



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Consultation Paper | CP5/14

Occasional Consultation Paper

March 2014

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Please address any comments or enquiries by 15 April 2014 to:

OCPresponses@bankofengland.co.uk

Consultation closes on 15 April 2014.

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1 Financial Conglomerates Capital Adequacy

1 Introduction

1.1 This chapter sets out proposals to clarify certain issues which have been identified in the technical amendments to the rules for financial conglomerates introduced in PS3/13.⁽¹⁾

1.2 Proposed handbook changes are presented in Appendix 1.

2 Summary of proposals

2.1 First, the Prudential Regulation Authority (PRA) proposes to amend the definitions of *ultimate insurance parent undertaking* and *ultimate EEA insurance parent undertaking*, in order to remove an asymmetry which could result in group capital adequacy reporting requirements applying at the level of both the ultimate (EEA) holding company and an intermediate holding company. It is not a directive requirement and it was not our intention in PS3/13 to require reporting at both levels. The amendments proposed will ensure that reporting is required at the higher level but not the lower level.

2.2 Second, the PRA proposes to correct a typographical error in the amendment in PS3/13 to 6.1.17R(1)(ba) of the Prudential sourcebook for Insurers (INSPRU). The word 'ultimate' in the defined term *ultimate mixed financial holding company* should have been italicised but was not. This will avoid potential anomalies.

2.3 Finally, in PS3/13 INSPRU 6.1.64AR was amended in response to the removal of the deduction method as an available method for calculating conglomerate capital adequacy in respect to *ancillary services undertakings* in insurance-led conglomerates. The PRA proposes amending the explanatory note D2 of form 95 in appendix 9.9 of IPRU(INSPRU) to reflect this amendment.

3 Cost-benefit analysis

3.1 The PRA does not consider that there will be any significant costs or benefits as a result of these changes. They are technical in nature and will clarify certain issues identified with recently amended conglomerate rules, which may have led firms to incur unnecessary costs.

4 Statutory obligations

4.1 The PRA considers that the changes are compatible with the Regulatory Principles⁽²⁾ because they make PRA requirements clearer and more transparent. The removal of the potential for financial conglomerate reporting to apply both at the ultimate and intermediate holding company levels also ensures that conglomerate reporting requirements remain proportionate. This contributes to the PRA general objective to promote the safety and soundness of firms.⁽³⁾ The impact on mutual societies is not expected to be any different to that on any other type of authorised person.⁽⁴⁾

4.2 The PRA does not expect these changes to give rise to any adverse effects on competition. In light of the introduction from 1 March 2014 of a statutory secondary competition objective for the PRA, it has also assessed whether the content of this consultation facilitates effective competition in markets for services provided by PRA-authorised persons in carrying on regulated activities. As these amendments contribute to the appropriate UK implementation of EU harmonised reporting requirements for financial conglomerates, the PRA considers the content of this consultation as compatible with its competition objective.

4.3 The PRA has considered the equality and diversity issues that may arise from the proposals in this consultation. The conclusion reached is that the proposals do not give rise to discrimination issues and are of low relevance to the equality agenda.

(1) www.bankofengland.co.uk/pr/Pages/publications/financialconglomerates.aspx. The statement is relevant to financial conglomerates and financial groups which carry out activities in both banking/investment and insurance sectors.

(2) Section 3B of FSMA 2000.

(3) Section 2B(1) and 2B(2) of FSMA 2000.

(4) Section 138K(2) of FSMA 2000.

2 Proposed amendment to SS5/13

1 Introduction

1.1 This chapter sets out proposed amendments to the Prudential Regulation Authority (PRA) supervisory statement on the Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP) (SS5/13).⁽¹⁾ It brings to the attention of supervised firms the December 2013 European Banking Authority (EBA) Guidelines on capital requirements for foreign exchange (FX) retail and small and medium-sized enterprise (SME) lending (referenced here as 'the Guidelines') and sets out the PRA's approach to compliance.

1.2 Proposed amendments to the supervisory statement are presented in Appendix 2.⁽²⁾

2 Summary of the EBA Guidelines and proposed amendments to the supervisory statement

2.1 The Guidelines provide guidance to national competent authorities on how to address the specific risk of foreign currency lending to unhedged borrowers as part of the SREP with capital measures where applicable.

2.2 The Guidelines apply where a firm meets the following materiality threshold: *loans denominated in foreign currency to unhedged borrowers constitute at least 10% of a firm's total loan book (total loans to non-financial corporations and households) where such total loan book constitutes at least 25% of the firm's total assets.*

2.3 In view of the Guidelines, the PRA proposes to amend SS5/13. The proposed amendments inform firms that:

- as part of their obligations under PRA rules (Internal Capital Adequacy Assessment 3.1) the PRA expects firms that lend in foreign currency to unhedged retail and SME borrowers⁽³⁾ to determine whether they meet the thresholds of materiality in the Guidelines and where they do so to notify the PRA and reflect the risk in their ICAAP; and
- the SREP will include the exposure to and management of foreign currency lending risk to unhedged retail and SME borrowers by firms, in line with the Guidelines.

2.4 The PRA proposes that these changes should take effect from 30 June 2014, consistent with the Guidelines.

3 Cost-benefit analysis and statutory obligations

3.1 The PRA considers that any increase of costs as a result of these changes will be of no more than minimal significance and therefore has not produced a full cost-benefit analysis. The impact on mutual societies is not expected to be different to that on other types of authorised person.

3.2 Consistent with the PRA's obligations with regard to EU legislation and CRD IV, the PRA proposes to amend SS5/13 in view of the Guidelines. The PRA has had regard to Regulatory Principles⁽⁴⁾ and considers that these amendments to SS5/13 advance the PRA's general objective of promoting the safety and soundness of PRA-authorised firms.⁽⁵⁾

3.3 In light of its statutory secondary competition objective, the PRA has also assessed whether the content of this consultation facilitates effective competition in markets for services provided by PRA-authorised persons in carrying on regulated activities. These proposals are designed to set out the PRA's approach to compliance with the requirements in the Guidelines. The PRA therefore considers the content of this consultation to be compatible with the facilitation of competition.

3.4 The PRA had due regard to the equality and diversity issues that may arise from the proposals in this consultation. The conclusion reached is that the proposals do not give rise to discrimination issues and are of low relevance to the equality agenda.

(1) www.bankofengland.co.uk/pr/Pages/publications/icaap.aspx.

(2) The proposed amendments are underlined.

(3) Title I 'Subject matter, scope and definitions' of the EBA Guidelines, section 2, page 8, provides definitions of 'FX', 'FX lending' (ie 'foreign currency lending') and 'unhedged borrower'. The Guidelines are available at: www.eba.europa.eu/documents/10180/535130/EBA-GL-2013-02+%28Guidelines+on+capital+measures+for+FX+lending%29.pdf/966f1ca0-7454-4003-a40a-e2fc98214fc1.

(4) Section 3B of FSMA 2000.

(5) Section 2B(1) and 2B(2) of FSMA 2000.

3 Shari'ah-compliant liquid assets

1 Introduction

1.1 This chapter sets out proposals to make amendments to the Prudential Sourcebook for Banks, Building Societies and Investment Firms (BIPRU). The proposals are relevant to banks, building societies and designated investment firms subject to BIPRU 12 whose operations are entirely Shari'ah compliant.⁽¹⁾

1.2 Proposed handbook changes are presented in Appendix 3.

2 Summary of proposals

2.1 There is currently only one asset that meets the eligibility criteria for inclusion in a firm's liquid assets buffer under BIPRU 12.7 in which a Shari'ah-compliant firm may invest (the sukuk issued by the designated multilateral development bank the Islamic Development Bank). This increases concentration risk, as the regulatory buffers of the Shari'ah-compliant firms are composed entirely of one asset. Recognising only one asset also potentially limits the growth of existing Shari'ah-compliant firms and creates barriers to entry for new Shari'ah-compliant firms due to the difficulties that can be experienced obtaining the asset.

2.2 The Prudential Regulation Authority (PRA) proposes to amend eligibility criteria in BIPRU 12.7 to allow Shari'ah-compliant firms to include a wider set of assets in their liquid assets buffers. These proposals are intended to help reduce the risks of concentration in Shari'ah-compliant firms' liquidity buffers and they are intended to help remove potential barriers to growth and entry.

