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Financial Services Advisory

Liquidity risk management and the ICARA process

Contents

Background

Of all the requirements under the Investment Firms Prudential Regime ("IFPR"), few have generated as much difference in approach as liquidity Risk Management. It is no surprise, therefore, that liquidity remains perhaps the area under the most scrutiny by the Financial Conduct Authority ("FCA") when considering whether firms appropriately resourced – whether on an ongoing basis or during periods of stress.

The FCA's approach to assessing the adequacy of liquid assets has undergone an evolution since the original rules for investment firms were created in the aftermath of the 2008 financial crisis. However, the core principle has remained unchanged – a firm must always maintain adequate liquidity resources to ensure there is no significant risk that it cannot meet its liabilities as they fall due, including in times of stress.

A robust and proportionate liquidity risk management framework ("LRMF") reduces the risk of disorderly failure. Firms are more likely to survive liquidity stress events if they have effective, practical approaches to managing liquidity risk, rather than simply adopting a tick-box approach to compliance with the requirements in MIFIDPRU. This explains the focus of the FCA's recent supervisory work and extensive guidance in this area, which deals with the intricate workings of firms' liquidity risk management processes rather than simply the outputs of firms' assessments of liquidity requirements for ongoing operations (i.e., Assessment A) and for effecting an orderly wind-down (i.e., Assessment B) as part of the Liquid Assets Threshold Requirement ("LATR").

Where firms do not operate fit-for-purpose LRMFs, they could be subject to material penalties in the form of Individual Liquidity Guidance ("ILG") arising from the FCA's Supervisory Review and Evaluation Process ("SREP"). Where the FCA have concerns about the effectiveness of a firm's LRMF, they could impose an ILG of several multiples of the Basic Liquid Asset Requirement ("BLAR").

In this paper we explore common issues across firms' design and operation of their LRMFs, and we provide examples of good practice in terms of computing liquidity requirements under MIFIDPRU (the main rulebook for investment firms).

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Principles of effective liquidity risk management

What is liquidity risk?

The FCA have previously defined liquidity risk as the risk that a firm, although solvent, either does not have available sufficient financial resources to enable it to meet its obligations as they fall due or can secure such resources only at excessive cost. Liquidity issues are often the primary culprit when firms fail. This is because they generally crystallise quicker than capital issues and leave the impacted firm with little time to address the consequences of the liquidity event. These impacts explain the FCA's concerns with liquidity as a high-risk issue that threatens the financial resilience of firms.

Liquidity risk management frameworks

To mitigate the risk of failure arising from a liquidity stress event, firms are required to have in place robust strategies, policies, processes and systems that enable it to identify, measure, manage and monitor liquidity risk over an appropriate set of time horizons, including intra-day, so as to ensure that it maintains adequate levels of liquidity buffers. Based on the FCA's feedback on firms' liquidity risk management framework, it is clear that this foundational expectation continues to apply under the IFPR.

"the systems that the firm uses to identify and monitor liquidity risk should be tailored to its business lines, the currencies in which it operates and its structure (taking into account, for example, whether it operates branches or supports subsidiaries or other group entities). In addition, those systems should consider liquidity costs, benefits and risks, including intra-day liquidity risk... [the systems] should be proportionate to the complexity, size, structure and risk profile of the firm"

MIFIDPRU 7 Annex 1.6

An effective LRMF answers three key questions:

- Do we know our expected short-term liquidity requirements, taking into account ongoing risks and plausible stress events?
- Can we promptly identify a stress event that is likely to crystallise?
- Do we have systems and processes in place to promptly react to and mitigate liquidity risk and recover from stress events?

Firms can answer these questions in the affirmative only if they have a robust framework for identifying, monitoring and moving quickly to mitigate stress events.

The fundamental principles of effective liquidity risk management are consistent across the financial services sector. They comprise the following:

- Robust identification and assessment of liquidity risks
- Effective governance and oversight
- Liquidity stress testing: inter and intra-day.

Principles of effective liquidity risk management

Robust risk identification and assessment

Effective liquidity risk management always begins with a clear definition of the risks that a firm is exposed to. Without an understanding of the liquidity risks inherent to the firm and its operating model, it is not possible to design and implement an effective LRMF. The first step is therefore to identify and record the full 'universe' of actual and potential liquidity risks arising, even if the firm has had no previous experience of these materialising in practice.

