Dear Mr Sharma,

The Association for Financial Markets in Europe (“AFME”) and the British Bankers’ Association (“the BBA”) thank the Financial Service Authority (“FSA”) for the opportunity to comment on its Guidance Consultation 11/18 titled “Liquidity swaps”.

AFME represents a broad array of European and global participants in the wholesale financial markets, and its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME was formed on 1st November 2009 by the merger of the London Investment Banking Association and the European operations of the Securities Industry and Financial Markets Association. AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

The BBA is the leading association for UK banking and financial services for the UK banking and financial services sector, speaking for over 230 banking members from 60 countries on the full range of the UK and international banking issues. All the major banking players in the UK are members of our association as are the large international EU banks, the US banks operating in the UK and financial entities from around the world. The integrated nature of banking means that our members are engaged in activities ranging widely across the financial spectrum encompassing services and products as diverse as primary and secondary securities trading, insurance, investment banking and wealth management, as well as deposit taking and other conventional forms of banking.

The primary focus of the Guidance Consultation is on bank-insurance company liquidity swap transactions. As you know, AFME and the BBA represent their members, which primarily include the major investment and retail banks. Therefore, our comments in this letter represent the views of the banking industry. AFME, the BBA and its members are keen to be a part of any future ongoing dialogue in relation to this issue.

In the Executive Summary below, we summarise a number of our key recommendations and concerns. In the section titled “Comments on the Guidance Consultation Questions”, we provide detailed responses to the specific questions asked by the FSA in its paper.
We hope you find our comments useful. Please contact us by email (irving.henry@bba.org.uk or sidika.ulker@afme.eu) should you require further information.

Yours sincerely,

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Consultation Response
FSA Guidance Consultation 11/18: Liquidity Swaps

21 September 2011

The Association for Financial Markets in Europe ("AFME") and the British Bankers’ Association ("BBA") thank the Financial Service Authority ("FSA") for the opportunity to comment on its Guidance Consultation 11/18 titled “Liquidity Swaps”.

The primary focus of the Guidance Consultation is on bank-insurance company liquidity swap transactions. As you know, AFME and the BBA represent their members, which primarily include the major investment and retail banks. Therefore, our comments in this letter represent the views of the banking industry.

AFME, the BBA and its members are keen to be a part of any future ongoing dialogue in relation to this issue. A description of AFME, as a leading representative for the wholesale capital markets in Europe and a description of the BBA, as the leading representative for the UK banking industry, are included in Annex I.

In the Executive Summary, we summarise a number of our key recommendations and concerns. In the section titled “Comments on the Guidance Consultation Questions”, we provide detailed responses to the specific questions asked by the FSA in its paper.

Executive Summary

1. The importance of liquidity swaps to the economy

It is our belief that liquidity swaps provide real and material benefits to the economy; these include: a) they provide an alternative means to utilise excess liquidity; and b) they provide an alternative source of liquidity that enables banks to lower their liquidity risks.

Since the peak of the crisis, there have been significant regulatory changes, which have made the value of liquidity and the need to lower liquidity risk more apparent to the financial markets. For example, amendments to the Capital Requirements Directive ("CRDIV") will introduce Europe-wide liquidity requirements for banks through the Liquidity Coverage Ratio ("LCR").

Additionally, insurance companies, due to the nature of their businesses, may want to hold less liquid, higher yielding assets in their portfolios; they may not want to solely hold liquid, lower yielding assets, such as gilts. Conversely, a bank that does not have excess liquidity looks to
raise liquid assets for its business operations. Therefore, there is a natural synergy between the banking and insurance industries regarding the distribution of liquidity.

**a. Liquidity swaps provide an alternative means to utilise excess liquidity**

For the reasons outlined above, if an entity holds assets in excess of their liquidity needs, it makes sense to utilise those surpluses. One option is to invest directly in securities or loans. Another option is to undertake liquidity swaps. The decision as to which option to adopt will be determined by the firm’s risk appetite. Indeed, most firms would most likely choose a mixture of the two options to optimise asset and counterparty diversification. Therefore, liquidity swaps are an important mechanism for enabling entities to utilise and distribute excess liquidity effectively.

**b. Liquidity swaps provide an alternative source of liquidity that enables banks to lower their liquidity risks**

At present, lowering liquidity risk is crucial for the banking industry; this is because: lower liquidity risk generally reduces risks to depositors and regulators are looking for banks to build significantly higher liquidity buffers through new legislation. Therefore, new tools that enable banks to lower their liquidity risks and diversify the ways in which they do so are extremely important. Liquidity swaps provide banks with an alternative source of liquidity and as such is a mechanism that could play an important role for the banking industry in lowering liquidity risk.

