Policy Statement | PS2/18

Pillar 2 liquidity

February 2018
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1 Overview

1.1 This Prudential Regulation Authority (PRA) Policy Statement (PS) provides feedback to responses to Consultation Paper (CP) 21/16 and CP13/17 ‘Pillar 2 liquidity’ (‘Pillar 2’).

1.2 It contains:

- final Statement of Policy (SoP) ‘Pillar 2 liquidity’ (Appendix 1);
- updated Supervisory Statement (SS) 24/15 ‘The PRA’s approach to supervising liquidity and funding risks’ (Appendix 2);
- final PRA110 template and reporting instructions (Appendix 3);
- final amendment to the Reporting Part of the PRA Rulebook (Appendix 4); and
- updated SS34/15 ‘Guidelines for completing regulatory reports’ (Appendix 5).

1.3 This PS is relevant to UK banks, building societies and PRA-designated investment firms, referred to collectively as ‘firms’ in this PS.

Background

1.4 In CP21/16 and CP13/17, the PRA made proposals to:

(a) use the methodologies consulted on, in future PRA liquidity assessments;

(b) introduce a cashflow mismatch risk (CFMR) framework and associated reporting template (PRA110) from 1 January 2019; and

(c) set survival guidance on the granular Liquidity Coverage Requirement (LCR) stress within the CFMR framework.

Statutory obligations

1.5 Where the final rules differ from the draft in the CP in a way which is, in the opinion of the PRA, significant, the Financial Services and Markets Act 2000 (FSMA) requires the PRA to publish:

(a) details of the difference together with a cost benefit analysis; and

(b) a statement setting out in the PRA’s opinion whether or not the impact of the final rule on mutuals is significantly different to: the impact that the draft rule would have had on mutuals; or the impact that the final rule will have on other PRA-authorised firms.

1.6 Following consideration of respondents’ comments, the PRA has made a number of changes to the CFMR framework, the PRA110 template, the PRA110 implementation date and methodologies for assessing liquidity risks. Changes of note to the proposals consulted on include:

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3 Section 138J(5) and 138K(4).
(a) the removal of monetisation in the granular LCR stress scenario on which guidance is being set;

(b) a six-month delay to the implementation of PRA110 reporting from January to July 2019;¹

(c) new timing assumptions on a number of outflows in PRA110;

(d) a new row in PRA110 for the reporting of Pillar 2 add-ons; and

(e) an amended stress uplift reference point for calculating intraday liquidity risk.

1.7 Further details on the changes made to the proposals as well as an assessment of their impact on firms, and specifically mutuals, are set out in the following chapter.

Implementation

1.8 The SoP (Appendix 1), the updated SS24/15 (Appendix 2) and the updated SS34/15 (Appendix 5) will take effect from the date of publication of this PS. The PRA110 template and reporting instructions (Appendix 3) and the Reporting Part of the PRA Rulebook (Appendix 4) will take effect from 1 July 2019.

2 Feedback to responses

2.1 The PRA is required by the FSMA to have regard to any representations made to the proposals in a consultation, and to publish an account, in general terms, of those representations and its response to them.

2.2 The PRA received eleven responses to CP21/16² and fourteen responses to CP13/17. Respondents made a number of observations and requests for clarification which are set out below.

2.3 The sections below have been structured broadly along the same lines as the chapters of the CPs, with some areas rearranged to better respond to related issues. The responses have been grouped as follows:

- Level of application;
- Cashflow mismatch risk scenarios and monetisation;
- PRA110 template and reporting instructions;
- Franchise viability risks;
- Intraday liquidity; and
- Other liquidity risks.

¹ See the PRA’s update on 17 January 2018, available on the Regulatory reporting – banking sector webpage at: www.bankofengland.co.uk/prudential-regulation/regulatory-reporting/regulatory-reporting-banking-sector.

² The PRA published a statement of feedback received on CP21/16 on 18 October 2016: www.bankofengland.co.uk/pra/Documents/publications/reports/prastatement181016.pdf.
Level of application

2.4 The PRA proposed that in general, the level of application for setting guidance under Pillar 2 Liquidity (‘Pillar 2’) will be aligned to Pillar 1.

