Discussion Paper

December 2007

07/7 *newsletter*

FSA®

This newsletter provides a summary of DP07/7. Please see the section 'Who should read this paper?' to see if DP07/7 is relevant to you.

Financial Services Authority

Review of the liquidity requirements for banks and building societies

Why are we issuing this Discussion Paper?

This Discussion Paper (DP) relates to liquidity policy, which is a regulatory tool we use to reduce (but not eliminate) the risk of banks failing. It also reduces the impact of bank failures if they occur. This helps us meet our statutory objectives of maintaining market confidence and securing the appropriate degree of protection for consumers.

The main purpose of this DP is to review our existing liquidity policies, taking account of some of the lessons to be learned for managing and regulating banks' liquidity from the recent market turbulence, and set out preliminary ideas for their reform. In doing that, we also aim to:

- understand how the market turbulence impacted banks' liquidity;
- find out how they coped with the market turbulence;
- take note of the differing role of liquidity in banks with different types of business; and
- seek confirmation from the banking sector that our more principles-based approach is the right one.

What is the background to this?

The market turbulence which began in early August 2007 and continues to affect many financial markets around the world has sharply focused attention on the crucial role which liquidity plays in assuring the effective functioning of the banking sector and related markets. The significant reduction of liquidity in short-term money markets, the virtual drying-up of liquidity in the securitisation and covered bond markets and problems in accessing funding in the secured financing markets, even for highly-rated assets, have caused severe difficulties for many firms in funding their on and off balance sheet activities. In the UK, the case of Northern Rock, a medium-sized bank with a prime residential mortgage book, has graphically illustrated many of these problems. A significant lack of market liquidity caused an intractable bank-specific funding liquidity problem and led to a call on the Bank of England for emergency liquidity assistance.

We want this DP to set the scene for a constructive dialogue with banks and building societies, other relevant firms, and other stakeholders about the shape and content of our future liquidity policy. We also explain some of the key questions which we think regulators and firms need to consider as they reflect on the recent turmoil in financial markets.

Who should read the full paper?

This paper directly affects all UK-regulated deposit-takers (banks and building societies), including branches of both EEA and other overseas banks operating in the UK. Major non-bank securities firms should also read it, as they are typically also active in the same money and debt securities markets as banks. It will also be of interest to other participants in the money markets, to various trade associations and to organisations representing banking consumers. The paper does not directly affect credit unions or electronic money institutions.

Is the paper of interest to consumers?

We do not think this paper will be of direct interest to individual consumers (although they may be affected indirectly by any change to liquidity policy resulting from the ideas and analysis in this paper).

How is the paper set out?

In Chapter 2 we look at what we mean by liquidity risk, and what the objectives of our liquidity policy should be. We describe the dependencies on the work flowing from the DP on Banking Reform published by the Tripartite Authorities in October, and what is happening on the international front.

Chapter 3 sets out our market failure analysis and comments on cost benefit issues.

In Chapter 4, we examine what lessons can be learned from the experience of market turbulence during the second half of 2007. Chapter 5 then reviews our existing liquidity requirements for banks and building societies, and considers the strengths and weaknesses of those policies.

In Chapter 6 we set out, at a more detailed level, preliminary ideas for the reform of liquidity regulation including, in particular:

- what outcomes are desired;
- why quantitative requirements are necessary;
- why, and how, we should differentiate between banks; and
- how should access to central bank facilities be factored in.

Finally, in Chapter 7 we review how information on liquidity is reported to us, how this is already being improved and what further changes we envisage.

The Financial Services Authority invites comments on this Discussion Paper. Please send us your comments to reach us by 31 March 2008.

Comments may be sent by electronic submission using the form on the FSA's website at (www.fsa.gov.uk/Pages/Library/Policy/DP/2007/dp07_07_response.shtml).

Alternatively, please send comments in writing to:

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How can I get the full paper?

You can download the full Discussion Paper from:

www.fsa.gov.uk/pages/Library/Policy/DP/2007/07_07.shtml

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What are the next steps?

We welcome comments on the analysis and issues raised in this Discussion Paper: these need not be limited to responding to the specific questions in each chapter. We will continue, in the meantime, our useful dialogue with the trade associations covering the whole banking sector.

After considering the responses to this paper, and taking stock of other relevant work by the Tripartite Authorities, and regulatory developments on liquidity in Basel and the EU, we expect to publish more definite proposals for taking forward our liquidity policy during the summer of 2008.