Some common liquidity risks:

- Time mismatch between receipt of fees received from clients and fees paid to trading platforms for transmission or execution of orders
- Outflows due to increased fees charged to access platforms
- Intraday and inter-day liquidity risks arising from trading book positions, including levels of intraday margin required under normal and stressed circumstances
- Failure of trade to settle on the agreed settlement date
- Delays in payments of fees due from clients
- Disruption to cashflows caused by an interruption to the firm's credit facilities
- Market-wide events that limit the firm's access to the markets and/or funding
- Claims and compensation paid out due to order execution errors
- Risk of default by clients to whom credit has been granted for the purpose of carrying out transactions in financial instruments

It is therefore vital that liquidity risks are appropriately described and included within the risk universe of the firm with clear allocation of risk and control owners.

Furthermore, firms must have a well-defined risk appetite for liquidity risk within their risk management framework. This should include qualitative and quantitative metrics of the levels of risk that the firm is willing to take in the pursuit of its objectives.

Principles of effective liquidity risk management

Case study

A wholesale sell-side firm has put in place the following liquidity risk appetite statement.

ABC has a low appetite for liquidity risk. The firm implements robust systems and controls for ensuring that the firm is able to meet its obligations under business-as-usual and stressed market conductions as they fall due. We negotiate fair and prudent trading terms with our counterparties to ensure we are able to swiftly manage liquidity exposures without excessive reliance on individual funding sources. To manage our liquidity risks, the firm will:

- *Maintain **ring-fenced liquid assets** to cover unexpected cash outflows under stressed conditions*
- *Ensure **intraday liquidity** is sufficient to meet margin calls and settlement obligations*
- *Avoid **excessive reliance on contingent liquidity sources***
- *Conduct **regular stress testing** and scenario analysis to validate resilience.*

Liquidity risk metrics monitored on a periodic basis include:

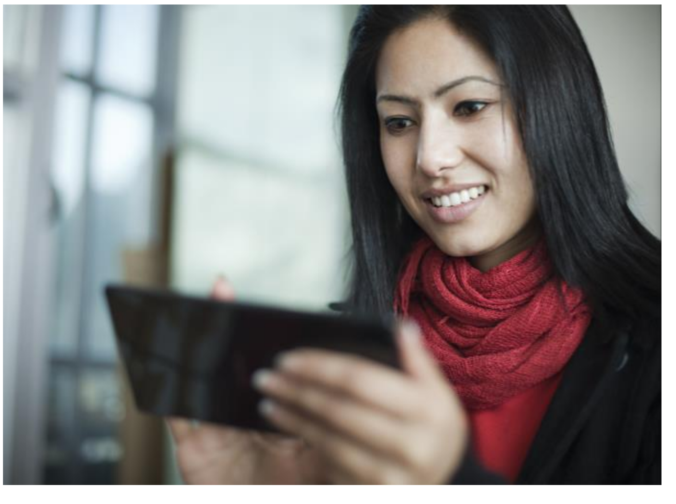
- *Buffer over LATR*
- *Survival Horizon*
- *Short-term facility usage*
- *Client credit line usage*
- *Liquidity concentration risk.*

This firm has set RAG levels for the metrics it monitors and has established escalation protocols for breaches of its Amber and Red thresholds.

Identified risks should be assessed for likelihood and impact. It is important that this assessment is carried out by suitably knowledgeable and experienced individuals who can provide reasonable and justifiable judgments on the level of risk faced by the firm pre- and post-controls.

Identification and assessment of liquidity risk - What does “good” look like

1) There is a clear definition of liquidity risk including intra-day risks. These are documented in risk registers with clear risk and control owners.
2) The firm has a defined risk appetite for liquidity risk that includes qualitative and quantitative triggers.
3) There is a shared understanding and collaboration of the liquidity risks that exist within the business between the Operations, Risk, Compliance and Finance functions.
4) There is a documented and regularly reviewed liquidity risk policy (and supporting procedures) that has clear ownership, defined roles and responsibilities, and scope of application.
5) Feedback loops exist to support the review and update of identified risks and their mitigation.



Principles of effective liquidity risk management

Governance and Oversight

Effective LRMFs must have clearly defined internal governance and managerial reporting protocols around key liquidity risks, including intraday and short-term liquidity risks. As recent FCA thematic work has showed, these governance arrangements work best when they involve teams across the three lines of defence working in an integrated manner.

Firms that view risk management as a standard way of working to optimise performance and maintain resilience rather than just a compliance tick-box exercise will be better positioned to deal with risks and stress events. The Board of the firm should set the right tone and encourage a view of risk that is focussed on the benefits of effective risk management and is fully embedded within the standard workflows of the organisation.