2.5 Three respondents suggested that Pillar 2 guidance should be set at the lowest relevant level of application. Two respondents requested that high quality liquid assets (HQLA) held against add-ons at lower levels of application, and which are considered trapped, be taken into account when sizing consolidated guidance. Two respondents commented that consolidated Pillar 2 guidance should not be the sum of individual solo or sub group guidance, citing offsets between liquidity risks in different entities and netting.

2.6 Having considered the feedback, the PRA has decided to maintain the level of application proposal as set out in CP13/17, but has slightly revised the wording to make clearer how the PRA arrives at its guidance. The PRA considers there to be liquidity risks at the consolidated level that would not be captured if guidance was set solely at the lowest level of application. The PRA typically assesses risks at both consolidated and lower levels of application and considers that it is appropriate to set Pillar 2 at the same level as Pillar 1. The location of liquid assets in the context of trapped liquidity is something that the PRA considers as part of intragroup risk. The PRA has considered feedback regarding netting of liquidity risks in different entities and clarified that the PRA may consider some netting of solo liquidity guidance to a limited extent, where appropriate.

Cashflow mismatch risk scenarios and monetisation

2.7 The PRA proposed to assess CFMR on both a consolidated currency and single currency basis and that all firms should survive throughout the granular LCR stress scenario (30 day horizon) combined with monetisation, on a consolidated currency basis.

2.8 Five respondents argued that combining monetisation profiles with stressed liquidity outflows would result in firms holding large cash buffers and increase the need to hold central bank reserves. The PRA has considered this feedback and has decided to remove the monetisation profile from the guidance proposed in SS24/15, which required firms to survive the granular LCR combined with the monetisation profile. It is replaced with guidance to survive the granular LCR stress scenario. The PRA will keep this issue under review. The PRA believes this change will lessen the cost to firms of meeting its policy.

2.9 As proposed in the CP, the PRA will still expect firms to assess the speed and scale with which they expect to be able to monetise different types of non-cash HQLA, for CFMR monitoring scenarios only. The PRA has included two tables in the SoP to explain differences between stress scenarios and stress tools. The tables list those scenarios on which the PRA is setting guidance, those which are for monitoring purposes and those which include monetisation profiles.

2.10 Some respondents commented that timing assumptions related to Pillar 2 risks are unrealistic, for example one respondent noted that some wholesale outflows, such as debt buy-backs, do not occur on day one of the stress but settle on at least a T+2 cycle. The PRA has made changes to timing assumptions associated with Pillar 2 risks to address respondents’ concerns. To facilitate changes to Pillar 2 timing assumptions, the PRA has added one row in PRA110 to allow firms to report Pillar 2 add-ons across all tenor buckets as appropriate. The PRA believes the changes will lessen the cost to firms. In the granular LCR stress and benchmark stresses (and those stresses with the monetisation profile), the PRA will assume that liquidity needs associated with Pillar 2 risks will materialise as follows:
(a) Unchanged from the PRA’s original proposal:
   (i) intraday, margined derivatives and securities financing margin on day 1.

(b) Updated Pillar 2 timings:
   (i) prime brokerage, matched books, debt buyback and non-margined derivatives uniformly over the business days contained within the first seven calendar days;
   (ii) liquidity systems and controls (L-SYSC) uniformly over the business days within the first 30 calendar days;
   (iii) intragroup to be advised individually to the firm if an add-on is applied.

2.11 Six respondents commented that some of the day 1 outflow assumptions (other than Pillar 2 risks covered in paragraph 2.10) proposed are unrealistic. For example, one firm observed that contingent wholesale outflows are often subject to contractual notice periods.

(a) In the granular LCR stress, the PRA considers a loss of funding calibrated by the LCR stress outflow rate. LCR rates are set to reflect the experience of firms under stress during the financial crisis. Case studies and research support the day 1 assumption for retail outflows: that withdrawals equal to the LCR outflow rate can occur in one day if the stress is severe. Experience during the financial crisis also shows that unsecured funding and other deposits can quickly flow out.

(b) With regard to contingent wholesale flows, firms report these according to contractual maturities. Firms should take into account notice periods when determining contractual maturities of cash flows.

