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BANK OF ENGLAND

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GUIDANCE FOR EMERGENT LENDERS AND NEWLY AUTHORISED INSTITUTIONS ON ACCESS TO BANK OF ENGLAND STERLING MONETARY FRAMEWORK LIQUIDITY FACILITIES

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Overview

The Bank provides sterling liquidity facilities to eligible firms under the Sterling Monetary Framework (SMF). This document provides guidance, tailored for emergent lenders and new banks and building societies (hereinafter referred to as 'banks'), on applying to those facilities and use of collateral in those facilities.

Applicant assessment process

Discuss intention to gain access to Bank of England liquidity facilities with PRA Supervisors

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Contact the SMF Applications Team and submit application

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The Bank undertakes a separate credit assessment of new participant (including an on-site visit)

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Credit risk assessment based on the credit visit and information supplied by the firm to the Bank, including information submitted as during the course of authorisation to the PRA

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Applicant eligibility reviewed by internal credit committee and decision communicated to applicant following sign-off

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Operational set-up conducted with the SMF Applications Team and provision of facilities can commence once this is completed and following authorisation

Eligibility of loans collateral

Initial introduction to determine loan product and proposed portfolio

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Discussion of due diligence and data requirements

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Initial data tape of the portfolio to be provided by participant

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Feedback on initial portfolio proposal

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Bank discusses any follow up actions identified before proceeding with full due diligence

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Proceed with full loans due diligence:
- ***Site visit and presentation***
- ***Due diligence questionnaire (DDQ)***
- ***Legal due diligence***
- ***Data audit***

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Eligibility decision by internal collateral committee

Application to Bank of England liquidity facilities

How can banks apply for access to sterling liquidity facilities?

The Bank provides sterling liquidity facilities to eligible firms under the Sterling Monetary Framework (SMF). Firms interested in applying for access to these facilities should contact the SMF Applications Team at applications@bankofengland.co.uk. The team will arrange an introductory meeting to: answer any queries; provide more information on eligibility requirements; and discuss what facilities might be most suitable. Some useful background information is listed below:

- 'The Red Book': This describes the various SMF facilities and their purpose: http://www.bankofengland.co.uk/markets/Pages/sterlingoperations/redbook.aspx
- The SMF Application Form and other templates are available at: http://www.bankofengland.co.uk/markets/Pages/money/applications.aspx
- Legal documentation (Eligibility Criteria, Terms and Conditions and Operating Procedures) can be found on the following link: http://www.bankofengland.co.uk/markets/Pages/money/documentation.aspx

What criteria does the Bank have to judge whether a new bank can access sterling liquidity facilities?

There is a presumption that all firms that meet the PRA threshold conditions may apply for the Bank's liquidity facilities and have full access to borrow in SMF facilities against eligible collateral. All new applicants are expected to have discussions with their PRA supervisors before applying and in the early stages of the authorisation process. It is important that these discussions take place as early as possible as the time taken for a firm to be admitted into the SMF can vary by counterparty.

There is an expectation that all SMF applicants will provide sufficient information for the Bank to risk manage its operations effectively. This could typically involve providing internal management information and forecasts. This will also include a review of information submitted to the PRA as part of the banking license application. Participation in the SMF is subject to the Bank being satisfied that legal, operational and credit requirements for access are met, and may be subject to the provision of a guarantee from another group entity.

What is the Bank's approach to assessing new banks seeking to apply for access to the SMF?

In order to risk manage its operations, the Bank conducts periodic credit assessments of all participants covering analysis of the firm's strategy, governance, business model, asset quality, risk management, funding strategy, liquidity management, capital, expected profitability and cost base. To support new banks wanting access to liquidity facilities at an early stage, the Bank can begin its credit assessment processes during the mobilisation stage, and will support the firm in starting operational set-up. For those new banks not going through mobilisation, the Bank can begin assessment shortly before the firm is authorised. All firms must be fully authorised and out of mobilisation before they can sign up to and use SMF facilities.

For new banks, there is often little historic financial performance upon which to base a credit assessment compared to established banks. The assessment of new banks is therefore naturally more weighted toward the plausibility of the firm's strategy, experience of the management team and capital in place. The analysis draws on the input of PRA supervisors throughout the mobilisation and/or authorisation process, and on an on-going basis for all participants. An assessment will be prepared for the Bank's bi-monthly credit committee and an eligibility decision will be made. Once a new bank's PRA authorisation is approved, and it is confirmed that it meets the Bank's operational, legal, and credit requirements, it can sign up to SMF facilities. For reserves accounts and Operational Standing Facilities, access can only commence on the date of an MPC meeting.

How often does the Bank review access for new banks to SMF facilities?

The Bank will conduct a credit review on a periodic cycle (typically annual) to confirm access and set the appropriate level of monitoring on a firm by firm basis. The periodic assessments usually involve further on-site visits or a phone call with management. For firms whose risk profile can change rapidly (including those that have just been authorised), the Bank is likely to maintain more frequent contact in order to maintain a close understanding of the risks in its SMF operations.

