

# Supervisory Statement | SS24/15

# The PRA's approach to supervising liquidity and funding risks

February 2018  
(Updating December 2016)



BANK OF ENGLAND  
PRUDENTIAL REGULATION  
AUTHORITY



1 January 2019: this document has been updated, please see: <https://www.bankofengland.co.uk/prudential-regulation/publication/2015/the-pras-approach-to-supervising-liquidity-and-funding-risks-ss>



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## 1 Introduction

1.1 This supervisory statement sets out the Prudential Regulation Authority's (PRA's) approach to supervising liquidity and funding risks. It is addressed to firms to which CRD IV<sup>1</sup> applies.

1.2 The statement should be read alongside the 'Internal Liquidity Adequacy Assessment' part of the PRA Rulebook (ILAA rules), the 'Liquidity Coverage Requirement — UK Designated Investment Firms' part of the PRA Rulebook; the PRA's approach to banking supervision;<sup>2</sup> Part Six (Liquidity) of the Capital Requirements Regulation (CRR) and the European Commission Delegated Act with regards to the liquidity coverage requirement (LCR) for credit institutions ('Delegated Act').<sup>3</sup> The PRA's approach is informed by the European Banking Authority's (EBA's) guidelines for common procedures and methodologies for the supervisory review and evaluation process (SREP).<sup>4</sup> The PRA expects firms to have regard to the detail contained in Titles 8 and 9 of the EBA SREP Guidelines to understand the PRA's expectations of them in respect of liquidity and funding risk management and control.

1.3 The Delegated Act specifies in detail the LCR provided for in CRR Article 412 and is directly applicable in the United Kingdom. It took effect from 1 October 2015. The Delegated Act only applies to credit institutions. PRA-designated investment firms must comply with the obligations laid down in the Delegated Act as they apply to credit institutions, by virtue of rule 2.1 of the 'LCR — UK designated investment firms' Part of the PRA Rulebook. They should read references in this statement to the Delegated Act accordingly.

1.4 The PRA is required under CRD IV to apply the Liquidity Supervisory Review and Evaluation Process (L-SREP) and any supervisory measures in accordance with the level of application of the requirements set out in the CRD IV framework. Therefore, the ILAA rules, including the requirement to carry out an Internal Liquidity Adequacy Assessment Process (ILAAP), apply on an individual basis and on a consolidated basis where firms must comply with Part Six (Liquidity) of the CRR on a consolidated basis. This enables the PRA to apply the L-SREP and any supervisory measures at both individual and consolidated level, where appropriate.

1.5 This statement is structured as follows:

- Section 2: The Internal Liquidity Adequacy Assessment Process.
- Section 3: The Liquidity Supervisory Review and Evaluation Process.
- Section 4: Drawing down Liquid Asset Buffers.
- Section 5: Collateral placed at the Bank of England.
- Section 6: Reporting.

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1 CRD IV implements the international regulatory framework for banks known as Basel 3 in Europe. The legislation comprises two instruments: the Capital Requirements Regulation (575/2013) (CRR) and the Capital Requirements Directive (2013/36/EU)(CRD), jointly known as 'CRD IV'.(2).

2 [www.bankofengland.co.uk/pras/Pages/supervision/approach/default.aspx](https://www.bankofengland.co.uk/pras/Pages/supervision/approach/default.aspx).

3 European Commission Delegated Regulation (EU) 2015/61 of 10 October 2014 to supplement Regulation (EU) No 575/2013 of the European Parliament and the Council with regard to liquidity coverage requirement for Credit Institutions.

4 European Banking Authority: 'Guidelines for common procedures and methodologies for the supervisory review and evaluation process (SREP)', available at <https://www.eba.europa.eu/regulation-and-policy/supervisory-review-and-evaluation-srep-and-pillar-2/guidelines-for-common-procedures-and-methodologies-for-the-supervisory-review-and-evaluation-process-srep->

## 2 The Internal Liquidity Adequacy Assessment Process

2.1 The ILAA rules require firms to identify, measure, manage and monitor liquidity and funding risks across different time horizons and stress scenarios, consistent with the risk appetite established by the firm's management body. A firm must carry out an ILAAP in accordance with the ILAA rules, and the ILAAP should be proportionate to the nature, scale and complexity of the firm's activities as set out in Chapter 13 of the ILAA rules.

2.2 An ILAAP document sets out a firm's approach to liquidity and funding. It should be updated annually, or more frequently if changes in the business, strategy, nature or scale of its activities or operational environment suggest that the current level of liquid resources or the firm's funding profile is no longer adequate.

### ILAAP governance

2.3 The PRA expects the ILAAP to be the responsibility of a firm's management body.<sup>1</sup> The ILAAP document must be approved by the management body and be consistent with the risk appetite set by the management body. It also must be consistent with the firm's approach for measuring and managing liquidity and funding risks. The management body is also expected to ensure that the ILAAP is well integrated into management processes and the firm's decision-making culture.

### Producing an ILAAP document

2.4 As a general guide, the PRA expects that the ILAAP document which supports its liquidity review and evaluation process is in line with the EBA guidelines on common procedures and methodologies for SREP<sup>2</sup> and aligns with the further guidance in this supervisory statement. The PRA has provided a template in Appendix 1 as a guide for firms when producing their ILAAP documents.

2.5 The PRA recognises that for small firms with simple business models it may not be necessary to follow the template, or all elements in the template, provided all the key aspects are covered. This approach is consistent with the PRA's secondary competition objective. The PRA expects the document to be firm specific, not prepared in a formulaic manner, and to reflect the applicable business model. The PRA is equally sceptical of overly large, unwieldy documents as it is of documents providing too little detail.

2.6 Firms should refer to Title 5 of the EBA SREP guidelines when assessing the soundness, effectiveness and comprehensiveness of their ILAAP document. In particular, the PRA expects a firm to demonstrate in its ILAAP document that it complies with the expectations outlined in the rest of this chapter.

### Transition from ILAA/ILSA to ILAAP

2.7 Most firms that were subject to Chapter 12 of the Prudential Sourcebook for Banks, Building Societies and Investment Firms (BIPRU 12) will have produced ILAA or an Individual Liquidity Systems Assessment (ILSA) document. The following guidance is intended to assist those firms in producing their ILAAP document.

