Finansinspektionen's Regulatory Code

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Finansinspektionen's Regulations regarding management of liquidity risks in credit institutions and investment firms;

decided 4 October 2010.

Finansinspektionen prescribes[1] the following pursuant to

– Chapter 16, section 1, subsection 3 of the Banking and Financing Business Act (2004:297), and Chapter 5, section 2, subsection 4 of the Banking and Financing Business Ordinance (2004:329),
– Chapter 8, section 42, subsection 2 of the Securities Market Act (2007:529) and Chapter 6, section 1, subsection 9 of the Securities Market Act (2007:572).

Chapter 1 Introductory provisions

Section 1 These regulations contain provisions governing how a firm shall manage its liquidity risks.

Scope of application

Section 2 These regulations apply to

1. banking companies,
2. savings banks,
3. members' banks,
4. credit market companies,
5. credit market associations, and
6. investment firms.

These provisions shall also be applied by financial groups.

This means that text in the regulations that refers to a firm shall subsequently also apply to the financial group. The parent company is responsible for ensuring the provisions are applied at the group level. Text referring to the board of directors and managing director shall subsequently apply to the parent company's board of directors and managing director.

A firm within a financial group can independently fulfil the requirements set out in Chapter 4, section 5 if together with other firms in the group it fulfils the group-level requirements, there is a legally binding commitment for sufficient liquidity support between the firm and the firm where the liquidity reserve is held and the

[1] Cf. European Parliament and Council Directive (2009/111/EC) of 16 September 2009 amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC.

liquidity is transferable between these firms. This also applies to a subsidiary in a foreign financial group that is under group supervision within the EEA if the firm is subject to national regulations regarding management of liquidity risk that correspond to these regulations.

Proportionality

Section 3 When applying these regulations, a firm shall take into account its size, risk tolerance, the complexity of its business, the nature and scope of its exposure to liquidity risks and its role as a liquidity provider on the market.

Definitions

Section 4 In these regulations the terms and expressions shall have the following meaning:

Subsidiary: Firms referred to in section 2 that are subsidiaries in accordance with the definition set out in Chapter 1, section 4 of the Capital Adequacy and Large Exposures Act (2006:1371).

Financial group: The part of a financial group as defined in Chapter 9, section 1, subsection 1 of the Capital Adequacy and Large Exposures Act consisting of an institution and subsidiaries that are institutions or equivalent foreign undertakings.

Liquidity risk: The risk of not being able to meet payment obligations on their due dates without the cost of obtaining the funds increasing considerably.

Parent company: The firm in the financial group that as per the definition in Chapter 9, section 3 of the Capital Adequacy and Large Exposures Act is responsible for compliance with the group-based requirements of the same act.

Investment firm: An investment firm in accordance with the definition in Chapter 1, section 5, subsection 26 of the Securities Market Act (2007:528).

Chapter 2 Organisational requirements

Risk tolerance

Section 1 A firm shall have a documented risk tolerance that is based on a clearly expressed quantitative and qualitative view of what constitutes appropriate liquidity risk and is adapted to the firm's operational objective, strategic direction and general risk preference. The firm's board of directors shall decide on the risk tolerance.

Guidelines and instructions

Section 2 A firm shall have strategies pursuant to Chapter 4 as well as guidelines and instructions for managing the firm's liquidity risk in accordance with the risk tolerance decided by the board of directors as set out in section 1 with the aim of ensuring that the firm has sufficient liquidity.

Section 3 A firm's managing director shall review and report the firm's management of liquidity risks and its liquidity to the board of directors on a regular basis.

Section 4 The board of directors of a firm, at least annually, shall review and approve strategies in accordance with Chapter 4 and guidelines related to the firm's management of liquidity risk. The board of directors shall also ensure that the firm's senior management manages liquidity risks in accordance with the firm's risk tolerance.

Section 5 Guidelines and instructions for the management of liquidity risk shall ensure that the firm monitors and meets future liquidity needs during both normal daily management and temporary and drawn-out crisis situations. Such documents shall also provide instructions for the division of responsibility and tasks, measurement methods, limits, follow-up and reporting. The guidelines and instructions shall refer to the firm as a whole including any branches and, where applicable, coordination between them.

A subsidiary of a financial group shall observe the guidelines and instructions that apply to the group as a whole when producing its own guidelines, instructions and strategies.

Section 6 All affected personnel in the firm shall be informed about the strategies, guidelines and instructions.

Liquidity risk control

Section 7 Every firm shall have a central function for the independent control of liquidity risk (liquidity risk control) that reports to the managing director or a member of senior management who is not responsible for position-taking units. The central liquidity risk control function shall be knowledgeable about financial instruments, liquidity risks and methods for governance and control of liquidity risks.

If the firm has a central function for risk control, the liquidity risk control can be carried out by this function.

If a firm is part of a financial group, the central function for liquidity risk control may be placed in the parent company. The central liquidity risk control function is responsible for the regular reporting and analysis of the firm's, and where applicable the group's, liquidity risks.