**2. Liquidity swap risks can be appropriately managed through existing risk management and governance procedures, requiring no separate regulatory treatment**

In addition to liquidity swaps, banking and insurance entities undertake many forms of collateralised lending and borrowing transactions in their day-to-day businesses. Examples include standard repo transactions, stock lending, covered bonds and derivatives. All these aforementioned transactions involve risks; however, firms effectively mitigate these risks through their existing prudent risk assessment and governance procedures.

We agree with the FSA that firms should appropriately manage and govern their risks in relation to liquidity swaps. However, firms can sufficiently mitigate the risks associated with liquidity swaps through their existing risk assessment and governance procedures. Specifically, we believe there are no features unique to liquidity swaps such that they would require different or more onerous measures compared to other forms of collateralised lending.

For example, in its Guidance Consultation, the FSA highlights a number of potential risks associated with liquidity swap transactions, including: a) the creation of increased interconnectedness through large bank exposures; and b) valuation on default. We stress that none of the risks highlighted in the paper are unique to liquidity swaps; the level of materiality of liquidity swaps needs to be considered in the broader context of overall asset diversification. Therefore, the mitigation of liquidity swap risks do not fall outside the standard risk management and governance practices of firms. In other words, the risk assessment measures discussed in the Guidance Consultation are applicable to all banks and insurance company transactions generally.
If the FSA wishes to introduce different requirements for liquidity swaps, we request that it identifies the risks unique to liquidity swaps and addresses those specific concerns directly.

a. Increased interconnectedness through large bank exposures

A key concern in the Guidance Consultation is that liquidity swaps could introduce increased systemic risk through greater interconnectedness between banks and insurance companies. In particular, the FSA notes that liquidity swaps are large transactions and would therefore increase the level of insurance company bank exposures.

It should be recognised that insurance companies may already have large bank exposures, for example, in the form of unsecured debt. Liquidity swaps are likely to raise fewer issues of interconnectedness.

b. Valuation of the collateral on default

A second concern noted by the FSA in relation to liquidity swaps is that insurance companies would be unable to assess their risks as the collateral may be difficult to value in the event of a bank default.

We highlight that insurance companies consider default events as part of their general risk assessment prior to entering into any transaction. In relation to liquidity swaps, insurers tend to look through the solvency of the liquidity buyer directly to value of the underlying collateral. The risks associated with underlying collateral are well understood by insurance companies. For example, insurance company portfolios already include assets such as corporate bond holdings and asset backed securities.

3. Requirements specific to liquidity swaps that in effect prohibit these transactions are inappropriate

As discussed above, we believe liquidity swaps provide real benefits to the economy and existing practices in place are sufficient to mitigate relevant risks. Requirements that in effect prohibit these transactions should not be introduced. Amongst others, we recommend that pre-execution of transaction reporting, mandatory inclusions of break clauses, specific limit structures and prohibition of intra-group transactions are inappropriate.

a. Reporting liquidity swap transactions to the FSA prior to execution

As part of a broad risk management re-assessment process, we would welcome the introduction of a reporting system, which would require reporting of liquidity swap transaction after execution. We believe that this would still promote good practices within firms. However, we believe the requirement for all liquidity swaps to be reported to the FSA prior to the execution of the transaction is inappropriate.

In particular, reporting each transaction prior to execution could make it too practically difficult to undertake these transactions. Also, again, there is nothing unique about liquidity swaps compared to other forms of collateralised lending that would necessitate a pre-execution requirement. Finally, by introducing overly onerous requirements for liquidity swaps, firms could simply enter into other types of transactions.
b. Mandatory break clauses

We understand the FSA's concerns regarding the uncertainty surrounding upcoming regulatory changes in relation to current transactions; however, we believe mandatory break clauses for liquidity swap transactions are completely inappropriate.

Regulations, such as Solvency II, that will have broad economic impacts, will affect all types of transactions. Therefore, again, it is unclear why liquidity swaps alone should be singled out for this requirement.

Additionally, we believe that mandatory break clauses would create undue commercial uncertainty and will make it difficult to price a transaction properly. For example, Solvency II is one of a number of wide-reaching regulations taking effect in the near future. Therefore, mandatory break clauses for Solvency II risks would force banks as well as insurer counterparties to protect their interests by including break clauses to account for all regulations (e.g. CRD IV for banks).