This is important as the practical implementation of an effective LRMF involves the monitoring of liquidity risk, measuring against risk appetite and regulatory limits, as well as taking realistic mitigating actions to ensure the control environment of the firm is robust enough.

Individuals and governance forums responsible for risk management and oversight must be able to demonstrate an understanding of their liquidity risks and how these are managed on a day-to-day basis.

In addition, the FCA has clarified that it is the Board's responsibility to calibrate the Board's risk appetite by establishing its limits framework in such a manner as to ensure that there is sufficient liquidity headroom in order to take effective action before any pre-set wind-down triggers are breached.

Signs of weak governance arrangements over the liquidity risk management framework:

There is no clear owner of the liquidity stress model or liquidity policy	There are no clearly defined liquidity risk appetite limits or triggers
The responsibility for the oversight of liquidity risk KRIs is not defined; and / or its oversight cannot be evidenced via regular reporting to the responsible forums	The LRMF is not regularly reviewed updated nor are its assumptions and inputs regularly challenged
There is limited interaction and information flow between the Operations and Risk teams	There is limited or ineffective delegation of authority to a responsible senior manager for dealing with liquidity risk matters promptly
Decision making and escalation protocols have not been clearly defined	The contingency funding plan and/or recovery plan is not detailed enough to be operable
There is limited or no review of the effectiveness of these arrangements by the third line	Liquidity risk management expertise is lacking across the three lines of defence.

Principles of effective liquidity risk management

Liquidity stress testing: Intra-and inter-day

Effective liquidity risk management requires a firm to maintain, at an appropriate frequency, comprehensive liquidity stress assessments to provide management with insight on the level of liquidity buffers to hold.

MIFIDPRU requires firms to *"consider relevant severe but plausible stresses that could affect the firm's business and consider whether the firm would still have sufficient... liquid assets to meet the overall financial adequacy rule"*. One of the challenges firms have faced in implementing IFPR is how to translate the high-level rules into practical actions. What is clear from the FCA's recent communications on the topic is that the good practice of prior regimes, such as the need for effective Contingency Funding Plans (CFPs) and solid recovery actions allow firms to maintain sufficient liquid assets under normal and stressed conditions. While recovery planning is designed to restore financial adequacy in the face of a breach or expected breach of regulatory thresholds through more holistic and longer-term measures, the recent communications suggest that there is an increased focus on CFPs. CFPs are specifically meant to ensure short-term solvency in the face of large one-off unforeseen liabilities, triggered by potential operational and market events.

The recent FCA multi-firm review feedback highlighted some good practice in firms' liquidity stress testing:

1) **Dynamic forecasting**: Better firms carry out two forward-looking liquidity stress assessments each day - one before banks and trading counterparties close and the other later in the evening. This allows to form a picture of where markets closed and forecast what could take place at the start of trading the following day to then plan contingency actions including possibly drawing on group liquidity facilities, or other funding sources if needed Whilst a twice-daily analysis may be more appropriate for principal dealing firms with fast moving liquidity profiles, other firms may find lower frequencies to be more appropriate depending on their business model.

2) **Proportionate Stress Testing**: It is important that stress tests reflect the complexity and scale of firms' operations. More complex firms' liquidity stress models should incorporate reasonable assumptions about client and counterparty behaviour, peak potential outflows from margin calls, settlement failures or increased settlement requirements, drawdowns on client facilities or withdrawal of unsegregated client money.

3) **Appropriate assumptions**: For stress testing to be effective, it needs to be based on plausible but severe scenarios and assumptions. They should reflect historical data, such as the number, magnitude and timing of margin calls, and the level of inflows from clients,, funding availability and short-term funding from banks and other counterparties. This includes considering the impact of a stress on uncommitted intra-group liquidity facilities and notifying group companies of use of facilities, potentially in excess of limits.

4) **Robust model management**: Where firms use models such as Value at Risk, it is important that the models are frequently reviewed and calibrated to ensure the outputs remain fit-for-purpose.

Principles of effective liquidity risk management

The ‘Big Four’ stress events for wholesale trading firms:

Some questions to consider when evaluating the adequacy of your stress testing:

- Large cash outflows due to margin calls
- Buy-ins of large open short settlement positions
- Losses arising from hitherto unknown concentration risk exposures
- Ability to raise funding in troubled markets or the speed of client withdrawals.