2.3 The proposals in this consultation broadly follow the approach to liquid assets set out in the Basel III Liquidity Coverage Ratio. Consistent with the PRA's current regime, sukuk issued by the highest-rated sovereigns may be included in a firm's liquid assets buffer without a haircut. In addition to these highest-quality assets, the PRA proposes to recognise sukuk issued by sovereigns with lower credit ratings and other sukuk that are not issued by a member of the financial sector. These lower-quality assets would be subject to haircuts and caps. The haircuts proposed use the Basel text as a benchmark, though in some instances the PRA proposes to increase the haircut to account for a less developed secondary market.

2.4 Sukuk issued by a member of the financial sector will not be eligible for the liquid assets buffer. This reflects the risk that such assets might become illiquid during a financial sector stress — when the firm might need to liquidate its liquid assets.

2.5 The European Commission is to adopt legislation by 30 June 2014 to specify the definition, calibration, calculation and phase-in of the Liquidity Coverage Requirement for implementation in 2015. The European Banking Authority's 'report on impact assessment for liquidity measures under Article 509(1) of the CRR' includes a section on 'the definition of Shari'ah-compliant financial products as an alternative to assets that would qualify as liquid assets for the purposes of Article 416, for the use of Shari'ah-compliant banks'. The PRA will consider, among other things, the Commission's delegated act as it comes to a view on the alterations to its liquidity framework that it considers appropriate.

3 Cost-benefit analysis

3.1 The proposed amendments to BIPRU 12 are intended to be available to firms that fall within the new definition of Shari'ah-compliant firm. Islamic banking currently accounts for a small proportion of the UK finance sector. Around 22 banks provide Islamic financial services in the United Kingdom, of which six are fully Shari'ah compliant. Globally, Shari'ah-compliant banks have been growing rapidly.⁽²⁾ It is important that the BIPRU 12 liquidity regime takes account of the specific requirements of Shari'ah-compliant firms and that the Shari'ah-compliant assets eligible to meet BIPRU 12 requirements are reasonably liquid.

3.2 Shari'ah-compliant firms have greater exposure to concentration risks due to the limited number of investments they may hold. This creates two risks in relation to liquidity risk management:

- (i) Shari'ah-compliant firms will optimise liquidity mismatch to a greater extent than similar non-Islamic firms would do limiting balance sheet growth and entry of Shari'ah-compliant firms; and

(1) That is, whose entire operations are structured and conducted in accordance with Islamic commercial jurisprudence and its investment principles.

(2) Sources: TheCityUK *Islamic Finance 2013* and The Banker *Islamic Finance Survey*. The surveys report that Islamic-compliant assets worldwide have grown annually by 20% on average over the last five years to reach £920 billion in 2012.

(ii) the liquid assets buffer of Shari'ah-compliant firms is more concentrated than that of similar non-Islamic firms resulting in comparatively higher risks to the safety and soundness of Shari'ah-compliant firms.

3.3 Developing a definition of liquid assets specific to Shari'ah-compliant firms which is different from the general definition may give rise to level playing field concerns. However, unlike Shari'ah-compliant firms, conventional firms can hold non Shari'ah assets to meet their liquidity requirements and therefore the proposals would allow Shari'ah-compliant firms to hold a similarly diverse liquidity buffer.

3.4 Additionally, a separate treatment for Shari'ah-compliant firms arguably leads to an inconsistent liquidity measure, as comparison of individual liquidity guidance across the Islamic and conventional sectors will be more difficult given that the assets held are different. Given the size and the limited number of Shari'ah-compliant firms in the United Kingdom, the impact of this difference of measurement is currently negligible.

4 Statutory obligations

4.1 These proposals contribute to the PRA's general objective to promote the safety and soundness of firms⁽¹⁾ as they are intended to help ensure that Shari'ah-compliant firms' liquid assets buffers are not concentrated in one asset.

4.2 These proposals apply to banks, building societies and designated investment firms subject to BIPRU 12, including mutuals,⁽²⁾ who are unlikely to be affected as we do not believe any mutual currently meets the definition of Shari'ah-compliant firm.

4.3 The PRA has considered matters to which it is required to have regard and believes that this statement is compatible with the Regulatory Principles.⁽³⁾ The proposals enable firms and the PRA to make judgements about concentration and liquidity risks in the liquid assets buffer and so advance the PRA's objectives. The proposals ensure that the affected firms are able to compete on an even footing with conventional firms.

4.4 The PRA assessed whether the proposals in this consultation facilitate effective competition in the markets for services provided by PRA-authorized persons in carrying on regulated activities. This consultation does not constrain firm behaviour. The PRA has therefore not identified any constraints on competition from these proposals.

4.5 The PRA has considered the equality and diversity issues that may arise from the proposals in this consultation. The conclusion reached is that the proposals will have a positive impact on equality in terms of the protected characteristic of faith.

(1) Section 2B(1) and 2B(2) of FSMA 2000.

(2) Section 138K(2) of FSMA 2000.

(3) Section 3B of FSMA 2000.

4 Risk management of asset encumbrance

1 Introduction

1.1 This chapter sets out proposed amendments to chapter 12 of the Prudential Sourcebook for Banks, Building Societies and Investment Firms (BIPRU 12) to introduce requirements and guidance for the risk management of asset encumbrance.⁽¹⁾ The proposals are relevant to banks, building societies and designated investment firms subject to BIPRU 12.

1.2 While secured funding markets have been a source of stability and have helped avoid additional funding distress in the crisis, the increasing levels of secured funding entail increasing asset encumbrance. As highlighted in the European Systemic Risk Board's (ESRB's) Annex to the recommendation on funding of credit institutions⁽²⁾ the risks of asset encumbrance include: (1) structural subordination of unsecured creditors; (2) issues related to future access to unsecured markets; (3) issues related to transparency and correct pricing; (4) increased funding and liquidity risks; and (5) issues related to contingent encumbrance.

1.3 The proposals in this consultation seek to implement ESRB recommendation B on the funding of credit institutions which recommends that the Prudential Regulation Authority (PRA) requires credit institutions to have in place risk management systems and controls for asset encumbrance, including plans for dealing with contingent encumbrance in their contingency funding plans and a monitoring framework for asset encumbrance.

1.4 Proposed handbook changes are presented in Appendix 4.

2 Summary of proposals

2.1 The PRA proposes to incorporate requirements for the risk management of asset encumbrance alongside the existing requirements for the management of liquidity risk within BIPRU 12.3 and BIPRU 12.4. This follows a recommendation from the ESRB published in February 2013.⁽³⁾ This ESRB recommendation relates to credit institutions only, however the proposed changes to PRA rules will apply to designated investment firms as well. This is to ensure there is a consistent approach across all PRA-regulated firms.

2.2 The proposed amendments will require firms to put in place risk management policies to define their approach to asset encumbrance, as well as procedures and controls that ensure that the risks associated with collateral management and asset encumbrance are adequately identified, monitored and managed. These policies must be proportionate to the complexity, risk profile and scope of operation of the firm. The policies should be approved by the firm's governing body.

2.3 A rule requiring firms to actively manage their asset encumbrance positions and to ensure governing bodies receive timely information on encumbrance positions is also being proposed. A firm's stress testing should allow it to identify contingent encumbrance from credit rating downgrades, devaluation of pledged assets and increases in margin requirements. A new rule is added to require a firm's contingency funding plan to outline strategies to address contingent encumbrance resulting from stress events.

3 Cost-benefit analysis

3.1 The costs to firms of implementing the proposed requirements are expected to be minimal given the existing requirements in BIPRU 12 that firms manage their collateral positions and distinguish between pledged and unencumbered assets. The additional asset encumbrance systems and controls (and so any minimal costs) should be proportionate to the complexity, risk profile and scope of operation of the firm. The most significant benefits of the proposal are the mitigation of risk (2), (4) and (5) identified in the introduction, through:

- (i) ensuring that all firms are aware of their encumbrance level and have established a comprehensive framework to monitor the encumbrance of their assets;
- (ii) ensuring that firms can cope better with stress situations by establishing strategies to address the contingent encumbrance resulting from stress events; and

(1) Asset encumbrance occurs when assets are used to secure creditors' claims so that they are no longer available to general creditors in the event of a firm's failure.
 (2) www.esrb.europa.eu/pub/pdf/recommendations/2012/ESRB_2012_2_annex.en.pdf?8292f192ea8c6fee508eb1e21a686968.
 (3) Recommendation of the ESRB of 20 December 2012 on funding of credit institutions (ESRB/2012/2), OJ 2013/C 119/01.

- (iii) increasing market confidence by establishing a minimum level of control by firms over their level of asset encumbrance.

4 Statutory obligations

4.1 These proposals contribute to the PRA's general objective to promote the safety and soundness of firms,⁽¹⁾ as they will seek to ensure firms have appropriate risk management systems and controls in place for asset encumbrance.

