about intraday risk exposures from minute-by-minute data. Furthermore, we suggest that the Bank of England may be able to provide some information on flows across the clearing banks.

Furthermore, small firms do not have the capability of measuring intraday liquidity risk as they are not equipped with the necessary front office functions and manage their intraday settlements via custodian banks. We urge the FSA to adopt the principle of proportionality here and only look at systemically significant firms that are active in intraday settlement.

With regard to the proposed BIPRU 12.3.21 (1) (a) and (b) we wonder what the FSA concern is with measuring and identifying gross liquidity inflows. In Recommendation 11 of CEBS's Technical Advice to the European Commission on Liquidity Risk Management it has been advised that a firm manages its intraday liquidity on a net basis. In line with CEBS we do not accept that it would be feasible to monitor and manage intraday liquidity on a gross basis as suggested. We would be grateful for the FSA's clarification on its focus regarding gross and net intraday liquidity positions.

There is concern that, without an overview to monitor or regulate, these proposals may create an incentive for correspondent banks to hold onto intra-day liquidity. There should be a flexible demarcation allowed between how firms choose to split responsibility for liquidity risk, as separate from credit and operational risk.

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

From a collateral management perspective, we broadly agree with the proposals in the CP, and support the formal inclusion of collateral assets into an assessment of firm wide liquidity. It may be helpful to recognise collateral used and available for trading purposes – in repo and reverse etc, in margin calls, in support of derivatives – from that used and available for accessing central bank facilities. There will be overlap, of course, but the collateral for accessing central bank facilities (and breaking it down between that which is available to access normal rather than stress central bank facilities) will be a key component of any contingency planning process. Furthermore in the banking book, in particular, the ability to identify the proportion of the asset base which has been encumbered will be important in judging how well the non-wholesale depositors are "covered" by assets.

However, it would be helpful if the FSA could clarify in its final proposals how it plans to use much of the requested data relating to collateral and what impact it will have on other areas of UK regulatory compliance, such as the proposed stress testing requirements, the CFP and the Liquid Asset Buffer in Chapter 3 and 6 of the CP.

In answering question 18, we thought it might be helpful to provide commentary on the detailed collateral items and outline practical recommendations either as to how firms might meet the proposed standard, or otherwise present a case against including the requirement in the final version of the Handbook.

Broadly speaking, we see the value in contributing data around margin exposure figures, calculating unencumbered assets for the liquidity model, analysing concentration risk and ensuring an understanding of all eligible forms of collateral with our major counterparties.

However, we question the relevance of our counterparties' rehypothecation / onward pledging activities and funding terms as reportable items into the liquidity model. We are also concerned that implementation and adherence to these operational controls will not be feasible within the proposed timeframes. It is strongly recommended that the FSA revise its timelines in accordance with what institutions can feasibly develop.

Detailed commentary:
In meeting the FSA's requirement that firms calculate the sum of collateral positions versus security required, we recommend the use of an aggregated "margin exposure" figure. This is a post-haircut, post-threshold value and is used in standard margin calls between counterparties. This is preferable to the "loss given default" value because: firstly, haircuts are used to simulate the potential drop in value in collateral during stressed market conditions, and these values are therefore more relevant in the context of liquidity and; secondly smaller UK firms might find it difficult to produce the "loss given default" figure, whereas the "margin exposure" figure is already being generated for margin call purposes.

In meeting the FSA's requirement that firms calculate "unencumbered assets", we suggest defining "unencumbered assets" as collateral that is physically held at an institution, but has not yet been allocated for any other purpose. It can, therefore, be contributed to a firm's liquidity position.

We suggest the FSA remove its requirement to "take into account the extent to which counterparties re-hypothecate collateral." If, as we have assumed, the FSA is looking for firms to consider the possibility of market tightness causing delays in the return of collateral, it is our view that this would be an unreliable and ineffective metric for this purpose.

When using the term "rehypothecation" care must be taken to understand and appreciate the possible legal inferences of the term. Use of the term creates an important distinction between the ISDA 1995 English Law CSA and the ISDA 1994 New York Law CSA. The term "rehypothecation" is only relevant to the NY Law CSA where a security interest is created and perfected over the collateral assets and where express permission must be granted to the secured party allowing them to re-use any assets pledged to them. This is different to the English Law CSA where outright ownership of the assets is transferred to the secured party under a Title Transfer approach. Care should be taken when discussing title transfer assets in the context of "re-hypothecation" as this invites the risk of re-characterization; this in turn could result in the secured party's rights to the collateral assets becoming null and void.

Nonetheless, in the case of both agreements, because there is no way of knowing how much pledged collateral is then onward "utilized" by the counterparty, then firms seeking to comply with the FSA's proposals may choose to report the worse-case scenario figure - i.e. all collateral that can be re-hypothecated is re-hypothecated. We question whether this would be an effective way of preparing collateral managers for illiquid market conditions.

We also think the FSA should consider removing its requirement for collateral managers to "ensure access to adequately diversified sources of collateral." For larger firms the sources of collateral are typically (a) assets received as collateral from other counterparties, (b) cash funding from a central treasury function, or (c) fixed income assets from an internal Repo Desk. As each type of collateral has an intrinsic cost of funding and an opportunity cost of utilising elsewhere, Collateral managers will optimise the collateral assets available to support the firm's liquidity, by maximising the opportunity to post the cheapest eligible assets with central banks and fund providers. For example, the Bank of England announced in December 2008 that they were including corporate bonds of part-nationalised firms in their collateral schedule. For institutions that took up this opportunity, it would have increased their availability of cash and G10 collateral available for, amongst other uses, supporting the firm's liquidity base. However, much of this is unlikely to be relevant for the vast majority of firms having to comply with this requirement. Smaller firms are not faced with the same choices and are unlikely to have access to either central bank or repo funding. Perhaps the FSA should consider covering this requirement in a separate section of the framework? Either way, we would like to see much more recognition of the principle of proportionality.

We also think it might be worth considering removing its requirement for collateral managers to "monitor the potential impact of [changing] funding terms" as we do not see it as a significant contributor to firm liquidity. Funding is the second parameter in the equation, after collateral eligibility, that determines the optimum collateral to pledge a counterparty.

However, should these requirements continue to be considered relevant for liquidity purposes, one possible solution might be to ask firms to provide a matrix listing eligible collateral and cost of funding for every major counterparty. This would potentially satisfy the requirements questioned above. This is a good example of an area where an explanation as to what the FSA plans to do with the additional information could be helpful, otherwise we do not think these requirements are particularly useful in building understanding of a firm's liquidity.

We recommend the FSA gain a better understanding of collateral and collateral management, before requesting real time data feeds. We understand that nearly all collateral agreements are based on previous day's data, and therefore collateral management is typically performed using previous day's end-of-day prices. Furthermore, requiring real-time contributions to intraday liquidity figures is unnecessary. Collateral functions should not need to send real-time data into a liquidity model, but rather contribute an end-of-day estimated figure followed by occasional updated snapshots should actual liquidity diverge significantly.

We suggest the FSA clarify what it means by requiring collateral managers to "monitor the location of collateral." In principle this information is available but not currently part of management information requirement. It would be helpful to understand what the FSA is seeking to understand with this requirement. This information may be intended to identify forms of concentration risk with regard to location of agents or sovereign exposures. If so, there may even be potential for duplicative requirements under Pillar 2 with respect to concentration risk, or there may be more effective methods of identifying concentrations. Further, dialogue between the FSA and collateral managers would be helpful in order to draw up the data requirements in a meaningful way that would also benefit the firm.

It is currently unclear from the FSA paper what the definition of timeliness should be. Without clarification, it is assumed that the mobilisation of collateral be timely enough to not cause delivery to extend out beyond existing minimum settlement periods. We suggest that the FSA defines "timely manner" when referring to collateral managers having to mobilise collateral as such. We support the inclusion of simulated scenarios for additional collateral requirements in the FSA model, but request clarification around what those scenarios should be.

Finally, it would be helpful to know what the definition of collateral is that the draft BIPRU sections 12.3.22- 12.3.25 intends to cover. Our initial reading of this section is that it applies to collateral in its widest and fullest sense, including client collateral received/paid in relation to OTC business. However, recent discussions between Firms and the FSA seemed to indicate that collateral as per the context of chapter 3, referred to liquid assets that a firm holds for use as collateral in context of the requirement to hold qualifying liquid assets to meet the liquidity related regulatory requirements. This clearly could result in a very different scale of application with respect to systems and controls.

