Response on CP 16 on Large Exposure from Ipswich Building Society

I am writing to respond formally to the above consultation process.

Ipswich BS is extremely concerned at the implications of the proposed changes to the LE regime, in particular the proposed removal of the exemption currently applying to inter-bank exposures of up to 1 year's residual maturity.

The Society's holding of liquidity at 31 January 2008 was comprised as follows:

8-day liquidity *1	£ 46.65M
Other prudential liquidity *2	£ 65.84M
Other, non-prudential liquidity	£ 2.08M
Total	£114.57M

*1 - as defined in IPRU(BSOC) 5.4.3 and represents high-quality, short-term liquid assets such as bank and local authority deposits maturing in not more than 8 days and bank CDs maturing in not more than 3 months. We do not hold gilts on the basis that we are concerned that volatility in terms of capital (i.e. realisable) value may impair the degree of liquidity such instruments carry.

*2 - as defined in IPRU(BSOC) 5.5.2 and Annex 5A and broadly represents bank and local authority deposits maturing in more than 8 days but not more than 3 months and negotiable securities maturing in more than 3 months.

Holdings of 8 day liquidity comprised:

Cash	£ 0.32M
Bank deposits	£ 6.32M
Local authority deposits	£ 7.35M
Short-dated clearing bank CDs	£32.66M
Total	£46.65M

Within these 8 day assets, individual counterparty exposures in excess of 25% of own funds (which for us translates into £6.7M) were:

Barclays	£10.33M
HBOS	£10.04M
Royal Bank of Scotland	£18.30M

Within the LE framework and utilising the <1 year exemption, we have as a policy sought to include significant holdings of UK clearing bank CDs within 8 day liquidity on the grounds that such assets are very high quality (Fitch S/T issuer rating of F1+ and Support rating 1) and are highly liquid, with the result that we can prudently view them as being realisable within a very short timeframe (and certainly within the 8 day threshold as set by IPRU(BSOC) Chapter 5). The Society's actual experience in H2 2007 has been that clearing bank CDs have remained genuinely liquid, notwithstanding the more general impact of the credit/liquidity squeeze.

The impact of removing the <1 year exemption on LEs will be to effectively prevent us from maintaining what has been proven to be a prudent policy. Were this proposed change to be implemented it would not simply be the case that we would have to restrict exposures to UK clearing banks to around the £6.7M level, but that our ability to hold any exposure whatsoever to the most important market counterparties would be threatened. Because of their size UK clearing banks rarely issue CDs in less than £10M size - so an issue of £6.7M ceases to be an option, period.

The only possible option for us would be to hold call accounts or overnight deposits with the clearers - but at present only Barclays and RBS are prepared to put in place direct dealing lines for what are non-market sized amounts. We have in the recent past attempted to put similar facilities with the other clearers, without success. Our access, as a small firm, to this important sector is therefore very restricted, even under the present LE regime.

The market size issue will also apply to most other exposures to well-rated counterparties, so we would in practice be faced with the prospect of either placing liquidity with smaller, lower-rated counterparties or redirecting liquidity into say Treasury Bills.

The former option immediately gives rise to concerns regarding (a) asset quality and (b) liquidity (i.e. realisability, particularly in stressed market conditions). Both these factors would appear to be directly contrary to the investment objectives applicable to 8 day liquidity, where asset quality and (consequential) depth of liquidity are paramount from the perspective of prudent management. The experience in H2 2007 generally and Q4 2007 specifically is that negotiability within smaller banking name paper became very problematic.

Under the latter option, the opportunity cost of moving assets from say 3 month clearing bank CDs into Treasury Bills would itself represent a material erosion of our operating profit before tax. Last Thursday morning

(14 Feb) the following rates were being paid by UK clearing banks for 3 months CDs issued in £10M size (HBOS were only issuing in £25M+ size, I am informed):

- Abbey 5.58%
- Barclays 5.30%
- Lloyds TSB 5.50%
- RBS 5.57%
- Average 5.49%
- In contrast the 3 month T-Bill auction on Friday (15 Feb) was expected to see successful bids in the region of 5.05 - 5.08%

If we make the assumption that we would, were the LE regime to be changed as is currently proposed, we move say £30M of 8 day liquidity currently held in UK clearing bank CDs into T-Bills, the annualised margin erosion (assuming that the spread seen today holds for the full term) would be in the region of £128,000 - equating to around 17% of this firm's forecast pre-provisions/pre-tax operating profit for 2008.

This reduction in profitability would be likely to be passed on directly to our retail investors and borrowers, since at this level we could not possibly absorb it within the p&l account elsewhere without making very significant changes to the present business model.

There is a further aspect to the proposed changes that needs to be clarified urgently by CEBS. Since Barclays are our main clearing bank (for transactional services) an exposure limit of 25% of own funds (without any exemption applying) would create an unworkable scenario for us. If we take the example of incoming funds on the day of £10M (not an infrequent occurrence given the overall size of the business) then does the 25% limit apply to daylight or intra-day exposures? And what would be the position where, at the end of the day, we have been simply unable to find a suitable counterparty with whom to place part of that £10M (up to £6.7M)? Under the proposed changes as they stand it would appear that we would be immediately in breach of the maximum exposure limit, with regulatory consequences arising. Unlike larger firms who under the Cash Ratio Deposits scheme in the UK have direct access to place funds with the central bank, we have no such facility - so are entirely dependent on having lines into (certain) UK clearing banks for the purposes of managing short-term liquidity.

There is a genuine concern that in the absence of any exemption applying to short-term exposures, under CEBS proposals we and smaller firms in general will face severe operational issues within our treasury management activity. We would see a direct consequence of removing the exemption as being a material increase in liquidity, counterparty, settlement and operational risk, as well as a significant financial cost to be borne by our customers. Each of these outcomes would individually, let alone in combination, represent a detrimental change from what we consider to be currently a prudent and proven approach to risk management.

We would counter-propose that if CEBS is committed to changing the present regime. the principle of an exemption should be retained, but apply to exposures up to and including three months, for the various reasons set out above.

I trust that the above points are straightforward. If you require any further information or clarification, please do not hesitate to contact me.

A formal acknowledgement of receipt of this email is requested. Thank you.

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