4.2 These proposals apply to banks, building societies and designated investment firms subject to BIPRU 12, including mutuals, who are unlikely to be affected any differently from other firms.⁽²⁾

4.3 The PRA proposals enable firms and the PRA to make judgements which advance the PRA's objectives. As such, the

PRA has considered matters to which it is required to have regard and believes that these amendments are compatible with the Regulatory Principles.⁽³⁾

4.4 The PRA assessed whether the proposals in this consultation facilitate effective competition in the markets for services provided by PRA-authorized persons in carrying on regulated activities.⁽⁴⁾ This consultation does not constrain firm behaviour, it introduces requirements for the risk management of asset encumbrance. The PRA has therefore not identified any constraints on competition from these proposals.

4.5 The PRA has considered the equality and diversity issues that may arise from the proposals in this consultation. The conclusion reached is that the proposals do not give rise to discrimination issues and are of low relevance to the equality agenda.

(1) Section 2B(1) and 2B(2) of FSMA 2000.

(2) Section 138K(2) of FSMA 2000.

(3) Section 3B of FSMA 2000.

(4) As introduced by the Banking Reform Act on 1 March 2014.

FINANCIAL CONGLOMERATES DIRECTIVE (HANDBOOK AMENDMENTS) INSTRUMENT 2014**Powers exercised by the Board of the Prudential Regulation Authority (PRA)**

- A. The Prudential Regulation Authority makes this instrument in the exercise of the following powers and related provisions in Financial Services and Markets Act 2000 (“the Act”):
- (1) section 137G (The PRA’s general rules); and
 - (2) section 137T (General supplementary powers).
- B. The rule-making power referred to above is specified for the purpose of section 138G(2) (Rule-making instruments) of the Act.

Pre-conditions to making

- C. In accordance with section 138J of the Act (consultation with the Financial Conduct Authority) (“FCA”), the PRA consulted the FCA. After consulting, the PRA published a draft of proposed rules and had regard to representations made.

Commencement

- D. This instrument comes into force on [date].

Amendments

- E. The rules in the modules of the PRA’s Handbook listed in column (1) below are amended in accordance with the Annexes to this instrument listed in column (2).

(1)	(2)
Glossary of definitions	Annex A
Prudential sourcebook for Insurers (INSPRU)	Annex B
Interim Prudential sourcebook for Insurers (IPRU (INS))	Annex C

Citation

- F. This instrument may be cited as the Financial Conglomerates Directive (Handbook Amendments) Instrument 2014.

By order of the Board of the Prudential Regulation Authority

[DATE]

Annex A

Amendments to the Glossary of definitions

In this Annex, underlining indicates new text and striking through indicates deleted text.

ultimate EEA insurance parent undertaking an *EEA insurance parent undertaking* that is not itself the *subsidiary undertaking* of another *EEA insurance parent undertaking* or of a mixed financial holding company which has its head office in an *EEA State*.

ultimate insurance parent undertaking an *insurance parent undertaking* that is not itself the *subsidiary undertaking* of another *insurance parent undertaking* or of a mixed financial holding company.

Annex B**Amendments to the Prudential sourcebook for insurers (INSPRU)**

In this Annex, underlining indicates new text and striking through indicates deleted text.

Scope – undertaking whose group capital is to be calculated and maintained

6.1.17 R The *undertakings* referred to in *INSPRU* 6.1.8R, *INSPRU* 6.1.9R, *INSPRU* 6.1.10R and *INSPRU* 6.1.15R are

(1) for any *firm* that is not within (2), each of the following:

...

(ba) the ~~ultimate~~ ultimate mixed financial holding company at the head of a *MFHC conglomerate* of which the *firm* is a member;

...

Annex C

Amendments to the Interim Prudential Sourcebook for Insurers (IPRU(INS))

Appendix 9.9: Group Capital Adequacy (Form 95)

Form 95 is amended as set out below:

In this Part, the text in the data item set out in column (1) is amended as indicated in column (2).

(1)	(2)						
	Retain the text and amend as follows (underlining indicates new text):						
Form 95: INSURANCE GROUP CAPITAL ADEQUACY REPORTING FORM	...						
	<table border="1"> <thead> <tr> <th data-bbox="446 653 599 705"><i>Ref</i></th> <th data-bbox="602 653 1375 705"><i>Instructions</i></th> </tr> </thead> <tbody> <tr> <td data-bbox="446 709 599 793">A (pages 2, 3 & 4)</td> <td data-bbox="602 709 1375 793">...</td> </tr> <tr> <td data-bbox="446 798 599 1486">D2 (page 2)</td> <td data-bbox="602 798 1375 1486"> <p>This column should be completed only for <i>related undertakings</i> which are <i>ancillary services undertakings</i> when computing the <u>group capital resources of an insurance group</u>. The entry is the higher of: the book value of the direct or indirect investment by the <i>ultimate insurance parent undertaking</i> or <i>ultimate EEA insurance parent undertaking</i> in the <i>ancillary services undertaking</i>; and the <i>ancillary services undertaking's</i> notional capital resources requirement (see <i>INSPRU</i> 6.1.62R to 6.1.64R).</p> <p><u>For insurance-led conglomerates, for the purposes of <i>INSPRU</i> 6.1.43R, in calculating the <i>group capital resources of an undertaking</i> in <i>INSPRU</i> 6.1.17R (1)(ba) or (bb) or in applying the provisions of <i>INSPRU</i> 6.1 for the purposes of calculating the <i>conglomerate capital resources of a financial conglomerate</i> under the provisions of <i>GENPRU</i> 3.1, a firm must, in accordance with <i>GENPRU</i> 3.1.30R but subject to <i>GENPRU</i> 3.1.31R, apply Method 2 (Deduction and Aggregation Method) or Method 1 (Accounting Consolidation Method) as set out in <i>GENPRU</i> 3 Annex 1 R to reflect direct or indirect investments by the <i>undertaking</i> in <i>INSPRU</i> 6.1.17R (1)(ba) or (bb) or by members of the <i>financial conglomerate</i> in each <i>related undertaking</i> which is an <i>ancillary services undertaking</i>.</u></p> </td> </tr> </tbody> </table>	<i>Ref</i>	<i>Instructions</i>	A (pages 2, 3 & 4)	...	D2 (page 2)	<p>This column should be completed only for <i>related undertakings</i> which are <i>ancillary services undertakings</i> when computing the <u>group capital resources of an insurance group</u>. The entry is the higher of: the book value of the direct or indirect investment by the <i>ultimate insurance parent undertaking</i> or <i>ultimate EEA insurance parent undertaking</i> in the <i>ancillary services undertaking</i>; and the <i>ancillary services undertaking's</i> notional capital resources requirement (see <i>INSPRU</i> 6.1.62R to 6.1.64R).</p> <p><u>For insurance-led conglomerates, for the purposes of <i>INSPRU</i> 6.1.43R, in calculating the <i>group capital resources of an undertaking</i> in <i>INSPRU</i> 6.1.17R (1)(ba) or (bb) or in applying the provisions of <i>INSPRU</i> 6.1 for the purposes of calculating the <i>conglomerate capital resources of a financial conglomerate</i> under the provisions of <i>GENPRU</i> 3.1, a firm must, in accordance with <i>GENPRU</i> 3.1.30R but subject to <i>GENPRU</i> 3.1.31R, apply Method 2 (Deduction and Aggregation Method) or Method 1 (Accounting Consolidation Method) as set out in <i>GENPRU</i> 3 Annex 1 R to reflect direct or indirect investments by the <i>undertaking</i> in <i>INSPRU</i> 6.1.17R (1)(ba) or (bb) or by members of the <i>financial conglomerate</i> in each <i>related undertaking</i> which is an <i>ancillary services undertaking</i>.</u></p>
	<i>Ref</i>	<i>Instructions</i>					
A (pages 2, 3 & 4)	...						
D2 (page 2)	<p>This column should be completed only for <i>related undertakings</i> which are <i>ancillary services undertakings</i> when computing the <u>group capital resources of an insurance group</u>. The entry is the higher of: the book value of the direct or indirect investment by the <i>ultimate insurance parent undertaking</i> or <i>ultimate EEA insurance parent undertaking</i> in the <i>ancillary services undertaking</i>; and the <i>ancillary services undertaking's</i> notional capital resources requirement (see <i>INSPRU</i> 6.1.62R to 6.1.64R).</p> <p><u>For insurance-led conglomerates, for the purposes of <i>INSPRU</i> 6.1.43R, in calculating the <i>group capital resources of an undertaking</i> in <i>INSPRU</i> 6.1.17R (1)(ba) or (bb) or in applying the provisions of <i>INSPRU</i> 6.1 for the purposes of calculating the <i>conglomerate capital resources of a financial conglomerate</i> under the provisions of <i>GENPRU</i> 3.1, a firm must, in accordance with <i>GENPRU</i> 3.1.30R but subject to <i>GENPRU</i> 3.1.31R, apply Method 2 (Deduction and Aggregation Method) or Method 1 (Accounting Consolidation Method) as set out in <i>GENPRU</i> 3 Annex 1 R to reflect direct or indirect investments by the <i>undertaking</i> in <i>INSPRU</i> 6.1.17R (1)(ba) or (bb) or by members of the <i>financial conglomerate</i> in each <i>related undertaking</i> which is an <i>ancillary services undertaking</i>.</u></p>						

