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Our response to the FSA guidance consultation on liquidity swaps (GC 11/ 18)

Background

The Building Societies Association represents mutual lenders and deposit takers in the UK including all 48 UK building societies. Mutual lenders and deposit takers have total assets of over £365 billion and, together with their subsidiaries, hold residential mortgages of almost £235 billion, 19% of the total outstanding in the UK. They hold more than £245 billion of retail deposits, accounting for 22% of all such deposits in the UK. Mutual deposit takers account for about 35% of cash ISA balances. They employ approximately 50,000 full and part-time staff and operate through approximately 2,000 branches.

Introduction

Very few of our members engage in the types of activities listed in the guidance consultation, certainly not at the level, duration or concentration mentioned. Our response therefore concentrates on high level issues. We believe the joint response made by the British Bankers' Association and the Association for Financial Markets in Europe more than adequately describes concerns on the detail.

Response

Recycling surplus liquidity has clear benefits for the economy as a whole as well as for individual firms. As the BBA/ AFME response says, in bank-insurance company liquidity swap transactions, the bank is able to access liquidity from the excess liquidity of an insurance company that, by nature of its business, is likely to hold on to the collateral long term. Current market conditions make these transformations more important than in benign times. Regulation should therefore not impede this important activity.

We understand the very publication of this guidance has already served to increase costs of liquidity swaps and, in some cases, to cause parties to leave the market. One building society has told us that pricing for liquidity swaps has increased substantially. The reporting requirement, and counting liquidity swaps under the 2008 asset encumbrance limit, will have a further discouraging effect on all liquidity swap parties. We cannot believe that was the intention of the regulator, especially where mutuals are concerned. But, as we explain below, the scope of the guidance is not entirely clear either.

Such transactions are much less frequent in the mutual sector and what there is does not warrant such a heavy handed approach. Therefore, we suggest that workable and proportionate guidance – focused solely on the sort of liquidity swaps the larger mutuals may enter into - is developed for the sector.

Systemic risk

The FSA's fears that liquidity swaps could increase interconnectedness between the insurance and banking sectors and therefore increase systemic risk are well understood. But insurance companies are the principal holders of bank and building society lower tier 2 subordinated debt which presents significantly more risk of permanent capital loss than the most senior tranche of a retail mortgage backed security that has suffered a haircut. Insurers have proved to be able to manage this LT2 debt, and underlying risk, well. And other trade bodies have pointed out that insurance companies have large existing unsecured bank exposures such as corporate bond holdings and have been successful in managing the associated risks through governance policies such as credit control and diversification.

BBA and AFME say that the level of materiality in terms of adding secured exposure to these unsecured exposures should be recognised when determining the application of any guidance and requirements. When such a transaction does not materially increase the likelihood of systemic risk, the proposed notification requirements are an unnecessary hurdle to transactions that benefit the underlying economy. We support this argument.

We do not see why regulation should prevent firms from gaining access to funding through a mechanism such as liquidity swap when the seller of the funding/ liquidity is fully informed and has systems in place to assess risks. Like the BBA and AFME, we consider the risk assessment measures discussed in the guidance consultation to be too broad and not specific to a liquidity swap. Furthermore, as we argue earlier, we do not think they are proportionate for those mutuals that do liquidity swaps.

The FSA is also concerned that the end of the Bank of England Special Liquidity Scheme in 2012 could increase demand for liquidity swaps. This will undoubtedly be the case. Some guidance will therefore be helpful to firms. But the requirements laid out in this guidance consultation are draconian, particularly for the mutual sector which is a small player in the market. Mutuals may well be disproportionately hit by this guidance. Again we do not think that is the intention of the FSA.

This proposed guidance appears to have an impact on building societies that have recently carried out securitisations and kept on their books a sizeable proportion of their own residential mortgage-backed securities to use as collateral.

We would like confirmation whether the FSA is proposing to rule out own-issued collateral because of wrong-way risk, or because it is considered inferior. The latter point could lead to higher Pillar 2 charges because of margining and asset encumbrance. Like BBA and AFME, we believe that own-issued collateral should be allowed providing the assets are of sufficiently high credit quality and there is a sufficient haircut to cover short-term price correlation.

We are surprised to read that regulated covered bonds are specifically excluded from the scope of the liquidity swap guidance. RCBs are a direct obligation of the bank: the link between bank risk and the insurance must therefore be greater for an RCB than for an arms' length RMBS. This is why most third party repo providers prefer RMBS.

Scope

The scope of the proposed guidance is not clear. Although the FSA states its proposed guidance is aimed at bank-insurance company transactions, it also states it is not limited to such transactions. Our members have expressed concern that attempts to use their own originated collateral for any activity to raise cash or other liquidity would be subject to this guidance, as would transactions between building societies and investment banks and interbank transactions.

We agree with the BBA and AFME that if a party has excess liquidity, it should not be prohibited from entering into a liquidity swap transaction. We also believe that interbank lending is essential for a healthy financial market and therefore support the BBA and AFME's proposal to exclude interbank transactions to prevent the erection of any new barriers to such lending.

Notification

We have reservations about the proposed notification requirements. The FSA says that it expects those firms contemplating liquidity swap transactions to notify it under PRIN 11. Firms should make available sufficient information well in advance of the execution date. But no more information is provided.

Our members' main worry is the timing. Some of these transactions may have to be concluded quickly. This is especially pertinent as these swaps are part of firms' contingency funding plans when faced with a liquidity crisis. This will be the worst time to delay a transaction through bureaucratic overkill. How is the FSA going to cope with that? And how is "contemplating“ to be interpreted, when in the process should a firm contact the FSA?

Another question concerns materiality; is there a lower limit? We feel there should be.

BBA and AFME have suggested that firms should submit their policies and procedures to the FSA for approval rather than be forced to submit every transaction for approval. We support this proposal.

Valuation

We note the FSA’s point that accurate collateral valuation is fundamental to risk managing these transactions. And that the FSA anticipates scrutinising it in detail.

However, we foresee difficulties in independent valuation. If it has to be trade specific, and not broad brush, this could have an impact on those bonds issued to both the public and private markets.

In general, however, we agree with BBA and AFME that firms do not require additional guidance on correlation risks with collateral, as these are already adequately covered by BIPRU 4 and 5.

Haircut

The FSA says that the haircut on the collateral is typically recorded as a credit exposure and could be segregated through an escrow mechanism. We would like to know if that is only for insurers. The difficulty with an escrow mechanism is that it stops that security being “on lent” which could reduce availability and liquidity for this type of transaction. If this is meant for building societies and banks, we also believe that that this will be difficult to achieve operationally.

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