1) Is the firm’s stress testing dynamic, forward looking and supported by immediate and long-term horizon scanning?

2) Does it allow the firm to anticipate and respond promptly to potential and emerging stress?

3) Has the firm developed liquidity stress scenarios whereby liquidity / credit facilities become partially or completely unavailable?

4) Does the firm’s liquidity stress model anticipate and quantify actual prospective stressed liquidity cashflows by counterparty?

5) Is the firm able to complete an accurate 36-month lookback analysis to identify observed and potential peak historic liquidity outflows that occurred in the short term?

6) Does the firm monitor all relevant operations reports daily and ensure their liquidity risk analysis, prospective liquidity stress modelling and potential stressed liquidity requirements are based on accurate up-to-date information?

Significant weaknesses in the design and operation of the LRMF have prompted the FCA to issue Individual liquidity guidance of the order of several multiples of firms’ own assessments of liquidity requirements.

An effective LRMF is one in which the key components are not just well-designed individually but also integrated, which reduces the need of intervention by the Regulator. This means that the risk identification and assessment, cashflow modelling approach and stress testing analysis and wind-down assumptions should all be coherently interlinked and consistent with the business and operating model of the firm. All of this should be supported by effective governance that can demonstrate appropriate oversight and action when appetite limits are breached.

Liquidity Risk Assessments within the ICARA

With the foundation of an effective LRMF in place, attention rightly turns to the quantification of the amount of liquid assets the firm needs to meet the overall financial adequacy rule ("OFAR"). In the sections below, we discuss the approaches to quantifying the LATR which is the liquidity component of OFAR.

The LATR is the sum of the BLAR, and the higher of the liquid assets needed to fund ongoing operations (Assessment A) and to commence an orderly wind-down (Assessment B). The BLAR is reasonably well understood so we will focus on the two Assessments in this paper.

Liquidity requirements for ongoing operations (Assessment A)

Overview

This aspect of the liquidity requirements stems from the general OFAR expectation to fund ongoing operations and remain financially viable throughout the economic cycle, considering potential harms and stress that may arise.

Under MIFIDPRU 7.7, the FCA's expects this assessment to take account of:

- the ordinary level of liquid assets that would typically be required to operate the firm's underlying business
- any material harms that may realistically occur during the next 12 months and their potential impact
- any liquid assets that a firm may need to use as collateral or to meet margining requirements
- any estimated gaps in funding, including during periods of severe but plausible stress.

The expectation is that firms estimate how much liquidity they will require at any point in the next 12 months (the period covered by the ICARA assessment) assuming not just the continuation of business as normal but also the impact of realistic liquidity risks and severe but plausible stress scenarios crystallising.

Firms must assess liquidity requirements over the next 12 months and identifying the cash requirements in each quarter following the application of risk and stress assumptions. The Assessment A figure is then the highest cash requirement over the four quarters.

Common challenges

Under MIFIDPRU, the FCA has adopted a high-level, principles-based approach with minimal prescriptive detail. This was intended to accommodate both small firms and large, complex organisations. However, this flexibility has led to varied interpretations, with some firms applying methodologies for Assessment A that fall short of regulatory expectations or are misaligned with their business complexity.

A common area of confusion is the relevance of BIPRU 12 liquidity rules under IFPR. Firms previously subject to BIPRU 12 should already have established liquidity risk management and stress testing practices. While some initially viewed MIFIDPRU as a relaxation of standards, FCA feedback has clarified that these practices remain necessary where the firm's liquidity risk profile is unchanged. Thus, maintaining core elements of the Liquidity Risk Management Framework (LRMF) remains essential.

Liquidity Risk Assessments within the ICARA

For firms lacking robust liquidity arrangements, the non-prescriptive nature of MIFIDPRU has posed challenges—particularly in forecasting cashflows, modelling stress scenarios, and integrating management actions. The FCA has emphasised through industry guidance that firms with historically rigorous liquidity assessments should maintain that standard under IFPR. Others must now develop proportionate frameworks incorporating cashflow analysis, risk factors, and stress outcomes.

Some of the common blind spots we have observed in firms' assessments include:

- Not identifying and properly assessing all applicable sources of liquidity risk; and reflecting these in the analysis of how much liquidity is required. For example, a sell-side firm that does not properly assess the risk of significant margin calls or model the timing of stress events will likely have an Assessment A figure that falls short of expectations.
- Some liquidity stress testing analyses select scenarios (for example, a percentage reduction in revenues) that model a longer, slower reduction in capital without conducting a high impact scenario that crystallises quickly and erodes liquid asset reserves. Such analyses over a 3-5-year horizon instead of over a 1-day, 7-day, 30-day, 90-day or 1-year period do not reflect the nature of liquidity stress events that are modelled.