Supervisory Statement | SS5/13

The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)

December 2013

1 Introduction

- 1.1 This supervisory statement is aimed at firms to which CRD IV⁽¹⁾ applies.
- 1.2 The purpose of this supervisory statement is to set out the expectations that the Prudential Regulation Authority (PRA) has in relation to the Internal Capital Adequacy Assessment Process (ICAAP) and the requirements set out in the PRA Rulebook in the Internal Capital Adequacy Assessment rules.
- 1.3 It provides further detail in relation to the high-level expectations outlined in The PRA's approach to banking supervision.⁽²⁾
- 1.4 The PRA will review a firm's ICAAP as part of its Supervisory Review and Evaluation Process (SREP), and this supervisory statement also sets out some of the factors that the PRA will take into consideration during the SREP.
- 1.5 In addition, this supervisory statement sets out the PRA's expectations with regard to firms' coverage and treatment of interest rate risk arising in the non-trading book, group risk operational risk and foreign currency lending to unhedged retail and SME borrowers.

2 Expectations of firms undertaking an ICAAP

- 2.1 A firm must carry out an ICAAP in accordance with the PRA's ICAAP rules. These include requirements on the firm to undertake a regular assessment of the amounts, types and distribution of capital that it considers adequate to cover the level and nature of the risks to which it is or might be exposed. This assessment should cover the major sources of risks to the firm's ability to meet its liabilities as they fall due and incorporate stress testing and scenario analysis. The ICAAP should be documented and updated annually by the firm or more frequently if changes in the business, strategy, nature or scale of its activities or operational environment suggest that the current level of financial resources is no longer adequate.
- 2.2 The PRA expects firms in the first instance to take responsibility for ensuring that the capital they have is adequate, with the ICAAP being an integral part of meeting this expectation. The PRA expects the ICAAP to be the responsibility of a firm's governing body, that it is reviewed and signed off by the governing body, and that it is used as an integral part of the firm's management process and decision-making culture. The processes and systems used to produce the ICAAP should ensure that the assessment of the adequacy of a firm's financial resources is reported to its governing body and senior management as often as is necessary.

¹ The Capital Requirements Directive (2013/36/EU) (CRD) and the Capital Requirements Regulation (575/2013) (CRR), jointly "CRD IV".

² www.bankofengland.co.uk/pras/pages/supervision/approach/default.aspx

- 2.3 The ICAAP, and internal processes and systems supporting it, should be proportionate to the nature, scale and complexity of the activities of a firm, as set out in Internal Capital Adequacy Assessment 3.3 in the PRA's Rulebook. Where a firm has identified risks as not being material, it should be able to provide evidence of the assessment process that determined this and discuss why that conclusion has been reached.
- 2.4 Liquidity risk should also be assessed, including in relation to potential losses arising from the liquidation of assets and increases in the cost of funding during periods of stress. The requirements in relation to liquidity risk may be found in BIPRU 12.
- 2.5 As outlined in the supervisory statement on stress testing, the PRA expects firms to develop a framework for stress testing, scenario analysis and capital management that captures the full range of risks to which they are exposed and enables these risks to be assessed against a range of plausible yet severe scenarios. The ICAAP should outline how stress testing supports capital planning for the firm.
- 2.6 Where a firm uses a model to aid its assessment of the level of adequate capital, it should be appropriately conservative and should contribute to prudent risk management and measurement. The firm should expect the PRA to investigate the structure, parameterisation and governance of the model, and the PRA will seek reassurance that the firm understands the attributes, outputs and limitations of the model, and that it has the appropriate skills and expertise to operate, maintain and develop the model.

3 The SREP

- 3.1 The SREP is a process by which the PRA will, taking into account the nature, scale and complexity of a firm's activities:
- review the arrangements, strategies, processes and mechanisms implemented by a firm to comply with its regulatory requirements laid down in PRA rules and the CRR;
 - evaluate the risks to which the firm is or might be exposed;
 - assess the risks that the firm poses to the financial system; and
 - evaluate the further risks revealed by stress testing.
- 3.2 As part of its SREP, the PRA will review the firm's ICAAP and have regard to the risks outlined in the overall Pillar 2 rule in Internal Capital Adequacy Assessment 3.1, the governance arrangements of the firm, its corporate culture and values, and the ability of members of the management body to perform their duties. The degree of involvement of the governing body of the firm will be taken into account by the PRA when assessing the ICAAP, as will the appropriateness of the internal processes and systems for supporting and producing the ICAAP.
- 3.3 When the PRA reviews an ICAAP as part of the SREP, it does so in order to determine whether all of the material risks have been identified and that the amount and quality of

capital identified by the firm is sufficient to cover the nature and level of the risks to which it is or might be exposed.

3.4 The SREP will also consider:

- (a) the results of stress tests carried out in accordance with the CRR by firms that use the Internal Ratings-Based (IRB) approach or internal models for market risk capital requirements;
- (b) the exposure to and management of concentration risk by firms, including their compliance with the requirements set out in Part Four of the CRR and Chapter 6 of the ICAAP rules;
- (c) the robustness, suitability and manner of application of policies and procedures implemented by firms for the management of the residual risk associated with the use of credit risk mitigation techniques;
- (d) the extent to which the capital held by a firm in respect of assets which it has securitised is adequate, having regard to the economic substance of the transaction, including the degree of risk transfer achieved;
- (e) the exposure to and management of liquidity risk by firms, including the development of alternative scenario analyses, the management of risk mitigants (including the level, composition and quality of liquidity buffers), and effective contingency plans;
- (f) the impact of diversification effects and how such effects are factored into firms' risk measurement system;
- (g) the geographical location of firms' exposures;
- (h) the exposure of firms to the risk of excessive leverage; and
- (i) whether a firm has provided implicit support to a securitisation.
- (j) the exposure to and management of foreign currency lending risk to unhedged retail and SME borrowers by firms, in line with the European Banking Authority's Guidelines on capital measures for foreign currency lending to unhedged borrowers under the Supervisory Review and Evaluation Process (SREP).⁽³⁾

3.5 The PRA will also assess as part of the SREP the risks that the firm poses to the financial system.

3.6 The PRA may need to request further information and meet with the governing body and other representatives of a firm in order to evaluate fully the comprehensiveness of the ICAAP. The management of the firm, including the governing body, should therefore be prepared to discuss all aspects of the ICAAP, covering both quantitative and qualitative components. Additionally, the PRA will consider the business model of the firm and the

³ <http://www.eba.europa.eu/documents/10180/535130/EBA-GL-2013-02+%28Guidelines+on+capital+measures+for+FX+lending%29.pdf/966f1ca0-7454-4003-a40a-e2fc98214fc1>. Title I "Subject matter, scope and definitions" of the EBA Guidelines, section 2, page 8, provides definitions of "FX", "FX lending", (i.e. "foreign currency lending") and "unhedged borrower".

advocated rationale for the model, as well as the firm's expectations regarding the future market and economic environment and how they might affect its business model.

- 3.7 The SREP will generally be the same across all types of firms, but will be proportionate given the nature, scale and complexity of a firm's activities. There may also be a different emphasis depending on the type of firm or its potential risk to the financial system. For example, banks and building societies may be more exposed to credit concentration risk and interest rate risk in the non-trading book, with investment firms being more likely to be exposed to market risk; these potentially different areas of emphasis will be reflected in the conduct of the SREP, where applicable, for relevant firms.
- 3.8 On the basis of the SREP, the PRA will determine whether the arrangements implemented by a firm and the capital held by it provide sound management and adequate coverage of its risks. If necessary, the PRA will require the firm to take appropriate actions or steps at an early stage to address any future potential failure to meet its prudential regulatory requirements.