2.8 Where ILAA or ILSA documents were fit for purpose under BIPRU 12, the PRA expects that they broadly align with the requirements of an ILAAP document, with some exceptions. A key exception is that firms will need to conduct an ILAAP on an individual basis and on a consolidated basis where firms need to comply with the LCR on that basis. The PRA expects firms which will comply with the

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1 As defined in the Glossary section of the PRA Rulebook, [http://media.fshandbook.info/Handbook/Glossaryv7\\_PRA\\_20150402.pdf](http://media.fshandbook.info/Handbook/Glossaryv7_PRA_20150402.pdf).  
2 <https://www.eba.europa.eu/documents/10180/935249/EBA-GL-2014-13+%28Guidelines+on+SREP+methodologies+and+processes%29.pdf/4b842c7e-3294-4947-94cd-ad7f94405d66>.

ILAA rules on an individual and on a consolidated basis to only produce one ILAAP document which should address the requirements at both individual and consolidated level.

2.9 There is also a greater focus in the ILAAP on whether firms have adequate stable funding over the medium to long term as distinct from liquidity risk which focuses on firms' ability to meet their obligations in the short term. This may need to be reflected in the updated document.

2.10 Firms should also consider carefully the appropriateness of the liquid assets held, even where they are compliant with the Delegated Act, given that the Delegated Act permits a far wider range of eligible liquid assets than is eligible under BIPRU 12.

2.11 Firms do not need to transition their ILAA document to an ILAAP document immediately. The PRA would expect ILAAP documents to be updated and approved by the management body at the latest at the firm's next annual ILAAP review date. The PRA expects that all firms will have a management body approved ILAAP document, replacing their existing ILAA or ILSA, by the end of October 2016.

2.12 An overview of how the firm applies the Delegated Act in its LCR reporting may also be appropriate, including, if relevant, how the firm has interpreted the classifications of retail and operational deposits and the work undertaken annually in response to Delegated Act Article 23.

### **Overall liquidity adequacy**

2.13 A key purpose of the ILAAP is to document and demonstrate overall liquidity adequacy. The PRA's approach to liquidity supervision is based on the principle that a firm must have adequate levels of liquidity resources and a prudent funding profile, and that it comprehensively manages and controls liquidity and funding risks.

2.14 The firm itself is responsible for the effective management of its liquidity and funding risks. This overarching principle is set out in the overall liquidity adequacy rule (OLAR) in Chapter 2 of the ILAA rules, and supplemented by Chapter 3 of the ILAA rules on overall strategies, processes and systems.

2.15 As part of the ILAAP, a firm should undertake a regular assessment of the adequacy of its liquidity resources to cover its liabilities as they fall due in stressed conditions. Central to this process is an appropriate and clearly articulated risk appetite statement defining the duration and type of stress or stresses that the firm aims to survive. This risk appetite should be cascaded throughout the firm in the form of appropriate limits, which may include gap limits or concentration limits around currency, funding sources, the makeup of liquid asset buffers and the firm's structural liquidity position. The PRA also expects firms to articulate for themselves the amount of risk they are willing to take across different business lines to achieve their strategic objectives. This risk appetite should be consistent with the PRA's duty to advance its general objective of promoting the safety and soundness of firms.<sup>1</sup>

2.16 For the purposes of the OLAR, liquidity resources are not confined to the amount or value of a firm's marketable, or otherwise realisable, assets. Rather, in assessing the adequacy of those resources, a firm should have regard to the overall nature of the liquidity resources available to it, which enable it to meet its liabilities as they fall due.

2.17 The LCR is distinct from and does not replace the concept of overall liquidity adequacy. The LCR is a set of rules applying to all firms and therefore could fail to capture firm-specific risks. The LCR also does not capture any of the qualitative arrangements that the PRA requires a firm to implement

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<sup>1</sup> See also, 'The Prudential Regulation Authority's approach to banking supervision', June 2014; [www.bankofengland.co.uk/publications/Documents/prapproach/bankingappr1406.pdf](https://www.bankofengland.co.uk/publications/Documents/prapproach/bankingappr1406.pdf).

to ensure compliance with the OLAR. It follows that a firm cannot rely solely on meeting the LCR and/or LCR and Pillar 2 guidance in order to satisfy the OLAR.

### **Stress testing**

2.18 Comprehensive, robust stress testing is vital to ensure compliance with the OLAR. The PRA expects firms to consider in their stress testing the impact of a range of severe but plausible stress scenarios on their cash flows, liquidity resources, profitability, solvency, asset encumbrance and survival horizon. Stress scenarios should be selected to reveal the vulnerabilities of the firm's funding, including for example, a vulnerability to previously liquid markets becoming unexpectedly illiquid. Stress testing scenarios should include a macroeconomic stress. The PRA expects the degree of conservatism of the scenarios and assumptions to be discussed in the ILAAP document.

2.19 The PRA expects, in line with paragraph 3.12, firms to consider the lowest point of cumulative stressed net cashflows both within the 30-day LCR horizon and within the context of survival days along the horizon of their own risk appetite. Daily granularity is necessary for this analysis.

2.20 In analysing the key risk drivers set out in Chapter 11 of the ILAA rules, the PRA expects firms to make appropriate assumptions, both quantitative and qualitative. In particular, firms should include the following assumptions, discussed in detail in the EBA SREP Guidelines, where appropriate (the PRA's presumption is that these are consistent with existing internal liquidity management policies adopted by firms).

#### **(i) The run-off of retail funding**

This includes an assessment of the likely run-off of different components of the retail book, taking into account common features such as guarantee cover, maturity, interest rate sensitivity, customer type, product type, deposit size, or the channel through which the deposits were affected.

#### **(ii) The reduction of secured and unsecured wholesale funding**

This includes an assessment of the type and geographical location of the counterparty, the level of creditor seniority, the nature of the relationship the firm has with the counterparty, the type of underlying collateral (if applicable), and the speed of outflow. The risk of shortening tenors should also be assessed.

#### **(iii) The correlation and concentration of funding**

Firms should include an assessment that takes into account instrument type, markets, currency, liability term structure, counterparty and market access, as appropriate. A firm should also consider the effectiveness of its diversification strategy.