(c) As a result of feedback received, the PRA has updated the day 1 assumption for a number of contingent outflows by allowing firms to report such outflows as per contractual maturity, if known. The changes to the PRA110 in order to reflect the updated assumptions are detailed in paragraph 2.26 as part of PRA110 template. The PRA believes the change will lessen the cost to firms.

2.12 One respondent suggested that the cashflow mismatch gap under all stress scenarios should exclude Pillar 2 add-ons, since low point risk lies within Pillar 1. HQLA buffers cover both Pillar 1 and Pillar 2 risks and liquidity needs associated with Pillar 2 risks can materialise at the same time as Pillar 1 risks. Therefore, the PRA considers that a net liquidity profile that does not take into account Pillar 2 risks understates CFMR and gives false comfort regarding firm survival under stress.

2.13 Two respondents suggested that the monetisation framework should consider that some outflows can be covered with securities rather than cash. The PRA notes that this is taken into account in PRA110 reporting instructions for PRA110: row 7240, ‘Outflows which can be met by posting securities (Total)’, allows firms to cover outflows through securities instead of cash where appropriate.

2.14 One respondent asked which methodology should be used to assess speed of monetisation. The PRA does not envisage a specific methodology. Firms should undertake their own assessment and explain this in their Internal Liquidity Adequacy Assessment Process (ILAAP) documents, as set out in SS24/15.
2.15 One respondent suggested that foreign currency mismatches would be better assessed by setting LCR guidance by currency, at a level below 100%. The PRA has considered the feedback but still considers it important to be able to monitor cliff risk and low point risk on both a consolidated and single currency basis. Setting LCR guidance by currency would not give the PRA sight of these risks.

2.16 One respondent argued that the historical look-back approach (HLBA) for derivative outflows, calculated as net cumulative variation margin flows across 30 days, selected over the worst month in the last 2 years, is too conservative. The PRA’s supervisory experience suggests that cumulative net outflows over 30 days have been smaller than the worst day of the worst 30 day period in the last 2 years. Therefore, the PRA does not consider it appropriate to deviate from HLBA for the CFMR granular LCR and benchmarks stress scenarios.

2.17 One respondent asked whether it is expected that the PRA110 cash flows will align with the LCR Delegated Act. The 30 day point on the PRA110 should closely align to cash flows reported in the LCR, but without applying the inflow cap.

**PRA110 template and instructions**

2.18 The PRA proposed to introduce a new liquidity reporting template (PRA110) to monitor CFMR. It proposed to collect the new liquidity reporting template on a weekly basis with a one business day remittance period for large firms, and a monthly basis with a fifteen business day remittance period for small firms, as detailed in the PRA Rulebook amendment (Annex 4).

2.19 Four respondents requested a delay to the proposed implementation date of 1 January 2019 for the PRA110 return. Firms expressed concern that the proposed implementation date overlap with the implementation of other regulatory requirements. In light of this feedback, the PRA has decided to revise the implementation date for the PRA110 return to 1 July 2019, as recently announced.1

2.20 One respondent stated that PRA110 requirement to report 92 days of daily data placed an overly-onerous burden on firms. The PRA has considered the arguments put forward but considers that 92 days of daily data is appropriate and necessary. The 92 day horizon has three primary benefits. It allows:

(a) for the monitoring of cliff risk;

(b) in times of firm-specific stress, sufficient lead time for the supervisor to discuss potential liquidity recovery options proposed by the firm, including whether liquidity support may be sought; and

(c) the PRA and the Bank to be able to plan for market-wide stress events.

2.21 The PRA clarifies that prudential sub-consolidation groups (ie ring-fenced bodies) will report the PRA110, as set out in the PRA Rulebook amendment.

2.22 The PRA has updated SS24/15 to clarify that the PRA will notify a firm in times of stress if it intends to increase its PRA110 reporting frequency.

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2.23 The monetisation actions section in PRA110 has been changed to allow firms to include monetisation of HQLA using a combination of collateral swaps and sale of the swapped HQLA. In response to a question on whether this section is to be completed on a contractual or behavioural basis, the PRA has updated the reporting instructions to clarify that the monetisation section is based on firms’ intended (behavioural) monetisation of securities over the time horizon.

2.24 The PRA has amended the item reference numbers in the PRA110 for rows not common with the European Banking Authority (EBA) Maturity Ladder (ML), to make clear where the PRA110 differs from the EBA ML.