4 The setting of Individual Capital Guidance (ICG) and the Capital Planning Buffer (CPB) ICG

- 4.1 Following the SREP, including both a review of the ICAAP and any further interactions with a firm, the PRA will normally give the firm Individual Capital Guidance (ICG), advising the firm of the amount and quality of capital that the PRA considers the firm should hold to meet the overall financial adequacy rule in Internal Capital Adequacy Assessment 2.1.
- 4.2 The PRA will give ICG on a consolidated basis to firms which must comply with the overall financial adequacy rule in Internal Capital Adequacy Assessment 2.1 on a consolidated basis. The PRA may decide not to give ICG on an individual basis to members of a group where firms are able to demonstrate that capital has been adequately allocated among subsidiaries and that there are no impediments to the transfer of capital within the group. This does not absolve individual firms or members of the group of their obligation to comply with the overall financial adequacy rule in Internal Capital Adequacy Assessment 2.1, which applies to all firms on an individual basis whether or not it also applies to the firm on a consolidated basis.
- 4.3 Where the PRA gives ICG to a firm it will generally specify an amount of capital (Pillar 2A) that the firm should hold at all times in addition to the capital it must hold to comply with the CRR (Pillar 1). It will usually do so stating that the firm should hold capital of an amount at least equal to a specified percentage of that firm's capital requirement under the CRR, plus one or more static add-ons in relation to specific risks in accordance with the overall Pillar 2 rule in Internal Capital Adequacy Assessment 3.1. The PRA expects firms to meet Pillar 2A with at least 56% Common Equity Tier 1 (CET1) capital and no more than 44% in AT1 by 1 January 2015.

- 4.4 It is for firms to ensure that they comply with the overall financial adequacy rule in Internal Capital Adequacy Assessment 2.1. However, if a firm holds the level of capital recommended as its ICG that does not necessarily mean that it is complying with the overall financial adequacy rule. Deviation by a firm from the terms of the ICG given to it by the PRA does not automatically mean that the firm is in breach of the overall financial adequacy rule or that the PRA will Consider that the firm is failing or is likely to fail to satisfy the Threshold Conditions (TCs). However, firms should expect the PRA to investigate whether any firm is failing or likely to fail to satisfy the TCs, with a view to taking further action as necessary.
- 4.5 The PRA does not expect a firm to meet the CRD IV buffers with any CET1 capital maintained to meet its ICG. If a firm agrees with its ICG, the PRA will expect the firm to apply for a requirement under Section 55M(5) of the Financial Services and Markets Act 2000 (FSMA) preventing the firm from meeting any of the CRD IV buffers that apply to it with any CET1 capital maintained to meet its ICG. The firm will normally be invited to apply for such a requirement at the same time as it is advised of its ICG. If the firm does not apply for such a requirement the PRA will consider using its powers under Section 55M(3) to impose one of its own initiative.
- 4.6 Where a firm is subject to the Basel 1 floor the PRA does not expect a firm to meet the CRD IV buffers with any CET1 maintained by the firm to meet the Basel 1 floor and will use its powers under Section 55M to prevent a firm from doing so. Where applicable to a firm, global and other systemically important institution buffers will also be set by the PRA using its powers under Section 55M of FSMA.

CPB

- 4.7 Following the SREP, the PRA may also notify the firm of an amount and quality of capital that it should hold as a Capital Planning Buffer (CPB), over and above the level of capital recommended as its ICG, and will generally do so at the same time as advising the firm of its ICG. The CPB, based on a firm-specific supervisory assessment, should be of sufficient amount and adequate quality to allow the firm to continue to meet the overall financial adequacy rule in Internal Capital Adequacy Assessment 2.1. This should be the case even in adverse circumstances, after allowing for realistic management actions that a firm could and would take in a stress scenario. Use of the CPB is not of itself a breach of capital requirements or the TCs. The automatic distribution constraints associated with the CRD IV buffers do not apply to the CPB.
- 4.8 The PRA may set a firm's CPB either as an amount of capital which it should hold from the time of the PRA's notification following the firm's SREP or, in exceptional cases, as a forward-looking target that a firm should build up over time. More information on setting the CPB is outlined in the supervisory statement on stress testing. Where the general stress and scenario testing rule, as part of the ICAAP rules, applies to a firm on consolidated basis the PRA may notify the firm that it should hold a group CPB.
- 4.9 Where the amount or quality of capital which the PRA considers a firm should hold to meet the overall financial adequacy rule in Internal Capital Adequacy Assessment 2.1 or as a CPB

is different from that identified by the firm through its ICAAP, the PRA usually expects to discuss the difference with the firm and may consider the use of its powers under Section 166 of FSMA to assist in such circumstances.

- 4.10 If a firm considers that the ICG or the CPB advised to it by the PRA is inappropriate to its circumstances it should notify the PRA of this, consistent with Principle 11 (Relations with regulators). If, after discussion, the PRA and the firm do not agree on an adequate level of capital, the PRA may consider using its powers under Section 55M of FSMA to impose a requirement on the firm to hold capital in accordance with the PRA's view of the capital necessary to comply with the overall financial adequacy rule in Internal Capital Adequacy Assessment 2.1. In deciding whether it should use its powers under Section 55M of FSMA, the PRA will take into account the amount and quality of the capital that the firm should hold for its CPB.

5 Failure to meet ICG and use of the CPB

- 5.1 The PRA expects every firm to hold at least the level of capital advised to it via its ICG at all times. If a firm's capital has fallen or is expected to fall below that level it should inform the PRA as soon as practicable (even if the firm has not accepted the ICG given by the PRA), explaining why this has happened or is expected to happen. The firm will also be expected to discuss the actions that it intends to take to increase its capital and/or reduce its risks (and therefore capital requirements), and any potential modification that it considers should be made to the ICG.
- 5.2 Where this has happened, the PRA may ask a firm for alternative and more detailed proposals or further assessments of capital adequacy and risks faced by the firm. The PRA will seek to agree with the firm appropriate timescales and the scope for any such additional work.
- 5.3 Where a firm has a CPB in place, it should only use that buffer to absorb losses or meet increased capital requirements if certain adverse circumstances materialise. These should be circumstances beyond the firm's normal and direct control, whether relating to a deteriorating external environment or periods of stress such as macroeconomic downturns or financial/market shocks, or firm-specific circumstances.
- 5.4 Consistent with Principle 11, a firm should notify the PRA as early as possible in advance where it has identified that it would need to use its CPB (even if the firm has not accepted the PRA's assessment of the amount or quality of the capital required for the CPB). The firm's notification should state as a minimum:
- what adverse circumstances are likely to force the firm to draw down its CPB;
 - how the CPB will be used up in line with the firm's capital planning projections; and
 - what plan is in place for the eventual restoration of the CPB.

- 5.5 Following discussions with the firm, the PRA may put in place additional reporting arrangements to monitor the firm's use of its CPB in accordance with the plan agreed to restore that buffer. The PRA may also identify specific trigger points as the CPB is being used up by the firm, which may lead to additional supervisory actions.
- 5.6 Where a firm's CPB is being drawn down due to circumstances other than those arising from a deteriorating external environment or periods of stress (eg macroeconomic downturns or financial/market shocks), or firm-specific circumstances (eg poor planning), the PRA may ask the firm for more detailed plans to restore its CPB. In light of the relevant circumstances, the PRA may consider taking other remedial actions, which may include using its powers under Section 55M of FSMA to require the firm to take specified action to restore its CPB within an appropriate timeframe.
- 5.7 Where a firm has started to use its CPB in circumstances where it was not possible to notify the PRA in advance, it should notify the PRA and provide information about the cause, the current and projected usage of the buffer, and its eventual restoration as soon as practicable afterwards.

6 Interest rate risk in the non-trading book

- 6.1 Firms must have appropriate systems and processes, proportionate to the nature, scale and complexity of their business, to evaluate and manage interest rate risk in the non-trading book. Examples of interest rate risk in the non-trading book include:
- the mismatch of repricing of assets and liabilities and off balance sheet short and long-term positions (termed 'repricing risk');
 - hedging exposure to one interest rate with exposure to a rate which reprices under slightly different conditions ('basis risk');
 - the uncertainties of occurrence of transactions, eg where actual transactions do not equal those that were expected in the future ('pipeline risk'); and
 - consumers redeeming fixed rate products when market rates change ('optionality risk').
- 6.2 The systems and processes should allow the firm to include:
- the ability to measure the exposure and sensitivity of the firm's activities, if material, to repricing risk, yield curve risk, basis risk and risks arising from embedded optionality (eg pipeline risk, prepayment risk) as well as changes in assumptions (eg those about customer behaviour);
 - consideration as to whether a purely static analysis of the impact on its current portfolio of a given shock or shocks should be supplemented by a more dynamic simulation approach; and
 - scenarios in which different interest rate paths are computed and in which some of the assumptions (eg about behaviour, contribution to risk and balance sheet size and composition) are themselves functions of interest rate level.