An example approach to an Assessment A quantification

An asset manager manages multiple institutional discretionary mandates. It identifies its main liquidity risks as arising from non-payment of its fees and a one-off operational risk event impacting its IT infrastructure with significant impact on payments to suppliers. This is based on its risk profile and operational risk incidents over the past three years. It also identifies a liquidity risk arising from currency fluctuations due to the nature of its cashflows being in different currencies and the possibility that hedging arrangements may not work as intended. Its highest net cash outflow is in Q2 when bonuses are paid. This firm estimates its Assessment A considering the value of the BAU net outflow in Q2, the value of the outflow arising from the IT incident and a significant adverse move in the USD-GBP rates. It does not have significant intra-day movements; therefore, it does not assess any liquidity requirements arising from intra-day stress events.

- We have also observed cases where although the risk management procedures were designed with liquidity risk in mind, the assessments were not granular or suitably frequent compared to the nature of liquidity risk faced – for example, a business with significant intraday cash fluctuations should have metrics and monitoring reports supporting its assessment of its stressed intra-day liquidity risk requirement. Not having an assessment for intra-day risk or not revising this component of the analysis periodically may indicate that the Assessment A figure is inadequate.
- Some firms use a formula with no basis for its use. For example, X% of BLAR or FOR. Such calculations are simplistic and do not demonstrate the level of rigour in assessing and quantifying liquidity risks that the FCA expect.

Liquidity Risk Assessments within the ICARA

Things to think about

- Do your staff have the right skills and capacity to understand the liquidity risks of the business and model its exposure periodically?
- Does your business have appropriate systems and controls for monitoring and reporting on the exposures periodically?
- Is there evidence of timely action being taken to rectify breaches and adjust internal KRIs as required?
- If models are used, can the firm justify its inputs and outputs?
- Does your firm have the right skills in the second and third line to review the outputs, including the accuracy of the regulatory reports filed?

Liquidity requirements for wind-down (Assessment B)

In recent times, we have seen a number of market-wide events that have had significant impacts on firms' financial resilience; for example, the Swiss-Euro decouple, COVID and the 2022 Nickel crisis. The increasing frequency of these systemic events and their potential impact on firms has driven the regulatory focus on ensuring firms have appropriate arrangements and resources to exit the market in an orderly way if they do fail. A disorderly wind-down of a financial firm negatively impacts markets by destroying asset values, reduced client confidence, and potentially harming financial stability, especially in the case of large, interconnected firms. The FCA requires firms to maintain robust wind-down plans to ensure they have adequate resources, including liquidity, to be able to cease operations in an orderly manner.

The FCA has clear expectations when it comes to financial resource planning under Assessment B.

In the sections below, we explore the requirements and common weaknesses that the FCA has highlighted on its various feedback forums.