Collateral eligibility in SMF facilities

Are there different rules for newer firms in collateral prepositioning?

All Sterling Monetary Framework lending is conducted against eligible collateral. All collateral is subject to a 'haircut', determined by the Bank. All firms are subject to the same collateral eligibility criteria published on the Bank's website.[1] All new firms eligible for SMF access can access the Bank's facilities by delivering marketable securities as collateral or portfolios of unsecuritised loans. Firms typically find it quicker to deliver marketable securities than portfolios of loans, and so the Bank encourages them to consider carefully which option best suits their needs. For all counterparties, the Bank will usually discuss the type of collateral proposed and respond to any high level queries on the Bank's due diligence process in an introductory call.

How does the Bank interact with the PRA supervisors in the context of collateral eligibility?

The Bank's Financial Risk Management Division (FRMD), which is responsible for collateral management, will make contact with the PRA supervisors to understand if there are any material issues or challenges the Bank should be aware of from both a credit and collateral perspective for each lender. The Bank will use this information as an input where possible.

Loans collateral eligibility

How should new banks approach the Bank to discuss eligibility of loans collateral?

Enquiries can be directed to the Bank's collateral assessment team through SMF Applications Team contacts (see page 3). Counterparties considering what collateral they might utilise in the Bank's operations should contact the Bank at the earliest opportunity to discuss different options and an indication of the time that the process could take based on the information available.

How broad is the list of eligible loan collateral?

The Bank has substantially increased the range of loans collateral eligible to be positioned, since first accepting loans in 2011. In addition to owner-occupied and buy-to-let mortgage loans, the Bank has also accepted portfolios of unsecured consumer loans, social housing, SME, corporate, asset finance and auto loans from a range of counterparties, including a number of new banks.

[1] http://www.bankofengland.co.uk/markets/Pages/money/eligiblecollateral.aspx

Is there a minimum portfolio size?

There is no minimum portfolio size, in either value or number of loans. The Bank encourages all participants to shape their collateral into suitable pool structures, taking into account their liquidity needs and encumbrance considerations. In all cases, the Bank makes an initial decision whether it can value the collateral accurately and set a suitable haircut. The Bank will work closely with counterparties to remove or mitigate any risks that might prevent this. Following initial pre-positioning, the Bank will continually assess the collateral and adjusts its view on eligibility and suitable haircut accordingly.

There are proportionate costs associated with the review and positioning of loan collateral, most of which tend to relate to the due diligence of the loan pools. That due diligence includes legal sampling and data audits. The Bank can provide advice on the expected costs but all firms must make their own decision as to whether they accept potential costs before proceeding.

As the prepositioned assets will generally amortise, redeem or develop arrears, the available drawing capacity will typically reduce over time. It is the responsibility of counterparties to manage their own encumbrance levels to ensure that additional or alternative collateral could be delivered intra-day to cover any active exposures.

How frequently can additional loans be added to the portfolio (‘top-ups’)?

Additional loans may be added to a loan portfolio from time to time, known as a ‘top-up’. The frequency of top-ups depends on the preferences of the individual firm, but to manage the operational risk of adding new loans across all of the Bank’s counterparties, the frequency is expected to be no more than quarterly.

Any top-up in relation to the original portfolio requires additional analysis of the portfolio, review of haircuts and internal approval. It may also be subject to further legal and data due diligence where the additional loans exceed the Bank’s internal risk tolerance for loan additions relative to the original portfolio, or if there have been significant changes in IT systems or to core legal terms and conditions.

Where regular top-ups are planned, the Bank will discuss a structured schedule with individual counterparties.

How does the Bank set haircuts for loans collateral?

The Bank uses all available information, both qualitative and quantitative, to assess and value loans collateral. Good quality loan level data is expected from all participants as a fundamental input into the Bank’s analysis. The haircut the Bank sets will reflect the quality and characteristics of the loans and any other risk factors identified in the Bank’s due diligence process.

In order for the Bank to value the loan portfolio, the Bank requests that participants also provide information on the historical performance of the business line. Where there is little or no historical performance data available, the Bank will seek to identify whether it is still able to capture inherent risks via additional layers of protection, peer comparison, and expert judgment. The haircut will also reflect a qualitative assessment of the full due diligence of the participant covered through an on-site visit and review of policies, processes and procedures.

Are haircuts higher for new banks?

Haircuts are a function of the risk characteristics of the underlying loans presented to the Bank, so are not set to be higher for any particular type of counterparty. In addition to the information contained in the data tape, consideration is given to a qualitative assessment of the processes and organisational structure in place around the origination and management of the loans. This may lead to higher haircuts to take into account areas such weak risk or controls, poor data quality, low seasoning and legal risks. These judgments apply to firms of all sizes.