6.3 Under Internal Capital Adequacy Assessment 13.1, a firm is required to make a written record of its assessments made under those rules. A firm's record of its approach to evaluating and managing interest rate risk as it affects the firm's non-trading activities should cover the following issues:

- the internal definition of the boundary between 'banking book' and 'trading activities';
- the definition of economic value and its consistency with the method used to value assets and liabilities (eg discounted cash flows);
- the size and the form of the different shocks to be used for internal calculations;
- the use of a dynamic and/or static approach in the application of interest rate shocks;
- the treatment of commonly called 'pipeline transactions' (including any related hedging);
- the aggregation of multi-currency interest rate exposures;
- the inclusion (or not) of non-interest bearing assets and liabilities (including capital and reserves);
- the treatment of current and savings accounts (ie the maturity attached to exposures without a contractual maturity);
- the treatment of fixed rate assets (liabilities) where customers still have a right to repay (withdraw) early;
- the extent to which sensitivities to small shocks can be scaled up on a linear basis without material loss of accuracy (ie covering both convexity generally and the non-linearity of pay-off associated with explicit option products);
- the degree of granularity employed (for example offsets within a time bucket); and
- whether all future cash flows or only principal balances are included.

6.4 In accordance with Internal Capital Adequacy Assessment 9.2, a firm should apply a 200 basis point shock in both directions to each major currency exposure. The PRA will periodically review whether the level of the shock is appropriate in light of changing circumstances, in particular the general level of interest rates (for instance, during periods of very low interest rates) and their volatility. The level of shock required may also be changed in accordance with EBA guidelines. A firm's internal systems should, therefore, be flexible enough to compute its sensitivity to any standardised shock that is prescribed. If a 200 basis point shock would imply negative interest rates, or if such a shock would otherwise be considered inappropriate, the PRA will consider adjusting the requirements accordingly.

6.5 Alongside the requirement to monitor and evaluate the potential impact of changes in interest rates on economic value, the PRA expects firms to monitor the potential impact on earnings volatility. This should be assessed on an appropriate timeframe of three to five years, and factor in the firm's forward-looking view of product volumes, based on its proposed business model, and the projected path of interest rates.

7 Group risk

7.1 Under SYSC 12.1.8R a firm is required to have adequate, sound and appropriate risk management processes and internal control mechanisms for the purpose of assessing and managing its own exposure to group risk, including sound administrative and accounting procedures.

8 Operational Risk

8.1 In meeting the general standard referred to in Internal Capital Adequacy Assessment 10.1, a firm that undertakes market-related activities should be able to demonstrate to the PRA:

- in the case of a firm calculating its capital requirement for operational risk using the basic indicator approach or standardised approach, that it has considered; or
- in the case of a firm with an Advanced Measurement Approach (AMA) permission, compliance with the Committee of European Banking Supervisors' Guidelines on the management of operational risk in market-related activities,⁽¹⁾ published in October 2010.

8.2 In meeting the general standards referred to in Internal Capital Adequacy Assessment 10.1, a firm with an AMA approval should be able to demonstrate to the appropriate regulator that it has considered and complies with Section III of the European Banking Authority's Guidelines on the Advanced Measurement Approach (AMA) — Extensions and Changes,⁽²⁾ published in January 2012.

8.3 The matters dealt with in a business continuity plan should include:

- (a) resource requirements such as people, systems and other assets, and arrangements for obtaining these resources;
- (b) the recovery priorities for the firm's operations;
- (c) communication arrangements for internal and external concerned parties (including the PRA, clients and the press);
- (d) escalation and invocation plans that outline the processes for implementing the business continuity plans, together with relevant contact information;
- (e) processes to validate the integrity of information affected by the disruption; and
- (f) regular testing of the business continuity plan in an appropriate and proportionate manner.

9 Foreign currency lending to unhedged retail and SME borrowers

- 9.1 Foreign currency lending is defined in the EBA Guidelines on capital measures for foreign currency lending to unhedged borrowers under the Supervisory Review and Evaluation Process (SREP).⁴
- 9.2 As part of its obligations under Internal Capital Adequacy Assessment 3.1 a firm that lends in foreign currency to unhedged retail and SME borrowers should determine whether it meets the thresholds of materiality in Title II, section 1 paragraph 9 of the European Banking Authority's Guidelines on capital measures for foreign currency lending to unhedged borrowers under the Supervisory Review and Evaluation Process (SREP). Where a firm meets the threshold it should notify the PRA and reflect the risk in its ICAAP.

⁴ <http://www.eba.europa.eu/documents/10180/535130/EBA-GL-2013-02+%28Guidelines+on+capital+measures+for+FX+lending%29.pdf/966f1ca0-7454-4003-a40a-e2fc98214fc1>. Title I "Subject matter, scope and definitions" of the EBA Guidelines, section 2, page 8, provides definitions of "FX", "FX lending", (i.e. "foreign currency lending") and "unhedged borrower".

**PRUDENTIAL SOURCEBOOK FOR BANKS, BUILDING SOCIETIES AND INVESTMENT FIRMS
(LIQUIDITY STANDARDS) AMENDMENT
INSTRUMENT 2014**

Powers exercised

- A. The Prudential Regulation Authority (“PRA”) makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 (“the Act”):
- (1) section 137G (The PRA’s general rules); and
 - (2) section 137T (General supplementary powers).
- B. The rule-making powers referred to above are specified for the purpose of section 138G (2) (Rule-making instruments) of the Act.

Pre-conditions to making

- C. In accordance with section 138J of the Act (consultation with the Financial Conduct Authority (“FCA”), the PRA consulted the FCA. After consulting, the PRA published a draft of proposed rules and had regard to representations made.

Commencement

- D. This instrument comes into force on [DATE].

Amendments

- E. The Glossary of definitions is amended in accordance with Annex A to this instrument.
- F. The Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU) is amended in accordance with Annex B to this instrument.

Citation

- G. This instrument may be cited as the Prudential sourcebook for Banks, Building Societies and Investment Firms (Liquidity Standards) Amendments Instrument 2014.

By order of the Board of the Prudential Regulation Authority
[DATE]

Annex A**Amendments to the Glossary of definitions**

Insert the following new definitions in the appropriate alphabetical position. The text is not underlined.

<i>Shari'ah compliant firm</i>	a <i>firm</i> whose entire operations are structured and conducted in accordance with Islamic commercial jurisprudence and its investment principles.
<i>sukuk</i>	certificates of equal value representing an undivided interest in the ownership of specified assets or investments acquired or to be acquired and that comply with Islamic commercial jurisprudence and its investment principles, but excluding <i>shares</i> .

Annex B

Amendments to the Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU)

In this Annex, all text is new and is not underlined.

12.7 Liquid assets buffer

...

12.7.2A R Notwithstanding *BIPRU* 12.7.2R, for the purpose of satisfying *BIPRU* 12.2.8R a *Shari'ah compliant firm* may include *sukuk* in its liquid assets buffer.

...

12.7.8A R For the purpose of *BIPRU* 12.7.2AR, a *Shari'ah compliant firm* may include only a *sukuk* which:

- (1) is issued by a government or central bank or *designated multilateral development bank*; or
- (2) satisfies the following conditions:
 - (a) the *sukuk* is not issued by a member of the *financial sector* or where that member is a member of a *group* by any member of that *group*; and
 - (b) the issuer of the *sukuk* has been assessed by at least one *eligible ECAI* as having a credit rating associated with credit quality step 3 or above in the table set out in *BIPRU* 12 Annex 1R (Mapping of credit assessments of *ECAs* to credit quality steps).

...