It would be helpful for the FSA to develop a model that differentiates trading from banking book collateral exposures. If the FSA is focussed on liquidation conditions, then trading/banking differentiation may well make sense.

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?

We agree the monitoring and control of liquidity across legal entities, business lines, and currencies is an important part of group wide liquidity risk management.

However, it is clear from the FSA's proposals, that for some very large and complex firms, some with over a thousand legal entities over many different time zones, the new rules could be extremely burdensome. We believe that it would be more fruitful for firms to focus on group limits, for example considering the materiality of existing exposures that are significantly long or short and their potential impact on the group as a whole.

Otherwise, we believe that firms will significantly limit their exposures via liquidity buffers for individual legal entities which fulfil the self-sufficiency principle.

With regard to currency risk we also believe that a firm should focus its understanding and FX surveillance on material currency positions that have significant structural impacts and manage them appropriately.

We believe that supervision via the college of supervisors could and should play a significant role in identifying and managing the liquidity risks of cross-border banking.

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

The shape of funding should be viewed on a case-by-case basis taking into account a firm’s business model and its counterparties. Counterparties should be analysed by term and tenor as well as behavioural history.

Also, it is important to take a proportionate approach where the FSA acknowledges that smaller firms have less scope for diversifying their funding.

With regard to BIPRU 12.3.28 we express particular concern with regard to testing markets for pricing as this may trigger reputational risk and may also effect accounting treatment under IFRS.

Also we are concerned with the overall objective of placing less reliance on wholesale funding as this concerted action will make firms equally vulnerable to the same factors that may influence retail depositors and have the potential to create a contraction in spending with all the associated macroeconomic effects. Further, we do not like the idea of wide scale testing of markets for pricing. Wholesale funding should be considered as a real funding source even if stickiness can be challenged so that leverage can be monitored and controlled.

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

We welcome the FSA’s approach to liquidity stress testing and welcome the measures proposed as they will raise the profile of stress testing within firms, particularly at senior management and board levels. In the context of stress testing we urge the FSA to consider also the comments made to FSA CP08/24 on Stress and Scenario Testing.

We are not, however, wholly clear on the FSA's proposals in respect of the understanding of "governing body" (BIPRU 12.4.1) when applied to a branch. Is the FSA expecting that stress testing would be applied at group level? Would the FSA expect stress testing to be applied to the group when there is a subsidiary in the UK? At present subsidiaries in the UK are more likely to apply stress tests on a stand alone basis, not least as the parent entity might be in a location that is not at the same stage of the economic cycle. Of course, a branch is not a legally separate entity and is a division of an entity which leads to legal and practical consequences in attempting to conduct stress testing on a stand alone basis. It would be helpful to clarify the FSA's intentions in this area. Historically stress testing has been a top-down rather than bottom-up process. We are not convinced of the benefits of stress testing a branch or subsidiary on a stand alone basis unless legal or regulatory frameworks prevent liquidity from being brought in from the rest of the group.

The stress testing provisions also relate to the requirements concerning adequacy of liquidity resources, specifically, BIPRU 12.2.1(2) which states that a firm cannot include in its adequacy calculation liquidity resources available from the rest of its group. This requirement tends to support the concept of stand alone stress testing of the UK entity, and of course suggests that the overall group will have to amplify the overall level of its liquidity holdings.

We would also welcome clarification of the FSA's expectation of "frequency" in stress testing (BIPRU 12.4.4G). We support the FSA's intention to apply a proportionate approach based on the size and systemic risk of a firm. However, we are not clear that frequency of stress testing would increase in a more stressed environment. In such cases we suggest that increased frequency of calculation of expected cash flows and other projections would be of much greater value and utility. This would allow a firm, for example, to react to market developments as they occurred, such as the downgrade of counterparties or the sovereign jurisdiction in which they were located. Additionally, we are not clear what value the FSA expects to obtain from daily or weekly reporting of stress testing and would be glad to discuss this with the FSA.

In stress tests of liquidity, recent events have demonstrated the importance of the central bank's function in providing liquidity to the banking system, and it is important to be able to incorporate this.

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

We support the central role that the FSA attributes to CFPs within liquidity management of firms, however we would like to point out that there needs to be an appropriate level of proportionality vs prescription based on the size and systemic risk of a firm.

We also recommend that central banks actively involve themselves in the formulation and testing of funding plans with the industry. The role of central banks as lender of last resort should be recognised and incorporated in contingency planning. There should be a close relationship between the central bank's role, actions and provisions and a firm's internal liquidity risk management decision-making processes. Additionally, the status and operation of standing facilities should be clarified and communicated to the media and general public as regular and routine operational funding measures, in order to avoid the negative stigma associated with central bank borrowing.

With regard to central bank funding and the liquidity buffer for firms we urge the FSA and Bank of England to recognise overseas central bank funding if it is material and proportionate to a firm's overseas operations.

Smaller firms have expressed concern with regard to their limited dependence on head office's repo functions. More specifically our members would like to know:

1. Whether branches have the ability to novate their liabilities to their parents.
2. Will current overseas standby facilities i.e. from external stakeholders, such as shareholders still be accepted by the UK authorities? Or will the FSA consider this form of funding to be reliance on intra-group resources? We note, however, that firms pay not insignificant fees in order to retain these standby lines and if the FSA is not minded to grant recognition to them, then firms are more likely to let these lines lapse.

We believe that the FSA needs to take into consideration the limitations of small firms, branches and subsidiaries in its requirements for liquidity funding and its formulation of the CFP.

With regard to the proposed BIPRU text section 12.4.14 we make the following comments regarding the points (5), (6), (8) and (9).

(5) Testing of CFPs: We understand that the FSA is keen to ensure that firms have a realistic opportunity of being able to access all relevant funding sources. However, in our view there is a significant risk associated with "testing the market" when a firm has no specific need to do so. There is concern that requirements to have CFPs tested in actual 'dry runs' could be misinterpreted by markets and negatively impact a firm's reputation in terms of its funding ability and lead to a run on a bank.

We believe that all stakeholders need to be involved and actively participate in the test in order to avoid any false signals. We note the experience in Scandinavia where CFP tests were conducted in cooperation with counterparties and stakeholders including the central banks and regulators. However, we also note the industry concern for the use of resources that this would entail as it would require potential overtime, strain system requirements and/or divert financial expertise from there vital business and trading operations. Therefore, we suggest that such tests would be performed less frequently.

(6) and (8) Intraday and Payment and Settlement Systems: We note here that smaller firms usually do not have access to this.

(9) External and Internal Communications: We would like to emphasise the importance of including stakeholders such as the regulator, central banks and media in the communication planning.

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

We would like the FSA to clarify the types of remedial actions the FSA may take in the case of non-compliance, i.e. higher liquidity buffers or call for further investments in systems in controls.

Chapter 4 – Individual Liquidity Adequacy Standards

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

We welcome the new approach, however currently the proposals for the ILAS appear to be quite prescriptive although the principle of proportionality seems to be implied. As mentioned above, the over-arching principle of proportionality needs to be made more explicit throughout. We are also concerned that the prescriptive nature of the ILAS ignores the unique experiences and judgements that are the foundation of business model decisions made by each firm operating in the UK.

Section 4.2 states that "one-size-fits-all quantitative regimes do not capture the particular circumstances of individual firms and also potentially discourage firms from assessing and mitigating their own liquidity risk properly." Therefore concerns are expressed about the proposed quantitative metric. The ILAA is one that well-managed firms already do in their own way based on their own circumstances. Therefore potential improvements to this process using principles-based regulatory guidance should be applied rather than introducing new detailed and formal prescriptive processes.

We would also welcome a similar approach as under the ICAAP where firms that are systemically less significant are not required to submit a full ICAAP. We would welcome an indication from the FSA that this is indeed the case. In addition, for certain firms, it may make sense to assess the liquidity requirements of their UK operations on an integrated basis. We would therefore suggest that the ILAS regime need not be applied strictly on legal entity basis but similar to the ICAAP can be put in place for a sub-group of related entities.