If a firm has placed a function for liquidity risk control locally within a position-taking unit, the local function shall report to the central liquidity risk control function or the central risk control function if one exists.

A subsidiary in a financial group shall adapt its liquidity risk control function to the group's shared liquidity risk control function.

Independent review

Section 8 A firm shall regularly allow an independent review and evaluation of the firm's governance and control of liquidity risks. A function for independent review shall report directly to the firm's board of directors. If the firm has an internal audit function, this function may carry out the independent review.

The firm shall review the liquidity risk control to identify weaknesses or problems with procedures, methods and systems for calculating and reporting liquidity risks. The firm shall also regularly review compliance with established guidelines and processes and ensure the processes meet established goals. The independent review shall also follow up that the organisation within the firm is suitable for its liquidity management.

Chapter 3 Identification and measurement of liquidity risks

Scope

Section 1 A firm shall identify and measure its exposures to liquidity risks and funding needs within and across business lines and currencies.

A financial group shall in particular take account of and document any legal and operational limitations to freely transferring liquidity and securities between firms within the financial group.

Internal pricing of liquidity risk

Section 2 A firm shall calculate its costs for liquidity and take these costs into account in its internal pricing and performance measures. Costs for liquidity shall reflect the firm's current cost of refinancing upcoming maturities and the cost the firm incurs to maintain a liquidity reserve in accordance with Chapter 4.

Different liquidity measures

Section 3 A firm shall use several customised risk measures and key ratios to calculate its comprehensive liquidity risk. The firm shall apply a forward-looking view to its liquidity risk and assess the structure of the balance sheet, cash flows, liquidity positions and risks in off-balance sheet items. Risk measurements and key ratios shall identify vulnerabilities in day-to-day operations and during periods of stress. The measurement methods, where applicable, shall distinguish between liquidity risks in different currencies.

Section 4 A firm shall calculate the cash flows expected to arise when total assets, liabilities and off-balance sheet items are settled. Cash flows shall be allocated to the various horizons in which they are normally expected to occur. However, cash flows from assets in the liquidity reserve in accordance with Chapter 4 shall be attributed to the earliest horizon in which the asset can be converted into funds.

The firm shall use daily horizons in its calculation. Unless because of its size it is deemed inappropriate or unreasonable to use daily horizons, the firm may use a minimum of seven horizons: one day, more than one day to one week, more than one week to one month, more than one month to three months, more than three months to six months, more than six months to one year, more than one year. The horizons shall be mutually exclusive and collectively exhaustive. A financial group shall always use daily intervals up to one year.

The firm shall calculate the net cash flow for each horizon as the sum of the expected cash outflows minus the sum of the expected cash inflows. The firm shall thereafter accumulate the net cash flow across all horizons in order to demonstrate how long it has a positive cash flow.

Section 5 When the firm calculates its expected cash flows, it shall distinguish between contracted cash flows with established payment dates and cash flows for which the payment dates and amounts are influenced by the firm's own decisions, customer behaviour or market developments. In situations where customer behaviour or market developments serve as a basis for the calculation of cash flows, they shall be based on empirical observations and established calculation conventions.

The firm shall ensure that methods and assumptions used to calculate the expected cash flows are relevant.

Section 6 A firm shall also measure its structural liquidity risk. The firm shall calculate and follow over time appropriate key ratios from the balance sheet to illustrate the financial structure and specific characteristics of the firm’s liquidity risk.

Stress tests

Section 7 A firm shall be well prepared to manage liquidity under abnormal conditions. The firm shall therefore regularly conduct stress tests that identify and measure the liquidity risk under different scenarios and ensure that the firm's current exposures to liquidity risk agree with the established risk tolerance.

The firm shall design appropriate scenarios based on its current risk profile. These scenarios shall be based on varying degrees of stress and duration and take into consideration both firm-specific and market-related problems. The problems should be tested both individually and in combination.

The stress tests shall take into consideration intraday liquidity and the need for liquidity for time-critical payments.

Section 8 A firm shall design its stress tests based on its own and its customers' risk exposure and the focus and complexity of its business. The primary components in a firm's stress tests, where applicable, shall be the assumption that the firm no longer has access to unsecured market financing and the assumption that the general public will make large deposit withdrawals. Market-wide stress tests shall be based on assumptions of rapidly falling market values for some assets and a general deterioration in the conditions for market funding.

The firm shall regularly review the assumptions that form the basis for the applied stress test scenarios to ensure they are still relevant.

Section 9 A firm shall use the stress test results to adjust its strategies, guidelines and positions. The results of the stress tests should agree with the firm's risk tolerance.

Section 10 A subsidiary in a financial group may take into account its role and position in the group when applying sections 7–9.