12.7.8B R For the purpose of *BIPRU* 12.7.8AR, a *Shari'ah compliant firm* may count *sukuk* only up to the limits on the share of total assets in the *firm's* liquid assets buffer and after haircuts have been applied as follows:

- (1) For the purpose of *BIPRU* 12.7.8AR(1),
 - (a) if the central bank or government or *designated multilateral development bank* in question has been assessed by at least one *eligible ECAI* as having a credit rating associated with credit quality step 1 in the table set out in *BIPRU* 12 Annex 1R (Mapping of credit assessments of *ECAs* to credit quality steps), *sukuk* can comprise an unlimited share of the total assets in the *firm's* liquid assets buffer and are not subject to a haircut; or
 - (b) if the central bank or government or *designated multilateral development bank* in question has been assessed by at least one *eligible ECAI* as having a credit rating associated with credit quality step 2 in the table set out in *BIPRU* 12 Annex 1R (Mapping of credit assessments of *ECAs* to credit quality steps), *sukuk* can comprise not more than 40% of the total assets in the *firm's* liquid assets buffer after a haircut of 25% has been

applied; or

- (c) in all other cases, *sukuk* can comprise not more than 20% of the total assets in the *firm's* liquid assets buffer after a haircut of 50% has been applied.
- (2) For the purpose of *BIPRU* 12.7.8AR(2), *sukuk* cannot comprise more than 10% of the total assets in the *firm's* liquid assets buffer after a haircut of 50% has been applied.
- (3) The total amount of *sukuk* not falling under *BIPRU* 12.7.10BR(1)(a) cannot comprise more than 40% of the total amount of assets in the *firm's* liquid assets buffer.

...

12.7.12A R For the purpose of *BIPRU* 12.7.8AR(1) and (2), a *Shari'ah compliant firm* must count *sukuk* only that comply with *BIPRU* 12.7.9R(1), (2) and (3).

**PRUDENTIAL SOURCEBOOK FOR BANKS, BUILDING SOCIETIES AND INVESTMENT
FIRMS (LIQUIDITY STANDARDS NO 2) AMENDMENT
INSTRUMENT 2014**

Powers exercised

- A. The Prudential Regulation Authority ("PRA") makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):
- (1) section 137G (The PRA's general rules);
 - (2) section 137T (General supplementary powers); and
 - (3) section 138C (Evidential provisions).
- B. The rule-making powers referred to above are specified for the purpose of section 138G(2) (Rule-making instruments) of the Act.

Pre-conditions to making

- C. In accordance with section 138J of the Act (consultation with the Financial Conduct Authority) ("FCA"), the PRA consulted the FCA. After consulting, the PRA published a draft of proposed rules and had regard to representations made.

Amendments

- D. The Prudential sourcebook of Bank, Building Societies and Investment Firms (BIPRU) is amended in accordance with the Annex to this instrument.

Commencement

- E. The Annex to this instrument comes into force on [DATE].

Citation

- F. This instrument may be cited as the Prudential sourcebook of Bank, Building Societies and Investment Firms (Liquidity Standards No 2) Amendments Instrument 2014.

By order of the Board of the Prudential Regulation Authority

[Date]

Annex

Amendments to the Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU)

In this Annex, underlining indicates new text and striking through indicates deleted text, unless otherwise stated.

12.3- Liquidity risk management

12.3.1 ~~G~~ The approach taken in ~~BIPRU 12.3~~ is to set out:

- ~~(1) overarching systems and controls provisions in relation to a firm's management of its liquidity risk;~~
- ~~(2) provisions outlining the responsibilities of that firm's governing body and senior managers for the oversight of liquidity risk;~~
- ~~(3) more detailed provisions covering a number of specific areas, including:~~
 - ~~(a) pricing liquidity risk;~~
 - ~~(b) intra-day management of liquidity;~~
 - ~~(c) management of collateral;~~
 - ~~(d) management of liquidity across legal entities, business lines and currencies; and~~
 - ~~(e) funding diversification and market access.~~

12.3.1A G The approach taken in BIPRU 12.3 is to set out:

- (1) overarching systems and controls provisions in relation to a firm's management of its liquidity risk;
- (2) provisions outlining the responsibilities of that firm's governing body and senior managers for the oversight of liquidity risk;
- (3) more detailed provisions covering a number of specific areas, including:
 - (a) pricing liquidity risk;
 - (b) intra-day management of liquidity;
 - (c) management of collateral;
 - (d) management of liquidity across legal entities, business lines and currencies;
 - (e) funding diversification and market access; and
 - (f) asset encumbrance.

- ...
- 12.3.5A R The strategies, policies, process and systems referred to in *BIPRU* 12.3.4R must ensure that the risks associated with collateral management and asset encumbrance are adequately identified, monitored and managed.
- ...
- 12.3.8A R A firm must ensure that its *governing body* establishes that *firm's* approach to asset encumbrance and that this is appropriately documented.
- ...
- 12.3.12 R A firm must ensure that its *senior managers*:
- (1) ~~continuously review that *firm's* liquidity position, including its compliance with the *overall liquidity adequacy rule*; and~~
 - (2) ~~report to its *governing body* on a regular basis adequate information as to that *firm's* liquidity position and its compliance with the *overall liquidity adequacy rule* and with *BIPRU* 12.3.4R.~~
- ...
- 12.3.12A R A firm must ensure that its *senior managers*:
- (1) continuously review that *firm's* liquidity position, including its compliance with the *overall liquidity adequacy rule*;
 - (2) report to its *governing body* on a regular basis adequate information as to that *firm's* liquidity position and its compliance with the *overall liquidity adequacy rule* and with *BIPRU* 12.3.4R; and
 - (3) continuously review that *firm's* asset encumbrance position in accordance with that *firm's* approach to asset encumbrance.
- ...
- 12.3.15 R (1) ~~In relation to all significant business activities, a *firm* should ensure that it accurately quantifies liquidity costs, benefits and risks and fully incorporates them into:~~
- (a) ~~product pricing;~~
 - (b) ~~performance measurement and incentives; and~~
 - (c) ~~the approval process for new products.~~
- (2) ~~For the purposes of (1), a *firm* should ensure that it:~~
- (a) ~~includes significant business activities whether or not they~~

are accounted for on-balance sheet; and

(b) ~~carries out the exercise of quantification and incorporation both in normal financial conditions and under the stresses required by *BIPRU* 12.4.1R.~~

(3) ~~A firm should ensure that the liquidity costs, benefits and risks are clearly and transparently attributed to business lines and are understood by business line management.~~

(4) ~~Contravention of any of (1), (2) or (3) may be relied upon as tending to establish contravention of *BIPRU* 12.3.4R.~~

12.3.15A R (1) In relation to all significant business activities, a firm should ensure that it accurately quantifies liquidity costs, benefits and risks and fully incorporates them into:

(a) product pricing;

(b) performance measurement and incentives; and

(c) the approval process for new products.

(2) For the purposes of (1), a firm should ensure that it:

(a) includes significant business activities whether or not they are accounted for on-balance sheet; and

(b) carries out the exercise of quantification and incorporation both in normal financial conditions and under the stresses required by *BIPRU* 12.4.1AR.

(3) A firm should ensure that the liquidity costs, benefits and risks are clearly and transparently attributed to business lines and are understood by business line management.

(4) Contravention of any of (1), (2) or (3) may be relied upon as tending to establish contravention of *BIPRU* 12.3.4R.

...

12.3.19 R For the purposes of *BIPRU* 12.3.17R, a firm must ensure that:

(1) ~~it is able to meet its payment and settlement obligations on a timely basis under both normal financial conditions and under the stresses required by *BIPRU* 12.4.1R; and~~

(2) ~~its arrangements for the management of intra-day liquidity enable it to identify and prioritise the most time-critical payment and settlement obligations.~~

12.3.19A R For the purposes of *BIPRU* 12.3.17R, a firm must ensure that:

(1) it is able to meet its payment and settlement obligations on a timely basis under both normal financial conditions and under the stresses required by *BIPRU* 12.4.1AR; and

- (2) its arrangements for the management of intra-day liquidity enable it to identify and prioritise the most time-critical payment and settlement obligations.
- ...
- 12.3.24 G For the purposes of *BIPRU* 12.3.23R (8) and (9), a *firm* should take into account the impact of the stresses that it conducts under *BIPRU* 12.4.1AR on the requirements which may be imposed on the provision of its assets as collateral (for example, haircuts) and also the availability of funds from private counterparties during such periods of stress.
- 12.3.24A G For the purposes of *BIPRU* 12.3.23R (8) and (9), a *firm* should take into account the impact of the stresses that it conducts under *BIPRU* 12.4.1AR on the requirements which may be imposed on the provision of its assets as collateral (for example, haircuts) and also the availability of funds from private counterparties during such periods of stress.
- ...
- 12.3.25 E (1) ~~A *firm* should ensure that its arrangements for the management of *liquidity risk*:~~
- ~~(a) enable it to monitor shifts between intra-day and overnight or term collateral usage;~~
 - ~~(b) enable it to appropriately adjust its calculation of available collateral to account for assets that are part of a tied hedge;~~
 - ~~(c) include adequate consideration of the potential for uncertainty around, or disruption to, intra-day asset flows; and~~
 - ~~(d) take into account the potential for additional collateral requirements under the terms of contracts governing existing collateral positions (for example, as a result of a deterioration in its own credit rating).~~
- (2) ~~Contravention of any of (1)(a) to (d) may be relied upon as tending to establish contravention of *BIPRU* 12.3.4R.~~
- 12.3.25A E (1) A *firm* should ensure that its arrangements for the management of *liquidity risk*:
- (a) enable it to monitor shifts between intra-day and overnight or term collateral usage;
 - (b) enable it to appropriately adjust its calculation of available collateral to account for assets that are part of a tied hedge;
 - (c) include adequate consideration of the potential for uncertainty around, or disruption to, intra-day asset

flows; and

(d) take into account the potential for additional collateral requirements under the terms of contracts governing existing collateral positions (for example, as a result of a deterioration in its own credit rating) and the impact of these on its asset encumbrance position.

