



THE INSTITUTE
OF CHARTERED
ACCOUNTANTS
IN ENGLAND AND WALES

27 July 2008

Our ref: ICAEW 88/08

Your ref:

CEBS
Floor 18, Tower 42
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By email: cp19@c-ebs.org

Dear Sirs

TECHNICAL ADVICE ON LIQUIDITY RISK MANAGEMENT (SECOND PART)

The Institute of Chartered Accountants in England and Wales is pleased to respond to your request for comments on the above paper.

Please contact me or Iain Coke, Head of the Financial Services Faculty, should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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ICAEW Representation

ICAEW REP 88/08

CEBS – TECHNICAL ADVICE ON LIQUIDITY RISK MANAGEMENT (SECOND PART)

Memorandum of comment submitted in July 2008 by The Institute of Chartered Accountants in England and Wales in response to the CEBS paper.

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the Institute) welcomes the opportunity to comment on the Consultation Paper *Technical Advice on Liquidity Risk Management (Second Part)*, issued by the Committee of European Banking Supervisors in June 2008.

WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 130,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.
3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.

MAJOR POINTS

General support for the initiative

4. We welcome the paper, which we see as a helpful attempt to tackle an area that is both difficult and important.
5. In doing so it is important to strike the right balance between setting minimum supervisory requirements on outcomes, and letting firms decide on the best business model to meet them. In one or two places (eg the rather prescriptive comments about liquidity risk management being a cost source under Recommendation 2) it is not always clear that this balance has been achieved.
6. Rather than going through the recommendations one by one, we have concentrated on two key points, with additional comments on three of the recommendations in an appendix.
7. The key points are as follows:
 - the role of quantitative limits, and how far these are amenable to non-standard methodologies; and
 - to understand in more detail the difficulties and benefits posed by additional transparency and disclosure, in normal and stressed circumstances.

Quantitative limits (Recommendations 13, 25 and 26-28)

8. Given the different business models, legal structures and risk profiles of international banks, we agree that an effective liquidity policy should be principles-based, with flexibility for limits to be set to reflect the differing risk

characteristics of each organisation. However, in the longer-run there may need to be some minimum quantitative standards to supplement any set of qualitative principles. These need to be very carefully drawn up so as to encourage effective risk management. Many banks question the need for detailed quantitative reporting rules and believe that the regulatory emphasis should be on internal modelling and qualitative standards. In their view this forces them to understand their underlying capacities better and is therefore more appropriate than a one size fits all approach. This view was expressed in the Institute of International Finance Paper on *Principles of Liquidity Management (IIF Report)* issued in March 2007.

9. We believe that much can be achieved by using elements of ‘modelling’ of cash flows and discounts on marketable assets. To be clear, we accept that full-scale stochastic modelling is not yet in place in most, perhaps all, firms, and given the particular characteristics of liquidity risk that this may be an unattainable goal. This is in line with the analysis under Recommendations 13 and 14 of the Committee’s paper.
10. Instead, we agree with the Committee that what is needed is the systematic capture of all potential cashflows, whether these relate to business that is on or off balance-sheet at present, and the prudent and thoughtful assessment of how these flows could alter in a variety of stressed circumstances. Capturing these ‘behavioural’ effects is crucial: to the extent that this is done in a rigorous and conservative fashion, less of the measured ‘gap’ would need to be covered by liquid assets than if the shortfall had been assessed in a less systematic and prudent fashion, and in consequence seemed smaller. Through reviews and benchmarking regulators should be able to challenge firms on their methodologies and assumptions used, and allow a range of approaches to meet any particular minimum standard. Such modelling can be used to focus the attention of senior management on the key assumptions underpinning the firm’s liquidity, given its specific business.
11. All that said, we believe that some form of quantitative requirements, agreed with the regulator, are a necessary part of an effective liquidity regime, rather than an optional extra. Moreover it is undesirable for too great a range of regimes to persist across countries, if these produce radically different results for firms with the same risk profile but of different nationality. At the same time, it is desirable that there is not a vast array of reporting requirements between countries – but rather than address this through enhanced common reporting requirements it could instead be resolved through the use of information that is already produced by the firm for liquidity management information purposes.

