

Regulatory Masterclass: Liquidity risk compliance

Liquidity risk management strategies will have to be reviewed and upgraded to comply with the incoming, mandatory, additional reporting requirements from the UK's Financial Services Authority (FSA), as well as increased stress testing and reporting tools.

'We appreciate that for some firms the exact scope, frequency and switch-on date of the reporting requirements is dependent on the outcome of a modification or waiver application. However, we expect that even those firms will have started preparations for liquidity reporting.' So said Jon Pain, Managing Director of Supervision at the Financial Services Authority, whose now somewhat infamous 'Dear CEO' letter of January 13, detailing the new FSA requirements on firm's liquidity risk management, opened with the statement: ***I am writing to you to set out how we will monitor compliance with our new liquidity regime and to outline how you can confirm, by 12 February 2010, that your firm complies with our new systems and control requirements.***

Business intelligence and financial reporting software specialists, FinArch (Financial Architects nv), recently held a webinar on *How to comply with the UK FSA liquidity risk requirements and strict deadlines?* Here, FinArch regulatory experts outline the most important points for complying firms.

In December 2009, the Basel Committee published its liquidity risk guidelines, and while the overall framework is the same, firms complying with the FSA's requirements need to be aware of the difference in the detail.

Nancy Masschelein, head of Risk and Capital Management at FinArch, says that because cash flow estimations are always the basis for any liquidity risk calculation the

overall framework of the FSA's liquidity risk regulations does not differ greatly from the Basel Committee guidelines.

She says: "Liquidity risk calculations focus on gap analysis, in which you compare cash in and cash outflows with your liquid asset buffer; on concentration risk and on ratio analysis. The Basel Committee particularly focuses on the latter by the introduction of two liquidity risk ratios being liquidity coverage ratio, which addresses the sufficiency of a stock of high quality liquid assets to meet short term liquidity needs, and the net stable funding ratio which addresses longer term structural liquidity mismatches."

However, although the general framework is the same, the details are definitely not. Firstly there is no uniform definition of liquid assets. As Masschelein points out, the Basel Committee guidelines, and also the Australian regulator's considerations, include corporate and covered bonds in the liquid asset buffer, which is not allowed by the FSA.

There are also major differences in the description of the various firm-specific and systematic stress scenarios, as well as significant differences in regulatory configuration. "The Basel guidelines, for example set the draw down on committed credit and liquidity facilities at fixed percentages (e.g. 10 percent for retail deposits), whereas the UK's FSA allows the firm to determine their own percentages. Also, for internal risk management purposes, you may want to construct scenarios

tailored at your business. Finally, some liquidity risk drivers get more attention than others. For example, liquidity risk coming from currency risk, or from intra-day risk, is an important component in the UK FSA regulations but is hardly mentioned in the Basel Committee guidelines," Masschelein says.

For these reasons, firms need a liquidity risk framework which is sufficiently generic to comply with overall calculations and stress testing requirements but which is sufficiently



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flexible to comply with any supervisory or internal specificity.

The financial crisis illustrated the difficulties some firms had in releasing accurate and timely information on their liquidity risk positions. Not surprisingly, the new FSA requirements focus on very granular reporting records of an extensive number of liquidity risk metrics and of liquidity risk stress results. As already mentioned, these metrics include intra-day data. In order to automate the whole submission process, FSA wants these data to be submitted electronically. Says Masschelein: "This stresses the importance of firms having a liquidity risk framework that allows them to produce timely and accurate liquidity risk information."

The new regulatory requirements will require both long-term and short-term changes to financial firms' operations. Nigel Lee, Chief Commercial Officer at FinArch, says that institutions must ensure that they have the appropriate technology for meeting these requirements and that the technology is flexible and robust to take care of the immediate requirements but also ever increasing changes in the future regulatory landscape.

He points out that there may be an impact to the structure of the institution's business and it must be prepared to restructure out of certain business, or at least price such business accordingly, to meet the liquidity buffer obligations.

He says: "The FSA's liquidity risk requirements are the first signs of a regulatory necessity to integrate risk and finance. It is no longer possible to take a silo view of corporate performance. This will demand flexibility of resources, and perhaps re-training, but certainly the availability of consistent and reconciled data between the two functions. This, of course, is, and always has been, a strategic necessity, but now there is little or no choice."

Central to the new requirements is the modification of the self-sufficiency rule. The basis of the liquidity regime is that UK-incorporated subsidiaries or UK branches of a foreign bank must be self-sufficient for liquidity purposes. This means that the new liquidity risk regulations will apply in whole to the every UK subsidiary or UK branch.

Masschelein says that in some cases the FSA recognises it may not be appropriate to supervise the liquidity of a UK branch or subsidiary in isolation from its head office or parent, and in some cases the nature and structure of the group make it more prudent to consider the liquidity position of the whole group, rather than the position of the solo UK subsidiary or branch. Therefore, some branches and subsidiaries can get a modification for the requirement to be self-sufficient. For this, firms have to submit a modification form. There are two types of modifications: branches can go for a whole-firm liquidity modification; subsidiaries can opt for an intra-group liquidity modification.