2.25 The PRA has clarified the PRA110 reporting instructions with reference to derivative transactions in the PRA110 (rows 61-66) to state that ‘margin’ refers to amounts given and received both in collateralised-to-market and settled-to-market transactions.

2.26 Based on feedback detailed in paragraph 2.11, the PRA has changed the assumption of day 1 outflows for a number of rows in PRA110. The PRA, having considered the feedback, will allow firms to report contractual profiles, if known, for flows that do not typically have a defined contractual maturity, within the following rows:

(a) Rows 6800 to 6870: downgrade reporting of 8 notches;
(b) Row 6890: Collateral other than Level 1 assets collateral posted for derivatives;
(c) Row 6900: Level 1 EHQ Covered Bonds assets collateral posted for derivatives;
(d) Row 6920: Callable excess collateral;
(e) Row 6930: Due collateral; and
(f) Row 6940: Liquid asset collateral exchangeable for non-liquid asset collateral.

2.27 One respondent noted that under the section ‘Cumulative Liquidity Resources post Firm Actions’ in PRA110, the formula for ‘Total usable liquidity resources’ (Row 7420) excludes the value of Level 2A and Level 2B securities. The PRA has updated the formula to include all HQLA securities.

2.28 Two respondents sought clarification on item 60.36 (item reference 70 in final PRA110 template) in PRA110 – whether it is contractual or behavioural and whether gross or net outflows are to be reported. The reporting instructions clarify that firms should report, on a cumulative basis, total LCR and Pillar 2 gross outflows, where the contractual terms allow the firm to meet the outflow by posting securities and the firm holds sufficient eligible securities on the specified date.

2.29 One respondent noted that for cash and securities collateral received in the context of collateralised derivatives, the PRA110 instructions do not include the collateral as part of a firm’s HQLA and therefore do not align to the reporting treatment under the LCR and Enhanced Mismatch Report. In this case the PRA reporting instructions mirror the EBA ML reporting instructions. The PRA110 reporting instructions only include additional instructions, above and beyond the EBA ML reporting instructions, for new rows added by the PRA. The PRA has not changed the reporting instructions for lines common between the EBA ML and PRA110, other than where a cross-reference to another PRA110 row and column is required.
2.30 One respondent asked whether a weekly submission frequency is necessary. The PRA considers access to frequent and timely data as fundamental. Frequent reporting and short remittance periods ensure that the information received is up to date and usable.

2.31 One respondent asked whether the PRA has considered any thresholds to exempt firms from the ‘stand–ready’ expectation of section 3.8 of CP13/17. The PRA has considered this feedback but does not envisage such exemptions, as in a time of stress access to timely and accurate data is fundamental.

2.32 One respondent noted that in the section ‘Memorandum Items’ of PRA110, the instructions for item 60.20 (item reference 60 in final PRA110 template), collateral swap flows, do not indicate if the flows need to be reported at market value or at liquidity value (ie market value net of haircut as in LCR C75 template). The PRA clarifies in the reporting instructions that all security values shall be reported in the relevant bucket at current market values.

2.33 One respondent noted that the reporting instructions for PRA110 in the monetisation actions section do not refer to Articles 7 and 8 of Regulation (EU) No 2015/61 for tradable assets. The PRA clarifies that firms should report the market value of tradable assets, in accordance with Articles 7 and 8 of Regulation (EU) No 2015/61, that firms would expect to monetise under the LCR stress scenario by outright sale. Reporting instructions have been amended accordingly.

2.34 One respondent noted that rows 1330-1460, referred to in reporting instructions in 60.48 (item reference 73 in final PRA110 template) that do not appear in the reporting template. The PRA has amended the reporting instructions to include the correct items.

2.35 One respondent asked if reverse repos were assumed to mature as part of reporting instructions for cumulative liquidity resources post firm actions in the monetisation actions section. The PRA has amended the reporting instructions to clarify that cash received from contractually maturing reverse repos of HQLA can be reported in this section, where the firm’s monetisation strategy includes contractual maturity of those reverse repos.

2.36 Reporting of securities flows in the monetisation actions sections of the PRA110 have been amended (rows 7250 and rows 7290) to align with instructions in counterbalancing capacity section – outflows of securities should be reported with a negative sign and inflows of securities should be reported with a positive sign.

