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Client Alert

Current Issues Relevant to Our Clients

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FINRA Provides Additional Guidance on Broker-Dealer Liquidity Risk Management

The Financial Industry Regulatory Authority, Inc. ("FINRA") recently issued a Regulatory Notice providing guidance on liquidity risk management practices that FINRA expects member firms to consider and implement in preparation for adverse circumstances. The primary role of liquidity risk management is ensuring the availability of cash or highly liquid assets to support a broker-dealer's funding needs under both normal and stressed conditions, including idiosyncratic or systemic events. The notice is directed to member firms that (1) hold inventory positions or (2) clear and carry customer transactions. The notice follows FINRA's review of member firms as they underwent stress tests and describes FINRA's observations and recommendations resulting from that review. The Regulatory Notice is available here.

Background

FINRA expects each member firm to regularly assess its funding and liquidity risk management practices so that it can continue to operate under adverse circumstances. FINRA has previously provided guidance outlining funding and liquidity risk management practices that member firms may wish to implement in preparing for adverse firm-specific events or systemic credit events. For more information on FINRA's previous guidance, please see our Client Alert available here.

As discussed in both this recent Regulatory Notice and prior guidance, FINRA believes that one way for member firms to protect against failure during extreme events is to plan for adverse liquidity conditions based upon stress tests. Beginning in March 2014, FINRA conducted a review of the policies and practices at 43 firms related to managing liquidity needs in a stressed environment. Of the 43 firms, FINRA staff considered 37 to have sufficient resources, staff and liquidity plans to be likely to surmount the stress scenario posed. The Regulatory Notice describes practices intended to inform senior management and risk managers at broker-dealers of steps that they should consider and implement in connection with liquidity risk management.

Effective Practices for Managing Liquidity Stress

The following are some of the key practices that FINRA identified as effective practices for managing liquidity stress.

Management and staff understand issues that can be expected to arise

- Understanding that counterparties would not continue to conduct business as usual during a stress period is a critical attribute of a member firm's liquidity risk management plan and mitigating actions.
- Designating a group to ensure that systems and reports are available for use by responsible personnel to understand and manage the member firm's funding and liquidity processes is part of a well-developed plan.
- A new product approval process that includes an assessment of liquidity risk introduced by each new product under normal and stress scenarios is an effective practice. Including liquidity risk in this process is critical for any firm that provides new products to its customers or to the market.

Measure risk

- The ability to anticipate and measure cash outflows under stress scenarios and having reports that enable management to consider the impact of stresses are essential tools to developing an appropriate contingent funding plan.

Plan for responding to idiosyncratic stress events

- FINRA considers a realistic assessment of the effects of potential shocks to be essential. Conducting regular stress tests that are appropriate considering a firm's business, services and products contributes to achieving a realistic assessment of liquidity risks.

- The stress scenarios used by a firm should be based on severe stresses that the firm could face or that have arisen in the past for firms in similar businesses. Firms should also conduct ongoing reviews of the stress scenarios that are part of the firm's own risk management process.
- Having a governance process around stress test results and use of contingency funding plans is part of a well-developed liquidity risk management plan.
- Establishing clear criteria for when a firm should shift from "business as usual" to implementing its contingent funding plan is critical to successfully executing the plan.

Have committed loan facilities and access to a committed liquidity pool

- A well-developed contingent funding plan should include a committed loan facility dedicated exclusively to the broker-dealer firm and access to a committed liquidity pool. FINRA believes that a committed facility should not be committed to multiple affiliates.
- Third-party lending facilities that have terms and conditions that make the availability of funding unlikely should be appropriately discounted or excluded.

Plan for funding and liquidating inventory

- Having reasonable assumptions regarding the haircuts that counterparties are likely to require in stress scenarios, especially on less liquid collateral, is necessary to ensure the effectiveness of a firm's contingent funding plan.
- Firms relying on Fixed Income Clearing Corporation's General Collateralized Finance repo facility for general collateral will need to anticipate capacity limitations. Diverse sources of funding in the repo market can be a significant risk mitigation method.
- While reducing inventory is helpful in raising liquidity, it does not resolve the problem that less liquid securities may need to be marked down substantially in order to sell quickly.
- A firm's plan should include processes to train and designate staff to perform a daily computation of the firm's customer reserve fund requirement in response to customer withdrawals of funds during adverse conditions.
- FINRA strongly believes that firms should incorporate a cushion for losses (haircuts) as part of their stress planning and calculations.

FINRA's Expectations

FINRA believes that broker-dealers that implement liquidity risk metrics should ensure that conservative and appropriately difficult assumptions are used in designing the risk measurement and management systems. FINRA expects that each member firm will:

- rigorously evaluate its liquidity needs related to both market-wide stress and idiosyncratic stresses;
- devote sufficient resources to measuring risks applicable to its business and report the results of that measurement to senior management, including a review for risks based on historical events and stresses that could occur but have not yet been observed;
- develop contingency plans for addressing those risks so that the firm will have sufficient liquidity to operate after the stress occurs while continuing to protect all customer assets;
- conduct stress tests and other reviews to evaluate the effectiveness of its contingency plans; and
- have a training plan for its staff and have tested processes on which it intends to rely if such stresses occur.

For More Information

To discuss any topic covered in this Client Alert, please contact a member of the Investment Management Group or visit us online at chapman.com.

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