Assessing Financial Resources

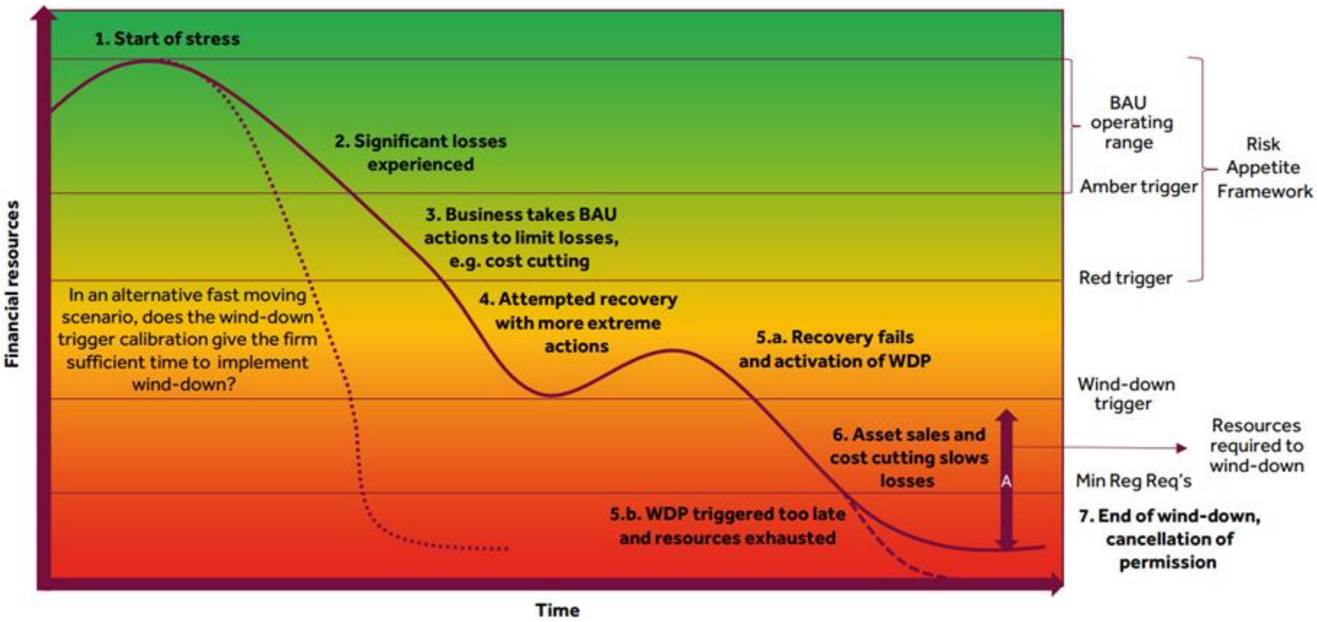
Stress to Wind-down Continuum

At its most basic, a wind-down plan provides a firm with a blueprint for how it will cease operations in an orderly fashion. A good analysis therefore begins with a consideration of the factors that could prompt the firm to consider winding down its business. The reverse stress test therefore provides a useful starting point. Reverse stress testing helps a firm to identify the scenarios that could lead to failure of the business, assess likelihood and determine effective mitigation approaches which are regularly assessed for continued effectiveness.

Liquidity Risk Assessments within the ICARA

Effective reverse stress testing analysis is not just about identifying potential threats; it also plays a vital role in financial planning for a wind-down. By identifying and simulating scenarios that could lead to business failure, firms can better estimate the financial resources required in each of those scenarios. Wind-down planning therefore does not exist within a vacuum; it has to be linked to the business model of the firm and the scenario that got the firm into wind-down in the first place.

This is partly why the FCA views wind-down as the end of a stress continuum as depicted in the image below.



FCA TR22/1 - Observations on wind-down planning: liquidity, triggers & intragroup dependencies

Liquidity Risk Assessments within the ICARA

Under Assessment B, the starting assumption is that wind-down is arrived at from a period of stress. Consequently, the expectation is that the stress event that led to this would likely have depleted BAU levels of capital and liquidity by the time the decision is made to wind-down. By starting from an assumed stressed position, firms are able to take a more prudent view of how much liquidity they will need to maintain on a BAU basis as a buffer over and above the BLAR. By incorporating these considerations, firms can enhance their resilience and ensure compliance with regulatory expectations, ultimately safeguarding client interests and maintaining market integrity.

Examples of stress events that could lead to firm failure:

- **Market Volatility**: Extreme market fluctuations in interest rates, equity or bond markets, or currency exchange rates.
- **Operational Risks**: Operational failures, such as cyber-attacks or failure of a critical outsourced service provider.
- **Credit Risk**: Defaults by significant counterparties or clients.
- **Regulatory Changes**: Significant regulatory changes that could increase operational costs and/or make the business model unviable.
- **Reputational Damage**: Operational incidents that cause irreparable damage to the company's reputation or brand leading to client exodus.
- **Economic Downturn**: Severe macroeconomic downturn that increases the likelihood of client failure or reduces revenues below breakeven.

Whilst there is no mandatory expectation to model all the scenarios that could lead to wind-down, identifying the more likely scenarios and modelling how these could crystallise will lead to better forecasts of the liquid assets required over the wind-down period.

Quantifying liquidity requirements for wind-down

The calculation of the liquid assets required to wind-down involves detailed cashflow modelling. Similar to the Assessment A exercise above, more granular modelling to consider the first few days and weeks of the wind-down period will be necessary to demonstrate a robust analysis. For example, you would expect more complex firms with material intra-day and inter-day cash movements to perform similar modelling in their wind-down analysis. Such granularity allows firms' boards to identify any gaps in liquid resources over the wind-down period.

The granular assessment also supports firms in accurately modelling the timing of cash flows during the wind-down period and any contingency funding needs. A disorderly wind-down is more likely if the timing of inflows is misaligned with cash outflows at any point during the wind-down period. By understanding the contractual and operational factors that affect cashflows, firms can better anticipate the timing of financial movements and adjust their strategies accordingly to maintain stability throughout the wind-down process.

