Financial Services Authority

Guidance consultation

Review of implementation of systems and controls requirements in liquidity regime

Proposed Dear CEO letter

December 2010

Review of implementation of systems and controls requirements in liquidity regime

Dear CEO,

I am writing to you and other chief executives following a review of how firms are meeting our new liquidity rules, to highlight areas of concern and to encourage you to put steps in place to make sure your firm is meeting our rules.

As you know, we introduced our new liquidity regime last year, with changes designed to protect customers, counterparties and other participants in financial services markets from the potentially serious consequences of imprudent liquidity-risk management. The new rules will bring about substantial long-term benefits to the competitiveness of the UK financial services sector, which depends on counterparties' perception of the financial soundness of the firms that operate here.

Improvements needed in liquidity risk management

Our review earlier this year of a sample of firms' new liquidity arrangements found three areas of particular concern, all relating to measures to limit the extent to which failures in liquidity risk management will contribute to any future market-wide stress:

- pricing liquidity risk (FSA rule reference: BIPRU 12.3.15 – 12.3.16)
- intra-day management of liquidity (BIPRU 12.3.17 – 12.3.21)
- management of collateral (BIPRU 12.3.22 – 12.3.25).

I have attached a summary at Annex A, covering some of the common findings as well as the information we expect to see to demonstrate compliance with the liquidity regime. There is also a summary of our review process at Annex B.

Why this is important for your firm

We will be reviewing firms' Individual Liquidity Assessments (ILAAs) over the coming months and we suggest all firms pay attention to the results of our review, in particular the three risk areas mentioned above, when preparing their ILAAs.

Your firm's compliance with our systems and controls requirements set out in BIPRU 12.3 and 12.4 will be a significant factor used in determining the resulting Individual Liquidity Guidance (ILG) we issue your firm.

In the meantime if you or others in your firm wish to discuss the matters raised in this letter, please contact your FSA relationship manager.

Separate work will begin soon to assess the reliability of quantitative liquidity information now starting to be reported to us on the new regulatory liquidity returns.

Appendix A – Discussion of observations

Conclusions from the review:

Overarching liquidity systems and controls requirements

A healthy majority of firms did appear to have an effective, treasury-led, framework in place around liquidity risk. Those firms that failed to demonstrate compliance generally supplied no evidence of having strategies, policies, processes and systems in place relating to liquidity risk. An effective framework can demonstrate that liquidity risks are embedded in a firm's culture and provide a platform for discussion and escalation of risks that firm's will inevitably face.

Governing body and senior management oversight: liquidity risk tolerance

The small minority of firms that failed to demonstrate compliance in this area generally alluded to having a liquidity risk tolerance without actually including it in the information they provided or making it clear how appropriate it was for the firm. A stated risk tolerance is expected to be expressed as a finite metric or series of metrics including survival days under stress and structural ratios as opposed to an aspiration to maintain a "low" risk tolerance. The implementation of Individual Liquidity Guidance as part of the liquidity regime offers an example of what will be required but a firm is also expected to have its own view of risk tolerance.

Governing body and senior management oversight: approval and review of arrangements

The very small minority of firms that failed to demonstrate compliance in this area either did not have a specified forum for reviewing liquidity risk. All firms are expected to have a (minimum) monthly Asset and Liability Committee and have procedures to escalate liquidity concerns to the governing body.

Pricing liquidity risk

Most firms failed to either allude to having in place any process for incorporating liquidity costs, benefits or risks in to their business activities, or if it was mentioned, they did not explain how it was managed or used to influence asset and liability decision making.

In summary, we believe that firms should employ a centrally managed "funds transfer process" that allocates rewards to the part of the business that raises liabilities and charges parts of the business that take exposure via assets. A failure to do so could result in a misaligning of risk incentives and this was undoubtedly a major contributing factor to the onset of the financial crisis in 2007.

The process should attribute the costs, benefits and risks instead of holding the costs at the centre; be applied on a granular level; be applied consistently to on and off balance sheet businesses; utilise automated inputs where possible; avoid using only blended historical and/or budgeted funding costs and allow senior management to consider the marginal cost of funding where appropriate.

A previous thematic review was conducted earlier this year and the results communicated to Treasurers on 5 July 2010: http://www.fsa.gov.uk/pubs/international/ftp_treasurer_letter.pdf

Intra-day management of liquidity

A majority of firms did not give enough evidence that they actively managed their intra-day liquidity positions, especially under stressed conditions.

Many firms that are not a direct participant in a clearing or settlement system simply stated this fact or stated that they were confident that their nominated agent would ensure that payments and settlement obligations are made on a timely basis.

As a minimum, we would expect a firm to have contingent procedures in place to deal with an unexpected reduction in a daylight limit and also an operational failure of their agent. At the point of failure due to a lack of liquidity, history has demonstrated that intra-day payment failure could be the tipping point.

Management of collateral

For a large majority of firms, evidence of active management of collateral was ignored or stated that it was delegated to an operations area. Any firm that is exposed to risks from movements of collateral in cash or securities must maintain the ability to calculate positions and mobilise resources from a central treasury function. For firms engaging in a degree of stock borrow/lend, the necessity to manage collateral is self evident, but even for firms whose only requirement around collateral management is related to derivative exposure, an efficient process is essential to manage counterparty perceptions of liquidity.

Managing liquidity across legal entities, business lines and currencies

Some firms failed to articulate in their information how the interaction within a group structure is managed from a liquidity viewpoint. We found that intra-group funding from subsidiaries is sometimes treated as guaranteed so the risks of liquidity becoming trapped were ignored. This is specifically stressed in the quantitative analysis performed by us in the liquidity regime and firms are expected to have appreciated this aspect.

