

IMA response to CP128: Liquidity risk in the Integrated Prudential Sourcebook: systems and controls chapter

Because of the nature of the IMA's membership, this response does not follow the questions set out in CP 128, although it is intended to provide the information asked for in the questions. Instead, it is divided into three parts; general comments are followed by comments specific to those IMA Members operating Collective Investment Schemes and specific to those operating as asset managers. This separation is made because the relationship between these types of firms and their customers differs, as does the regulatory environment.

1 General comments

- 1.1 In terms of the Prudential Sourcebook (PRU) categorisation scheme, IMA Members fall into PRU categories 3 and 4, apart from Occupational Pension Scheme (OPS) Member firms, which (in CP 97) the FSA proposed to exempt from all the requirements of the PSB by virtue of PRAG 1.1.1R(6).
- 1.2 We note the comments in paragraph 2.2 of CP 128 concerning the relationship between the material in CP 128 and that in CPs 97 and 115. We would refer you to the AUTIF and FMA responses to CP 97, and the IMA response to CP 115. In particular, we would draw your attention to AUTIF's preference for drawing all the systems and controls material (including that referring to liquidity risk) into a single module, and eliminating duplication.

1.3 Definition of liquidity risk

- 1.3.1 Paragraph 3.1 of CP 128 defines liquidity risk as "the risk that a firm, *though solvent*, either does not have sufficient financial resources available to enable it to meet its obligations as they fall due, or can secure them only at excessive cost." [our emphasis]. 'Solvent' is not a defined term in the Handbook: however, compare this definition with the wording of PRAG 4.3.1R in CP 97: "A firm must maintain overall financial resources adequate, on reasonable assumptions, to ensure that there is no significant risk that liabilities to customers cannot be met as they fall due."
- 1.3.2 If we accept PRAG 4.3.1R as a working definition of solvency for these purposes, then there would seem to be a problem with the proposed definition of liquidity risk. A firm that was unable to meet its obligations as they fell due could not, by virtue of PRAG

4.3.1R, be regarded as solvent. This problem could perhaps be addressed by replacing 'solvent' in paragraph 3.1 with a term such as 'having positive net worth'. This would draw a distinction between the case of a firm that was unable to meet its obligations because the accounting value of its liabilities exceeded that of its assets (i.e. insolvent on a 'gone concern' basis) and that of a firm that was unable to meet its obligations due to liquidity problems (i.e. insolvent on a 'going concern' basis).

1.4 Scope

- 1.4.1 Paragraph 3.17 states that the systems and controls chapter is intended to apply to all firms in PRU categories 1 to 4B. This would, we believe, include all IMA Members with the exception of Occupational Pension Scheme firms, which as already explained are exempt from PRU.
- 1.4.2 Currently, the issue of liquidity for IMA Member firms is dealt with by deducting illiquid assets from the definition of regulatory capital (see, for example, the Interim Prudential Sourcebook for Investment Firms, chapters 5 and 10). We infer from paragraph 2.9 of CP 128 that this deduction will be retained until the quantitative framework for liquidity risk management is implemented, along with the changes stemming from the Basel / CAD3 process.
- 1.4.3 Thus, the proposals in this chapter represent a net increase in the regulatory burden for IMA Member firms, at least in the short term. Annex D of CP 128, which shows that all the proposed deletions from the Interim Prudential Sourcebooks are from the volumes relating to banks and building societies, reinforces this. None are from the investment firms volume.
- 1.4.4 As noted in paragraph 3.13, at a number of points in the draft chapter specific guidance is given for category 1 and 3 firms, and on less frequent occasions for category 2 firms. At no point is there any specific guidance addressed to category 4 firms. In addition, the general guidance is often slanted towards a particular category of firm. For example, the material in PRLR 2.5 (Identifying liquidity risk), which amplifies PRAG 4.1.1(A)R, gives detailed guidance that refers to assets such as overdrafts and undrawn commitments, and refers to the behavioural characteristics of liabilities. These are all familiar concepts in the deposit-taking sector, but are meaningless in the investment management sector.

- 1.4.5 So with the chapter as drafted many IMA Member firms are faced with a novel approach to the regulation of liquidity but are given no specific guidance on how to apply the regulations. We would urge that specific guidance be given to firms in category 4, and are ready to assist in drafting such guidance.
- 1.4.6 A further oddity in the way that different categories of firms are treated can be seen in paragraph 3.18, which proposes that (as now) incoming EEA firms which are credit institutions providing services through a branch would be subject to this chapter. However, in the case of other firms operating in the UK on an analogous basis, they would not be subject to this chapter even though their UK-based competitors would be. This appears to create a competitive distortion.