The ILAS requirements appear overly onerous as drafted for non-bank firms such as for example securities trading firms and asset management companies. In the event that these were to become insolvent clients and counterparties would be largely protected by the operation of the CASS rules and by clearing house arrangements. We therefore recommend that the ILAS be less rigid in respect of non-bank firms or more accurately reflect the risk profiles of those businesses and the existing protections in the markets in which they operate.

Finally it should be considered to exclude small firms and/or those with simpler business models from the ILAS process given their limited impact and materiality to FSA objectives and systemic risk.

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?

We agree stress testing is a good method to underpin the measurement of liquidity risk appetite. However, we need convincing of the value of performing idiosyncratic and market wide stress tests independently for larger firms. The two are very difficult to separate as they interact with each other. Further, recent experiences have demonstrated the need for comprehensive all encompassing stress tests. Survival period may be one way of expressing the risk. A small firm on the other hand will have little to no impact on the market stability if it had a financial/liquidity difficulty, and therefore stress scenarios 1 and 2 will be more appropriate. We therefore suggest to determine stress tests based on the size of the firm.

For large firms, we believe the Liquid Asset Buffer and CFP will be determined by the combined stress test that considers both types of stress, idiosyncratic and market wide. In many cases it is highly likely that if a firm is able to survive the third stress test, which is based on the combined scenario, it is able to withstand both the first and the second stress test, which look at each of the scenarios in isolation.

Any stress test is only as good as the underlying assumptions and the important thing is for a firm to know where its sensitivities are. Banking remains the business of maturity transformation and some risk is therefore inevitable. Any discussion will centre on remaining level of risk and a link needs to be made to "reverse-stress" testing in CP08/24.

Finally we also would like to understand how the FSA proposes to quantify the buffer based on the stress test results. The current reporting is based on monitoring liquidity expressed in %, the stress test will show decrease in liquidity as the %. Will the FSA base the buffer ‘on one for one’ decrease in the %, i.e. decrease in ratio through stress test will have to be held as government securities. If that is the case than we would like to pose the question: How are total assets and the buffer defined in terms of i.e. net assets, gross assets, assets inc./excl. repos.

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

Prescriptive requirements run the danger of a firm losing sight of its firm specific stress factors. While it is definitely helpful for the FSA to identify stress scenarios and to have a view on the behavioural adjustments under those stress tests, it needs to concede a degree of flexibility for a firm to perform its own internal methodology, recognising among other things that firms differ widely in terms of their dependence on retail and wholesale funding and their behavioural adjustments. Firms will have their own views on what stress tests are important and how they can optimise contingency pans. It would be advisable for the FSA to adopt a “comply or explain” approach where it finds a firm is an outlier in any of its assumptions.

Smaller firms find the proposed prescription too detailed and burdensome. They are potentially disproportionate for low impact firms.

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

As with the ICAAP we suggest that an annual submission of the ILAA is sufficient.

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?

Two weeks appears to be a sensible survival period. However, the FSA needs to acknowledge that the length of an idiosyncratic stress is firm specific and therefore will vary from firm to firm.   Thus, the FSA needs assess this on a case-by-case basis, influenced, perhaps, by the firm’s systemic importance.

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?

As noted in the answer to Question 24, we believe that a broader interpretation of stress factors is preferred over the prescription due to the firm specific nature of the impact of these scenarios on its business. In essence guidance is preferred while firms ultimately rely on their internal models to suggest firm specific idiosyncratic stress, for example the additional risk related to secured activity as distinct from unsecured wholesale activity.

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?

The industry prefers definitions and guidance rather than prescription on stress scenarios from the FSA, but also needs the FSA to understand a firm's reliance on its internal analysis to identify the relevant risk factors that are pertinent to its own circumstances.

Here we would also suggest a link to the reverse-stress test in CP08/24 where firms are requested to assess the specific stresses relevant to them.

The prescription may need to vary over time, and possibly quite quickly. This is better done through flexible communication between the FSA and firms rather than in the Handbook.

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?

There is always an interaction between idiosyncratic and market stresses and the two can never be separated with any degree of purity because of the dependence on the reaction of relevant markets. All the first and second stress tests do is define a firm's exposures and correlations between risk factors for the compound stress test in the third scenario.

As pointed out in Question 25 we believe that the combined stress test, arrived at via a building block approach, is the most appropriate method of identifying a firm's exposure to risk. The discussion then needs to focus on what is an acceptable level for failure which defines a firm's risk appetite. We believe that this particular aspect should be determined by a firm's internal business model and its governance.

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?

The success of the proposals is conditional of the recognition and acceptance that differing business models will result in differing impacts. For example, the impact of a market-wide event that closes/curtails the UK money markets will be less severe for firms that have reliable and stable overseas liquidity sources.

As noted in the answer to Question 24, we believe that a broader interpretation of stress factors is preferred over the prescription due to the firm specific nature of the impact of these scenarios on its business. In essence guidance is preferred while firms ultimately rely on their internal analysis to suggest firm specific idiosyncratic stress, for example the additional risk related to secured activity as distinct from unsecured wholesale activity.

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

We believe that secured funding should be separated from wholesale risk and stand as a category by itself. There are significant differences between banks that are asset-driven (seekers of funding from the marketplace), and liability-driven (lenders of funds into the marketplace, or buyers of short-dated assets). Essentially we suspect that removing intra-group funding and the introduction of the principle of self-sufficiency introduces new risks.

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

The FSA's guidance within an overall framework of flexibility should ensure that the ILAA achieves its purpose. For this purpose the FSA needs to be clearer about what it expects to see in the ILAA. Whilst it will include the stress testing and the behavioural discussion of each of the risk factors we assume there will be more sections covering, for example, the diversification of funding, structural balance sheet issues, forecast balance sheet growth, etc, etc. To that end it would be helpful if the FSA put forward an example proforma ILAA, however, recognising that such a document is a guide to the format only. Firms should be allowed to develop their own formats and, if a best practice format emerges the FSA might share that format with the industry over time.

In addition to further clarity on the ILAA process, a better understanding of the subsequent ILG process is required to properly assess the impact of the ILAA. How the FSA administers the ILG will have an impact on the cost of doing business in the U.K. and choices regarding business model, operational structure and product offerings.

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

The industry is concerned with the level of prescription for stickiness ascribed to the wholesale funding categories. For example overseas wholesale funding has been attributed with a very low level of stickiness. Some experiences, however, have shown the very opposite and it must be concluded that stickiness is dependent on the client and firm specific business model.

While the risk types are helpful, firms need to maintain flexibility to override assumptions of stickiness if firm internal evidence exists for specific counterparties to support this. We suggest that a 'comply or explain' approach be adopted for such cases.

More generally, whilst not disagreeing with what is said in paragraph 4.36, precise quantification of all these sources of funding could be burdensome and could change relatively rapidly. At the same time the degrees of sensitivity can only be broad estimates – and hence the outcome of the calculation will inevitably be only indicative. Thus, care should be taken not to impose quantitative requirements beyond the point where the benefit exceeds the cost.

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

Retail funding risk should be examined in a segmented way recognising that a firm may specifically design products to provide the firm with a higher degree of funding certainty.

The recent crisis has provided firms with a benchmark for retail client behaviour under extreme stress conditions. As each firm likely experienced a different degree of outflow based on client, product and market specific factors, we would urge the FSA to allow firms to apply this experience to its assessment of retail funding risk.

Q37: Are there any other factors that we should ask firms to consider as part of their assessment of intra-day liquidity risk?

No, the FSA is to be commended on its comprehensive identification of the liquidity risks that firms face.

However, it needs to be pointed out that throughout the whole period of the credit crisis, the major UK payment infrastructures of CHAPS, CREST, BACS and globally CLS, have operated extremely efficiently.

Any move towards putting either arbitrary or theoretical minimum holdings of collateral held in payment systems may well undermine the strong record in UK payment systems so far. This is because the fluidity of which the payment flows occur can be so significant in both speed and size, the FSA should give no reason for banks to change their current holdings or practices. For a similar reason, snapshots of intraday data would not be meaningful.

Given the above we would be interested in more background from the FSA as to their view on the need for additional collateral and the benefit of monitoring intra-day data.

