U.K. FINANCIAL SERVICES AUTHORITY ADOPTS ENHANCED LIQUIDITY STANDARDS — A FIRST TEST OF GLOBAL COORDINATION?

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To Our Clients and Friends:

The Financial Services Authority ("FSA"), the U.K.'s primary regulator of financial institutions, has determined that during the worst days of the liquidity crisis problems were caused by:

- inadequate quality and quantity of liquid asset buffers, leading to firms' inability to liquidate the assets in a stress event;
- poor liquidity risk management capabilities (*i.e.*, inadequate stress testing, contingency funding planning and senior management oversight);
- specific liquidity risk factors:
  - over-reliance on short-term credit-sensitive wholesale funding markets;
  - large pipelines of new business with limited or no ability to fund them;
  - over-reliance for funding on securitisation markets;
  - inability to meet significant retail outflows; and
  - firms entering into ratings-based liquidity contracts without valuing the underlying option;
- U.K. branches and subsidiaries of foreign groups which maintain global liquidity pools that can be disadvantageous to U.K. depositors; and
- insufficient data to assess properly firms' liquidity positions or to form sector and industry-wide views.

The FSA is the first major regulator to address these problems by introducing tighter liquidity requirements for firms. As discussed in the October 2009 Debevoise & Plimpton Financial Institutions Report, at the conclusion of the Pittsburgh Summit on September 25, 2009, the leaders of the G-20 and the Financial Stability Board ("FSB") cited the need for

globally coordinated liquidity standards. While the G-20 Leaders and the FSB called on the Basel Committee on Banking Supervision ("Basel Committee") to adopt such a standard by the end of this year, the FSA's early finalization of liquidity principles may provide the blueprint for the Basel Committee's approach to this issue. As a result, the FSA's publication warrants review by U.S. and other financial institutions. If, on the other hand, the Basel Committee's standard proves materially different from the FSA's, the liquidity standards may prove to be the first test of whether the FSA then amends its own liquidity standard to make the spirit of international cooperation and coordination proclaimed at the G-20 Summit a reality.

As to the FSA's approach, its policy statement: "Strengthening Liquidity Standards" (the "Policy Statement"), published on 5 October 2009, sets out a new liquidity regime (the "New Liquidity Regime") which aims to ensure that firms have the necessary resilience to withstand severe and chronic liquidity stress. It imposes: (i) heightened systems and controls requirements on firms; (ii) quantitative liquid asset requirements (including self-sufficiency of subsidiaries and U.K. branches of foreign firms); and (iii) enhanced reporting requirements. These requirements are intended to apply proportionately to a particular firm's size, business model and the risks that the firm represents.

Central to the new regime are the new Individual Liquidity Adequacy Standards ("ILAS"). The New Liquidity Regime provides for three categories of ILAS: (i) standard ILAS; (ii) simplified ILAS; and (iii) non-ILAS, depending on the type of firm. The FSA recognises that the full liquidity regime would be challenging for smaller firms and disproportionate to their risk profile. Consequently, firms with simpler business models are able to use the simplified liquid asset buffer ratio instead of adhering to the full ILAS.

WHO DOES THE NEW REGIME APPLY TO?

The New Liquidity Regime applies to U.K. regulated deposit takers, *i.e.*, U.K. banks and building societies and investment firms (collectively known to the FSA as BIPRU firms), as well as branches of overseas firms operating in the U.K. Approximately 2,800 entities will fall within the scope of the New Liquidity Regime. The FSA expects that many of the branches of overseas firms will apply and receive modifications to aspects of the New Liquidity Regime.

In terms of investment firms, only the larger full-scope BIPRU[1] investment firms with total assets minus called-up share capital, minority interests and reserves exceeding U.S.$50

[1] *See the FSA's Prudential Sourcebook for Banks, Building Societies and Investment Firms.*

million will be subject to the full ILAS framework and will have to comply with the regime's full and detailed quantitative requirements.

KEY ELEMENTS OF THE NEW LIQUIDITY REGIME

The key elements of the new regime are:

- over-arching principles of adequacy and self-sufficiency of liquidity resources;
- enhanced systems and controls requirements;
- updated quantitative requirements coupled with a narrow definition of liquid assets;
- a new modifications regime for branches and subsidiaries; and
- granular and frequent reporting requirements.

ADEQUATE LIQUIDITY AND SELF-SUFFICIENCY

The new regime aims to ensure each firm individually has adequate liquidity at all times and is self-sufficient for liquidity purposes. What this means is that, generally, U.K. firms will not be permitted to rely on other parts of their group to satisfy the overall liquidity adequacy rules.

For example, a self-sufficient branch will only be allowed to count liquidity resources that are:

- under the day-to-day control of the branch's senior management;
- held in account with one or more custodians in the sole name of the U.K. branch;
- unencumbered; and
- attributed to the balance sheet of the branch.

The effect of this will be that a self-sufficient branch will need to hold a local operational liquidity reserve. The purpose of the reserve is to ensure that: (i) the branch has at least some capacity to meet local outflows and (ii) the FSA will receive early warning of liquidity problems because the FSA will be notified if the reserves begin to be used.

It is possible to modify the self-sufficiency requirements in certain circumstances.

ENHANCED SYSTEMS AND CONTROLS

The heightened systems and controls requirements will apply to all BIPRU.

Liquidity risk management. Firms will be required to have in place robust strategies, policies, processes and systems to identify, measure, manage and monitor the liquidity risks to which they may be exposed, including intra-day risk.