Further, break clauses contingent on legislation will most likely take effect on the date of implementation of the regulation; this could result in many transactions being unwound at the same time, adversely impacting on market stability.

We recommend that, as with other transactions, counterparties to liquidity swaps should be left to make their own commercial arrangements for regulatory uncertainty. We would welcome the FSA in its Guidance to encourage counterparties to agree in good faith to renegotiate their commercial arrangements in the event of regulatory implementation.

c. A prescriptive limit structure

We believe that a one-size-fits-all limit structure for all firms is not appropriate. Companies differ significantly (e.g. in size and levels of exposure) and as such require different frameworks. For example, a large company could have a large exposure relative to others; however, the exposure may not be significant in size for that particular firm. Therefore, limit structures should be determined on a case by case basis and should form part of the risk management and supervision process.

d. Prohibition of intra-group transactions

Intra-group transactions occur for many types of other transactions; therefore, again, we do not believe that it is appropriate for liquidity swaps to be subject to different intra-group measures compared to other forms of transactions.

If a firm has appropriate governance measures, we believe that it is inappropriate to prohibit intra-group transactions for liquidity swaps. In particular, firms have policies and procedures, mandated by the FSA, already in place to ensure risks such as conflicts of interest are mitigated and parties act on arms length terms.
4. **Scope and definition of liquidity swaps transactions should not capture standard collateralised lending transactions**

As mentioned above, the banking industry, as part of its normal course of business, engages in many types of collateralised lending transactions. It is critical that the Guidance does not impact on these other transactions.

Generally, we believe that a prescriptive definition of a liquidity swap, specifying exact quantitative thresholds (e.g. on maturity), is not appropriate as it could create arbitrage opportunities. Whether a particular transaction falls within the definition of a liquidity swaps should be determined on a case-by-case basis. However, normal collateralised lending transactions should always fall outside the definition of a liquidity swap; for example, standard bank to bank stock lending and repo transactions should not be captured.

We believe that the current definition provided by the FSA is too vague and would impact other transactions; therefore, the definition should be made clearer.

The Guidance primarily focuses on bank-insurance company transactions, whereby the insurance company is liquidity seller. However, the paper mentions that the definition of a liquidity swap is not limited to bank-insurance company counterparties. We note that banks generally source and provide liquidity from all kind of counterparties; therefore, the Guidance should consider the role of a bank as a liquidity seller. Additionally, we would like to confirm that that proposed Guidance would apply to all transactions irrespective of the counterparty – whether one party is regulated by the FSA or not – that has excess liquidity (e.g. pension, hedge funds and UCITS).

In the section “Comments on the Guidance Consultation Questions” below, we provide our suggestions on the form of the definition. AFME, the BBA and their members would welcome the opportunity to work with the FSA to develop this definition further.

5. **The absence of harmonisation with non-UK banks and insurance companies would create an unlevel playing field**

We note that the proposed Guidance will be UK specific. However, both UK and non-UK firms may enter into liquidity swaps transactions. Also, UK firms transact with counterparties from around the world. Therefore, in the event the FSA introduces requirements specific to liquidity swaps, we believe in the absence of harmonisation, firms UK firms will be set at a disadvantage to other non-UK firms, as they will be not as able to access this form of funding.

6. **Summary**

In summary, we recommend that as: a) the introduction of limits to UK firms alone would create an unlevel playing field, b) liquidity swaps have no unique risks that mean they need different treatment from other forms of collateralised lending; c) existing risk assessment and governance procedures of firms are sufficient to mitigate risks; and d) liquidity swaps provide real benefits to the economy, such as providing banks with an alternative means to lower liquidity risk, the FSA should not introduce new and separate requirements for liquidity swaps.
Comments on the Guidance Consultation Questions

Q1: Do you agree with the scope definition? If not, please explain any proposed changes and the rationale for those changes.

As mentioned above, we believe that a prescriptive definition of a liquidity swap, specifying exact quantitative thresholds (e.g. on maturity), is not appropriate as it could create arbitrage opportunities. Whether a particular transaction falls within the definition of a liquidity swaps should be determined on a case-by-case basis. However, normal collateralised lending transactions should always fall outside the definition of a liquidity swap; for example, standard bank to bank stock lending and repo transactions should not be captured.