#### **(iv) Additional contingent off-balance sheet exposures**

Firms should include, where appropriate, an assessment of derivative cash flows caused by maturity, exercise, repricing, margin calls, a change in the value of posted collateral, collateral substitution, sleeper collateral, and volatile market conditions. Firms should also consider funding commitments (facilities, undrawn loans and mortgages, overdrafts and credit cards), guarantees and trade finance contracts, as well as facilities to support securitisation vehicles, including sponsored and third-party structures.

#### **(v) Funding tenors**

Firms should consider vulnerabilities within the term structure due to external, internal or contractual events (where the funding provider has call options).

#### **(vi) The impact of a deterioration in the firm's credit rating**

Firms should consider all types of contractual and behavioural outflows resulting from credit downgrades of varying magnitude, the types of collateral which may be required and the speed of outflow where appropriate.

**(vii) Foreign exchange convertibility and access to foreign exchange markets**

Firms should calculate stressed outflows by individual currency and tenor where appropriate. This information must support an assessment of how shortfalls can be funded in a stressed market with impaired access to foreign exchange markets and loss of convertibility.

**(viii) The ability to transfer liquidity across entities, sectors and countries**

Firms should assess the intragroup support assumed available in stress, or the impact of a failure of a group entity to repay loans in a timely manner, where appropriate. This assessment should include considering existing legal, regulatory and operational limitations to potential transfers of liquidity and unencumbered assets amongst entities, business lines, countries and currencies. Firms should detail information on their approach for measuring and managing intragroup liquidity risk and develop their own assessment of the risk of contingent trapped liquidity, on an individual, sub-consolidated (where applicable) and consolidated level. Firms should consider the likely implications of these risks in their stress scenarios and discuss the degree of conservatism and assumptions applied.

**(ix) Estimates of future balance sheet growth**

This should include considering how planned or forecast balance sheets may behave in stress and whether the firm's risk appetite would be breached.

**(x) The impact on a firm's reputation or franchise**

Firms should include an assessment of implicit liquidity requirements arising from a need to fulfil expectations to acquire assets, rollover or buy back assets, to extend or maintain other forms of liquidity support, or to permit premature termination of retail term or notice liabilities or derivative exposures for reputational reasons or to protect the franchise, as appropriate. Firms should also bear in mind that responses to a liquidity stress cannot include actions that would significantly damage their franchise.

2.21 In addition, the PRA also expects firms to consider the quantitative and qualitative assumptions for the following risk drivers which are not explicitly addressed in the EBA SREP Guidelines, where appropriate:

**(i) Marketable asset risk**

Firms should include a consideration of how factors affecting their ability to liquidate assets or monetise them through sale or repurchase agreements may change in stress. This should include market access, haircuts, timelines, pricing, operational capacity or eligibility.

**(ii) Non-marketable asset risk**

The PRA defines non-marketable assets as being those assets which cannot be monetised via repo or immediate outright sale. They could be monetised, for example, via the securitisation market or as covered bonds. Firms should include an assessment of how factors affecting the liquidity of those assets (eg counterparty stress, whether market access is frequent and established, early amortisation triggers, or financing of warehoused assets) may change under stress.

**(iii) Internalisation risk**

Internalisation risk occurs where firm or customer long positions are funded using the proceeds from customer short trades. When clients close out their short positions and these arrangements unwind, this may generate substantial liquidity outflows. Internalisation and netting efficiencies within synthetic prime brokerage also give rise to liquidity risk. Firms should include an assessment of these risks.

2.22 Consistent with Chapter 11 of the ILAA rules, the PRA expects the results of the stress testing exercise to be presented to the firm's management body on a regular basis.

**Intraday liquidity risk management**

2.23 A further risk driver where the PRA expects firms to make appropriate assumptions is intraday liquidity risk. This is the risk that a firm is unable to meet its daily settlement obligations, for example,

as a result of timing mismatches arising from direct and indirect membership of relevant payment or security settlement systems. Firms should ensure that they have sufficient liquidity at all times to maintain normal payment activity if:

- incoming payments are delayed by several hours or until close to the payment cut off times;
- credit lines are withdrawn and/or require full collateralisation; or
- large individual clients default on their payments.

2.24 The PRA assesses that intraday liquidity risk exposures are material for firms and firms are therefore expected to demonstrate robust analysis of their intraday liquidity risk profile both in business-as-usual and under stress scenarios.

2.24A All direct participants in payment and securities settlement systems should be able to calculate their maximum net debit position for each respective system in which they participate. Indirect participants that are currently unable to calculate their maximum net debit position are encouraged to engage with their correspondent bank(s), with the aim of improving the granularity and timeliness of payment settlement data to enable them to do this. The PRA will be proportionate in its expectations on the ability of indirect participants to be able to do this for all markets.

### **Managing the High Quality Liquid Assets (HQLA) buffer**

2.25 As part of their ILAAP, and within OLAR, firms should assess their ability to convert their buffers of liquid assets into cash in a short timeframe. The PRA would expect firms to set a risk appetite and framework which will govern the management and monitoring of their liquid asset portfolio. This includes having appropriate internal limits and controls to ensure that the ability to monetise HQLAs in stress is not limited in any way.

2.26 Some of the risk drivers identified above inform the assessment of firms' ability to monetise their buffers. These include 'marketable asset risk', 'foreign exchange convertibility and access to foreign exchange markets' and 'the ability to transfer liquidity across entities, sectors and countries'. Related to consideration of these risk drivers, the operational requirements in Delegated Act Article 8 also establish key principles which firms should observe.

2.27 This section highlights certain factors which the PRA regards as particularly important if firms are to demonstrate their ability to monetise their buffers on an appropriate timescale.

### **Testing the ability to monetise**

2.28 Delegated Act Article 8(4) requires firms to regularly monetise a sufficiently representative sample of their holdings of HQLA (with the exception of certain asset classes). The PRA's expectations of firms' compliance with this requirement will be proportionate, taking into account the firm's business model.

