Mr David Morgan
Prudential Standards, Conduct and Organisational Policy
Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

4 March 2009

Dear Mr Morgan,

Subject: **Response to the questions 1-64 within the Consultation Paper 08/22 entitled 'Strengthening liquidity standards', issued for comment in December 2008**

Avantage Reply has pleasure in submitting responses to some of the questions within the range 1 to 64 of the above referenced document (CP 08/22) as follows:

Q1: To what extent should the reduction of 'moral hazard' be a key objective of liquidity regulation?

Two of the statutory responsibilities assigned to the FSA are the maintenance of confidence in the financial system and securing the appropriate degree of protection for consumers. In so doing history has demonstrated that in order to fulfil these responsibilities it has sometimes been necessary for the regulator to stand behind credit institutions. The objective of regulation must therefore be to provide rules and guidelines that limit the probability of credit institutions failing, as opposed to eliminating the possibility of failure, unless failure of an institution would significantly undermine the continuing wellbeing of other credit institutions and the entire operation of the financial markets.

Improved regulation designed to protect the wellbeing of consumers and the orderly operation of the financial markets should be a sufficient enough objective for and justification of the role of the regulator. Reduction of moral hazard is an unquantifiable concept which cannot be eliminated entirely, if one accepts that the regulator will always provide a safety net for poorly managed credit institutions where their demise significantly undermines the stability of the credit market.

The extent to which moral hazard exists and that it potentially undermines and certainly dilutes the effectiveness of regulation is a statement of fact and needs not be the subject of debate.

Q2: Do you agree that central bank policies and frameworks and supervisors' views of liquidity risk are intrinsically linked?

The mandate of the Bank of England is to promote and maintain monetary and financial stability. Similarly the FSA seeks to maintain confidence in the financial system. This is possibly a more demanding obligation as it relates to the financial markets but lesser in scope than the mandate of

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the central bank which focuses on the wider economic implications of financial stability and macroeconomic conditions, particularly as they relate to monetary policy.

Liquidity risk as a reflection of the probable survival of credit institutions individually and collectively represents a major driver of confidence in the financial system. Similarly market liquidity may be said to reflect the health of the financial markets. The involvement and oversight of the FSA in liquidity risk regulation has a profound impact on confidence in the wider financial arena as an essential element of wider economic considerations. Hence one must agree with the proposition that UK central bank policies and frameworks and FSA views of liquidity risk are intrinsically linked.

Where credit institutions operate in global markets, similar central bank mandates exist to those operated by the Bank of England and the same can be said when comparing the local regulators to the FSA. However, this may not always be the case and even where similar, the policy options available may differ and the policies themselves may not be applied uniformly across all participants or markets. Hence whilst unalloyed agreement with the proposition can be given with respect to UK, this may not be the case globally despite its desirability.

Q3: To what extent is the reputation of, and creditors' confidence in, a firm the key to that firm's liquidity position?

The key to a firm's liquidity position is that it has sufficient reliable credit available to finance its known and anticipated liquidity requirements in all circumstances and at all times. In the first instance reputation and creditors' confidence could be said to be dependent upon a firm's liquidity position. Failure to manage liquidity adequately (or clearly articulate the liquidity position of the firm) will undermine reputation and creditors' confidence. It is reasonable to assume that this will potentially undermine credit availability which in turn could further undermine both creditors' confidence and liquidity.

A firm's reputation and customers' confidence in a firm can significantly add to the deterioration in a firm's liquidity position. However, it should be regarded as a secondary rather than a primary factor in a firm's liquidity position.

Q4: Do you agree that a buffer of liquid assets alone cannot protect against the consequences of liquidity stress?

Yes a liquid assets buffer is not adequate in and of itself to protect against the consequences of liquidity stress.

Liquidity risk management requires a dynamic approach to the monitoring of exposures which in themselves should be forward looking rather than limited to a point in time measure. The forward looking nature of the exposure means that it is not possible to derive a single number that represents a failsafe against all potential liquidity outcomes. Asset (and to a lesser degree liability) values change over time leading to a variable liquidity risk exposure. Events outside the control of a firm whether it be market or firm specific will have an impact not only on market values but also through the behaviour of other stakeholders on the liquid value of net assets and the supply of credit to a firm. It is therefore not appropriate to assume that any liquidity buffer can guarantee that in all circumstances and at all times a firm's liquidity exposure is covered.

Q5: Do you believe that legal entities are an important consideration for the purpose of liquidity regulation?

An understanding of the nature and form of legal entities is essential if a comprehensive understanding of liquidity risk exposures is to be achieved. The concept of limited liability incorporation brings with it the risk that an entity may become insolvent resulting in the creditors and debt-holders participating in the consequences of the insolvency. Where a group structure exists the holding company may choose to allow a subsidiary to fail in order that the pain is shared with third parties rather than attaching entirely to the holding company. From a liquidity risk perspective it is therefore imperative that an asset/investment/security held in an entity that is the subsidiary of another is not assumed to be the same credit quality as its holding company.