Transparency and disclosure (Recommendation 18)

12. Recommendation 18 states “*Institutions should have policies and procedures that provide for the disclosure of adequate and timely qualitative and/or quantitative information on their liquidity risk management and/or their liquidity positions, in both normal and stressed times. The nature, depth, and frequency of the information disclosed should be appropriate for their different stakeholders (liquidity providers, counterparties, investors, rating agencies, and the market in general)*”. We have reservations about this on three differing grounds.
13. First, we are not sure that much use has been made of information that has been disclosed in this area to date. In other words, as disclosures have got

longer they have not always become correspondingly useful. IFRS 7 *Financial Instruments: Disclosure* already requires disclosure about an institution's liquidity risk management framework. These were only required for 2007 year ends, and it would be sensible first to evaluate their effectiveness, and how best to build on or adapt them (and the equivalent US rules).

14. Second, we note that in a crisis some consider that it is not always helpful for market participants to have an accurate view of the position – for example that a firm's liquidity position is such that it requires emergency lending assistance. In the UK changes are proposed that would have the effect of delaying promulgation of this fact. It is important that regulatory policy in this area is consistent and that it is made clear how Recommendation 18 should be interpreted in the circumstances catered for by the UK authorities. We note that as drafted the Recommendation applies to banks that are under pressure, as well as those in normal circumstances: and that in any case the suspension of standard disclosures is not an option if it is seen as a sign that the firm is in trouble. These points are hinted at in some of the preceding analysis, but it is not reflected fully in the Recommendation itself. In our view it should be.
15. Finally, the liquidity position of a firm can deteriorate extremely quickly. Published information on Bear Stearns (eg chart 11 in the Bank of England *Financial Stability Review* published in April 2008) suggests that it was only in the three or four days before the 'rescue' that its stock of liquid assets began to fall at all significantly. Of course, other disclosures (such as fair values) can also change rapidly.

APPENDIX: COMMENTS ON SPECIFIC PRINCIPLES

Recommendation 2: Institutions should have in place an adequate internal liquidity cost/benefit allocation mechanism – supported where appropriate by a transfer pricing mechanism – which provides appropriate incentives regarding the contribution of liquidity risk of the different business activities. This mechanism should incorporate all costs of liquidity (from short to long term, including contingent risk).

While we agree with the sentiment behind this observation, and are aware of instances in the public domain that may have triggered interest in these issues, we believe it is important to apply the concepts of materiality and proportionality to a firm's activities in this area. Most of the benefits will be achieved if higher risk and illiquid assets (both) attract significantly higher internal funding rates than do assets that are held to provide liquidity for the firm as a whole. Developing a full-scale in-house industry to refine this approach, and apply it to activities of very limited size, is unlikely to be justifiable on cost/benefit grounds and it would be helpful if regulators were more explicit in stating that they share this assessment.

Recommendation 24

Stress testing is important but we believe that firms will need guidance in relation to the type and size of shock that they are meant to guard against, and on how far particular modelling techniques are acceptable. We also believe that the focus of stress testing should be for the firms to identify points of failure in the more extreme scenarios, and use these to decide on mitigating action, if any: in some cases there may be little scope for such action.

In our view it is important that a firm takes account not only of institution-specific issues, and problems across the financial system as a whole, of the type listed in the paper, but also lessons from business continuity planning more generally. These often focus on widespread disruption, including physical dislocation, relating to operational incidents that are economy-wide, such as an incident that affected a key settlement system, under which a marketable asset might not realise any of its value until after a delay of several days.

Recommendation 29

There is a very clear analysis of the issues relating to the liquidity of branches in the text leading up to this Recommendation, and it might be helpful to reflect this a little more fully so that it has at the end “and to facilitate the delegation of tasks relating to the supervision of branch liquidity”.

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