However, we believe that the current definition provided by the FSA is too vague and would impact other transactions; therefore, the definition should be made clearer.

As a means of guidance, we suggest that key features of liquidity swaps may include:

a. the transaction does not fit within the liquidity seller's normal securities lending or repo policy in terms of counterparty choice, transaction size, collateral acceptability, duration or contractual framework;
b. it includes amendments to the securities lending, repo or other master agreement that (i) restricts or otherwise discusses what the counterparty may do with collateral; or (ii) limits or restricts the party's rights to terminate the agreement;
c. liquidity buffer eligible and liquidity non-eligible assets are traded; and
d. the term of the transaction is greater than one year.

Regarding counterparties, we note that the FSA does not limit liquidity swaps purely to bank-insurance company transactions. Therefore, we would like to confirm and understand the application of the requirements to non-bank-insurance company transactions.

In relation to bank-bank transactions, we believe that bank-bank lending is an essential requirement for a healthy economy. Therefore, as with bank-insurance company transactions, bank-bank liquidity swaps should not be in effect prohibited.

Additionally, the FSA in its paper considers the role of a bank as a liquidity buyer. We stress that banks also play an important role in the economy as providers of liquidity.

Finally, specific clarifications that we would like to request are:

- Page 7 of the paper can be interpreted as applying to transactions that involve transfer of legal ownership. Therefore, we request further clarification on whether a transaction without transfer of legal ownership would ever qualify as a liquidity swap.
- It is not clear whether transactions operating under a continuous margining agreement (CSA) are considered to be different to transactions where the collateral is not adjusted.

We would welcome the opportunity to work with the FSA to further develop the definition of a liquidity swap.
Q2: Does this accurately describe liquidity swap structures?

We believe that there are structures in addition to stock loans, repos and TRS, which could be used to execute liquidity swap transactions. We have identified and described a number of these in Question 3.

In its paper, the FSA states that liquidity swap structures have a common key risk – the price correlation in the event of a default means the counterparty lending the excess liquidity will have an unsecured claim against a defaulted bank to the extent collateral haircuts/over-collateralisation (or whatever credit risk mitigant is used) proves insufficient at the point of default and may force the counterparty to retain collateral rather than use it.

While we do not disagree that there is a potential risk that the liquidity seller will be left with an unsecured claim against the liquidity buyer, we believe that this is much less of a risk when compared with alternative structures that entities commonly invest in (e.g. unsecured bank debt). For example, in a liquidity swap, the insurer holds an unsecured claim against a defaulted bank only to the extent that the collateral value is insufficient. Conversely, the claim of a creditor to alternative structures may be completely unsecured.

Finally, prior to entering into a liquidity swap transaction, the liquidity seller will take the value of the collateral in the event of a default into account as part of their standard risk assessment and accordingly apply relevant haircuts. In particular, in the event of a default, insurance companies are most likely to hold the collateral to maturity rather than undertake a fire sale; therefore, they will account for this in their risk management procedures.

Q3: What other liquidity swap structures are there? Please describe.

In addition to repo, stock lending and TRS mechanisms, we suggest that a liquidity swap transaction may be executed also using the following structures:

- the liquidity buyer may borrow cash deposits and give ABS or other securities as collateral to the liquidity seller, achieving the same economic effect as a repo or sale & TRS.
- the liquidity buyer may borrow cash and give ABS or other securities as collateral to the liquidity seller; in turn, the liquidity buyer loans to the liquidity seller secured on other assets, achieving the same economic effect as a stock loan.
- a secured loan format; for example, a loan to the counterparty with a pledge on the collateral; and
- a repackage via a SPV; for example, an SPV note purchased by a liquidity swap provider, which is secured by liquid collateral, while the counterparty seeking liquidity enters into a liquidity swap with the SPV by which it borrows the collateral.

Q4: Do you agree with the description of risks? If not, please explain any proposed changes and the rationale for those changes.

The risks associated with liquidity swaps are no different to the risks associated with other lending programmes.

In particular, the paper states that in a liquidity swap there is uncertainty over the viability of a ‘fire-sale’ of collateral and therefore efficacy of ‘fire-sale’ as a ‘back-stop’ credit risk mitigant. Liquidity swaps provide a benefit over other forms of collateralised lending in that in the event
of a default of the liquidity buyer, the non-defaulting party controls the liquidation of the collateral (as opposed to a liquidator following a set procedure). Therefore, the liquidity seller can hold onto the collateral until maturity or wait to sell the collateral at a date when a better price can be obtained.