2.29 Firms are also reminded of the obligation in of Delegated Act Article 8(2) to have ready access to their holdings of HQLAs and to ensure that there are no legal or operational restrictions to monetising HQLAs at any time during the 30 calendar day stress period. In particular, while accounting classifications remain decisions for firms, where firms hold HQLAs in the held-to-maturity portfolio, they should be able to demonstrate that this does not create barriers to their ability to monetise these assets.

### **Cashflow mismatch risk (CFMR) monetisation assumptions**

2.29A From the date firms first report PRA110, the PRA expects firms to assess, at least annually in their ILAAP, the speed with which they expect to be able to monetise different types of non-cash HQLA, on a daily basis, through repo markets and outright sales in times of stress. Firms should take

into account relevant factors such as market depth, number of regular counterparties, the firm's individual turnover and incremental market access in stress, the need to rollover short-term repo transactions and settlement times etc. Firms should also consider the extent to which their ability to monetise HQLA through outright sale could be adversely affected by the accounting classification, in particular where sale of the asset would crystallise a loss that arises because of the difference between the fair value at the point of sale and the carry value in the firm's accounts. Firms should provide evidence of the data used for their assessments in their ILAAPs. Firms should not include public liquidity insurance as a non-cash HQLA monetisation channel in this assessment. This enables the PRA to monitor firms' resilience to different stresses using self-insurance alone. The monetisation profile will not be included in the granular LCR stress scenario for the purposes of assessing compliance with the guidance outlined in paragraph 3.12.

2.29B Firms should use their assessments to apply daily monetisation limits to their stock of different types of non-cash HQLA available at the reporting date, in the CFMR framework. The monetisation profiles should be computed on a consolidated currency level as well as in each significant currency. Firms will report the resulting monetisation profiles in PRA110.<sup>1</sup>

### Diversification of assets

2.30 Delegated Act Article 8(1) requires firms to have in place appropriate internal limits and controls to ensure that they appropriately diversify their HQLA buffer. This should be sufficient to demonstrate that their ability to monetise HQLAs in a short timeframe without significant loss of value is not compromised by exposure to a common risk factor. In addition, the PRA expects larger firms to take into account the absolute size of their HQLA holdings and to be able to monetise these without compromising on either speed of disposal or price. They should also consider the impact of their actions on the wider market and on financial stability.

2.31 Firms should have due regard to their own business model when determining the appropriate level of diversification in their buffer. In particular, they should consider the risk that a particular asset holding becomes illiquid just when the firm itself needs to draw down its buffer, for example, because both the firm and the asset are exposed to a common risk factor. Conversely, they should also consider whether their choice of assets is appropriate given their ability to manage properly the risk in those assets, and to access the relevant repo or sale market.

2.32 In accordance with Delegated Act Article 8(1) the PRA may set requirements on a firm to enforce increased diversification of the HQLA buffer, or conversely to restrict holdings of particular asset classes. This may include requirements on a firm's liquidity management practices or investment policies. Under CRD Article 103, the PRA may also restrict holdings of particular asset classes if it observes that this exposes several firms to a common set of risk factors.

### Currency mismatch (see also risk driver vii)

2.33 Currency conversion is an additional step between monetising HQLA and using HQLA to meet specific outflows. Therefore, firms should have appropriate policies and controls to manage the risk that the currency denomination of assets is an obstacle to using their assets when meeting outflows in a specific currency in stress.

2.34 The PRA reminds firms that Delegated Act Article 8(6) gives the PRA, as the competent authority, the option to restrict currency mismatches. It can do so by setting limits on the proportion of currency-specific net stressed outflows that can be met by holding HQLAs not denominated in that currency. The PRA may apply this discretion through a range of firm-specific measures, including setting the LCR by currency on significant currencies (therefore including the reporting currency).

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<sup>1</sup> PRA110 is available on the Regulatory reporting – banking sector section of the Bank of England's website: [www.bankofengland.co.uk/prudential-regulation/regulatory-reporting/regulatory-reporting-banking-sector](http://www.bankofengland.co.uk/prudential-regulation/regulatory-reporting/regulatory-reporting-banking-sector).

### Transferability of funds (see also risk driver viii)

2.35 With regard to the risk that, in severely stressed circumstances, liquidity might not be freely transferable between and within group entities, across national borders, as well as between currencies, the PRA expects firms to demonstrate that the assumptions they make are realistic.

### Eligibility of reserves held at the Bank of England

2.35A Delegated Act Article 10(1)(b)(iii) requires the conditions for withdrawal of central bank reserves to be specified in an agreement between the relevant competent authority and the central bank in order for such reserves to be eligible as Level 1 HQLA. An agreement between the PRA, as competent authority, and the Bank of England, acting in its capacity as the central bank, states that:

'All reserves held in firms' primary reserve accounts, and in their reserve collateralisation accounts that are in excess of the minima required to pre-fund deferred net settlement payment systems, are withdrawable in times of stress. This is without prejudice to the Bank of England's ability to set a minimum balance on a reserve account. Reserves subject to a minimum balance would not be withdrawable up to the amount of the minimum balance. In the event that the Bank of England set a minimum balance it would, other than in exceptional circumstances (for example in response to a Court order), notify the account holder.'

### Eligibility of shares

2.35B For the purposes of Delegated Act Article 12(1)(c)(i), the PRA has identified the Financial Times Stock Exchange 100 (FTSE 100) as a major stock index for the United Kingdom.

### Eligibility of non-interest bearing assets, including sukuk<sup>1</sup>

2.36 Delegated Act Article 12(1)(f) allows firms to include in their liquidity buffer non-interest bearing assets which do not otherwise meet the minimum rating criteria, provided these assets meet other specified criteria and if these firms are unable for reasons of religious observance to hold interest-bearing assets, in accordance with their statutes of incorporation. The PRA expects that this provision will apply only to firms whose entire operations are structured and conducted in accordance with Islamic commercial jurisprudence and its investment principles. However, firms should satisfy themselves that their assets are eligible for inclusion in their HQLA buffers.

2.37 These firms may also benefit from the derogation available under of Delegated Act Article 12(3) which allows competent authorities to disapply two specific criteria that determine the eligibility of corporate debt securities for inclusion in a firm's Level 2B HQLA buffer: these two criteria are the minimum issue size and maximum time to maturity. The PRA expects that a number of sukuk will meet the conditions that allow the PRA to exercise this discretion. Firms that consider they would be eligible to benefit from these derogations should apply to the PRA for a permission.