Stress testing. Stress-testing, which must be reviewed and approved by a firm's governing body, will allow a firm to identify sources of potential liquidity strain, and ensure that current liquidity exposures continue to conform to the liquidity risk tolerance established by the firm's governing body. ILAS firms will need to report their stress testing results to the FSA in their Individual Liquidity Adequacy Assessment ("ILAA").

Contingency funding plans ("CFP"). A CFP should set out a firm's strategy for addressing liquidity shortfalls in stressed conditions with the aim of ensuring that a firm will have sufficient liquidity resources to meet liabilities as they fall due. The outputs of firms' stress tests should feed clearly into the CFP design. As with the stress tests, the CFP must be approved and reviewed by the firm's governing body.

How firms demonstrate their compliance with the new provisions will depend on their Individual Liquidity Adequacy Standards.

THE INDIVIDUAL LIQUIDITY ADEQUACY STANDARDS ("ILAS") AND QUALITY OF LIQUID ASSETS

The new individual liquidity standards aim to ensure that firms are better positioned when a crisis occurs. They comprise: (i) an assessment to be carried out by the firm, the ILAA and (ii) a Supervisory Liquidity Review Process by the FSA ("SLRP"), which together result in Individual Liquidity Guidance ("ILG") issued by the FSA. All BIPRU firms are required to maintain a buffer of high quality liquid assets in the form of government bonds, central bank reserves and bonds issued by multi-lateral development banks. The actual size of the buffer that will be required will vary depending on the FSA's view of the quality of risk management within a firm. For smaller firms, the FSA has widened the definition of liquid assets. For example, for smaller firms investments in qualifying money market funds will be acceptable, subject to certain conditions.

ILAA. The FSA has proposed that firms consider the following stresses: (a) idiosyncratic liquidity stress, (b) a market wide liquidity stress, and a combination of the two. A firm's ILAA will look at the effect the stresses would have on sources of liquidity risk, such as retail funding risk, wholesale secured and unsecured funding risk and off-balance sheet liquidity

risk and the net outflows that would occur before any management actions. A firm's ILAA should be proportionate to the nature, scale and complexity of its business and documented so that it can be submitted to the FSA upon the FSA's request. The FSA expects a firm to carry out its ILAA at least annually, or more frequently if changes in the business, strategy, nature or scale of its activities or the operational environment suggest that its level of liquidity resources or stress assumptions may no longer be adequate. If the firm is part of a wider financial group, it may be appropriate for the firm's ILAA to take into account the financial resources available to it from other parts of its group, but only to the extent that such reliance is permitted by the FSA through a rule modification process.

Supervisory Liquidity Review Process. SLRP is the next level where, following a firm's own assessment of its liquidity adequacy, the FSA will review a firm's:

- ILAA;
- systems and controls for liquidity risk; and
- internal stress testing and contingency funding plan.

The FSA will conduct an SLRP at a frequency depending on the risk profile of the firm, with the aim of forming a view of any Individual Liquidity Guidance to be given to a firm.

Individual Liquidity Guidance. As a result of the ILAA and SLRP, and following an internal validation process, the FSA will provide ILG to a firm which will be communicated to the firm's governing body. ILG will contain guidance about the quantity of a firm's liquid asset buffer and the firm's funding profile.

Firms with simple business models and straightforward liquidity risks may be eligible for the simplified ILAS regime.

GRANULAR AND FREQUENT REPORTING

The key features of the new regime are as follows:

- granular reporting requirements which capture the ILAS liquidity risk drivers across the full maturity spectrum;
- standardised data items collected on a contractual basis to allow for peer comparisons;
- appropriately high reporting frequencies, which step up in times of stress;
- currency reporting for those firms with material liquidity risk in multiple currencies; and

- several levels of reporting, reflecting liquidity flows within a firm or group of firms.

The quantitative reporting requirements will apply to all ILAS firms, at a frequency varied according to whether the firm is a standard or low frequency reporting firm and whether it has been granted a modification.

Low frequency reporting firms are those firms that fall within the scope of the FSA's buffer ratio regime or which have balance sheets of less than £1 billion.

Reporting frequencies on certain data items can be daily, monthly or quarterly.

TIMING

1 December 2009 is the "go live" date for the systems and controls and certain other provisions of the New Liquidity Regime. A transitional period is available for U.K. branches of overseas banks with a global liquidity concession. The quantitative aspects will be introduced in several stages over a period of several years, to take into account the market-wide stress that all firms are experiencing. The FSA will notify firms individually of the prospective impact of the new quantitative requirements on them. The FSA will then agree with each firm (other than firms operating under the simplified regime) on a timetable of some years for completing the transition.

COSTS OF THE NEW LIQUIDITY REGIME

Although, given the different types of firms, it is difficult to be definitive about the exact costs, the FSA, in its example case study, has estimated that for full scope ILAS firms, the New Liquidity Regime could result in an annual cost of £2.2 billion. For the 90 or so simplified ILAS firms, the FSA envisages an annual cost of £14 million across the industry.

Firms will also need to bear in mind the reporting costs that will accompany compliance with the New Liquidity Regime.

CONCLUSION

The FSA has moved aggressively to implement liquidity standards in response to the recent crisis. If the FSA's blueprint does indeed become a blueprint for the G-20, it will raise costs for banks worldwide. If the Basel Committee adopts a different approach, then the FSA may provide a test case as to how home country regulators will balance their own vision of the right way to respond to the crisis with the desire for coordination and arbitrage mitigation within the global community.

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