A whole-firm liquidity modification applies to all branches. Without a modification branches need to comply with the following four requirements:

- Self-sufficiency rule - holding of high-quality assets in the form of high quality government bonds;
- Systems and control questionnaire;
- ILAS requirements, including submission of Individual Liquidity Adequacy Assessment, which the FSA will review afterwards and discuss with every firm;
- Regulatory reports.

Says Masschelein: "With a modification, firms will not be subject anymore to these requirements, with the exception that part of the reporting requirements will transfer from the branch to the whole-firm at much reduced frequency and granularity. Definition of a whole-firm firm will be determined on a case-



by-case basis. Very often, the whole-firm is the legal entity to which branch belongs, but possibly at higher level within group in cases where the liquidity of those entities is materially relevant to the applicant firm."

Furthermore, intra-group liquidity modification applies to UK subsidiaries. Getting a modification implies that firms can split up the liquidity risk requirements between the subsidiary and a self-defined liquidity group. These groups can be a UK or a non-UK defined group, depending on whether the group includes UK firms or not. Masschelein says: "A modification means that you will have the option to rely on other parts of the defined liquidity group for the liquidity risk requirements. Without the modification, the subsidiary will need to satisfy the stringent liquidity risk requirements."

The crisis also illustrated how quickly, and severely, liquidity risk can crystallise and showed that certain sources of funding can evaporate quickly. Not surprisingly, regulators will now require firms to have sufficiently large liquid asset buffers.

In order to set the liquidity asset buffers, Masschelein says firms can follow the following steps:

Step 1: Define liquid asset buffers. Typical characteristics of liquid assets are assets

that are deemed less risky, easy to value, are not correlated with risky assets, and often listed on a recognised exchange (which increases transparency). The regulators give guidance on which assets are liquid and which not.

Step 2: Set the buffer large enough to meet contingent liquidity needs in stress periods. After specifying the stress scenarios, you need to specify your survival period, which is the period during which a bank can continue operating without needing to generate additional funds and still meet all its payments due under the assumed stress scenarios. Firms need to hold sufficient liquid assets in order to survive in a predefined stress periods. The regulators, including UK FSA, have given high level guidance on which scenarios to consider.

Step 3: Manage liquid asset buffer. Firms can amend their business models and activities to reduce buffer requirements.

According to Lee, there are a lot of solutions available that look at the problem from a regulatory reporting point of view, but this is a flawed approach. He says: "There are some modelling tools available in the market but

banks will need to assemble an assortment of these kinds of tools to succeed. Banks also have a plethora of in-house solutions already in their application architecture."

He believes what is really required is a solution that can take care of the requirement from end to end -- from a data management perspective and from a calculative perspective, with reports as an integral automated facility. "Given the potential impact on most banks, the reporting capability should not just be limited to regulatory reports, but should also encompass comprehensive internal reporting facilities. Such a solution should also allow banks to integrate various components of their own existing application architecture, where available," Lee says.

Naturally, any solution should contain powerful Risk and Capital Management functionality, as well as comprehensive Financial Management functionality. Says Lee: "To my mind, and according to Chartis Research (Risk and Finance Integration. Leading Practices and Systems, December 2009) there is a clear market leader in this arena, Financial Architects."

Throughout 2010, the FSA will be holding a series of Liquidity reporting workshops.

The FSA is offering a series of half-day workshops for basic products and advanced





Type of Firm	Effective date
Sterling Stock Banks Non-Simplified Building Societies	1 June 2010
Mismatch Banks Simplified Building Societies	1 October 2010
Branches Full Scope BIPRU Investment Firms	1 November 2010

products to help you identify the relevant data items, frequency and submission deadlines that apply to different categories of firms at solo, group and whole firm levels. They will also provide you with the opportunity to learn more about the new data items with particular emphasis on worked examples of how to report typical product types. You should attend the workshop most suitable to your firm's needs and the product types offered by your firm.

Firms who are likely to qualify for the Simplified ILAS regime as described in BIPRU 12.6, will probably find the Basic Products Workshop the most suitable.

WHO SHOULD ATTEND?

Workshops will be suitable and useful for:

- individuals responsible for liquidity reporting to the FSA within regulated firms, and
- senior managers responsible for review and signoff of regulatory reporting submissions.

FORMAT

Each session will run for approximately half a day. We will welcome participation by delegates and there will be ample time for questions. The

presentation format will use demonstrations of worked examples and case studies, to illustrate how to populate the new data items for a progression of products and business lines from the most simple to the most complex. Each workshop will have a maximum of 24 delegates. The Basic Products Workshop will cover the following:

Overview

- Liquidity data items
- Scope of application and the effect of modifications
- Overview of data items
- Importance of timely and accurate information

Populating the data items - retail commercial banking balance sheet

- Memorandum items
- Loans and deposits
- Outright holdings of securities (excluding self-issued securities and whole loans)
- OTC downgrades triggers

FOR A FULL LIST OF DATES AND LOCATIONS, VISIT: www.fsa.gov.uk