2.38 Delegated Act Article 7(6) requires firms to assess whether a trading venue provides for an active and sizeable market, in order to confirm that assets that are not listed on recognised exchanges are tradable via outright sale. In particular, firms are required to take into account the minimum criteria specified in Delegated Act Article 7(6)(a) and (b) when making this assessment. The PRA acknowledges that firms will need to exercise judgement in deciding whether these criteria are met in relation to specific assets, including sukuk. It is the responsibility of firms to satisfy themselves that their assets are eligible for inclusion in their HQLA buffers. Firms should contact their PRA supervisor if, after completing their assessment, they are still unsure whether their assets meet the requirement stated in the Delegated Act.

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<sup>1</sup> 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 shares.

2.39 When considering the option of restricting currency mismatches under Delegated Act Article 8, the PRA will take into account all relevant considerations: this will include considerations relevant to firms that, for reasons of religious observance, are unable to hold interest-bearing assets.

### **Liquidity contingency plan**

2.40 Chapter 12 of the ILAA rules sets out the requirements a firm needs to meet in relation to its liquidity contingency plan. In addition, the PRA requires firms to prepare a recovery plan under the Recovery Plans part of the PRA Rulebook. To the extent that the broader recovery plan addresses the requirements for liquidity contingency plans, firms do not have to develop a separate liquidity contingency plan. However, regardless of whether this is addressed in the liquidity contingency plan, or in the broader recovery plan, firms' arrangements must be cross-referenced, where appropriate, in the ILAAP document. These arrangements should also be informed by the results of firms' liquidity stress testing. The PRA expects to review these arrangements as part of its review of firms' liquidity management.

### **Transfer pricing**

2.41 As part of their compliance with Chapter 6 of the ILAA rules, the PRA expects firms to ensure that liquidity and funding costs, benefits and risks are fully incorporated into firms' product pricing, performance measurement and incentives, and new product and transaction approval processes. All significant business lines should be included, whether on or off-balance sheet. Both stressed and business-as-usual costs should be assessed. The process should be transparent and understood by business line management, and regularly reviewed to ensure it remains appropriately calibrated. The PRA expects to review these arrangements as part of its review of firms' liquidity management.

## **3 The Liquidity Supervisory Review and Evaluation Process (L-SREP)**

3.1 Consistent with the process set out in the EBA SREP Guidelines and building on previous liquidity reviews and ongoing supervisory activities, the PRA will carry out an L-SREP of the firm in a manner and at a frequency which is proportionate to the nature, scale and complexity of a firm's activities. This approach is consistent with the PRA's secondary competition objective.

3.2 In carrying out the L-SREP, the PRA will as a minimum undertake the following:

- review the arrangements, strategies, and processes implemented by a firm to comply with the liquidity standards laid down in the ILAA rules, Part Six (Liquidity) of the CRR and the Delegated Act. This includes reviewing firms' Common Reporting (COREP) liquidity returns.
- evaluate the liquidity and funding risks to which the firm is or might be exposed;
- assess the risks that the firm poses to the financial system;
- evaluate the further liquidity and funding risks revealed by stress testing; and
- evaluate whether the level and composition of the firm's liquidity resources are adequate to meet the firm's liquidity needs over different time horizons.

3.3 Based on this assessment, the PRA will:

- determine specific quantitative ILG (individual liquidity guidance);
- determine specific qualitative ILG; and
- determine firms' overall liquidity risk scoring.

3.4 The following paragraphs detail how the PRA will carry out L-SREPs, and how it will set ILG.

### **L-SREP**

3.5 The PRA will assess whether a firm, in its ILAAP document, has adequately identified its liquidity needs across appropriate time horizons in severe but plausible stresses for all relevant risk drivers and whether its liquidity resources are adequate to meet those needs. In addition, the L-SREP will also review the governance arrangements of the firm, its risk management culture, and the ability of members of the management body to perform their duties. The degree of involvement of the management body will be taken into account, as will the appropriateness of the internal processes and systems underlying the ILAAP. Examples of review topics might cover the firm's risk appetite, liquidity contingency plans and non-stressed funding plans, collateral management, the ability to monetise HQLAs and wider liquidity in a timely fashion, intraday arrangements, market access and asset encumbrance.

3.6 The PRA may need to request further information and meet with the management body and other representatives of a firm in order to evaluate fully the comprehensiveness of the ILAAP and the adequacy of the governance arrangements around it. The management body should be able to demonstrate an understanding of the ILAAP consistent with its taking responsibility for the ILAAP. And the management of the firm at appropriate levels should be prepared to discuss and defend all aspects of the ILAAP, covering both quantitative and qualitative components. Additionally, the PRA will consider the business model of the firm and the 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 liquidity position and funding profile.

3.7 The PRA will review if a firm accurately and consistently complies with the obligations of the Delegated Act, including whether a firm is appropriately applying the outflow rates prescribed in the Delegated Act.

3.8 On the basis of the L-SREP, the PRA will determine whether the arrangements, strategies, processes and mechanisms implemented by a firm and the liquidity it holds provide sound management and adequate coverage of its risks. This assessment is reflected in the PRA's ILG.

### **Setting ILG**

3.9 Following the L-SREP, the PRA will give ILG. Compliance with ILG does not relieve firms of their responsibility to comply with OLAR.

3.10 A key element of the PRA's ILG is to advise a firm of the amount and quality of HQLAs which it considers are appropriate, having regard to the liquidity risk profile of the firm. Quantitative guidance will extend beyond the liquidity buffer the firm is required to maintain under the LCR and will cover liquidity risks to which the firm is exposed to but which are not captured by the LCR ('Pillar 2' quantitative requirements). Qualitative guidance will include actions required to mitigate those risks identified as inconsistent with the PRA's objectives. Where appropriate, the PRA may also set specific guidance on pre-positioning collateral at the Bank of England.

3.11 Typically, ILG given to firms covers whether the:

- quantity of HQLAs held is sufficient;
- quality and composition of HQLAs held are appropriate;
- operational arrangements to manage HQLA are appropriate;
- firm's funding profile is appropriate; and

- firm should undertake any further qualitative arrangements to mitigate its liquidity risk.

