



## Key Contact

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*“... senior management must adopt a sound approach to liquidity risk management...”*

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# STRENGTHENING LIQUIDITY STANDARDS

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## Overview

**It is widely recognised that future regulatory approaches must place greater focus on prudential risk management. Part of FSA’s response to this includes its proposals in relation to liquidity regulation in the UK set out in CP 08/22 “Strengthening Liquidity Standards”. The proposals are far reaching and robust and will impact on all BIPRU firms and UK Branches of certain EEA and non EEA banks.**

## Background

The proposals consider not just the levels of liquid assets held but also additional systems and controls and reporting requirements for all BIPRU firms, enhanced modelling and focus on individual group entities. FSA has increased its expectations on the senior management of firms to adopt a sound approach to liquidity risk management to ensure every firm is self-sufficient for liquidity purposes.

## Structure of new liquidity standards

The FSA is proposing both qualitative and quantitative frameworks so that firms can develop policies to address liquidity risk and stress test their contingency funding plans. It also proposes introducing new liquidity reporting requirements. There are five key areas of the proposed policy all of which will be relevant to Full Scope firms. Limited activity and limited licence firms will be subject to the first three areas.

### 1. *Adequate Liquidity and self sufficiency*

The two principles in this area will be that all FSA regulated entities must maintain liquidity resources and limit liquidity risk and also that they must not rely on other parts of their group for liquidity purposes unless the FSA has given its express prior permission otherwise.

### 2. *Systems and controls framework*

The new systems and controls requirements to be implemented will be in addition to the current rules within SYSC. These requirements will also apply to UK branches of certain EEA and non-EEA banks. Firms will be required to have in place a robust liquidity risk management framework which includes proportionate and effective systems and controls to identify, measure, monitor and control liquidity risk.

### 3. *Reporting*

The FSA are pre-consulting on a new reporting framework for liquidity. The aim of the new reporting is to enable FSA to form views on liquidity risk exposures and it will consist of both quantitative and qualitative reporting.

*“...further emphasis is placed on the importance of stress testing...”*

#### **4. Individual Liquidity Adequacy Standards (“ILAS”)**

The ILAS part of the new regime will only apply to UK banks, building societies and full scope BIPRU investment firms. This will be a quantitative framework for liquidity management and is based on firms being able to survive liquidity stresses both in normal and in stressed times. ILAS has two components; an individual liquidity adequacy assessment (“ILAA”) which imposes a requirement on the firm to review the adequacy of the type and quality of liquidity resources it thinks it should hold against the sources of liquidity risk; and a supervisory liquidity review process (“SLRP”) in which the FSA reviews the results of the firm’s ILAA and issues individual liquidity guidance (“ILG”)

#### **5. Group-wide and cross-border management of liquidity**

The FSA has proposed a new framework to allow firms to deviate away from self sufficiency (heading 1 above) through either waivers or modifications which will need to be approved when the proposed rules come into effect.

It is proposed that all rules will come into force in October 2009 with the exception of those in relation to reporting which may be subject to transitional arrangements.

#### **Stress Testing**

The FSA has emphasised the importance of stress testing both in CP08/22 and in CP08/24 “Stress and scenario testing”. It is applicable to both ILAS and non ILAS firms and aims to address issues identified such as firms failing to consider the length and severity of scenarios of firm and market wide stresses, or failing to consider stresses that may occur at the same time and the impact that this has on sources of funding and liquidity needs.

The FSA has proposed that:

- firms should regularly conduct stress tests to identify sources of potential liquidity strain and to ensure that current liquidity exposures continue to meet the firm’s liquidity risk tolerance. Firms should separately analyse the impact of possible liquidity stresses on cash flows, liquidity positions, profitability and solvency;
- stress and scenario tests should be regularly reviewed by the firm’s governing body;
- firms should design stress tests that consider short term and protracted stress scenarios as well as institution and market wide stress scenarios;
- the results of stress tests should be adequately reviewed both internally and externally and used to establish processes, strategies, systems, internal limits, Contingency Funding Plans and business plans.

#### **Contingency Funding Plans (“CFP”)**

CFP is the follow on step from the stress tests and is the means by which a firm mitigates the risks identified in the stress tests so as to reduce them to fit within the firm’s risk appetite. The FSA proposes to introduce an overall requirement for a firm to have a CFP in place which is approved by its governing body.

#### **Summary**

Whilst the changes detailed above are not yet finalised, BIPRU firms should make themselves aware of the new liquidity standards which will be applicable to their firm. In addition, all BIPRU firms should review their procedures for managing liquidity to ensure that they appropriately capture any potential liquidity stresses through the use of robust stress and scenario testing. Please get in touch with your usual Bovill contact if you need assistance in assessing the impact of these new requirements on your firm.

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