MIFIDPRU does not require the Assessment B value to be the liquid asset required for the entire wind-down period but that needed to 'commence' wind-down. Whilst 'commence' has not been defined in the rules, general industry practice is to consider the initial period where the most significant wind-down cash outflows will be experienced; in many firms, this will cover the requirement in the first few months of the wind-down period. Notwithstanding, it would be prudent of firms to determine an Assessment B requirement that ensures there are no gaps in the firm's liquidity requirements throughout the wind-down period.

Liquidity Risk Assessments within the ICARA

In TR22/1, the FCA provided an example of the sort of analysis they will consider suitable. This involves consideration of BAU inflows and outflows; as well as wind-down specific inflows and cashflows.

The cashflow modelling exercise is indispensable to an appropriate Assessment B calculation. Where firms rely on simplistic multiples of BLAR or percentages of the Fixed Overhead Requirement, they should prepare to be challenged on the approach they have taken and how they have obtained comfort that those estimates are adequate.

In summary, the Assessment B exercise should:

- Consider BAU and wind-down specific cashflows
- Be sufficiently granular to reflect the liquidity profile of the firm, particularly in the early stages of the plan
- Consider any timing mismatches in the modelling of inflows and outflows, and how any gaps in liquidity will be covered
- Consider what a net cash outflow outcome means and how this would be addressed.

It is also worth noting that a consistent and coherent thread should run through the wind-down narrative. The scenarios modelled, the wind-down triggers, contingency funding options, the available recovery actions, the starting stressed cash position, the assumptions incorporated in the modelling, and the final figure determined should all be consistent and coalesce into a coherent narrative.

Finally, the plan should be periodically tested to check that it is operable in a stressed environment.

Cashflows to consider in the development of the wind-down plan

Inflows

- New revenue is likely to be reduced by wind down
- Revenues from residual and historic business may be largely unaffected
- Other contractually guaranteed inflows, e.g. trade settlement
- Returned collateral as trading activity reduces
- Natural cash generative reductions in back books of business e.g. a loan book
- Proceeds of any restructuring, e.g. asset sales.

BAU Outflows

- Contractually required outflows
- BAU business expenses, such as salaries and third-party payments
- Intra group fees and service costs
- Completing any pipeline of business, e.g. the firm may be committed to a loan at the point of wind down and is contractually obliged to provide the loan
- Settlement of trades.

Wind-down specific Outflows

- Retention bonuses to be paid to required staff
- Redundancy costs
- Professional fees
- Behavioural changes to counterparties and central clearers, such as increased collateral calls and reduced flexibility over the timing of payments

Liquidity Risk Assessments within the ICARA

What does good look like?

The calculation of liquidity requirements from ongoing operations involves incorporating all key components of the requirements in MIFIDPRU and from recent regulatory guidance.

Granularity of cashflow analysis

Intraday (minimum expected for wholesale sell side firms. Other firms may be able to do the analysis on weekly or monthly basis if consistent with their cashflow profile.

Time horizon

12-month minimum. The FCA accepts that the cashflow forecasts for later months may be less accurate. This should be assessed by considering cashflows in each quarter within the 12-month period

Completeness of risk sources

Consider the main sources of liquidity risk and reflect the key ones in the analysis

Robust stress testing in line with the granularity analysis

Incorporate robust stress testing into the analysis Incorporate robust stress testing into the analysis and do this frequently

A sound methodology should involve all of the following:

- Starting with a granular (daily or weekly, as appropriate) assessment of business-as-usual cashflow projections that is aligned to management's forecasts and the financial projections in the ICARA for that upcoming financial year. This should be as comprehensive as possible based on proposed business and experience from prior years, which is ratified at the highest levels of governance.
- Identifying the material residual liquidity risks and quantifying, based on justifiable assumptions, the exposure of the firm if those risks were to crystallise. If using models, ensure the models parameters are appropriately subject to the firm's model governance framework, back-tested and explainable.
- Quantification of risks should also incorporate realistic and stressed assumptions of the timing of the crystallisation of the risk event and the value of the liquidity impact in the forecast period. This should consider cash inflows and outflows. The stressed impact may be offset by mitigating actions in the form of available facilities and commitments and other realistic actions that management assesses can be credibly and reliably executed to meet the crystallised stress event.
- The above analysis should be done over a 12-month time horizon. Firms should assess the quarter with the highest liquidity requirement.