## Pillar 2 guidance

3.12 From the date firms first report PRA110, the PRA sets liquidity guidance on the basis that firms should survive throughout the granular LCR stress scenario (30 day horizon) of the CFMR framework on a consolidated currency basis. To clarify, no guidance is being set on the other CFMR stress scenarios at this time.<sup>1</sup>

3.13 Mismatches under the CFMR scenarios are taken into account when assessing compliance with the Overall Liquidity Adequacy Rule.

## Pillar 2 asset eligibility

3.14 The type of HQLAs held to meet interim Pillar 2 add-ons should be no wider than defined in the Delegated Act and follow the same composition by asset level as set out in the Delegated Act. The quality of HQLAs should be appropriate to mitigate firm-specific risks<sup>2</sup> and be consistent with the OLAR.

3.15 [Deleted]

3.16 [Deleted]

3.17 [Deleted]

## 4 Drawing down liquid asset buffers

4.1 Firms may draw down their liquid asset buffers as required in times of stress, including where this involves falling below the level of their quantitative ILG.<sup>3</sup> When this happens, the PRA will be content for firms to rebuild their buffers over a reasonable period of time. The PRA does not expect firms to hold higher liquid asset buffers than the amount advised in their ILG or as required to meet their assessment of overall liquidity adequacy, as appropriate. Specifically, there is no expectation on firms to hold excess liquid assets so as to avoid falling below this level in the event of a potential stress.

4.2 A firm is expected to notify the PRA immediately if it falls, or is expected to fall, below the level of its quantitative ILG. It should also expect to discuss with its supervisors its plan for restoring compliance with the guidance, including actions already documented in the firm's liquidity contingency plan or broader recovery plan.

4.3 In exercising its judgement on what constitutes a reasonable time to rebuild buffers drawn down in stress, the PRA will take into account how far the firm has run down its liquidity buffer and the expected duration of a stress. It will also consider the drivers of the firm's shortfall, including in the context of current and forecast macroeconomic and financial conditions. The PRA will also take into account the amount of pre-positioned collateral held at the Bank of England, or the amount available for drawing at other central banks to which the firm has access.

4.4 The PRA continues to expect firms to have robust levels of pre-positioning. However, the PRA also acknowledges the need for flexibility for firms to be able to use these assets to access market funding. The PRA would normally expect firms to pre-position collateral assets at the Bank of

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1 The PRA is not setting liquidity guidance on firms to meet the CFMR stress scenarios on a single currency basis at this time.

2 For example, where the PRA advises a firm of an amount of HQLAs which the PRA considers appropriate to mitigate intraday liquidity risk, the PRA expects the firm to be able to liquidate these HQLAs on an intraday basis, as required.

3 If a firm falls below the level of HQLAs indicated in its ILG and the minimum LCR requirement where this is lower, that does not create a presumption that it is not meeting Threshold Conditions.

England, as part of a complete suite of contingency funding arrangements and may provide explicit guidance as to minimum expected levels.

## 5 Collateral placed at the Bank of England

5.1 The Bank of England announced a number of changes to its liquidity insurance facilities in October 2013.<sup>1</sup> These changes were designed to increase the availability and flexibility of liquidity insurance, by providing liquidity at longer maturities, against a wider range of collateral, at a lower cost and with greater predictability of access. The certainty with which a firm can expect to be able to access the Bank of England's facilities has been reinforced through a presumption that all firms that meet Threshold Conditions may sign up for the Sterling Monetary Framework and have full access to use the Bank of England's facilities.

5.2 The terms of the Bank of England's liquidity insurance facilities are set to ensure counterparties have the incentive to manage their liquidity primarily through private markets in normal times. Consistent with this, for limited liquidity shocks, it is appropriate for firms to draw initially on their holdings of HQLAs. For larger or more severe liquidity outflows, the Bank of England expects firms to consider using the Discount Window Facility or other liquidity insurance facilities alongside, rather than after, using a significant proportion of their liquidity buffer. As noted in the PRA's approach document,<sup>2</sup> the PRA expects firms to have credible options in their liquidity contingency plan for restoring their HQLAs following firm-specific or market-wide stress.

5.3 A firm can count assets pre-positioned at the Bank of England to meet the PRA's quantitative liquidity guidance, if these assets are eligible for inclusion in the HQLA buffer under the Delegated Act. If pre-positioned assets are not eligible for inclusion in the HQLA buffer, they cannot be used to meet the PRA's quantitative liquidity guidance. However the PRA will consider the firm's pre-positioning position as part of its assessment of the effectiveness of the firm's liquidity contingency plans and will take appropriate mitigating action where it is inadequate.<sup>3</sup>

5.4 The PRA continues to expect firms to have robust levels of pre-positioning. However, the PRA also acknowledges the need for flexibility for firms to be able to use these assets to access market funding. The PRA would normally expect firms to pre-position collateral assets at the Bank of England, as part of a complete suite of contingency funding arrangements and may provide explicit guidance as to minimum expected levels.

## 6 Reporting

6.1 CRD Article 104(1)(j) enables the PRA to impose additional or more frequent reporting of liquidity positions. CRR Article 414 requires institutions which do not meet the LCR to report the LCR, stable funding and additional liquidity monitoring metric returns, as appropriate, daily by the end of each business day unless the competent authority authorises a lower frequency and a longer delay.

6.2 The PRA considers that for firms with a balance sheet total above £5 billion it is appropriate to submit the following returns on a daily basis during times of stress in accordance with of CRR Article 414:

- Liquidity Coverage templates (C 72.00–C 76.00); and

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1 'Liquidity Insurance at the Bank of England: developments in the Sterling Monetary Framework', October 2013; [www.bankofengland.co.uk/markets/Documents/money/publications/liquidityinsurance.pdf](http://www.bankofengland.co.uk/markets/Documents/money/publications/liquidityinsurance.pdf).

2 See footnote (1) on page 4.

3 Note that 'holding collateral immediately available for central bank funding' is a specific operational step which firms must take to ensure that their plans can be implemented immediately (see ILAA rule, 12.3 and Article 86(11) of the CRD).

- Rollover of funding (C 70.00).