Similarly, entities that operate under licence/regulatory/legal/market rules that restrict their ability to either distribute reserves and/or remit funds to third parties present a much higher liquidity risk than those entities not subject to the same restrictions. It is therefore important for the purpose of liquidity regulation that a full understanding is gained of the markets and jurisdictions that an entity operate within, its legal form (limited unlimited liability) and the degree of support provided by the parent of a subsidiary company.

Q9: What is your opinion of the priorities for the international and European forward agendas on liquidity?

We think that the highest priority should be given to achieving agreement amongst global (and not just EEA) regulators on the minimum standards to be applied consistently. Furthermore, it is essential that responsibility for the regulation of global entities is clearly determinable based upon consistent criteria, observable and capable of being applied without ambiguity by all regulators. The concept of regulatory equivalence should be established as the primary objective of all regulators. The degree to which a host regulator can rely upon the consolidated supervisor and the information (both scope and level of detail) that a host regulator can submit to and request from a consolidated regulator should be clearly understood and consistently applied across the population of regulators.

For stakeholders trying to understand the liquidity risk exposures of a global institution, it is preferable to be able to assume that a minimum standard of risk management is applied commensurate with the regulatory requirements of every jurisdiction in which the institution is located/present. In order to ensure this is the case, each regulator must take responsibility/accountability for maintaining the consensus minimum requirement in its own jurisdiction in order to provide the same degree of protection to those regulators and stakeholders in jurisdictions outside their own.

Q10: What is your view on our principle of adequate liquidity resources? Do you agree that quality, nature and behaviour of the asset are as important to determine its liquidity value as its amount and face value?

We agree that liquidity resources should include not only current (or future contracted) assets but also the ability to generate further liquid resources e.g. unsecured loans/debt. However, we would caution that the latter is dependent on the overall credit rating (formal or otherwise) of the borrower and the status of the credit market at the time.

We also agree that the liquidity value of an asset is not necessarily reflected in the face or market value of an asset. The liquidity value of an asset is a function of a combination of the current market value, the reasonable time within which the value can be realised and any haircuts to be incurred to achieve a realised value. Liquid value may be achieved through direct sale or secured borrowing. The haircuts and time taken to realise the liquidity value are themselves a function of

- the credit standing of the institution
- the credit quality of the asset/product
- relative size of the asset in relation to market average/ total issuance
- market liquidity of the asset class/type
- market liquidity of the secured lending product
- utilisation of secured lending lines

All of the above factors need to be assigned a value in relation to the specific asset being evaluated for its liquidity value that will represent an adjustment to the carrying value of the asset in the balance sheet.

Q11: What is your view on our principle of self-sufficiency? Do you agree that it constitutes a prudent approach to liquidity risk management?

We agree with the principle of self-sufficiency, in that it will be virtually impossible for the regulators to identify all areas where reliance is or should be placed on a parent firm and even if they can, to then satisfy themselves that appropriate protections are in place to ensure that all liquidity within the group can be rolled up to the parent or down to the subsidiary without restriction if required.

By placing the onus on the institution, not only is the FSA recognising the weakness of its own position as outlined above but more importantly re-enforcing the obligation on the institution to ensure that its liquidity risk capital management capability is adequate (in line with the principle approach favoured by the FSA).

Q14: Do you agree with the proposed overarching systems and controls requirements for liquidity risk management?

We recognise that effective management of liquidity risk must be predicated upon a robust framework of systems, controls and limits enabling the projection of cash flows and demand for liquidity from both on and off balance sheet positions and also contingent obligations (contractual and non-contractual). The ability to evaluate whether the framework is adequate for purpose is an area on which the consultation paper is mute, both in terms of how adequacy will be evaluated and by whom, other than the generic requirement that the Board of Directors is responsible for everything. This principle is enshrined in Company Law but it is not obvious this has provided an incentive for directors to be experts in the liquidity exposures of their organisations.

There must be an underlying assumption that the FSA knows best. Aside from the broader question as to what insights the FSA can provide on the quantity and quality of a liquidity buffer that should be retained, one questions whether the FSA is in a position to evaluate whether a representation made by the directors that a firm possesses the systems to enable it to “minimise the risk that its liquidity resources might in the future fall below the level, or differ from the quality, of those resources advised as appropriate ..... in that firm’s Individual Liquidity Guidance (ILG)”.

So although the principle that adequate systems and controls must be in place cannot be argued with, the policing of such a requirement is difficult to comprehend from two prospective. First, how can the FSA make an informed evaluation? Secondly, if subsequently it were discovered that significant weaknesses had not been addressed, what sanction can the FSA impose or what measures can the FSA take that would not have already been taken by the firm (assuming the results were not so catastrophic as to undermine the survival of the firm)?

