Chapter 12

Liquidity standards

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

12.3.1A G

12.3.2 G BIPRU 12.4 contains further *rules* and *guidance* on stress testing and *contingency funding plans*. These are both extensions of the overarching systems and controls provisions in BIPRU 12.3. In formulating the *rules* and *guidance* in these two sections, the *appropriate regulator* has taken account of the Principles for Sound Liquidity Management and Supervision dated September 2008 issued by the Basel Committee on Banking Supervision. It is intended that the content of BIPRU 12.3 and BIPRU 12.4 be consistent with those Principles.

12.3.3 G BIPRU 12.5.4R provides that, in relation to a *standard ILAS BIPRU firm*, it must include in its *ILAA* an assessment of its compliance with the standards set out in BIPRU 12.3and BIPRU 12.4, including the results of the stress tests required by the *rules* in BIPRU 12.4. A *simplified ILAS BIPRU firm* is not subject to BIPRU 12.5 and consequently it is not required to prepare an *ILAA*. Instead, the *rules* in BIPRU 12.6 provide that such a *firm* is to carry out an *ILSA*, being alone an assessment of that *firm*'s compliance with the standards set out in BIPRU 12.3 and BIPRU 12.4.

Overarching liquidity systems and controls requirements

12.3.4 **R** A *firm* must have in place robust strategies, policies, processes and systems that enable it to identify, measure, manage and monitor *liquidity risk* over an appropriate set of time horizons, including intra-day, so as to ensure that it maintains adequate levels of liquidity buffers. These strategies, policies, processes and systems must be tailored to business lines, currencies, *branches* and legal entities and must include adequate allocation mechanisms of liquidity costs, benefits and risks.

[**Note:** article 86(1) of the *CRD*]

12.3.4A **G** The strategies, policies, processes and systems referred to in BIPRU 12.3.4 R should include those which enable it to assess and maintain on an ongoing basis the amounts, types and distribution of liquidity resources that it considers adequate to cover:

(1) the nature and level of the *liquidity risk* to which it is or might be exposed;

(2) the risk that the *firm* cannot meet its liabilities as they fall due; and

(3) in the case of an *ILAS BIPRU firm*, the risk that its liquidity resources might in the future fall below the level, or differ from the quality and funding profile, of those resources advised as appropriate by the *appropriate regulator* in that *firm's individual liquidity guidance* or, as the case may, its *simplified buffer requirement*.

12.3.5 **R** The strategies, policies, processes and systems referred to in BIPRU 12.3.4 R must be proportionate to the complexity, risk profile and scope of operation of the *firm*, and the liquidity risk tolerance set by the *firm's governing body* in accordance with BIPRU 12.3.8 R, and must reflect the *firm's* importance in each *EEA State*, in which it carries on business.

[**Note:** article 86(2) (part) of the *CRD*]

12.3.5A **R**

12.3.6 **E** (1) [deleted]

(2) [deleted]

(3) A *firm* should ensure that its strategies, policies, processes and systems in relation to *liquidity risk* enable it to identify, measure, manage and monitor its *liquidity risk* positions for:

(a) all sources of contingent liquidity demand (including those arising from off-balance sheet activities);

(b) all currencies in which that *firm* is active; and

(c) correspondent, custody and settlement activities.

(4) [deleted]

(5) A *firm* should ensure that it has in place early warning indicators to identify immediately the emergence of increased *liquidity risk* or

12

vulnerabilities, including indicators that signal whether embedded triggers in funding or security arrangements such as warranties, covenants, events of default, conditions precedent or terms having similar effect are likely to, or will, be breached, occur or fail to be satisfied, or contingent risks will or are likely to crystallise, in either case with the result that access to liquidity resources may be impaired.

(6) A *firm* should ensure that it has in place reliable management information systems to provide its *governing body, senior managers* and other appropriate personnel with timely and forward-looking information on the liquidity position of the *firm*.

(7) Contravention of any of (3), (5) and (6) may be relied upon as tending to establish contravention of BIPRU 12.3.4R.