6.2A The PRA considers that during times of stress, for example in accordance with Article 5 of Commission Delegated Regulation (EU) No 2015/61, it is appropriate, upon notification from the PRA, for firms with:

- total assets above €30 billion to submit the PRA110 on a daily basis; and
- total assets below €30 billion to submit the PRA110 on a weekly basis.

6.3 Therefore, the PRA expects those firms to have systems and processes in place that enable them to report these returns on a daily basis. The PRA recognises that firms may require time to develop systems and processes and will be proportionate in its expectations.

6.4 In requiring any additional or more frequent reporting from a firm during a stress, the PRA will be proportionate.

6.5 In addition to the above, the PRA expects all firms to have the capability to produce key data to monitor liquidity buffers, contractual and stress-tested cashflows, wholesale counterparties and Financial Services Compensation Scheme balances in the event of a crisis.

## **7 Disclosure of Pillar 2 guidance**

7.1 In line with legal requirements, firms report all eligible HQLA within their publically disclosed liquidity coverage ratios (LCRs). This includes HQLA held for Pillar 1 requirements, Pillar 2 guidance, and any eligible 'surplus' above that. However, firms should be clear to investors that the HQLA they report in their LCRs is to cover both Pillar 1 and Pillar 2 risks.

7.2 The PRA expects firms not to disclose publically their total ILG. Disclosure of ILG may lead to an expectation, from both firms and markets, that firms should hold a further buffer of liquid assets, above their level of ILG. The PRA has no such expectation, as outlined in paragraph 4.1. Therefore, the PRA expects that firms will not provide any further details on their Pillar 2 guidance unless disclosure is required by law, and that firms will notify the PRA in advance of any proposed disclosure announcement.

## Appendices

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**1 Suggested structure and content of ILAAP document**

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**2 Glossary of Acronyms**

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**Annex Changes to SS24/15**

## Appendix 1

### Suggested structure and content of ILAAP document

Heading	Detail
<b>Overview</b>	<p>This section is for introductory text describing the business model, the reach and systemic presence of the firm. Internal and external changes since the last liquidity review should be described. Changes in the scope of the document since the last review by the management body should be included.</p> <p>Firms should justify the comprehensiveness and proportionality of their process. (Proportionality may also be addressed under the relevant headings below where this fits better).</p>
<b>Summary conclusions</b>	<p>Firms should provide the summarised conclusions of their overall liquidity adequacy review, stating how and whether they meet the Overall Liquidity Adequacy Rule (Internal Liquidity Adequacy Assessment 2.1) and with regard to the additional guidance provided in supervisory statement SS24/15, 'The PRA's approach to supervising liquidity and funding risks', under 'Overall liquidity adequacy'. Any shortcomings and remedial plans should be discussed.</p> <p>The firm should present its assessment of any additional liquidity it believes it should hold on account of risks not captured in Pillar 1.</p>
<b>LCR reporting</b>	
HQLA	<p>In this section, firms should discuss their approach to ensure compliance with the Delegated Act overall. The following areas, where relevant, should receive particular focus: the approach to implementation of Article 7, the operational requirements detailed in Article 8, the work undertaken in response to Article 23, the approach to classification of retail deposits specified in Articles 24 and 25 and classification of operational deposits specified in Article 27.</p>
Outflows	
Inflows	
<b>Liquidity Risk Assessment</b>	
Evaluation of liquidity needs in the short and medium term	<p>In this section, firms should describe their liquidity profile at appropriate time horizons out to 12 months, the sources and uses on gross and net basis, and their activities undertaken to cover such liquidity needs in both BAU and stress. The firm should also describe any ways in which the LCR metric does not capture its liquidity risks within 30 days and how that risk will be managed. For further guidance, firms should refer to EBA Guidelines 2014/13, 'Evaluation of liquidity needs in the short and medium term', within Title 8.</p>
Evaluation of intraday risk	<p>In this section, firms should describe how intraday risk is created within their business, whether part of the payments system or not, their appetite for and approach to managing intraday liquidity risk of both cash and securities accounts and in both business as usual and stress conditions. They should include the approach to stress testing and conclusions. For further guidance, firms should refer to the EBA Guidelines 2014/13 'Evaluation of intraday liquidity risk' within Title 8, as well as additional material contained within SS24/15.</p>
Evaluation of liquidity buffer and counterbalancing capacity	<p>In this section, firms should describe the procedures for calculating, controlling and monitoring the liquid assets buffer and counterbalancing capacity, and their effectiveness in different scenarios which should include those affecting the liquidity of the assets and counterbalancing capacity. The firm's use of pre-positioning at the Bank of England or any other central bank should be included. For further guidance, firms should refer to the EBA Guidelines 2014/13 'Evaluation of liquidity buffer and counterbalancing capacity' within Title 8, as well as additional material contained within SS24/15, especially under 'Managing the HQLA buffer' and 'Role of collateral pre-positioned for use in the Bank of England's liquidity insurance facilities'.</p>
<b>Inherent funding risk assessment</b>	