Q15: Do you believe that the requirements placed on firms' governing bodies and senior management deliver the right degree of oversight?

Clearly there should be a degree of senior management oversight of liquidity risk management. However, the degree of detail to which it is possible to define a tolerance for liquidity risk in the context of such broad measures as business strategy and financial condition can itself only be broad and high level. There is likely to be a significant gap therefore between the more general description of tolerance and the detailed definition and quantification of the adequacy of liquidity. It is therefore questionable how effectively the FSA can evaluate and reconcile the risk tolerance of a firm and the adequacy of its liquidity.

If the FSA cannot demonstrate how it reconciles liquidity tolerance and adequacy and thus provide a policing function, some may conclude that there is little value in providing anything other than rudimentary responses. This would undermine the objective of improving senior management oversight and governance over liquidity risk management. The FSA may well have expertise and envisaged measures and evaluation processes for reconciling the adequacy of liquidity management to a firm's business strategy and risk appetite. However, this is conundrum that the industry has found difficult to resolve in the more linear and less complex determination of capital adequacy. Some might question how realistic such an exercise would be for liquidity risk which is so dependent upon uncertain cash flows and events which in themselves are subject to the uncertain and inconsistent behaviours of outside agents.

Q18: What are your views on our proposals for ensuring that firms are able to manage their collateral positions proactively?

The identification of unencumbered collateral represents a key element in capturing the maximum potential available liquidity. However, it is also suggested that a firm regularly review and test its secured funding lines individually and in aggregate since restrictions on class/type and concentration of collateral imposed by counterparties may lead to overall capacity restrictions on certain collateral classes/types.

Secondly, collateral may be located in jurisdictions where rights of hypothecation are not granted and rights of beneficial interest in an asset cannot be clearly perfected. Firms should ensure that a regular review of hypothecation agreements is undertaken and jurisdictions where rights of hypothecation can and have been granted are clearly known, understood and regular updated.

Q20: In your view, are the proposed requirements sufficient to ensure that firms establish an adequate funding strategy?

The aims of the objective are well merited. The requirements themselves are not considered to be contentious. Whether they establish an adequate funding strategy is a judgment that the FSA will need to make.

The issue for the regulator is how is such a qualitative objective to be evaluated, particularly in the context of a stress environment. The most recent stress environment (being the current credit crunch) has not been experienced in the period for which reliable and relevant data has been collected. Hence, correlations between market conditions and the ability to access funds from diverse sources are less than meaningful. What was inconceivable is now conceivable. Stress events going forward should therefore not be restricted to the plausible.

The question then becomes to what extent is the FSA to accept implausible stress events? Furthermore, even if implausible events are to be accepted, to what degree can they be representative of or deterministic of adequacy in the context of defining a funding strategy?

Fundamentally the question comes down to how much more confidence does the FSA have in its ability to define/determine adequate in terms of a liquidity strategy, by comparison with the firm itself who on a day to day basis is responsible for the management of liquidity and may be considered closer to the market and better placed to define /determine its own liquidity adequacy requirements.

Without strong arguments to counter those of a supposedly inadequately liquidity managed firm the FSA will struggle to achieve the objective of ensuring the adequacy of funding strategies of firms.

Q22: Do the proposals go far enough to improve the quality and effectiveness of firms' CFPs sufficiently?

It is suggested that a CFP should contain an evaluation of those potential sources of funds that are at most risk of becoming less available during the course of a liquidity event. In this way a priority list of liquidity sources to be accessed should be available and understood by those responsible for funding.

The requirement to draw on facilities prior to reductions in their availability could form the basis of a series of soft limits designed to ensure that a firm recognises the extent to which it is experiencing a liquidity event. The effectiveness of any CFP is dependent upon the timing of its deployment. However, is it realistic to assume there is a clearly defined point at which a CFP is invoked? It is suggested that the requirement to establish clear invocation procedures be explained in more detail reflecting an expectation of a series of triggers being established that indicate the relative seriousness of the liquidity situation and the varying degree to which mitigating actions should be taken. Triggers should also be in place to provide an indication of when the stress event has been successfully negotiated.

The question as the degree to which a CFP includes reliance on central bank facilities is only relevant to the extent that by using the facility the firm is potentially exacerbating its liquidity issue. Although not a consideration for the FSA directly, it is suggested that access to Bank of England facilities needs to be perceived as an unexceptional occurrence otherwise the mere draw down of the facilities becomes a self-fulfilling indication of collapse, leading to the levels of public ownership currently being experienced. For this to be avoided it is suggested that CFPs of credit institutions can only be relevant where the utilisation of Bank of England facilities is not an exceptional occurrence.