(2) Contravention of any of (1)(a) to (d) may be relied upon as tending to establish contravention of BIPRU 12.3.4R.

...

Asset encumbrance

12.3.33 R A firm must actively manage its asset encumbrance position.

12.3.34 R For the purposes of BIPRU 12.3.33R, a firm must ensure that:

(1) its policies take into account the firm's business model, the specificities of the funding markets and the macroeconomic situation; and

(2) its governing body receives timely information on:

(a) the level, evolution and types of asset encumbrance;

(b) the amount, evolution and credit quality of unencumbered but encumberable assets; and

(c) the amount, evolution and types of additional encumbrance resulting from stress scenarios (contingent encumbrance).

12.3.35 G Asset encumbrance occurs when assets are used to secure creditors' claims so that they are no longer available to general creditors in the event of a firm's failure. The PRA considers that this is the case where an asset is, either explicitly or implicitly, pledged or subject to an arrangement to secure, collateralise or credit-enhance a transaction.

12.4 Stress testing and contingency funding

...

12.4.1 R In order to ensure compliance with the overall liquidity adequacy rule and with BIPRU 12.3.4R and BIPRU 12.4.1R, a firm must:

(1) conduct on a regular basis appropriate stress tests so as to:

(a) identify sources of potential liquidity strain;

(b) ensure that current liquidity exposures continue to conform to the liquidity risk tolerance established by that firm's governing body; and

- (e) identify the effects on that *firm's* assumptions about pricing; and
 - (2) analyse the separate and combined impact of possible future liquidity stresses on its:
 - (a) cash flows;
 - (b) liquidity position;
 - (c) profitability; and
 - (d) solvency.
- 12.4.1A R In order to ensure compliance with the *overall liquidity adequacy rule* and with *BIPRU* 12.3.4R and *BIPRU* 12.4.-1R, a *firm* must:
- (1) conduct on a regular basis appropriate stress tests so as to:
 - (a) identify sources of potential liquidity strain;
 - (b) ensure that current liquidity exposures continue to conform to the *liquidity risk* tolerance established by that *firm's governing body*; and
 - (c) identify the effects on that *firm's* assumptions about pricing; and
 - (d) identify contingent asset encumbrance; and
 - (2) analyse the separate and combined impact of possible future liquidity stresses on its:
 - (a) cash flows;
 - (b) liquidity position;
 - (c) profitability; and
 - (d) solvency.
- 12.4.1B G For the purpose of *BIPRU* 12.4.1AR(1)(d), the stress tests should take into account a range of different stress scenarios, including downgrades in the *firm's* credit rating, devaluation of pledged assets and increases in margin requirements.
- ...
- 12.4.12 G ~~A *contingency funding plan* sets out a *firm's* strategies for addressing liquidity shortfalls in emergency situations. Its aim should be to ensure that, in each of the stresses required by *BIPRU* 12.4.1R, it would still have sufficient liquidity resources to ensure that it can meet its liabilities as they fall due.~~
- 12.4.12A G *A contingency funding plan* sets out a *firm's* strategies for addressing liquidity shortfalls in emergency situations. Its aim should

be to ensure that, in each of the stresses required by BIPRU 12.4.1AR, it would still have sufficient liquidity resources to ensure that it can meet its liabilities as they fall due.

- 12.4.13 R *A firm must ensure that its ~~contingency funding plan:~~*
- ~~(1) outlines strategies, policies and plans to manage a range of stresses;~~
 - ~~(2) establishes a clear allocation of roles and clear lines of management responsibility;~~
 - ~~(3) is formally documented;~~
 - ~~(4) includes clear invocation and escalation procedures;~~
 - ~~(5) is regularly tested and updated to ensure that it remains operationally robust;~~
 - ~~(6) outlines how that firm will meet time-critical payments on an intra-day basis in circumstances where intra-day liquidity resources become scarce;~~
 - ~~(7) outlines that firm's operational arrangements for managing a retail funding run;~~
 - ~~(8) in relation to each of the sources of funding identified for use in emergency situations, is based on a sufficiently accurate assessment of:

 - ~~(a) the amount of funding that can be raised from that source; and~~
 - ~~(b) the time needed to raise funding from that source;~~~~
 - ~~(9) is sufficiently robust to withstand simultaneous disruptions in a range of payment and settlement systems;~~
 - ~~(10) outlines how that firm will manage both internal communications and those with its external stakeholders; and~~
 - ~~(11) establishes mechanisms to ensure that the firm's governing body and senior managers receive management information that is both relevant and timely.~~

- 12.4.13A R *A firm must ensure that its contingency funding plan:*
- (1) outlines strategies, policies and plans to manage a range of stresses;
 - (2) establishes a clear allocation of roles and clear lines of management responsibility;
 - (3) is formally documented;
 - (4) includes clear invocation and escalation procedures;

- (5) is regularly tested and updated to ensure that it remains operationally robust;
- (6) outlines how that *firm* will meet time-critical payments on an intra-day basis in circumstances where intra-day liquidity resources become scarce;
- (7) outlines that *firm's* operational arrangements for managing a retail funding run;
- (8) in relation to each of the sources of funding identified for use in emergency situations, is based on a sufficiently accurate assessment of:
- (a) the amount of funding that can be raised from that source; and
- (b) the time needed to raise funding from that source;
- (9) is sufficiently robust to withstand simultaneous disruptions in a range of payment and settlement systems;
- (10) outlines how that *firm* will manage both internal communications and those with its external stakeholders;
- (11) establishes mechanisms to ensure that the *firm's governing body* and senior managers receive management information that is both relevant and timely; and
- (12) outlines strategies to address the contingent asset encumbrance resulting from the relevant stress events.
- 12.4.14 E (1) In designing a *contingency funding plan* a *firm* should ensure that it takes into account:
- (a) the impact of stressed market conditions on its ability to sell or securitise assets;
- (b) the impact of extensive or complete loss of typically available market funding options;
- (c) the financial, reputational and any other additional consequences for that *firm* arising from the execution of the *contingency funding plan* itself;
- (d) its ability to transfer liquid assets having regard to any legal, regulatory or operational constraints; and
- (e) its ability to raise additional funding from central bank market operations and liquidity facilities.
- (2) Contravention of any of (1)(a) to (e) may be relied upon as tending to establish contravention of *BIPRU* 12.3.4R.
- 12.4.14A E (1) In designing a *contingency funding plan* a *firm* should ensure that it takes into account:

- (a) the impact of stressed market conditions on its ability to sell or securitise assets;
 - (b) the impact of extensive or complete loss of typically available market funding options;
 - (c) the financial, reputational and any other additional consequences for that *firm* arising from the execution of the contingency funding plan itself;
 - (d) its ability to transfer liquid assets having regard to any legal, regulatory or operational constraints;
 - (e) its ability to raise additional funding from central bank market operations and liquidity facilities; and
 - (f) the impact of increased collateral requirements.
- (2) Contravention of any of (1)(a) to (f) may be relied upon as tending to establish contravention of *BIPRU* 12.3.4R.

...

- 12.4.16 ~~G~~ ~~The *appropriate regulator* expects that a *firm's contingency funding plan* will encompass a range of actions that the *firm* might take in anticipation of or in response to changes in its funding position. These changes could result from either *firm-specific* or general developments. The *appropriate regulator* anticipates that different actions in a *contingency funding plan* would be taken at different stages of a developing situation.~~
- 12.4.16A G The *appropriate regulator* expects that a *firm's contingency funding plan* will encompass a range of actions that the *firm* might take in anticipation of or in response to changes in its funding position or asset encumbrance position. These changes could result from either *firm-specific* or general developments. The *appropriate regulator* anticipates that different actions in a *contingency funding plan* would be taken at different stages of a developing situation.