Q38: Are there any other factors that we should ask firms to consider as part of their assessment of group risk?

It is important to make a distinction between branches and subsidiaries; the relationship between a branch and its Head Office is substantially different to the relationship between a firm and another member of its group – and in turn these relationships may vary e.g. a firm may be able to place more reliance on its parent than on a distant member of the group. It would be helpful to see the pro forma for collection of this type of information.

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

Some firms manage their liquidity risk centrally, and therefore not on a currency by currency level other than for a few currencies which are not widely traded. On the other hand there are firms that prefer to assess their liquidity risk on a currency by currency level. Convertibility of currencies, particularly, developing market currencies, cannot be assumed at all times. Recent market evidence has even suggested that US dollars can at times be in short supply. This is an issue perhaps the FSA should address in bilateral discussions with firms, depending on their specific business models.

The reference to “major currencies” could be misleading. A firm may have substantial exposure to a “non-major currency” and manage this specific currency risk explicitly; on the other hand a firm may have only minimal exposure to one or more “major currency”. The important criterion is what is “major” to the firm, not to the market as a whole. Again the issue of proportionality is relevant here.

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

We appreciate this area being singled out as a significant risk area to consider. However, with regards to derivative portfolios, collateral and margin payments are likely to vary from one firm to the next. The treatment of derivatives will have a significant impact on the complexity of risk assessment and we would be happy to assist the FSA in defining an appropriate treatment of derivatives based on firms' own best practices.

We note that the treatment of derivatives is not addressed in the CP. We believe that material cash flows related to financial derivatives and interest rate flows should be included in liquidity risk analysis. There are a number of practical challenges in forecasting derivative flows related to the uncertain outcomes arising from the optionality inherent in such structures and each firm needs to make an informed judgment as to the materiality of these challenges. It is not the gross amount of derivative or interest rate cash flows originating from each contract that should drive the determination of materiality; rather, it should be the net amount of all contracts within each time bucket being measured that should be the driver for firms assessment of materiality. This is likely to have a significant impact on the ILAA for larger more internationally active firms and the industry would be keen to assist the FSA in its development of an appropriate framework.

For many smaller firms, cash flows from derivatives are not likely to be material. Significant systems development effort may be required to generate numbers for derivatives, and we would urge a pragmatic approach from the FSA towards their expectations for liquidity reporting, especially given the frequency and the short timeframe which is being envisaged. In other words, and under the principle of proportionality, where firms can show that the net cash flows are small, they should be exempted from having to develop complex systems.

Also access to the Bank of England for small firms remains an outstanding issue.

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

Should consideration be given to arrangements for small firms to transfer or novate transactions to the parent so they (the UK branch) are no longer the funding entity?

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

It would be useful to consider the work the Bank of England has undertaken with regard to its discussion paper: “What Constitutes a Reliably Liquid Asset in the Market?”

We fully support this paper, the factors that have been identified and what is trying to be achieved. It covers all the main aspects of what constitutes a liquid asset in the market.

However, in terms of market related liquidity factors, the paper fails to mention central bank eligibility as a key consideration. At times of stress, knowing that an asset is eligible with a central bank as part of regular open market operations will increase its liquidity value in the market. Thus, it is essential to make reference to central bank eligibility. In extremis central bank eligibility may be the only criterion that matters, where an institution is holding assets which are eligible at a central bank to which it has access.

Furthermore the FSA needs to acknowledge that small firms risk being disadvantaged in this area as they are not usually active in the repo markets. Being forced to hold government bonds small firms face a costly set up of a repo desk that is not necessarily in their commercial interest. Without this it is impossible to demonstrate “market use” in isolation, or without parent assistance. Small firms thus rely on larger firms for their market operations and so as currently drafted the section on marketable asset risk is more applicable for larger firm.

It is essential that there is proportionality in the application of this risk category. What constitutes a liquid asset often depends on the type of firm and its role in the market. Testing the market for inactive small firms may be dangerous sending the wrong signal to other market participants. Thus, in order to consider marketable asset risk small firms who are seldom active in markets should only be required to research market prices periodically rather than actually executing trades.

As mentioned elsewhere, it also needs to be made clear that assets other than those eligible for inclusion in the proposed liquidity buffer have liquidity value in many circumstances. In particular in countries whose government debt is not rated AAA, that type of debt is a reliable source of liquidity for that country’s liquidity exposures.

Accounting principles will need consideration. Generally, assets held for liquidity (especially by smaller firms) are held to maturity and accrued. Turning them over to demonstrate market use will force them into either holding them for trading purposes (where they will cause volatility in both P/L and capital; or making them available for sale (where they will cause volatility in capital). Perhaps such assets held for liquidity (again especially for smaller firms) should be allowed to be held as loans and receivables to avoid these accounting issues.

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

Bulk asset sales of some of the asset types listed under non-marketable assets are possible in the normal course of business, and some stressed situations.

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

The definition of this risk category ignores the volume and concentration of funding sources. Firms should also be encouraged to consider the historical behaviour and reliability of funding sources.

Also, the FSA needs to acknowledge that small firms have fewer opportunities to diversify as they typically have a more limited group of counterparties with whom they have funding lines. Again the FSA needs to implement a proportional application of this risk category.

Q45: Do you agree with our view that firms need to maintain an adequate buffer of high-quality unencumbered liquid assets?

In principle the answer is yes. However, it is not the only prevention. The FSA needs to have discussions with firms to consider firm specific aspects that are addressed in firm internal models to identify an appropriate liquidity buffer while also considering further capital measures and risk mitigants in place. We also welcome the FSA's intention to introduce the liquidity buffers in a timely manner so as not to interfere with a firm's recovery from current market stresses.

Do you agree with our counter-cyclical approach to individual liquidity guidance in this regard?

There is an overall problem with the approach. In good times, the size of the liquidity buffer will diminish the profitability of firms and hence impact adversely on economic activity. This may smooth the impact of an economic crisis but lengthen the recovery period. A broader approach is needed, for example have a sliding scale of weights for asset classes rather than an on/off approach (i.e. as with the definition of Risk Weighted Assets under Basel I).

There are varying views in the industry. Some think it makes sense, to a limited degree, to reduce the size of the buffer in relaxed times in order to improve the economic performance of a firm and hence to create reserves for any upcoming stressed conditions. An early warning indicator system similar to what is proposed in the BCBS paper could be used to increase the buffer back to target size ahead of any distress materialising. The pre-condition would be a disciplined ramping up of the buffer in case conditions in the markets worsen, as measured by the early warning indicator system. In contrast other firms take the view that firms should be stock piling in good times in order to have liquid assets readily available in bad times. In any case the consensus is that the buffer should be a fluid number/amount.

It is important, particularly for the first ILAA and SLRP that there is time to discuss the respective results before ILG is issued. We note that the FSA will take into account the stress conditions that a firm finds itself in. This will be particularly important during 2009 if the current market stress continues.

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

While agreeing in principle, the application should be sparing and proportionate, especially in the use of section 45. The approach only makes sense if the FSA acknowledges differing business models and takes a flexible and proportionate approach.

We view the ILG as a national approach to liquidity risk management, which may not benefit international firms. We would urge the FSA to collaborate with other regulators on global standards.

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

We are not convinced of the need for a separate Liquidity Risk Publication. The substance could be included in the Financial Risk Outlook.

We would also urge the FSA to keep liquidity information confidential. Any aggregate results would have to be viewed with an understanding of both individual firms and aggregate activities for the industry. Otherwise, the risk of misinterpretation can undermine confidence in the industry.

Chapter 5 – Quantitative standards for simpler firms

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

We feel that the challenges for simple business models have been described very well in Chapter 5 of the CP, however we are more concerned with the definition of simple firms in this Chapter. The current definition restricts the eligibility criteria to those stated in the draft Handbook Text under BIPRU 12.6.6 which essentially only allows building societies to apply the simplified buffer. It thus ignores a whole range of other simple banking models that are similarly risk averse in their business models but face similar challenges in terms of cost, resources and access to central bank facilities. As we point out later in Chapter 9 we are concerned that the current cost benefit analysis largely ignores and dismisses the cost for small firms as insignificant. Although the FSA may consider the cost of implementation for small firms as low in the total scheme they are relatively very significant for small firms in that they may make their business models unsustainable, leading to firms closing their businesses and/or migrating to other financial jurisdictions.