12.3.7 G As well as the *rules* in BIPRU 12.3 requiring a *firm* to have robust systems to enable it to identify, measure, manage and monitor *liquidity risk*, an *ILAS BIPRU firm* is also subject to obligations in SUP 16 (Reporting requirements) requiring it to report quantitative data about its liquidity position to the *appropriate regulator*. That chapter of *SUP* sets out the applicable *data items* and the *rules* governing the frequency of their submission to the *appropriate regulator*. Absent a *firm-specific liquidity stress* or a *market liquidity stress*, the *rules* in SUP 16 do not require daily (weekly for a *low frequency liquidity reporting firm* and a *simplified ILAS BIPRU firm*) reporting of *data items*. An *ILAS BIPRU firm* should, however, note that those *rules* do require that it has systems in place to ensure that it is able at all times to meet the requirements for daily (or weekly as applicable) reporting of applicable *data items* even if there is no *firm-specific liquidity stress* or *market liquidity stress* and none is expected.

12

12.3.7A R A *firm* must, taking into account the nature, scale and complexity of its activities, have liquidity risk profiles that are consistent with and not in excess of those required for a well-functioning and robust system.

[**Note:** article 86(3) of the *CRD*]

Governing body and senior management oversight: liquidity risk tolerance

12.3.8 R A *firm* must ensure that:

(1) its *governing body* establishes that *firm's liquidity risk* tolerance and that this is appropriately documented;

(2) its *liquidity risk* tolerance is appropriate for its business strategy and reflects its financial condition and funding capacity; and

(3) its *liquidity risk* tolerance is communicated to all relevant business lines.

[**Note:** article 86(2) of the *CRD*]

12.3.8A R

12.3.9 G As part of the *SLRP*, the *appropriate regulator* will assess the appropriateness of the *liquidity risk* tolerance adopted by an *ILAS BIPRU firm* to ensure that this risk tolerance is consistent with maintenance by the *firm* of adequate liquidity resources for the purpose of the *overall liquidity adequacy rule*. The *appropriate regulator* will expect a *firm* to provide it with an adequately reasoned explanation for the level of *liquidity risk* which that *firm's governing body* has decided it should assume. In assessing the appropriateness of the *liquidity risk* tolerance adopted by a *firm*, the *appropriate regulator* will consider whether the tolerance adopted is consistent with the *firm's* satisfaction of threshold condition 2E, 3D, 4E or 5E as applicable. Consistent with the *appropriate regulator's* statutory objectives under the *Act*, in assessing the appropriateness of a *firm's* adopted *liquidity risk* tolerance the *appropriate regulator* will also have regard to the role and importance of a *firm* in the *UK financial system*.

Governing body and senior management oversight: approval and review of arrangements

12.3.10 R A *firm* must ensure that its *governing body* approves the *firm's* strategies, policies, processes and systems relating to the management of *liquidity risk*, including those described in BIPRU 12.3.4R.

12.3.11 R A *firm* must ensure that its *governing body* reviews regularly (and not less frequently than annually):

(1) the continued adequacy of any strategies, policies, processes and systems approved in accordance with BIPRU 12.3.10R; and

(2) the *firm's liquidity risk* tolerance.

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

12.3.13 G Although a *firm's senior managers* are likely to develop strategies, policies and practices for the management of that *firm's liquidity risk*, it is the responsibility of a *firm's governing body* to approve those strategies, policies and practices as adequate. In determining the adequacy of those strategies, policies and practices, a *firm's governing body* should have regard to that *firm's liquidity risk* tolerance established in accordance with BIPRU 12.3.8R.

12.3.14 G The *appropriate regulator* will assess the adequacy of an *ILAS BIPRU firm's liquidity risk* management framework as part of the *SLRP*.

Pricing liquidity risk

12.3.15 E (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

12.3.16 G The incorporation of liquidity pricing into a *firm*'s processes assists in aligning the risk-taking incentives of individual business lines within that *firm* with the *liquidity risk* to which the *firm* as a whole is exposed as a result of their activities. It is important that all significant business activities are addressed, including activities which involve the creation of contingent exposures which may not have an immediate balance sheet impact.

12

Intra-day management of liquidity

12.3.17 R A *firm* must actively manage its intra-day liquidity positions and any related risks so that it is able to meet its payment and settlement obligations on a timely basis.