Heading	Detail
Evaluation of risks to stability of the funding profile	In this section, firms should describe the funding risk strategy and appetite, and the profile, both the sources and uses on a gross and net basis. For further guidance, firms should refer to the EBA Guidelines 2014/13 'Evaluation of the firm's funding profile', within Title 8.
Evaluation of risks to stability of the funding profile	In this section, firms should analyse the stability of the liabilities within the funding profile and the circumstances in which they could become unstable. This could include market shifts including changes in collateral values, excessive maturity mismatch, inappropriate levels of asset encumbrance, concentrations (including single or connected counterparties, or currencies). For further guidance, firms should refer to the EBA Guidelines 2014/13 'Evaluation of the risks to the stability of the funding profile', within Title 8.
Evaluation of market access	In this section, firms should analyse market access and current or future threats to this access, including the impact of any short-term liquidity stresses or negative news. For further guidance, firms should refer to the EBA Guidelines 2014/13 'Evaluation of actual market access', within Title 8.
Evaluation of expected change in funding risks based on firms' funding plan.	Refer to EBA Guidelines 2014/13 Evaluation of expected change in funding risks based on the firm's funding plan.
<b>Risk management assessment (both liquidity and funding)</b>	
Assess risk strategy and risk appetite	In this section, firms should describe the risk appetite and strategy, how they were devised, approved, monitored and reported, and how they are communicated throughout the firm. For further guidance, firms should refer to EBA Guidelines 2014/13 'Liquidity risk strategy and liquidity risk tolerance' within Title 8.
Organisational framework, policies and procedures	In this section, firms should describe the governance and management arrangements around the ILAAP including the involvement of the governing body. They should describe also the risk framework overall and as it pertains to liquidity and funding risks, the technical and staff resources. The approach to maintaining market access should be included. For further guidance, firms should refer to EBA Guidelines 2014/13, 'Organisational framework, policies and procedures', within Title 8. SS24/15 also provides guidance on the involvement of the management body and proportionality of the framework.
Risk identification, measurement, management, monitoring and reporting	In this section, firms should describe the framework and IT systems for identifying, measuring, managing and monitoring and both internal and external reporting of liquidity and funding risks, including intraday risk. The assumptions and methodologies adopted should be described. Key indicators should be evidenced and the internal information flows described. For further guidance, firms should refer to EBA Guidelines 2014/13, 'Risk identification, measurement, management, monitoring and reporting' within Title 8. SS24/15 provides further guidance on management involvement and proportionality of the ILAAP process.
Firm's liquidity specific stress testing	In this section, firms should analyse the internal stress testing framework, including the process and governance of and challenge to scenario design, derivation of assumptions and design of sensitivity analysis, and the process of review and challenge and relevance to the risk appetite. The process by which the stress results are produced, and incorporated into the risk framework and strategic planning, and the liquidity recovery process should be scrutinised. The results and conclusions must be analysed, with breakdown by each relevant risk driver. For further guidance, firms should refer to EBA Guidelines 2014/13, 'Firm's liquidity specific stress testing,' within Title 8, as well as SS24/15, under the heading 'Stress testing', where a more detailed description of the risk drivers can be found.
Liquidity risk internal	In this section, firms should describe their internal limit and control framework, including the limits and controls around liquid asset buffers, and the appropriateness of the limit

Heading	Detail
control framework	structure to the risk appetite. The transfer pricing framework should also be described here, for example how the methodology was developed, the process controlled, monitored and reviewed, and the results cascaded throughout the firm to drive behaviours and support performance measurement and business incentives. For further guidance, firms should refer to EBA Guidelines 2014/13, 'Liquidity risk internal control framework', within Title 8. Some additional guidance can be found in SS24/15 under the heading 'Transfer pricing system'.
Liquidity contingency plans	In this section, firms should detail the policies, procedures and action plans for responding to severe disruptions in the firm's ability to fund itself. The plan should be that which is contained within their Recovery and Resolution Plan, and it should be either cross referenced or included within the ILAAP document. Guidance is provided in Supervisory Statement 18/13, 'Recovery Planning'. For further guidance, firms should refer to EBA Guidelines 2014/13, 'Liquidity contingency plans', within Title 8, and in SS24/15, 'Liquidity contingency plan'.
Funding plans	Firms should provide the full funding plan to demonstrate how it will support the projected business activities in both business as usual and stress, implementing any required improvements in the funding profile and evidencing that the risk appetite and key metrics will not be breached by the planned changes. Risks to the plan should be discussed. Where a funding strategy is new, implementation procedures should be detailed. For further guidance, firms should refer to EBA Guidelines 2014/13, 'Funding plans', within Title 8.

## Appendix 2

### Glossary of Acronyms

<b>BIPRU 12</b>	Prudential sourcebook for Banks, Building Societies and Investment Firms — Chapter 12, Liquidity Standards
<b>CRR</b>	Capital Requirements Regulation
<b>CRD IV</b>	Capital Requirements Directive IV
<b>EBA</b>	European Banking Authority
<b>HQLA</b>	High Quality Liquid Assets
<b>ILAA</b>	Internal Liquidity Adequacy Assessment
<b>ILAAP</b>	Internal Liquidity Adequacy Assessment Process
<b>ILG</b>	Individual Liquidity Guidance
<b>ILSA</b>	Individual Liquidity Systems Assessment
<b>L-SREP</b>	Liquidity Supervisory Review and Evaluation Process
<b>LCR</b>	Liquidity Coverage Requirement
<b>OLAR</b>	Overall Liquidity Adequacy Rule
<b>SREP</b>	Supervisory Review and Evaluation Process

## Annex: Changes to SS24/15

### February 2018

Following publication of Policy Statement 2/18,<sup>1</sup> this SS was updated to include the following paragraphs:

- 2.24A Calculation of maximum net debit position for direct and indirect participants in payments and securities settlements systems.
- 2.29A Assessment of speed of monetisation of HQLAs.
- 2.29B Application of monetisation limits in the CFMR framework.
- 3.12 Liquidity guidance on the granular LCR stress scenario.
- 3.13 Mismatches under the CFMR scenarios are taken into account when assessing compliance with the Overall Liquidity Adequacy Rule
- 7.1 and 7.2 Disclosure of Pillar 2 guidance

This SS was updated to amend the paragraphs 2.17, 2.19, 2.20 (viii), 6.2 and 6.3.

This SS was updated to remove the paragraphs 3.15, 3.16 and 3.17.

### December 2016

This SS was updated by PS35/16<sup>2</sup> to include the following paragraphs:

- 2.35A Eligibility of reserves held at the Bank of England: To make readers aware of the agreement between the PRA, as competent authority, and the Bank of England, acting in its capacity as the central bank, for the withdrawal of central bank reserves to be eligible as Level 1 HQLA under Delegated Act Article 10(1)(b)(iii).
- 2.35B Eligibility of shares: To identify the FTSE100 as a major stock index for the United Kingdom for the purposes of Delegated Act Article 12(1)(c)(i).

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1 PS2/18 'Pillar 2 liquidity', available at: [www.bankofengland.co.uk/prudential-regulation/publication/2016/pillar-2-liquidity](http://www.bankofengland.co.uk/prudential-regulation/publication/2016/pillar-2-liquidity).

2 PS35/16 'Responses to CP26/16', available at: <https://www.bankofengland.co.uk/prudential-regulation/publication/2016/responses-to-cp-26-2016>.