We therefore propose that the scope for simple firms be widened so that small firms with for example retail or trade finance focus have the option to perform a simplified ILAS, apply the standardised buffer or be classified as “non-ILAS”. A simplified ILAS would be of attraction to many small firms.

A simplified *ex-ante* ILAS could for example look at idiosyncratic risk scenarios only. We suggest that the supervisory dialogue with the firm in the SLRP/ILG process could help determine whether a simplified buffer or an ILG is appropriate.

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

We feel that the criteria are too narrowly drawn and have the effect of inflicting the full ILAS requirements on small and less complex firms, when we would argue that, for example, their lack of concentrated term exposure to the UK residential property market could make them intrinsically less risky than mortgage banks in terms of liquidity. The effect is to impose on such small firms costs that are disproportionate to the risks they represent to the FSA's objectives and we would wish FSA to review the criteria to correct this and to consider a firm's eligibility for the standardised approach on a case-by-case basis.

Also, we do not feel that it is satisfactory sufficient enough for the FSA to say that they will consider adopting a standardised approach later (5.15) when a simple firm will have had to incur the costs of compliance with the full scope of the regime in advance.

As stated above we suggest that the scope for simple firm definition be widened. To this end we suggest the following amendments to the draft Handbook Text under BIPRU 12.6.6

(1) …..secured on residential property or by *exposures* of less than twelve months maturity to *institutions*.

(2) Its assets and liabilities are denominated predominantly in sterling

There should also be the ability on a case-by-case basis for firms to operate the simplified ILAS approach with the agreement of FSA notwithstanding that they may not meet one or more of the above criteria.

As discussed above, small firms would like to have the option to adopt either the simplified buffer or a simplified ILAS treatment – at this stage small firms are being disadvantaged by an essentially uncompetitive treatment.

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

With regard to the composition of the liquidity buffer we questioned why Gilts and government-guaranteed CDs are not included. Central bank balances also appear to have been excluded and this raises another point regarding small banks' exclusion from eligibility to make deposits with the Bank of England, which is worth noting here again.

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

On a brief examination, it appears that small firms could operate with a standardised approach that consisted of the liquid assets buffer (assuming it is expanded as above) being 5% of client deposits <90 days maturity.

It would be a good practice to review the size and composition of the buffer, in order to make sure it appropriately reflects the risk taken respective of the cost of holding this buffer. We therefore ask whether the FSA is over time prepared, on a case by case basis, to adjust a simplified approach.

In terms of the defined threshold we would like to know how the ratios currently proposed where derived at i.e. 5% of retail deposits and 25% of undrawn commitments.

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

Maturity transformation is the fundamental business of banks, so this will reduce general lending in line with the amount of retail funding available. The divide between retail and wholesale is blurred, as the borrower's wholesale can be the lender's retail funds.

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?

Only recognising bills of less than three months will result in costly turnover, as bills with less than two weeks to maturity will have to be sold to be replaced with new bills of one month or more to maturity. Gilts of a longer term (in comparison to the overall asset maturity profile) funded by longer term liabilities will provide better liquidity.

Recent feedback on primary and secondary markets for UK and overseas Treasury Bills has indicated that the UK Treasury Bill market is actually not very liquid at the moment. This could have profound impact on this regime as smaller firms cannot access Bank of England facilities while we are sure that Treasury Bills are entirely satisfactory collateral for funding/liquidity purposes.

Small firms may be disadvantaged (or even illiquid), if forced down the route of holding more of these instruments, without complementary facilities elsewhere. There is a real danger for simpler firms liquidating Treasury bills in that they may have to take a sizeable discount in order to sell it. More importantly, such action will signal distress. And the process of doing so, for a typical small firm will also involve both credit and operational risk. Simpler firms should be allowed to hold Gilts subject to haircuts. Some firms have also argued for the inclusion of government guaranteed bonds arguing that they display greater liquidity than Treasury bills (and Gilts), which are t+1 settlement.

By contrast, mobilising funds from the sale or repo of Treasury Bills - especially for a small firm that does not deal in them regularly will take a little time; the firm has to find a counterparty actually willing to deal, and arrange for the cash proceeds to be remitted with good value to the clearing bank account where they must then sit ready to meet cheques due for presentation. There is potential both for delay and error, so increasing operational risk.

We recognise that the small firm takes a credit risk on its clearing bank(s). That is unavoidable, and will be controlled through the large exposure limits under the CRD amendments. Even where liquidity is initially held in the form of Treasury Bills, when these are liquefied, the firm faces the same credit risk as the proceeds have to flow through the clearing bank account. There will be at the very least an intra-day risk, but most likely the risk will extend for several days until the withdrawal cheques are presented. So if the intention of the Treasury Bill buffer is, inter alia, to eliminate credit risk on firms this will not be achieved.

Also, since many firms will continue to hold some of their liquidity at call with their main clearing bank to facilitate access for both wholesale as well as retail maturities they should be allowed full credit for this in the calculation.

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?

We agree smaller wholesale firms have diverse liquidity business models; however we do not agree that these are intrinsically more risky than building societies. Therefore, we do not agree that it would be imprudent to apply a simple ratio. It simply means that other appropriate benchmarks and measures need to be developed to identify simple wholesale firms and apply appropriate simple ratios.

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

Smaller firms are constrained by both human resources and technological infrastructure. As pointed out in Chapter 9 we find that the cost for implementing the ILAA are disproportionately high and may jeopardise the viability of the small firms business model.

We therefore suggest that it would be appropriate to either allow for a simplified ILAS or buffer ratio. The ILAS should be reviewed together with the ICAAP in supervisory review, except for branches as capital is not held.

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?

The concept of an ILG and a suggested liquid asset buffer is useful as a benchmark and guidance. However, we believe that a 'comply or explain' approach be taken by the FSA for the implementation of the liquid asset buffer. For instance when a firm finds that the suggested liquid asset buffer diverges significantly from its internal models it would be appropriate to have further discussions with the FSA to present evidence for a more appropriate liquidity buffer which meets the use test.

We are not convinced that there should necessarily be 100% protection against the idiosyncratic shock, depending on its severity and duration. Also, we do not understand the ranking of full protection against the idiosyncratic shock but only substantial protection against the market wide scenario. Due to cross contamination the opposite ranking would appear more sensible.

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

We welcome further clarity on the eligibility of reverse repos, which are a legitimate tool for raising liquidity, as well as government guarantees and other assets i.e. cash and precious metals, that are eligible as normal overnight central bank collateral. To be a real buffer, these assets also have to be funded with medium to long term unsecured liabilities.

Further, the current exclusion of some foreign government debt appears to be unfair to firms that base their business model on foreign emerging market countries. Thus, we suggest that firms with an operational presence in specific countries outside the G8, EU and EEA should be able to include respective government bonds of those countries in their liquid asset buffer, i.e. especially countries such as India and Singapore who have a high credit rating. Perhaps ratings could help identify comparable quality government guarantees or haircuts be applied to lower quality government assets on a case-by-case basis.

Furthermore, we are concerned with the exclusion of eligibility for the standardised buffer ratio because a firm has foreign currency assets or liabilities. Especially where currency balances are small would it be illogical to exclude firms. There is a 30% maximum for wholesale funding, so it would be helpful if a similar, albeit smaller, threshold could be agreed for foreign currency exposure.

It would make more sense to align liquid assets with currency balance sheet exposure. This would then align itself with the IIF's recommendation that:

III.2: Firms should mandate that assets held to back their liquidity positions need to be dimensioned in relation to the anticipated liquidity and currency denomination of such assets and with respect to the reasonably anticipated depth and sustainability of the money markets and capital markets. Portfolios held for such purposes should be well diversified by type of instrument and counterparty. The assessment of assets held primarily for liquidity purposes should not be established solely on the basis of credit ratings. Reporting should keep senior management and relevant control functions apprised of risks associated with assets held for liquidity purposes.

Similarly, it would be useful to consider whether a wider range of assets could be considered, e.g. highly rated firm and supranational paper with an appropriate haircut. This will ensure the buffer operates across different liquidity scenarios and avoids concentrations in government instruments. Indeed by limiting the assets that can be contained in the liquid assets buffer as proposed there is a risk that there is an excess exposure to government debt.