We stress that insurance companies generally consider default events as part of their general risk assessment prior to entering into any transaction. In particular, the risks associated with underlying collateral are well understood by insurance companies. For example, insurance company portfolios already include assets such as corporate bond holdings. Therefore, firms should assess their risks on a case by case basis as part of their normal risk management processes.

Our views on wrong-way risk and high sectoral correlation risk are provided in our answers to Question 7.

**Q5: Do you agree with the description and requirements of collateral valuation pre and post default? If not, please explain any proposed changes and the rationale for those changes.**

We agree that insurers should have a robust valuation process as part of their risk management. However, again, we believe that this is not a requirement specific to liquidity swaps, but is a requirement of general good risk management.

We note, however, the valuation process could be undertaken by a third party; we believe that this is a perfectly viable option and should not be precluded. Also, if the insurer intends to hold the collateral assets after a bank failure, they should have the ability to manage such assets.

The paper provides a requirement to keep a full audit trail evidencing the valuation and monitoring of collateral including collateral held, through segregated assets being individually identifiable and separated from firm's own assets. We highlight that this is not a requirement of the CASS rules. Therefore, we request that the FSA clarifies its position or looks to review its requirements more broadly than liquidity swaps.

**Q6: Do you agree with the description and requirements for wrong-way (collateral correlation) risk? If not, please explain any proposed changes and the rationale for those changes.**

Our views on wrong-way risk are provided in our response to Question 7. In general, however, we do not believe that banks require any additional guidance on correlation risk, as BIPRU 4 and 5 already adequately cover this.

**Q7: Do you agree with that materially positively correlated collateral should not be deemed adequate collateral for liquidity swaps? If not, please explain any proposed changes and the rationale for those changes and any supporting data.**

We agree that materially positively correlated collateral poses additional risks that need to be managed. However, it is clear that many own-issued or own-originated securities are not materially positively correlated to bank default. Certain own-originated securities provide good credit risk mitigation and should be regarded as providing acceptable collateral for liquidity swaps. This is supported by empirical data and analysis.
For example senior tranches of AAA rated securitisations should not be materially positively correlated to the default of the originating bank. It is however noted that a number of other asset classes would also provide effective credit mitigation.

Evidence from the recent financial crisis does not show a material positive correlation between the creditworthiness of a bank and the price of certain own originated asset backed securities. For example diagram 1 below shows the price performance of Northern Rock’s AAA Granite RMBS through the financial crisis and highlights the relatively stable price performance at the time of heightened probability of default by Northern Rock (see September 2007). Prices fell some time later (post nationalisation) as a result of the decision not to contribute additional mortgages into the Granite structure; such price reductions were primarily linked to the change in the maturity of the notes rather than the credit worthiness of the then nationalised bank. The assets remained strong from a credit perspective and prices recovered thereafter.

As a credit matter AAA rated RMBS have performed well under periods of stress given the diversified nature of the underlying assets, the structural credit enhancements and the bankruptcy remote nature of the investment. Such features justify the credit rating uplift over the originator’s credit rating. The degree of correlation will vary for different issuers and different programmes but even where correlation is positive; such assets should still provide effective risk mitigation given these features. Such assets offer superior credit mitigation than certain alternative securities issued by third parties.

The level of haircut and frequency of valuation are integral to an assessment of collateral suitability. Liquidity swaps will typically include ongoing daily mark to market and margining requirements. These provisions require the bank to adjust the collateral posted by reference to the relative mark to market movement of the collateral portfolio and the assets borrowed. The key question is therefore whether the level of margin exceeds likely point in time price changes of the collateral. The Northern Rock price history also indicates that daily price reductions are likely to be within the overcollateralisation level, see chart.

The insurer / liquidity seller’s intentions in the event of a counterparty default, the exit strategy noted in the guidance, are also relevant to the analysis. The position of the insurer or liquidity seller may be different from shorter term investors who might seek to liquidate collateral in stressed circumstances. This hold exit strategy may be consistent with other investments as asset classes such as RMBS and commercial property loans already form part of certain insurers’ asset portfolios, risk management framework and ICA calculations. The short term price performance of collateral will have less relevance if the insurer / liquidity seller intends to and can continue to hold the assets in the event of a bank default and the haircut adequately reflects the level of correlation. Credit correlation is likely to be of greater importance in the liquidity seller context than short-term price correlation.