1.5 Length and balance

- 1.5.1 The length of the proposed chapter is striking. At 20 pages, it comprises almost 40% by length of all the systems and controls material proposed for the PSB (including the redrafted operational risk material at 13 pages).
- 1.5.2 The structure of the chapter also differs from that of the other systems and controls chapters. These other chapters amplify the provisions of PRAG 6 (prudential systems and controls). However the draft chapter on liquidity risk systems and controls not only amplifies PRAG 6, but also devotes a significant amount of material to amplifying PRAG 4 (adequacy of financial resources). If this material were located elsewhere – for example in a separate chapter within the liquidity module, or possibly within PRAG itself – then the length and style of the remaining systems and controls material would exhibit much more uniformity with other systems and controls chapters. For example, in CP 97 material amplifying PRAG 4.3.2R is contained within PRAG 4.
- 1.5.3 Also striking is the use of evidential provisions, which again makes this chapter unique among the systems and controls chapters (as currently drafted). We would appreciate early warning of whether it is likely that the other chapters will be modified to include evidential provisions as well.

1.6 Cost benefit analysis

- 1.6.1 We note that according to paragraph B11 of CP128, the FSA has “used input from a firm of consultants with a wide range of firms as clients.” We do not know whether any

IMA Member firms are included in this range. However, this is the first time that Member firms will have been subject to an explicit systems and controls regime for liquidity, while there is no reduction in the current treatment for liquidity risk. So for them the cost of these proposals is likely to be significant, and the benefits unclear and potentially negligible if an inappropriate regime is imposed.

1.7 Groups

- 1.7.1 A number of our Member firms form part of groups of the kind envisaged in paragraphs 3.20 and 3.21. We have asked for guidance from the relevant Members on how this will affect them.

2 Comments specific to CIS operators

- 2.1 The requirements in this section are intended to apply to CIS operators. However, it is important at the outset to make two points.
- 2.1.1 A CIS's liabilities to its investors are essentially of a fiduciary nature: investors retain full legal title to their assets, which are held by a depositary (which is itself authorised and subject to capital requirements). In contrast, a deposit-taker's liabilities to its depositors are of a debtor-creditor nature.
- 2.1.2 A CIS's liabilities to its investors are not value-certain (in contrast to a deposit-taker's liabilities to its depositors). Instead, they depend on the market value of the assets in the fund.
- 2.2 Since orders for units (or shares) can be placed prior to monies being paid, it is possible that a large order could be made and the necessary units created, but the monies then arrive late (or not at all). A number of mechanisms exist to deal with this situation. Most firms will, as a matter of policy, limit acceptance of orders in advance of cash settlement, at least until a history of dealing is established. Firms may also have access to overdraft facilities for very short-term financing. If payment fails arrive, the units created can be cancelled. This leaves the firm exposed to market, rather than liquidity, risk. Other means of purchase, such as via an ISA wrapper, carry a cooling off period which helps to cover liquidity risk.
- 2.3 Authorised CISs are (by regulation) invested in marketable assets, which can be liquidated quickly in response to investor withdrawals. Also, because the claims of

investors are related to the market value of these assets, sudden withdrawals are not normally a problem.

- 2.4 In addition, when funds are unable to meet possible demands for redemptions by customers, either because they are denied access to markets for reasons beyond their control or because the volume of redemptions is extraordinarily large, provision exists (subject to safeguards) for the suspension of investors' dealings with funds.
- 2.5 These rules are designed to ensure that sufficient liquidity exists within the fund to meet obligations to investors; they do not protect the liquidity of the CIS operator. However, any risk to customers arising from liquidity difficulties within the CIS operator will only be material for customers in the process of investing in or redeeming units. It is therefore our view that the liquidity of the management company is of secondary importance in protecting investors provided that the fund is liquid enough to meet its obligations to investors compared with the existing rules ensuring the liquidity of the fund.
- 2.6 One point that needs to be stressed in this regard involves the definition of liquidity risk given in paragraph 3.1, and specifically the part referring to "excessive cost". Under the contract between the fund and its investors, it is clear that the market risk, including the price fall consequent on a significant liquidation of the fund, lies with the investor.

3 Comments specific to asset managers

- 3.1 The relationship between an asset manager and its clients differs from that between a CIS operator and its clients. Rather than the product regulations that ensure the liquidity of the fund in the case of CIS operators, the rules surrounding the investment of a fund in the asset management case will be governed by a mandate between the asset manager and the client. However, as in the case of a collective investment scheme, the key asset-liability relationship is between the fund and the investor, and the assets of the fund are increasingly often held by an independent custodian.