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# *Financial Services and Markets*

## *FSA Liquidity Standards for Investment Firms*

On 1 December 2009, the governance and stress testing aspects of the FSA's new liquidity standards came into force. These rules apply not only to banks and building societies, but also to investment firms which are subject to the FSA ICAAP requirements. The rules are set out in the new chapter 12 of the Prudential Sourcebook for Banks, Building Societies and Investment Firms (BIPRU). This note summarises which rules apply to the majority of the affected investment firms, including the new reporting requirements which apply from January 2011. This note does not cover the application of the rules to banks or building societies.

### What do the rules do?

They introduce new requirements for firms to monitor and manage their *liquidity risk*. The FSA defines this as "the risk that a firm, although solvent, either does not have available sufficient financial resources to enable it to meet its obligations as the fall due, or can secure such resources only at excessive cost".

### Which firms are caught?

BIPRU investment firms. These are firms which are currently required to perform the ICAAP or Internal Capital Adequacy Assessment Process. They cover BIPRU limited licence, BIPRU limited activity and full scope BIPRU investment firms.

Firms which are outside the scope of MiFID and "exempt CAD firms" are both excluded from the new rules.

### Did rules on liquidity risk apply before 1 December?

Yes. Some of these rules continue in force, some have now been replaced.

A BIPRU investment firm must continue to comply with the *overall financial adequacy rule* in GENPRU 1.2.26R, which requires a firm to "at all times maintain overall financial resources, including capital resources and liquidity resources, which are adequate, both as to amount and to quality, to ensure that there is no significant risk that its liabilities cannot be met as they fall due." A BIPRU investment firm must also take liquidity risk into account as part of its ICAAP – see e.g. GENPRU 1.2.30R.

Prior to 1 December 2009, BIPRU investment firms were also subject to the liquidity risk standards and controls in SYSC 11. These have now been replaced by BIPRU 12.3 and 12.4.

### Which rules in BIPRU 12 apply?

For firms which were FSA authorised on 1 December 2009, the new rules for BIPRU investment firms are being introduced in two phases. This is achieved by a number of new transitional provisions in BIPRU.

***Phase 1: 1 December 2009 – 31 October 2010***

During this period, all BIPRU investment firms are subject to the liquidity risk management rules in BIPRU 12.3 and the associated stress testing and contingency funding requirements in BIPRU 12.4.

According to the FSA, this "may initially seem like a substantial set of additional rules, however, when contrasting these requirements with the current qualitative liquidity requirements in SYSC 11 – with which investment firms should currently be complying – the modifications are not substantial" (FSA Policy Statement 09/16 para 12.15).

We summarise the new rules overleaf.

| BIPRU Reference | Requirement |
|---|---|
| 12.3 | ***LIQUIDITY RISK MANAGEMENT*** |
| 12.3.4R<br>12.3.5R<br>12.3.6E | ***Overarching liquidity systems and controls***<br>A firm must have in place robust strategies, policies etc. to identify, measure, manage and monitor liquidity risk, including the risk it cannot meet its liabilities as they fall due. These strategies etc. must be comprehensive and proportionate to the firm's activities. |
| 12.3.8R<br>12.3.11R<br>12.3.12R | ***Governing body and senior management oversight***<br>The firm's governing body must set and document the firm's liquidity risk tolerance, which must be appropriate for its business strategy and reflect its financial conditions and funding capacity. The firm's governing body must approve its strategy, policies, processes and systems relating to liquidity risk management. This must be documented and reviewed by the governing body at least annually, as must the firm's liquidity risk tolerance. Senior management must continuously review the firm's liquidity position. |
| 12.3.15E | ***Pricing liquidity risk*** |
| 12.3.17R<br>12.3.19E | ***Intra-day liquidity management***<br>A firm must be able to meet its payment and settlement obligations in a timely manner. |
| 12.3.22R<br>12.3.23R | ***Collateral management***<br>A firm must actively manage its collateral positions. BIPRU 12.3.23R sets out a number of detailed requirements relating to collateral management. |
| 12.3.26R | ***Managing liquidity across legal entities, business lines and currencies*** |
| 12.3.29R<br>12.3.30R | ***Fund diversification and market access***<br>A firm's governing body must regularly review its funding strategy. The firm must ensure it has access to adequately diversified funding. |
| 12.4 | ***STRESS TESTING AND CONTINGENCY FUNDING*** |
| 12.4.1R<br>12.4.5E<br>12.4.8E | ***Stress testing***<br>The firm must conduct appropriate stress tests on its cash flow, liquidity position, profitability and solvency. These should be reviewed by senior management and reported to the governing body. |
| 12.4.10R<br>12.4.11R<br>12.4.13R<br>12.4.14E | ***Contingency funding plan***<br>A firm must have an adequate contingency funding plan to deal with liquidity crises, approved by its governing body. |

***Phase 2: 1 November 2010 +***

BIPRU investment firms will become subject to the new *overall liquidity adequacy rule* and the associated requirements in BIPRU 12.2 from 1 November 2010 once the transitional provision for this rule expires (BIPRU TP 26.2R(8)). We summarise this requirement below.

| BIPRU Reference | Requirement |
|---|---|
| 12.2 | ***ADEQUACY OF LIQUIDITY RESOURCES*** |
| 12.2.1R<br>12.2.3R | ***Overall liquidity adequacy rule***<br>A firm must at all times maintain liquidity resources which are adequate, both as to amount and quality, to ensure that there is no significant risk that its liabilities cannot be met as they fall due. For these purposes a firm may not include liquidity resources which can be made available by other members of its group unless it obtains an appropriate rule modification (BIPRU 12.8 sets out guidance on this). |

From 1 November 2010, full scope BIPRU investment firms with net assets above £50 million will also be subject to the new quantitative requirements which set out how much of a particular type of asset (such as gilts) they must hold. These firms, together with banks and building societies, are referred to in the rules as ILAS BIPRU firms. "ILAS" stands for individual liquidity adequacy standards. This is roughly the liquidity equivalent of the ICAAP. Note that the vast majority of BIPRU investment firms will not be ILAS firms. The rules refer to firms falling outside of ILAS as "non-ILAS BIPRU firms".

## When do the new FSA reporting rules apply?

All BIPRU investment firms will be subject to reporting requirements.

Non-ILAS BIPRU firms will be required to complete and file report FSA055, for each calendar year. The report must be filed within 15 business days of the end of the relevant calendar year. The report will be required for the first time for the year ending 31 December 2010 (SUP TP 1.2 12T R(4) disapplies the reporting requirement prior to this). This report must be filed by 24 January 2011. A copy of FSA055 can be found at page 255 of the Policy Statement (http://www.fsa.gov.uk/pubs/policy/ps09_16.pdf).

If you would like further information or advice on these matters, please contact Tim Lewis in the Financial Services and Markets Department or your usual contact at Travers Smith.

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