Credit quality of collateral is important and for certain assets the credit rating offers a third party credit view and additional empirical data on default probability. Using the same asset example of RMBS, the senior tranches will typically have a c.15% credit enhancement which would require mortgage defaults to reach levels which are much greater than those seen in the UK before the holder of such assets would take credit losses. Data provided by the Council of Mortgage Lenders for mortgage arrears also offers empirical data, see chart. This shows that at its peak in 1992, mortgage arrears over 6 months (rather than defaults) reached c.3.5%. The
analysis supports the view that the likelihood of credit losses from AAA rated UK RMBS is very low.

In summary we suggest that own-originated collateral should be permitted providing the assets are of sufficiently high credit quality and there is a sufficient haircut to cover short term price correlation. The assessment of the level of correlation and the level of haircuts must be carried out on an asset by asset basis.

Finally, we suggest that correlation risks are present whether or not the assets are own originated. Indeed it is difficult to argue that correlation risks do not exist at all in a liquidity swap done with a mortgage firm providing non-own RMBS bonds (or covered bonds) from the same country while it does for global and diversified financial institution with a limited mortgage business but providing own originated RMBS bonds. Therefore, we do not believe that own originated assets should be the focus of the guidance, but whether the counterparties to the transaction have the relevant skills and procedures in place to assess the risks.

Charts: Positive Correlation and Own Originated Assets
Data sourced from MarkIT and references a typical AAA rated RMBS issued by Granite (ISIN XS0284076295).

Chart 1

Price of AAA rated Granite RMBS during Financial Crisis

- Run on Northern Rock
- Lehman insolvency
- Nationalisation of Northern Rock
- Northern Rock announces it is no longer adding mortgages to Granite

Granite (Northern Rock)

15% Haircut
Q8: Which own-issued / own-originated securities should potentially be deemed adequate collateral for liquidity swaps? The rationale for this should be set out and supported by robust empirical data and analysis, plus proposed haircuts.

Please refer to our comments in Question 7.

Q9: Please comment on what you think the micro-prudential risk based limit structure should be for individual firms and provide quantitative measures (e.g. absolute limits - £ and relative limits - %).

Micro-prudential risk based limits should be consistent with counterparty risk measurement and management for other financing based business and should form part of the normal risk management framework of any counterparty to a liquidity swap transaction. Micro-prudential limits should account for collateral haircuts as well as consider factors such as collateral type, the diversification of collateral and borrowers by type and geography.

We believe that a one-size-fits-all limit structure for all firms is not appropriate. Companies differ significantly (e.g. in size and levels of exposure) and such as require different frameworks. For example, a large company could have a large exposure relative to others; however, the exposure may not be significant in size for that particular firm. Therefore, limit structures need to be determined on a case-by-case basis.

Q10: Please comment on what you think the macro-prudential risk based limit structure should be and provide quantitative measures (e.g. absolute limits - £ and relative limits - %).

We do not believe an absolute macro-prudential limit for liquidity swaps should be used. As stated above, depending on the nature of the firm participating in a liquidity swap, the weight of its exposure will vary. Therefore, micro-prudential limits as part of the normal risk management processes are the most effective measure in ensuring market stability.
However, as with other transaction types, we encourage the authorities to monitor the trends in the use of liquidity swaps over time and ensure firms participating in liquidity swap transactions are undertaking effective risk management measures and are putting appropriate limit structures in place.

Finally, specific clarifications that we would like to request are:

- Whether the FSA will expect a limit on the type/maturity/eligibility of securities, which can be used as collateral? We believe it is up to the firm to decide its risk appetite.
- Are we correct to assume that regarding “collateral received”, the requirement to “treat as notional positions against Solvency I concentration limits for admissible assets”, is relevant to insurance companies alone and not banks?
- How should the ratio of positive correlation be measured?

**Q11: Do you agree with the description and requirements for legal risk? If not, please explain any proposed changes and the rationale for those changes.**

We recommend that existing market standard documentation generally address these issues. However, it should be up to the firms to decide whether a particular legal review is necessary in the context of the transaction.

For example, in relation to the requirement for obtaining a legal review on “legal effectiveness and enforceability of contractual right to liquidate the collateral in a timely manner in the event of a default, insolvency or bankruptcy or other credit event on the counterparty”, timeliness and enforceability is likely to be reliant on how quickly a custodian is prepared to act following a default event. As such, this requirement may not be something that a firm would obtain a legal opinion on.