Chapter 7 – Group-wide management of liquidity

Key issues in this section:

Waivers: We have a number of questions with respect to waivers which we hope will be addressed by the planned FSA CP on waivers and transitional arrangements. Our questions/concerns are touched on below but relate to: matters of timing, what preparation would be needed, how could comfort be gained by the FSA where not all requirements relating to the home state regulation are met, how does it fit with ILAS review, and scale of implied costs of compliance/lack of use test. We urge the FSA to explore these questions in the planned Transition CP or through a FAQ website..

Legal certainty: we would like to understand/discuss with the FSA whether the ring fencing or "self sufficiency" of an EU or 3rd Country branch is legally viable in the event of the wind-up or insolvency of the "parent" entity. We understand that the FSA's view of overseas branches of a UK firm is that these branches have no legal personality that is separate from their parent firm and their liquidity flows should be included in the UK firm. We do not think that this approach is entirely consistent with the FSA's view of EU or 3rd Country branches in the UK.

International Dimension:

- We are keen to encourage greater international consistency and coordination and to avoid overly stringent and non-coordinated local approaches that create complex and potentially conflicting requirements on firms.
- We are interested to understand whether the FSA has explored the prospect/impact of other jurisdictions adopting the approach taken by the FSA in this CP? We are concerned that home state supervisors may regard the FSA's proposals as having an extraterritorial effect and that this may lead to reciprocity issues. However, a postponed implementation of the FSA's planned regime to be in conjunction with a college of regulators abroad would level out the playing field, and simplify the waiver process, as the home system would meet the FSA's standards.
- It is important that the FSA is aware that the potential cost burden on firms could be extremely high. For groups with non-UK parents the costs are sufficiently high to cause firms to consider whether to retain subsidiaries or branches in the UK. One illustration of this point is that demonstrating market use for the stress-test requires the UK entity to be active in the relevant market. Many branches or subsidiaries will not have trading desks set up as the cost to do so would be prohibitively high. Presumably, the UK entity's Head

Office dealing in the market in the UK entity's name would not be acceptable to the FSA as it does not demonstrate the independence of the UK entity.

Note: As we point out in our reply to Chapter 9 we are of the opinion that the costs would be significantly higher than the estimation made by the FSA in the CP.

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?

We understand clearly the FSA's need to be able to assess and guard against damage to UK depositors and investors in the event of an institution having become a "gone concern". Nonetheless, if a firm or group must manage its liquidity on the basis of a "gone concern" assumption then it will be operating to extremely conservative norms. Firms will not interpret "self sufficiency of UK entity" to mean the same as "able to extinguish all claims in the event of bankruptcy."

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?

The term "having equal regard" is very strong. We presume it means that the FSA wishes to facilitate an outcome where depositors and investors of the whole group will be treated on a pari passu basis with no detriment to the depositors and investors located in the UK.

We agree that liquidity measuring, monitoring and reporting at the entity level is beneficial to the industry. However, a large proportion of firms do not believe that liquidity management is optimised through measures to establish liquidity protection for component entities of a group. For some holding liquidity buffers in the UK entities and possibly other entities as similar requirements are established in other jurisdictions, may reduce the availability of intra-company funds to meet local liquidity needs.

Reciprocity and relationships with other regulators
It is possible that other regulators may see the FSA's approach as having a potentially damaging impact on their own interests. We do not know the extent of the FSA's discussions with its peers and whether the "ring fencing" precepts of the CP are commonly held internationally, and likely to be applied more widely, but we think there is an important issue of potential reciprocity to be considered here. If other jurisdictions see the UK regime as being damaging to their own objectives, or if the UK proposals are felt to have extra territorial impact, then they may establish protective measures of their own. From the industry perspective this could lead not only to multiple trapped pools of liquidity, but even more complex and potentially conflicting requirements being imposed on the whole group.

In general, if the UK branch holds high quality liquid assets (certainly also acceptable in the head office's home market), the Head Office will probably also have to provide the additional funding to the branch to cover these assets. As these assets have to remain in the UK branch, and cannot be lent back to the Head Office for group liquidity, real liquidity in the form of unsecured liabilities will be trapped in the branch.

In terms of "optimising" group wide liquidity management, and related to the reciprocity issue noted above in the previous paragraph, we wonder whether the FSA has considered the implications of the FSA approach being replicated in other jurisdictions and whether this would be detrimental (or not) to the position of the UK market, both depositors and investors. Would the FSA be willing to accede to similar demands from other regulators in instances where the FSA is the home state supervisor? We note that some overseas jurisdictions (for example Australia, Netherlands, Hong Kong, Singapore and Switzerland) are already applying liquidity reserves in the form of pools of high quality assets; and simplified stress testing requirements. Therefore, in line with this, and acceptable regulatory standards, is there an opportunity for a simpler, lighter waiver?

Common international standards to enhance group liquidity management
With respect to enhancing global standards of group wide liquidity management, we would support progress towards an internationally agreed "common language" for the reporting of liquidity risk to understand liquidity across the globe. We are aware that CEBS has already begun some work in this area and we would welcome progress at EU and international level.

Branches
One particular aspect of international liquidity management of groups is that of branches and we are anxious to understand more fully the position of branches in the UK. Although a branch does not have a legal personality that is separate from its "parent" firm, the FSA has indicated that branches will need to be self sufficient if a waiver is not granted. It is not clear to us whether, in the case of the failure of the "parent" firm, it is technically possible to ring fence or safeguard the assets of the branch. In other words, in a winding up scenario, we are unsure that there can be any meaningful effect of the FSA's self sufficiency requirement. For EU and EEA branches, the Winding Up Directive for Banks puts the responsibility for liquidation with the Member State where the institution has its registered office, and will thus be governed by a single bankruptcy law (Directive 2001/24/EC). This would negate independence of the branch of a EU/EEA domiciled firm. This is consistent with the home country control principle that is the basis for the banking directive 2000/48/EC. We urge the FSA to engage in an international dialogue such as through colleges of supervisors to mitigate these cross-border concerns.

Regarding branches of non-EEA firm, some ring-fencing may be practical with insolvency proceedings in the UK, but in theory, UK insolvency law does not recognise ring-fencing for the benefit of local creditors. If insolvency proceedings are started in the country of the registered office, the local liquidator may not recognise UK proceedings, and in any event there would be extremely complex legal conflicts.

The FSA has indicated that overseas branches of UK firms are captured by the UK liquidity regime as part of the (UK) whole firm, rather than individually. For non material overseas branches this leads to IT and ongoing operational challenges that are disproportionate to any value gained by the FSA and firms involved from their inclusion. Currently the question of materiality of overseas branches and proportionality of applying the UK regime to them is not considered in the CP.

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

We agree and accept, as we have in the past, that there is a need for a fundamental review of the liquidity regimes in place in the UK and we recognise that such a review will also need to consider the group dimension. It is a supervisory responsibility to assess the appropriateness of group management of liquidity.

Not all firms agree, however, that the regime as set out by the FSA in CP08/22 is necessarily appropriate to meet the needs either of the industry or indeed of London as a financial centre. Some firms that are established in the UK as EU/EEA full branches oppose the FSA's proposed group regime for liquidity as Head Office protection should be sufficient for the FSA. Non-EEA branches or subsidiaries may or may not "conditionally support" the regime once further details are available.

Re questions 61, 62, 64: ***More information needed on waiver process***

Our responses to these individual questions are prefaced by the acknowledgement that we are awaiting the FSA's forthcoming CP on waiver and transitional provisions. For example, in the US, under the National Depositor Preference statute, the Federal Deposit Insurance Corporation (FDIC), as receiver, gives preference to deposit liabilities at the US offices of the firm over deposits at the non-US offices. In circumstances such as these, further guidance is needed from the FSA on whether, or in what circumstances, waivers / modifications may be obtained. We accept that the FSA will not be in a position to comment on all the specific individual issues that may arise, such as the US/FDIC example we have cited, but an indication of how the generic issue would be approached – i.e. likelihood of waiver when the home state has a strong regime that gives preference to local depositors – would be very important to help firms understand how to approach their regulatory dialogue.