Chapter 4 Managing liquidity risk

Liquidity strategy

Section 1 A firm's long-term plan for how it will be able to meet its payment obligations (liquidity strategy) shall include

– how its liquidity management will be organised,
– its composition of assets and liabilities,
– its allocation of maturities and currencies,
– its transfer of liquidity between countries,
– how it utilises borrowing instruments,
– its holdings of realisable assets, and
– contingencies for fluctuating intraday liquidity flows.

Funding strategy

Section 2 A firm shall, in a long-term plan for future funding (funding strategy), strive to have sufficient diversification within its sources of funding in terms of, where applicable, the number and type of counterparties, the type of financial instruments, secured and unsecured borrowing, maturities, currencies and geographic markets.

The firm shall be present in its chosen funding markets and ensure that it has a strong relationship with funds providers to promote effective diversification of funding sources. The firm shall identify the factors that have the largest impact on its ability to raise funds and closely follow these factors to ensure that the assessed funding opportunities still apply under various probable developments.

Intraday liquidity

Section 3 A firm shall manage its intraday liquidity positions and any associated risks to meet payment and settlement obligations in different currencies and in different payment systems. The firm shall be able to meet its obligations on a timely basis under both normal conditions and in the presence of market disruptions as well as identify and prioritise the most critical obligations. The firm shall also take into account obligations that may arise in its role as a correspondent bank, custodial institution or liquidity provider in payment systems.

Collateral

Section 4 A firm shall manage its collateral and monitor these for its subsidiaries with regard to jurisdiction and currency exposure. The firm shall distinguish between encumbered and unencumbered assets.

The firm shall primarily identify how the securities the firm holds are declared eligible as collateral for large counterparties and funds providers of secured lending on the private market. The firm shall furthermore identify the requirements that apply for using securities as collateral in central banks to gain access to intraday credit, repos and monetary policy credit, including lending from lending facilities. The market value of a security shall be adjusted by an appropriate valuation deduction (“haircut”).

The firm shall follow the location of available collateral and how this collateral can appropriately be mobilised.

Liquidity reserve

Section 5 A firm shall hold a separate reserve of high-quality liquid assets to secure the firm’s short-term capacity to meet payment obligations in the event of lost or impaired access to regularly available funding sources The assets in the liquidity reserve shall be unencumbered. The size of the liquidity reserve shall be such to enable the firm to withstand a serious liquidity shortfall without needing to alter its business model.

The liquidity reserve shall consist of assets that enable the rapid creation of liquidity at foreseeable values. The liquidity reserve shall be composed of assets that are both liquid on private markets and eligible for refinancing by central banks. Deposits with central banks or any other bank that will be available the following day may be calculated as part of the liquidity reserve.

The firm shall ensure that there are no obstacles to drawing on the reserve's assets for short-term financing.

When determining the size and location of the liquidity reserve, a financial group shall take into account the degree to which firms within the group shall be self-sufficient in terms of liquidity and the scope of liquidity support for subsidiaries.

A firm with liquidity risk in different currencies shall to the greatest extent possible allocate liquidity across currencies to avoid potential disruptions to the swap markets.

Other liquidity-creating measures

Section 6 A firm shall assess which other measures can create liquidity in the short-term without it needing to alter its business model.

Limits

Section 7 A firm shall set limits to control its exposure and sensitivity to liquidity risk in total and in different currencies. The limits shall be tested regularly and adjusted when circumstances or the board’s risk tolerance change. The choice of limits implemented in the firm shall take into account the methods it uses to measure liquidity risk and thereby shall be a result of the nature, scope and complexity of the business.

The firm shall use these limits in the ongoing management of liquidity in and across business lines and legal entities under normal conditions. Such a limit structure shall also ensure that the firm can continue to operate when the market is under stress, the firm is under stress or a combination of these two arises.

The firm shall have rules of procedure for the allocation of limits. These rules of procedure shall contain information about how, by whom and to whom limit breaches are reported and documented. They shall also set out if and on what terms limits can be reallocated and what measures should be taken in the event the limits are breached.

Surveillance

Section 8 A firm shall identify and use internal, firm-specific indicators for liquidity risks and, where possible, market-related indicators that can provide early warnings about negative trends and increased risk.

Contingency funding plan

Section 9 A firm shall have a contingency funding plan for managing liquidity crises.

The contingency plan shall clearly define the distribution of responsibility for all affected personnel and contain instructions for how the firm shall address liquidity shortfalls. The plan shall specify appropriate measures for handling the consequences of different types of crisis situations and contain definitions of events that trigger and escalate the contingency plan.

The contingency plan shall be tested and updated on a regular basis based on the results from the stress tests.

Section 10 A subsidiary in a financial group may take into account its role and position in the group when applying section 9.

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1. These regulations enter into force on 31 October 2010 and apply as of 31 December 2010.

2. Upon entry into force of these regulations, Finansinspektionen's general guidelines (FFFS 2000:10) regarding the management of market and liquidity risks in credit institutions and investment firms are repealed in the sections pertaining to liquidity risks.

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