**Q12: Do you agree with the description and requirements for break clauses – regulatory change (e.g. Solvency II, bail-in and asset encumbrance)? If not, please explain any proposed changes and the rationale for those changes.**

We understand the FSA’s concerns regarding the uncertainty surrounding upcoming regulatory changes in relation to current transactions; however, we believe mandatory break clauses for liquidity swap transactions are completely inappropriate.

Regulations, such as Solvency II, that will have broad economic impacts, will affect all types of transactions. Therefore, again, it is unclear why liquidity swaps alone should be singled out for this requirement. In particular, in relation to Solvency II, the legislation is an economic principles-based regime; insurance companies using internal models will be required to accurately reflect the economics of any transaction. Therefore, it is unclear why the Guidance assumes that Solvency II would specifically adversely affect liquidity swaps, such that these transactions alone would require break clauses.

There have already been a number of regulatory changes, which have impacted the financial sectors broadly. However, historically, firms have demonstrated that they are able to manage the risks associated with regulatory change. Additionally, regulatory changes generally include a transition period, which makes the use of blunt instruments, such as break clauses, unnecessary.
Further, we believe that mandatory break clauses would create undue commercial uncertainty and will make it difficult to price a transaction properly for a number of reasons, including:

- Solvency II is one of a number of wide-reaching regulations taking effect in the near future. Therefore, mandatory break clauses for Solvency II risks would force bank as well as insurer counterparties to protect their interests by including break clauses to account for all regulations (e.g. CRD IV).
- Break clauses contingent on legislation will most likely take effect on the date of implementation of the regulation; this could result in many transactions being unwound at the same time, adversely impacting on market stability.
- A clause treating the remainder of the term of the transaction after the break as an option is economically different (e.g. the spreads will not be the same) from a transaction with a full term length. For example, a five year contract cannot be deemed the same as a two year contract with a 3 year option.

We recommend that, as with other transactions, counterparties to liquidity swaps should be left to make their own commercial arrangements for regulatory uncertainty. We would welcome the FSA in its Guidance to encourage counterparties to agree in good faith to, if necessary, renegotiate their commercial arrangements in the event of regulatory implementation.

Q13: Do you agree with the concerns around intra-group liquidity swaps? What, in your view, are possible measures that can be effective in preventing intra-group transactions, which also effectively prevent arbitrage that might come about from a ban? If these transactions are not prevented, how should these concerns be mitigated?

Intra-group transactions occur for many types of other transactions; therefore, again, we do not believe that it is appropriate for liquidity swaps to be subject to different intra-group measures, unless there are specific concerns for these transactions.

If a firm has appropriate governance measures, we believe that it is inappropriate to prohibit intra-group transactions for liquidity swaps. In particular, firms have policies and procedures, mandated by the FSA, already in place to ensure: risks such as conflicts of interest are mitigated and parties act on arms length terms.

One commercial advantage on undertaking intra-group liquidity swap transactions is that it may be an effective form of liquidity management. In particular, liquidity swap transactions could be useful in the absence of a waiver for intra-group entities to comply with self-sufficiency or ring-fencing requirements. Otherwise, firms would need to use a third party to manage their liquidity. Therefore, the Guidance should not inhibit firm’s ability to manage liquidity risk across a group or to conduct transactions to facilitate centralised management.

Q14: Do you agree with the notification requirements? If not, please explain any proposed changes and the rationale for those changes.

We note that PRIN 11 already applies to insurance companies in respect of their transactions generally; therefore, we believe that insurance companies (in fact any counterparty in general) should also apply their existing governance procedures to ensure only appropriate liquidity swap transactions are entered into. However, we do not believe there is any reason why separate requirements should apply to liquidity swaps.
As part of a broad risk management re-assessment process, we would welcome the introduction of a reporting system, which would require reporting of liquidity swap transaction after execution. We believe that this would promote good practices within firms. However, we believe the requirement for all liquidity swaps to be reported to the FSA prior to the execution of the transaction is inappropriate.

In particular, seeking permission for each transaction prior to execution is too severely restrictive and practically difficult. For example, this kind of reporting system would prevent the ability of the liquidity seller to take advantage of favourable short-term market conditions, places significant pricing risk on banks and places the liquidity seller at a competitive disadvantage to other non-FSA-regulated counterparties.

Finally, by introducing overly onerous requirements for liquidity swaps, firms will simply enter into other types of transactions.