Franchise viability risks

Debt buyback

2.37 The PRA proposed that its approach to assessing liquidity risk associated with debt buyback would be based on supervisory discretion guided by the firm’s outstanding debt.

2.38 Respondents welcomed the PRA’s approach, in particular the proposal to take into account the need to maintain debt eligible for minimum requirement for own funds and eligible liabilities (MREL).

2.39 Two respondents questioned whether an add-on would be applied if the firm had a clear policy not to buy back debt, even in stress. The PRA confirms that this will be taken into consideration when the supervisor determines whether or not an add-on is appropriate.

2.40 One respondent requested that the PRA take account of the reduced likelihood of a subsidiary buying back debt issued by a parent legal entity. The PRA will consider the issuing entity of the debt when assessing whether an add-on is appropriate.
Early termination of non-margined derivatives
2.41 The PRA proposed that its approach to assessing liquidity risk associated with early termination of non-margined derivatives will be based on supervisory discretion guided by the firm’s exposures.

2.42 Two respondents questioned the need to set add-ons for early termination of non-margined derivatives given the declining materiality of the risk with the move to margining and central clearing of derivatives. The PRA has considered this feedback and acknowledges that the materiality of the non-margined derivative market has declined as a result of the move to greater margining and central clearing. However, the PRA considers that non-margined derivatives can be a material liquidity risk for some firms and will set guidance as appropriate.

2.43 One respondent requested additional clarity on how the PRA measures exposure to non-margined derivatives. The PRA clarifies that its measure of exposure to the risk of early termination of non-margined derivatives, is to consider contracts which were out-of-the-money on a mark to market basis.

Prime brokerage and matched book liquidity risk
2.44 The PRA proposed to assess prime brokerage and matched book risks based on supervisory judgement and guided by the LCR rates for secured transactions.

2.45 Three respondents were concerned about the potential for overlap with Pillar 1, noting many cash prime brokerage risks are captured in Pillar 1. One respondent welcomed the PRA’s intention to consider capped out inflows when assessing prime brokerage and matched book liquidity risks. The PRA agrees that risks from cash internalisation are predominantly captured in Pillar 1. The PRA reiterates the SoP assertion that in determining any liquidity guidance for cash prime brokerage or matched books, the PRA takes into consideration ‘capped out’ inflows from Pillar 1, and may in limited circumstances allow a firm to use capped out inflows in lieu of a liquidity add-on.

2.46 One respondent welcomed a further opportunity to work with the PRA to assess and calibrate prime brokerage and matched book risks. The PRA will continue its dialogue with firms through the Liquidity Supervisory Review and Evaluation Process (L-SREP).

Intraday liquidity
2.47 The PRA proposed that its approach to assessing intraday liquidity risk would be based on, at least, the firm’s maximum net debits, the firm’s stress testing framework, the firm’s key characteristics (such as whether it is a direct or indirect participant in payment and settlement systems), and the markets it operates in.

2.48 Eight respondents were concerned that the use of the firm’s maximum net debit to size intraday liquidity needs could lead to a double counting of liquidity risks captured by the LCR, for instance where clients pre-fund payments.

2.49 Two respondents proposed an alteration to the maximum net debit methodology to alleviate the potential for double counting with the LCR. The proposed methodology compares the maximum net debit in a system to the lower of either the start or end of day balance of the firm, in that system. The respondents believe that when a net end of day outflow has occurred, reducing the maximum net debit by an amount equal to the net end of day outflow, would alleviate the double count.
The PRA considers that this approach may significantly overestimate the potential double count. The net end of day outflow is greater than the potential double count; many of the LCR prescribed outflow rates are significantly less than 100% of the associated liability.

Furthermore, the asymmetry of the methodology (on days with a net end of day inflow, the maximum net debit is not adjusted up) could lead to a firm managing the shape of its intraday profile in order to increase its net end of day outflow, and thus reduce its intraday liquidity guidance.

Although no methodology has been presented to the PRA that can accurately calibrate any potential double count, the PRA has noted the concerns raised by respondents. It has decided to revise down its stress uplift reference point to reflect the fact that in some circumstances, a double count could exist.