However, we are conscious and presume that the FSA is also aware, that the home regulator may not be ready or willing or due to local legal restrictions even able to offer a speedy response to enquiries that are necessary to put the waiver in place. This factor alone would affect (potentially materially) the amount of time that a waiver process might need and therefore raises the consequent question of a transitional arrangement. There may be cases where the local regulator is unable to comply with the FSA's requirements, but the branch itself is also unable to fulfil the required conditions for independence, resulting in possible closure.

At present firms do not feel that there is sufficient information on which to be able to take a proposal to their home state regulator in order to prepare the home supervisor for the discussions that would be necessary to hold with the FSA should the firm apply for a waiver.

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?

Please note our comments above in respect of Questions 61, 62 and 64.

We appreciate that the FSA has made it clear that waivers cannot be granted unless there is, in effect, an approval by the home state regulator for arrangements required by the waiver.

However, we are concerned by potential issues that might arise in terms of interpretation of equivalence. It is not clear to us at this stage how the FSA would plan to assess the equivalence of an overseas supervisors' liquidity regime, nor what the demands on the home state regulator would be. If the home state supervisor were to apply a very different regime – for example approving models of liquidity – would that be acceptable to the FSA? Or would the home state regime have to mirror the FSA regime much more closely than that, for example, in granting a waiver, would the FSA expect to see identical stress tests applied at the group level to those applied to UK entities not subject to waivers?

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?

Please note our comments above in respect of Questions 61, 62 and 64.

The decision to apply for a waiver will imply a considerable cost for firms in terms of ensuring compliance with the FSA's requirements for daily information on group liquidity. This means that the decision to apply will not be made lightly by any firm, branch or sub group. This reporting requirement could be substantial enough to dissuade firms from applying for waivers altogether. We believe a more fruitful approach would be to achieve common global reporting liquidity standards. We would therefore encourage the FSA to work with the international regulatory community to develop common reporting standards for liquidity risk. This would serve to enhance global systemic risk control.

We would be grateful for clarity on some of the wording used in the CP. For example, in relation to reporting requirements as condition for waivers, the FSA refers (at different places) to the need for reporting to be either “in a format determined by us” or “in a format acceptable to us”. It is not clear whether the FSA intends to require all non-UK reporting to be specified identically to the reporting within the UK, or whether the FSA intends to scrutinise the group level reporting to determine whether this would be acceptable to FSA needs.

If the FSA were to insist on specifying a reporting format identical to that used in the UK, it is possible that the home state supervisor would regard this to be an extra territorial imposition. However, from the firms’ perspective there would be the potential need to duplicate group wide reporting with all the consequential impact on reporting systems. This would be a non trivial project and the costs would be significant. For some firms, this FSA style reporting for a branch will drive the implementation of much more expensive IT solutions. Moreover, the reporting to the UK FSA would fail the “use test”.

We also note that if a firm agrees to provide whole group information in FSA specified format, in order to obtain waiver/modification then this potentially sets a precedent for other regulators. Taking the example to its logical conclusion major groups might find themselves faced with a multiplicity of group reporting requirements on multiple formats to a multiple of regulators. Greater consistency of approaches between regulators would be highly desirable in this case – whether an agreement to use standard reporting for liquidity or for regulators to be willing to accept the formats demanded by their peer group.

In addition, some of the proposed FSA reporting presents a practical challenge for branches. For example under ISDA master agreements, the ”parent” firm is the contracting entity, and under the CSA, net exposure is calculated at the (“parent”) entity level. Thus, reporting collateral at the branch level does not reflect legal reality.

While firms will be using contractual cash flow information for internal liquidity management purposes, the FSA EMR format as currently envisaged has different levels of granularity and time horizons. Internal reports focus on material flows and a shorter maturity than the EMR. These factors, and the complexity of transforming data into FSA format, mean providing such firm wide information to the FSA in the EMR format will be a very major undertaking.

Where a branch is subject to competent home state supervision of liquidity, we question whether this substantial additional cost would be proportionate given that a branch has no legal personality that is separate from its parent firm, and the FSA could have oversight through other means. (Such oversight could be obtained through the firm’s internal reports, reports supplied to the home regulator, and meetings with the firm to discuss branch liquidity as part of routine FSA supervision.) Given the above, we believe that the FSA should only require information “in a format determined by us [FSA]” if there are very serious deficiencies in home state regulation of the branch.

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?

This question is not one of policy formation, but of legal certainty and enforceability. We are not completely clear what the FSA is envisaging when it talks about an indemnity. Our view is that a commitment from the parent to a subsidiary could be legally enforceable (with the caveat below). However, as a UK branch does not have a separate legal personality from the overseas parent as a matter of strict English law a commitment from parent bank to a UK branch would not be "legally" enforceable as technically a legal personality cannot contract with itself (although in some firms' structures another overseas entity might be able to be found to contract with). Whether whatever it is put in place would be irrevocable and enforceable will depend on the circumstances in which it is to be relied on – for example, if it is intended to be relied on in a 'gone concern' scenario it would not be irrevocable and enforceable.

Enforceability will depend on the circumstances prevailing at the relevant time and is likely to be subject to qualifications in the event of insolvency of the parent. The nature and extent of the qualifications will obviously depend on the insolvency laws applicable to the parent and any relevant branch. We are of the view that, if one of these "certain events" is the insolvency of the parent, an obligation to dispose of assets in favour of a separate legal entity is likely to be difficult to enforce.

Also, would firms expect the FSA to agree to a UK parent entity providing an indemnity of this nature to an overseas subsidiary or branch? For example would firms ask the FSA to show reciprocity? In this regard it will be important for the FSA to consider its reaction to foreign regulators insisting on a similar regime from them and the UK firms.

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

The FSA has clearly indicated that the granting of whole-firm liquidity waiver/modification or intra-group liquidity modification will be subject to continual review and that the decision to grant a waiver will not be "once and for all time."

We note that the ability of the FSA to carry out this review is dependent on the cooperation of the home state regulator. It is not within the control of the supervised entity to determine whether or not the home state regulator will be willing to offer annual (or timely) confirmation of the home state regulator or to agree to an annual meeting with the FSA. Therefore we are keen to understand the extent to which the FSA has discussed its proposals with other regulators and received assurances that the conditions stated in the CP for waivers or modifications to be granted can be achieved. It would be, in our view, inappropriate for the FSA to be in the position to offer the possibility of granting a waiver when it does not know whether the conditions attached to that waiver would ever have the prospect of being achieved.

Further Issues for the FSA to consider:

(a) Waiver processes

- There is insufficient clarity on the waiver application process. It will be helpful if the FSA will clarify the timeline and the order of the waiver application submission (i.e. should waiver application be submitted prior SLRP and ILAS?). What is the "default" state? Whilst firms are waiting for approval of their waiver, what would they have to do? Will they have to aim for full compliance with independence in case the waiver is declined? This would, of course, make seeking a waiver pointless.

- Can there be simplified waivers for UK subsidiaries of no systemic risk and simple structure?

(b) Macro issues

- We note that branches can be providers as well as recipients of liquidity with their Head Office and other group entities. The new proposals will prevent these flows being on the same basis internationally – or perhaps not possible at all.

- For some countries, allocating liquidity or capital from the Head Office to a UK - branch could affect the country's balance-of-payments

- There may be tax (and therefore cost) implications from the provision of additional liquidity or capital to a UK entity.

Specific Comments on Chapter 7 and Draft Handbook Text (noting that several of these points may usefully be included on the CP on Transitional Provisions):

Meaning of "Suitable undertaking" In paragraph 7.34 the CP text notes that "the parent will enter into a suitable undertaking with the firm committing the parent to provide liquidity support." We require further clarification from the FSA on 'suitable undertaking' definition, specifically whether the FSA is looking for a legal agreement between parent and the subsidiary. We would also need to understand the timeline the FSA would impose between, putting in an application, the FSA requesting some form of legal agreement, and the firm having to comply with this requirement – it would appear from the process that there is such a tight timeline between finalisation and implementation, that there will be insufficient time (and resource on the FSA side) for there to be adequate discussion and negotiation of plans between the firm and FSA.