**Q15: Do you agree with the description and requirements for systemic risk – FSA reporting? If not, please explain any proposed changes and the rationale for those changes.**

We believe the extensive existing reporting requirements under BIPRU 22 and FSA 47-8 for liquidity are adequate. Further requirements for liquidity swaps would be too onerous.

**Q16: Do you agree with the description and requirements for scenario and stress testing of cash-flows (liquidity risk)? If not, please explain any proposed changes and the rationale for those changes.**

N/A

**Q17: Do you agree with the description and considerations for insurers in Pillar 2 ICA / ICG – meeting liabilities as they fall due and capital levels? If not, please explain any proposed changes and the rationale for those changes using numerical examples where possible.**

It is inappropriate and inconsistent to apply a 100% probability of default to these transactions, when compared to other such financial instruments issued by banks such as corporate bonds.

Further, recourse to the bank has considerable economic value, even in stressed conditions.

**Q18: Do you agree with not re-hypothecating the collateral? If not, please explain any proposed changes and the rationale for those changes.**

We request further clarification by the FSA on the ringfencing requirement. For example, it is unclear whether the FSA expects the assets of a liquidity swap to be ringfenced in their entirety or whether the FSA is referring to the over-collateralisation.

Further, we note that rehypothecation is standard practice in the securities lending and repo markets; therefore, it should be permitted for liquidity swap transactions. In relation to risks, firms determine the necessary measures on a transaction by transaction basis; for example, haircuts, involving the retention of more illiquid assets in a custody account, may be used.
**Q19: Do you agree with the description and requirements for disclosure? If not, please explain any proposed changes and the rationale for those changes.**

We note that the disclosure requirements already exist in documentation as part of the broader management requirements of firms.

Specifically, we request for greater clarity on:
- the level of disclosure required; and
- whether disclosure is required at an aggregate level or single transaction level. To protect the (economic) interests of the counterparties, we suggest the latter should not be required.

**Q20: Do you agree with the description of the risks to banks and their unsecured creditors (e.g. retail depositors)? If not, please explain any proposed changes and the rationale for those changes.**

We agree; however, we note that the risks are neither new nor specific to liquidity swaps.

**Q21: Do you agree with the description and requirements for Pillar 1? If not, please explain any proposed changes and the rationale for those changes.**

The paper adequately summarises the Pillar 1 treatment for the structures described in Section A3 of the paper; however, we note that it does not address the secured deposit structure.

The Interim Prudential Sourcebook for Banks (chapter NE) provided specific rules concerning such situations which explicitly covered “over-provision” of collateral in the banking book. However, BIPRU does not include these rules. We believe that this may lead firms to conclude that there is no Pillar 1 counterparty risk requirement for such transactions (particularly when taken together with the general provision in GENPRU 1.3.4 that, in recognising and valuing an exposure or asset, accounting rules should be followed if there is no regulatory rule to the contrary). From an accounting perspective, a bank that borrows cash against provision of collateral under a secured deposit structure, should not record any counterparty exposure.

We request the FSA to clarify whether its intention for the provision of collateral against banking book borrowing to be dealt with in Pillar 2 rather than in Pillar 1.

**Q22: Do you agree with the description and requirements for Pillar 2? If not, please explain any proposed changes and the rationale for those changes.**

We believe that Pillar 2 capital charges and/or limits for asset encumbrance specific to liquidity swaps are inappropriate. Asset encumbrance is a broad issue and is not limited to liquidity swaps. Therefore, again, this is not a unique risk for liquidity swaps that would mean this transaction requires separate treatment from others. We recommend that if the FSA intends to address any concerns it may have regarding encumbrance, it should issue a separate broad consultation.
Annex I

The Association for Financial Markets in Europe (AFME) represents a broad array of European and global participants in the wholesale financial markets, and its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME was formed on 1st November 2009 by the merger of the London Investment Banking Association and the European operations of the Securities Industry and Financial Markets Association. AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

The British Bankers’ Association (“BBA”) is the leading association for UK banking and financial services for the UK banking and financial services sector, speaking for over 230 banking members from 60 countries on the full range of the UK and international banking issues. All the major banking players in the UK are members of our association as are the large international EU banks, the US banks operating in the UK and financial entities from around the world. The integrated nature of banking means that our members are engaged in activities ranging widely across the financial spectrum encompassing services and products as diverse as primary and secondary securities trading, insurance, investment banking and wealth management, as well as deposit taking and other conventional forms of banking.