More generally, two respondents proposed that an alternative to the maximum net debit approach would be to assess overdrafts and credit facilities provided to clients. The PRA has assessed this approach but does not consider it an accurate measure of intraday liquidity risk as it does not capture intraday liquidity risk arising from business conducted by the firm on its own behalf, which can be substantial. The PRA has not updated its methodology based on this feedback.

Two respondents stated that the burden of producing data to support analysis of the maximum net debit was too high given their size and business models. The PRA will proportionate in its expectations of a firm’s ability to provide intraday liquidity data for the calculation of the maximum net debit. Where a firm is a direct participant in a system, the PRA expects the firm to be able to calculate its maximum net debit.

One respondent proposed that small firms who are indirect participants be allowed to undertake double duty as the intraday flows encountered by small, simple firms are lower and more predictable than those of larger firms. The PRA has considered this feedback but notes that the level of settlement activity will be reflected in the size of any intraday guidance applied.

Two respondents suggested that intraday requirements will reduce over the 30 day stress period assessed under the LCR and CFMR, which will free liquidity to meet outflows later in the stress period. The PRA does not receive forward looking contractual data at an intraday granularity. It is therefore not possible to include intraday liquidity dynamically in the CFMR framework.

Two respondents requested clarification of the look back period for the intraday calculation. Having considered the feedback, as a best practice, the PRA seeks to use 12 months of data to alleviate seasonality, but the data period used will take into account the availability and suitability of the data.

Other liquidity risks
Margined derivatives
The PRA proposed to assess margined derivatives liquidity risks by considering the firm’s historical initial margin posted and received, with a stress uplift applied.

One respondent supported the PRA’s approach.

One respondent suggested an alternative approach for assessing risks from initial margin posted. The suggested methodology was for the PRA to assess clearing houses’ margin models...
and make a judgement on whether or not they are sufficiently conservative. The PRA has considered this feedback, but considers it appropriate to review the liquidity risks relating to margin derivatives from a firm-by-firm perspective.

2.61 One respondent sought a clarification from the PRA that the risk from loss of initial margin as a source of funding only applies to initial margin over which the firm has rehypothecation rights. The PRA confirms this to be the case.

**Securities financing margin**

2.62 The PRA proposed to assess securities financing margin liquidity risks based on the firm’s historical margin posted, with a stress uplift applied.

2.63 One respondent supported the PRA’s approach.

2.64 Two respondents noted that the day-to-day variation of securities financing margin is influenced by day-to-day changes in a firm’s portfolio composition. The respondent sought clarity on how firms are expected to offset the impact of portfolio changes. The PRA notes that the averaging within the methodology smooths the day-to-day changes of a firm’s portfolio composition.

**Intragroup liquidity**

2.65 The PRA proposed to assess intragroup liquidity risk on a case-by-case basis, taking into account intragroup interconnectedness.

2.66 Three respondents supported the PRA’s approach to assess intragroup risk on a case-by-case basis.

**Liquidity Systems and Controls (L-SYSC)**

2.67 The PRA proposed to assess liquidity systems and controls risks based on supervisory judgement.

2.68 One respondent asked whether the PRA would work with industry to clarify what is expected as best practice from a liquidity risk management perspective. The PRA has considered this but has no near-term plan to do so.

2.69 One respondent stated that an L-SYSC add-on should provide an incentive for a firm to remediate any issues with its systems and controls. Therefore, the firm’s view was that an add-on should not be applied if the institution is aware of issues and has a credible plan to remediate them. The PRA has considered this feedback and notes that in the event it is deemed necessary to apply an add-on, it will be sized in a manner proportionate to the scale of the risk.

2.70 One respondent agreed with the PRA’s approach but sought to ensure the PRA was proportionate in its expectations of smaller firms. As per paragraph 1.6 of the SoP, the PRA seeks to be proportionate to each firm’s business model and to the risk that the firm poses to the PRA’s statutory objectives in setting Pillar 2 guidance.

**Disclosure**

2.71 The PRA proposed that in disclosing information about their liquidity position, firms should note that their publically disclosed LCR ratios include HQLA held to cover Pillar 2 risks, with no further specific disclosure on their Pillar 2 guidance unless required by law.

2.72 Respondents broadly agreed with the PRA’s approach to disclosure of Pillar 2 liquidity guidance.
## Appendices

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