Is there a minimum seasoning requirement for loans?

There is a minimum seasoning requirement which varies by collateral type. For example, a minimum of two months seasoning is required for residential loans and one month for consumer loans to ensure the loan has made at least one payment.

Does the Bank have any concentration limits for a single loan pool?

There are no portfolio concentration limits. However, in deciding whether to accept a particular loan pool, the Bank will analyse the impact of a number of factors which could be considered as concentration within its valuation assessment of the loan pool (e.g. geography, industry or sector, loan and obligor diversity and granularity). The haircut may be adjusted according to risk issues identified and specific areas of concern may be discussed on a case by case basis with participants.

Does the Bank require historical loss data?

The Bank will normally review the available historical loss data from the participant's loan book based on the asset class they would like to preposition. Ideally, the data should cover an economic cycle as this would assist the Bank shape a more informative view of the loans, including the underlying risk, behaviour, lending policies and processes.

Absence of such information would not prohibit a participant from proposing a pool, but would mean that the haircut may be adjusted to reflect any additional uncertainty in potential loan performance. In doing so, the Bank would consider the lending policies and pricing models of the counterparty, as additional information on the likely performance of the proposed portfolio.

Does the Bank require updated information on a regular basis?

Following the prepositioning of a loan pool, the Bank will conduct surveillance to provide ongoing information on the quality and value of the portfolio. Haircuts will be kept under review and updated dynamically. The Bank has three key requirements for the purpose of on-going provision of data in relation to a prepositioned loan pool:

- On a weekly basis, participants are required to submit an updated pool balance.
- On a monthly basis, participants are required to provide a full updated loan pool tape.
- Other data/documentation may be requested typically at a quarterly or annual review basis.

Are there any restrictions on the type of loan?

A full list of the eligibility criteria for loan pools is included on the Bank's website.[2] Key eligibility criteria include only loans that are first ranking, written under UK law and enforceable in UK courts.

Are all loan products eligible?

Each product type will be reviewed by the Bank's legal counsel and an internal collateral committee, which will determine eligibility. Participants should contact the Bank if they would like an early indication of whether a particular loan product may be considered eligible. The Bank is willing to consider the eligibility of specific loan products, which are not already listed as eligible, as required.

[2] http://www.bankofengland.co.uk/markets/Pages/loandocumentation.aspx

Are loans in arrears considered eligible?

Participants may include loans in arrears in loan portfolios and these will be given an appropriate high probability of default when calculating the haircut. Loans assigned to a pool and which move into arrears should stay assigned to the pool, as this allows the Bank to better track the overall performance of the pool and compare it against the performance of the participant's book.

Can the Participant use other legal or audit reports prepared for non-collateral eligibility reasons?

The Bank requires all participants to comply with its legal and audit requirements, which have been designed specifically for the purposes of SMF collateral eligibility. Standard forms of relevant documents are provided by the Bank and are available on the Bank's website or by contacting the Bank.

Are there any legal aspects that a prospective participant should be aware of?

The Bank requires participants to appoint external legal counsel to review and analyse the documentation upon which the proposed loans have been written, to complete a legal due diligence questionnaire, and provide a legal opinion in respect of the portfolio. The Bank will generally ask that the participant's legal counsel reviews all template loan documentation, as well as a sample of actual loans. Where there is no standardised loan documentation, the Bank generally requires all loans to be reviewed on a short due diligence questionnaire, with a sample reviewed on a more in-depth due diligence questionnaire.

The Bank will engage its own legal counsel to advise on the findings of this legal due diligence. Costs relating to the Bank's external legal counsel review of the participant's legal due diligence will be recharged to the participant under the terms of the SMF.

What are the ongoing costs of maintaining a positioned loan portfolio?

Periodically, the Bank may request an update of legal and data due diligence. Additional due diligence may be requested for a number of reasons. This includes, but is not limited to:

- Additional loans added to the portfolio
- Loans written under updated legal Terms and Conditions
- Core systems or data output changes

The Bank retains the right to request further due diligence to be completed at any time.

How long does the prepositioning process take?

The prepositioning process can range from around eight weeks for standard residential mortgages to approximately three months or longer for more complex assets such as lending to larger corporates or commercial real estate. The time taken depends on the complexity of the assets and partly on the underlying legal work performed as part of the legal due diligence exercise, with legal complexities or other issues sometimes increasing the completion time materially. Nevertheless, additional portfolios of the same asset class can generally be prepositioned more quickly.

Are there any other documents that a prospective participant should review?

i) A loan prepositioning guide for new participants that is available upon request. This provides additional information on legal and audit requirements, weekly balance submissions and frequently asked questions.

ii) As part of the prepositioning process, there are a number of documents that the Bank would require all participants to complete. These can be found in: www.bankofengland.co.uk/markets/Pages/loandocumentation.aspx.