Q29: What are your views on the level of prescription embedded within the idiosyncratic liquidity stress and on the particular parameters where specified? Should more descriptive detail on the stress be included in the Handbook?

There is a level of prescription that is inappropriate. Idiosyncratic is defined as being name specific. Clearly the demise of Lehman Brothers had an immediate impact on market perceptions of the other US investment banks with the result that none have survived in their previous form. Closer to home the Northern Rock incident had a less than positive impact on UK banks particularly banks and especially those with large mortgage portfolios. Such events could be described as idiosyncratic events for organisations very similar to those crystallising the event.

It is suggested that the parameters of two weeks or a month (mere discussion of the merits of either period would suggest that the requirements are too prescriptive) if established as a rule will automatically assume the characteristics of a defined risk appetite. Why would firms move away from this? Wouldn't it be reasonable to expect that to avoid the requirement to justify to the FSA any departure from the prescribed period, most firms will simply adopt the period as a surrogate risk appetite/tolerance no matter how inappropriate that may be?

The Handbook provides sufficient examples and descriptive detail. More examples will be increasingly difficult to find with the result that the more examples that are provided the more prescriptive the list becomes.

Q30: What are your views on the level of prescription embedded within the market-wide liquidity stress and on the particular parameters where specified? Should more descriptive detail on the stress be included in the Handbook?

Once again we would question the need to make reference to a two week period other than by way of example in which case it would be prudent to reference two periods to highlight the illustrative nature of the examples.

Prescription is even less appropriate in the case of market events where the variety of events both in terms of the causes and particularly the effects can be so variable. Even if effects were not so variable a single defined effect can have different impacts on different firms for a variety of reasons (business profile, relative credit standing, liquidity status etc). It is up to each firm to establish the most relevant stress events for themselves and define the effects both from a market perspective and then directly upon themselves. Prescriptive events would be inappropriate, given the magnitude and scope of potential market liquidity events.

Q34: To what extent will the proposed methodology help the ILAA achieve its purpose?

One of the two purposes of the ILAA is to ensure that a firm maintains adequate liquidity at all times and in all circumstances. The requirement to undertake stress testing to evaluate the impact both on demand and supply of liquidity is intended to provide a means of determining the levels of liquidity to be maintained in all circumstances. To the extent that stress tests should evaluate the impact of an event (which in itself can be short-term or chronic, an idiosyncratic and market event plus a combination of both) on a firm's cash flows, liquidity position, profitability and solvency and in so doing cover the implications for each of the 10 risk sources listed in BIPRU 12.5.16, we would agree that a comprehensive stress testing framework has been defined.

Given the comprehensive description of all the elements expected to be considered, modelled and measured in the stress testing arena together with the need to undertake additional stress testing when significant changes occur in the firm's liquidity position, the markets in which the firm operates and the mix of business of the firm, we agree that the stress testing framework will provide a comprehensive analytical tool the results of which will provide a reasonable evaluation of a firm's liquidity adequacy with a relatively high degree of confidence.

All of the above plus assumptions used in deriving the liquidity requirement and liquidity availability and thus liquidity adequacy plus details of mitigating actions taken must be documented in the ILAA. This therefore facilitates the second objective of the ILAA which is to enable the FSA to evaluate whether a firm has adequate liquidity.

We therefore believe that the proposed methodology will help the ILAA achieve its purpose.

Q45: Do you agree with our view that firms need to maintain an adequate buffer of high-quality unencumbered liquid assets? Do you agree with our counter-cyclical approach to individual liquidity guidance in this regard?

We agree that a firm should maintain an adequate buffer of unencumbered liquid assets.

Clearly the argument for a liquidity buffer is compelling. However, what needs to be articulated is the purpose for which the buffer is being deployed, where it sits in the portfolio of liquidity management tools and the criteria used for determining the adequacy of the buffer if the number arrived as it to be meaningful and capable of being evaluated as to its fitness for purpose.

It is also advised that a stratification of the unencumbered assets should be carried out based upon their eligibility for use in various fund raising facilities/capacities. The term "Liquid" needs to be defined in the context of the facilities available to each firm. In this way a profile can be created of the finance raising capacity of the liquidity buffer to be compared with the demand for liquidity over time in a stressed environment.

With respect to the counter-cyclical approach, if additional liquidity requirements/actions were requested during a stress environment, despite events following the outcomes previously estimated/modelled and liquid resources have been denuded as anticipated, it would imply that previous assessments had been incorrect. Hence to do otherwise than the counter-cyclical approach to individual liquidity guidance suggested would undermine the faith placed in the ILAA process.

Should you require any clarification of the points noted above, please do not hesitate to contact me on 020 7709 4000 or by e-mail at n.walker@reply.eu.

Yours sincerely,

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