The use of liabilities in currencies other than that of the underlying assets is common practice but managing access to currencies and the ability to convert them, even under stress, was often ignored. Whilst access to currency flows was largely maintained even at the periods of highest stress in the recent past, the possibility of a lock out on currency markets cannot be ignored.

Funding diversification and market access

The firms that didn’t demonstrate adequate compliance with this requirement failed to show that they monitor the concentrations of particular liability providers or set limits that are actively monitored around the source and tenor of funding. Whilst we do not advocate diversification for diversification’s sake, the ability to monitor sources of liquidity is a basic requirement. Similarly, the ability to raise liquidity from providers can quickly evaporate unless a firm maintains a presence in the market by actively trading across currency and tenor. The ability to establish credit lines in a period of stress proved to be a major challenge for may firms that failed or requested outside assistance.

Stress testing

A small minority of firms failed to supply any policies or procedures around their approach to stress testing.

Of those that did, the FSA guidance was largely acknowledged but there are very few firms employing a degree of reverse stress testing to establish the breaking point or the point at which outside support may be required. What is difficult to assess in a desktop review is the level to which stress testing has informed a firm's approach to liquidity risk management but the SLRP will focus on this area in detail.

Contingency funding plans

Almost all of the sample firms supplied a contingency funding plan that did constitute a usable document in the event of a crisis. A common finding for many plans was that they were apparently prepared for an audience that would never have cause to rely on the directions set out within. An effective plan should be clearly designed for a team of informed managers to monitor signals and take appropriate action in a stigma-free environment. An effective plan should be tested frequently, not just in terms of logistics and communication but also in practical fund raising terms.

Appendix B – What our review found

Chronology of the review

We wrote to all chief executives of firms subject to the new liquidity regime on 13 January 2010 requesting confirmation that the new systems and controls requirements had been successfully embedded within your firm and to outline any remaining actions you needed to take.

In response to this first request, a majority of firms indicated that they were not in compliance. The number of firms attesting to non-compliance with the liquidity standards was disappointing and those firms have received a follow-up letter setting out the requirement for compliance and the possible sanction for non compliance.

For firms that confirmed they were in compliance, a follow up letter was sent to a sample in June 2010 requesting further information about the arrangements they have put in place to comply with our liquidity standards (BIPRU 12.3 and 12.4). Specifically, they were requested to provide:

- Board approved Liquidity Policy
- Board approved Stress Testing methodology and protocol (to include the Stress Testing Policy if separate from the Liquidity Policy) along with the assumptions used to drive the stress testing, and copies of the stress testing reports and MI used by the firm
- Board approved Contingency Funding Plan
- Board approved Terms of Reference for all liquidity management and governance committees/ sub-committees in place and having direct or indirect responsibility for liquidity management challenge and oversight

We reviewed the information, comparing it to the requirements, as defined by the Rules in BIPRU 12.3 and 12.4. Following this we made an assessment of each firm based upon 10 areas of risk:

- Overarching liquidity systems and controls requirements
- Governing body and senior management oversight: liquidity risk tolerance
- Governing body and senior management oversight: approval and review of arrangements
- Pricing liquidity risk
- Intra-day management of liquidity
- Management of collateral
- Managing liquidity across legal entities, business lines and currencies
- Funding diversification and market access
- Stress testing
- Contingency funding plans

Whilst the rules apply equally to every in-scope firm, we were careful to employ an appropriate degree of proportionality and context for the assessment. As such, where it appeared to us that a firm was failing to comply with our rules, this was often due to an outright lack of acknowledgement of the Rules as set out in BIPRU 12 or a failure to demonstrate enough consideration of the requirements of the Rules.

Observations and findings

On the basis of the assessment as set out above, again even amongst those firms purporting to comply with the new rules, we found that the vast majority fell substantially short of our expectations: the information provided did not constitute sufficient evidence to demonstrate that firms were in compliance with all of the 10 risk drivers.

Three risk drivers were particularly poorly addressed in the information reviewed, namely:

- Pricing liquidity risk (BIPRU 12.3.15 – 12.3.16)
- Intra-day management of liquidity (BIPRU 12.3.17 – 12.3.21)
- Management of collateral (BIPRU 12.3.22 – 12.3.25)

A compounding fact is that the failures represent the three specific areas of liquidity risk management that were added to the liquidity regime when BIPRU 12 replaced SYSC 11 for liquidity risk as set out in Policy Statement PS09/16 in October 2009.

Furthermore, we had formed the impression during the consultation period prior to the implementation of the regime in December 2009 that firms had acknowledged the relevance of all of the risk drivers included in BIPRU 12 and that firms recognised the need to change behaviours in order to limit the extent to which failures in liquidity risk management will contribute to any future market wide stress. Clearly more needs to be done for firms to focus on the changes required under our new liquidity regime.

A more encouraging picture emerged around governing body and senior management oversight in relation to liquidity risk tolerance and the approval and review of arrangements. Information provided in relation to stress testing and contingency funding plans also demonstrated a more satisfactory result. Evidence of management around overarching liquidity systems and controls, managing liquidity across legal entities, business lines and currencies and funding diversification and market access was also reasonable.

Firms who we have assessed to not be in full compliance are being required to take remedial action. This has been added to their FSA risk mitigation programme (RMP) and we will monitor this through our close and continuous supervision programme.

We expect all firms to be in full compliance with our requirements in accordance with the RMP and may undertake review work, or ask other parties to undertake reviews to confirm this is the case. Where firms have not taken the appropriate action we will consider a range of sanctions including Enforcement action.