Reliance on parent undertakings. We believe that there is a contradiction between 7.24 of the CP text and the proposed Handbook BIPRU 12.8.4. Paragraph 7.24 talks about intra-group liquidity modification, whereby it modifies rules for firms, such as 'subsidiaries of foreign banks and investment firms, to allow the UK firms to rely on their parent undertakings to meet local liquidity requirements'. BIPRU 12.8.4 refers to intra-group liquidity modification 'where a firm wishes to rely on liquidity resources from an entity in its group other than a parent undertaking'. The BIPRU text needs to be amended allowing firms to rely on their parent or any other group entity.

References to branches and subsidiaries. As a more general comment BIPRU 12 seldom refers to the UK subsidiaries; most of the time it talks about UK branches. We feel that a distinction between branches and subsidiaries should be made/clarified.

Reporting Requirements. In the CP text paragraph 7.21 (Reporting) states: '….where reporting requirements are waived or modified, we would expect to receive data on the liquidity of the whole-bank, parent undertaking and /or group …' We would like the FSA to provide further guidance on the information required (i.e. qualitative or quantitative) and how detailed that information has to be. We feel if the reporting requirement for a parent will mirror the individual reporting requirement, the benefit of applying for intra-group modification will be lost as the individual firms will not have sufficient information/resources to comply with the FSA requirements. Further the extent to which a parent is meant to reflect how it factors in the operations of a subsidiary should reflect the relative size between the two entities – again, at the risk of being repetitive, a lot of these concerns could be allayed if it was clear that there was sufficient time available for implementation i.e. to allow firms and the FSA to negotiate details specific to its circumstances before the proposed October deadline.

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?

We do not agree. In 9.9 the FSA states that 'UK banks will increase their holding of government securities from an average of around 4.6% of total assets…'. We are trying to analyse what effect there will be in holding the liquidity buffer, however the definition of total assets is quite vague. We would appreciate if the FSA will clarify what 'total assets' mean: (i) net assets (ii) gross assets (iii) including or excluding repos.

As yet, there is no distinction between government securities held as a liquidity reserve (for which term funding is required), and those held for other business such as trading and hedging (for which term funding is not required). Therefore the cost spread in funding the liquidity reserve will be much higher. These spread costs will vary considerably from firm to firm, depending on their ability to raise term funding, and at what price. The extra demand to fund the liquidity reserve will compete with the ongoing need to raise term funding to cover illiquid assets, and thus could considerably restrict a firm's ability to lend to the economy. The benefits of less risky balance sheets may be too high a cost to pay for banks and the economy as a whole, especially if set up in stressed conditions.

The benefits shown in the table attempt to quantify the benefits to the economy at large, whereas the costs to the greater economy are deemed unquantifiable – however as we have seen in the current crisis, the economic costs are turning out to be very high indeed.

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

Yes, some firms will pass on incremental costs. We expect however that a significant number will not be able to do so, e.g. for reasons of competition with foreign (non-EU) firms, and with no offsetting revenues will suffer falls in income.

In other cases there will be a reduced return to shareholders, resulting in a reallocation of their capital, which will result in a reduction in activity and employment in the UK.

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

As firms will be less engaged in interbank lending and more focused on retail deposits we expect to see a greater competition in the retail banking sector for deposits with less diversification in funding. Thus, firms that now share the same retail business model will share the same risk exposures to consumer behaviour.

There will be a reduction in illiquid assets generally, and reduced exposures to ILAA components that would require an increase in the amount of government bonds held as reserve.

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

Yes we agree. Many banks do not have central bank reserves.

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

9.38 - 9.40 talks about cost benefit analysis. We feel that FSA have not analysed sufficiently the cost that will be incurred by small/medium size banks. The cost that the FSA suggests is far greater than any benefit rising from implementing new liquidity regime – especially around the requirement to have a capability for intraday liquidity monitoring and reporting. Therefore, we would suggest that the FSA should review reporting frequency, stress testing and ILAA requirements for smaller firms that have a lower impact on the financial/liquidly stability of the market.

Q88: What do you estimate the implementation and ongoing "other costs" to be for your firm?

This is extremely difficult to estimate, especially until the final rules are produced. Small firm's business models can be highly divergent which results in incremental costs that can cover a broad spectrum specific to the model and as such these are difficult to quantify across the whole range of firms.

For example a firm could be in a position as follows:

Liquidity Buffer: £400mn currently held in securities yielding LIBOR plus will need to be converted into Gilts at much lower yield. If the reduction in yield is 1% per annum then this will cost us £4m p.a.

Administration costs including external advice and systems upgrades are estimated to be £100,000. This is a one time cost.

Subject to the outcome of the ILAA and SLRP, a firm may need to restructure its balance sheet. At worst it may need to reduce gearing by running down its loan book by up to US$400million. Margin earnings are 1% per annum = US$4million (at 1.4355 = £2.8million)

Taken together for this firm would see a reduction of around 22% in pre tax profits: a major "hit" for a small firm.

Another firm however providing liquidity into the wholesale markets as a meaningful part of its business model would be subject to a greater negative impact on the bottom line as the margins in the interbank markets are finer and the demand for Gilts/Treasuries can result in substantive negative yields. The only option in such circumstances would be to stop placing funds into the wholesale markets to the detriment of London as a whole and possibly reconsider the longer term viability of the operation.

There is probably a large spread of small firm models with diverse cost bases and materially differing IT structures. Some may be prepared to run at a loss or on marginal profitability for some time, but over the longer run focus always comes back to profitability.

Q89: Do you classify yourself as having a simple business model?

Not Applicable

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

As illustrated in our response to Question 8 of Chapter 1, the precise impact is currently difficult to determine without the complete details on waivers and modifications.

Also the impact of the FSA quantum of the proposed liquidity buffers will depend on other regulators. There is a danger that the current FSA proposals for liquidity requirements, if unmatched by overseas regulators, will differentiate the UK as an unacceptably expensive cost centre for firms and will lead to re-location if other jurisdictions do not follow the FSA suit. We therefore urge the FSA to pursue international cooperation in aligning its liquidity proposals with other overseas regulators.

Furthermore, we find that the current Cost Benefit Analysis does not take into account the significant impact on small firm business models. The current proposals in terms of increased reporting and repo activity require substantial investments and running cost for human and technological resources. The CP does not consider the potential that its new requirements will make small firm banking models unviable which could lead to the closure or migration overseas of these firms. We see the business model of trade finance to be under particular threat.

Therefore we urge the FSA to take a proportionate approach in the treatment of small firms i.e. through a simplified ILAS or buffer ratio.

If other countries introduce comparable regimes, but with lower cost impact, UK competitiveness will be eroded – this is a risk associated with unilateral implementation.

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

We are concerned that the focus on long term deposits for bank funding will result in an increase in the savings ratio which will manifest itself in the contraction of lending and spending.

Depending on whether other regulators follow suit we may see two possible scenarios unfolding:

<u>Other international regulators replicate the FSA's regime:</u> This will enhance the impact stated above where the global economy will see an increase in savings over spending. With less international wholesale lending we expect to see a further decline in spending and international trade.

<u>Other international regulators do not replicate the FSA's regime:</u> We will expect that the UK will lose out as a global financial centre in terms of firms and capital moving outside of the UK.

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

Yes we do. It encourages good practice and raises the profile of liquidity risk management amongst senior management and board levels.

Q93: How much more stable do you believe the new regime would make your firm?

We believe that this will depend very much on the metrics. It is essential to identify and price the liquidity risk in terms of formulating the right quantum for the liquidity buffer.

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

Reducing the risk of systemic crises will depend on many factors. Among these factors are central bank involvement, quality of supervision and quality of individual firm risk management.

Q95: By how much do you believe the new liquidity regime will improve your firm's management of liquidity risk?

To a certain extent the new regime will achieve a greater focus on liquidity risk management and raise its profile among board and senior management. The new regime reflects many of the improvements already made in the measuring and managing of liquidity risk.

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?

We believe greater international consistency and coordination of liquidity risk management supervision would lead to a more cost effective solutions for our larger internationally active firms. Please refer to our key messages on the international context (page 1-2). Greater international consistency will deliver significant benefits for the regulatory community.

As pointed out with respect to simpler firms, we find that the cost could be further significantly reduced without lowering the benefits by taking an increased proportional approach in some areas. Please also refer to the impact on simpler firms and overseas branches in our key messages (page 3-4).

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?

We agree.