



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

Recent events have highlighted the need for regulators worldwide to place a greater focus on prudential risk management. Part of the FSA's response to this is an overhaul of the UK liquidity regulatory framework, detailed in PS09/16 "Strengthening Liquidity Standards". New rules, set out in BIPRU 12 of the FSA Handbook, came into force on 1 December 2009.

Background

The new rules are far reaching and robust and impact on all BIPRU firms and UK Branches of certain EEA and non EEA banks. They consider not only 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. The 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

BIPRU 12 introduces both qualitative and quantitative frameworks so that firms can develop policies to address liquidity risk and stress test their contingency funding plans. There are also new liquidity reporting requirements. There are five key elements to the rules. All of these will be relevant to full scope firms with net assets exceeding £50m. Limited activity, limited licence and full scope firms with net assets equal to or less than £50m will be subject to the first three elements.

1. Adequate Liquidity and self sufficiency

The two principles in this area are 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.

2. Systems and controls framework

The new systems and controls requirements are set out in BIPRU 12. Firms are 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 new reporting framework for liquidity is intended to enable the FSA to form views on liquidity risk exposures and includes both quantitative and qualitative reporting. Banks, Building Societies and BIPRU Full Scope firms with net assets exceeding £50m are subject to a quantitative reporting regime. BIPRU limited licence, limited activity and full scope firms with net assets equal to or less than £50m will only need to complete an annual systems and controls questionnaire as at 31 December each year, with effect from 31 December 2010.

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4. Individual Liquidity Adequacy Standards (“ILAS”)

The ILAS part of the new regime, which only applies to UK banks, building societies and full scope BIPRU investment firms with net assets exceeding £50m, is a quantitative framework for liquidity management and is based on firms being able to survive liquidity stresses in both normal and 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”). Some ILAS firms with less complex arrangements will be required to complete an Individual Liquidity Systems Assessment (“ILSA”) instead of the ILAA.

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

The FSA has introduced a new framework to allow firms to deviate from self sufficiency (see heading 1 above) through modifications which for existing authorised firms should have already been approved when the new rules came into effect.

The new rules came into force in December 2009. The reporting rules are subject to transitional arrangements.

Stress Testing

The FSA continues to highlight the importance of stress testing. Stress testing is required in relation to liquidity as well as capital. It applies to both ILAS and non ILAS firms and aims to address issues such as firms failing to consider the length and severity of scenarios of firm and market wide stresses, firms failing to consider stresses that may occur at the same time and the impact this has on sources of funding and liquidity needs.

The new rules require 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;
- stresses 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 has introduced an overall requirement for firms to have a CFP in place which has been approved by the firm’s governing body.

Summary

BIPRU firms should already be aware of the new liquidity standards applicable to them and 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.