Liquidity Risk Assessments within the ICARA

- Withdrawal of funding facilities which may need to be repaid
- Withdrawal of client funds and trading activity, which can result in temporary (several days) liquidity mismatches for the firm depending on its trade settlement process
- Crystallisation of liquidity risks during the wind down period.

Things to think about

Does the firm's WDP identify a range of financial and non-financial scenarios whereby it would be beneficial to promptly invoke their wind-down plan?

Has the firm carried out reverse stress testing to identify scenarios that would lead to a point of non-viability at which point the firm will commence wind-down? If so, is this analysis used to calibrate action triggers that will allow the firm to wind-down in an orderly manner?

Does the firm's WDP include a list of contractual relationships, notice periods required to terminate contractual arrangements and analysis of functional interconnectivity across key contractual relationships?

Has the firm considered the risk that its wind-down may commence during a time of combined severe market and idiosyncratic stresses; and are its quantified action trigger(s) calibrated to invoke the wind-down plan at a point where the firm still has adequate liquid asset levels to wind-down in an orderly manner.

For example, if the firm's wind-down action trigger is set as the basic liquid asset requirement (BLAR) and the liquidity required to wind-down in an orderly manner is BLAR plus liquid asset threshold requirement (LATR) Assessment B, then this will mean that from a practical perspective, by the time the WDP is invoked, the firm will have insufficient liquidity to wind-down in an orderly manner.

Has the firm included its projected financials (Balance Sheet, Profit and Loss, and Cashflows) in the WDPs? If so, are they sufficiently granular to provide a useful roadmap for the firm during wind-down?

Do the projections include expected cashflows by day at critical junctures during the wind-down period, i.e., at the beginning of the wind-down period and at times when there are multiple critical anticipated liquidity inflows and outflows?

Do cashflows include appropriate contingency amounts, for example, to cover liquidity stresses during wind-down or other eventualities such as timing delays and unders/overs in estimated costs?

Liquidity Risk Assessments within the ICARA

Getting it right

Following the FCA's feedback, the following are key components that demonstrate an assessment of wind-down liquidity requirements that is fit-for-purpose:

- The liquidity cashflow analysis should be consistent with the liquidity profile of the firm. Firms with material daily cashflows should perform their analysis at similar levels of granularity, particularly in the first few days and weeks of the wind-down period.
- The wind-down planning financial forecast should begin from a position of stress. There may be instances where this may not be appropriate, for example, in a business model where the most likely wind-down scenario is one where there is a change in legislation which causes the company to cease operations from an as-is start. In such a scenario, the WDP should clearly and reasonably justify the assumptions made in the analysis.
- Ensure your cashflow forecast is complete, including both BAU and wind-down specific costs; and based on reasonable assumptions. To be credible, the wind-down plan should demonstrate a justifiable level of operational expenses based on the assessed resource needs, and wind-down costs such as redundancy payments, retention bonuses, legal and other professional services fees, contractual exit penalties, data and IT decommissioning costs, and costs for communications with clients and regulators.
- Identify critical third parties and assess the impact of the possible cessation of their services (or amendment of the terms of those services) during the wind-down period. The wind-down financial analysis should reflect possible additional cashflow impacts from keeping or replacing such services, taking into account timescales and costs.
- Prepare a robust resourcing plan for the wind-down period with clear rationale. More complex firms are likely to need working groups that can build a credible picture of the personnel needs of the business, costs of additional contractors, and any other costs that will need to be incurred to retain them during that period.
- The revenue forecasts during the wind-down period should also be credible and based on justifiable assumptions. BAU levels of revenue in wind-down may be justifiable if supported by contracts. Consideration should be given to contract enforceability and existence of break clauses. Forecasts of sales and conversion of receivable to cash should also reflect likely client behaviour once the wind-down becomes public knowledge.

Liquidity Risk Assessments within the ICARA

Conclusion

Effective liquidity assessments within the ICARA process are inextricably linked to the effectiveness of day-to-day LRMFs. Significant weaknesses in the LRMF increase the likelihood of adverse stress events having a material adverse effect on the firm and increase the likelihood that the FCA imposes liquidity guidance on the firm. Investing in the skills and competence of employees across the three lines of defence, and appropriate controls to manage and monitor liquidity risk will give Boards and regulators the confidence that the firm is in the best position possible to withstand material stress events.

If you have any questions, please get in touch with our specialist team:

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