12.3.18 G In complying with BIPRU 12.3.17R, a *firm* should take into account all obligations arising from its acting as a custodian, a correspondent bank or a settlement agent.

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

12.3.20 G The *appropriate regulator* considers that a *firm's* ability to meet its payment and settlement obligations on an intra-day basis is important not just for that *firm*, but also for the liquidity position of that *firm's* counterparties and for the smooth functioning of payment and settlement systems as a whole.

12.3.21 E

(1) A *firm* should ensure that its intra-day liquidity management arrangements enable it, in relation to the markets in which it is active and the currencies in which it has significant positions, to:

(a) measure expected daily gross liquidity inflows and outflows, anticipate the intra-day timing of these flows where possible, and forecast the range of potential net funding shortfalls that might arise at different points during the day;

(b) monitor its intra-day liquidity positions against expected activities and available resources;

(c) identify gross liquidity inflows and outflows attributable to any correspondent, custodian or settlement agency services provided by that *firm*;

(d) manage the timing of its liquidity outflows such that priority is given to that *firm's* most time-critical obligations;

(e) deal with unexpected disruptions to its intra-day liquidity flows;

(f) acquire sufficient intra-day funding such that it is able to meet its most time-critical obligations when expected and other less time-critical obligations as soon as possible thereafter; and

(g) manage and mobilise collateral as necessary for the purposes of achieving the aim in (f).

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

Management of collateral

12.3.22 R A *firm* must actively manage its collateral positions.

12.3.22A R A *firm* must distinguish between pledged and unencumbered assets that are available at all times, in particular during emergency situations. A *firm* must also take into account the legal entity in which assets reside, the country where assets are legally recorded either in a register or in an account as well as their eligibility and must monitor how assets can be mobilised in a timely manner.

[**Note:** article 86(5) of the *CRD*]

12.3.22B R A *firm* must also have regard to existing legal, regulatory and operational limitations to potential transfers of liquidity and unencumbered assets amongst entities, both within and outside the *EEA*.

[**Note:** article 86(6) of the *CRD*]

12.3.23 **R** For the purposes of BIPRU 12.3.22R, a *firm* must, in relation to all currencies in which it has significant positions and all jurisdictions in which it carries on significant business activities, ensure that it:

(1) can calculate all of its collateral positions, including assets currently provided as collateral, relative to the total amount of security required;

(2) can calculate the amount of unencumbered assets available to it to be provided as collateral;

(3) can mobilise collateral in a timely manner;

(4) monitors the location of available collateral;

(5) takes into account the extent to which counterparties with which it has deposited collateral may have re-hypothecated that collateral;

(6) has access to adequately diversified sources of collateral;

(7) assesses the eligibility of each major asset class that it holds for use as collateral with central banks;

(8) assesses on an ongoing basis the acceptability of its assets to major counterparties and providers of funds in secured funding markets; and

(9) monitors and manages the impact that the terms of existing funding or security arrangements, such as warranties, covenants, events of default, negative pledges and cross default clauses could have on its ability to mobilise collateral including for use in borrowing under any central bank facility (in particular, emergency liquidity assistance on a secured basis).

12

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 12.4.1R 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**

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 12.3.4 R.

12.3.25A E

Managing liquidity across legal entities, business lines and currencies

12.3.26 R In complying with BIPRU 12.3.4 R, a *firm* must ensure that:

(1) it actively manages its *liquidity risk* exposures and related funding needs; and

(2) it takes into account:

(a) the impact on its own liquidity position of its forming part of a *group*;

(b) the need to manage the liquidity position of individual business lines in addition to that of the *firm* as a whole; and

(c) the *liquidity risk* arising from its taking positions in foreign currencies; and

(3) where it forms part of a *group*, it understands and has regard to any legal, regulatory, operational or other constraints on the transferability to it of funds and collateral by other entities in that *group*.

12.3.27 R A *firm* must develop methodologies for the identification, measurement, management and monitoring of funding positions. Those methodologies must include the current and projected material cash-flows in and arising from assets, liabilities, off-balance-sheet items, including contingent liabilities and the possible impact of reputational risk.

[**Note**: article 86(4) of the *CRD*]

12.3.28 G In its *liquidity risk* management plans, a *firm* should identify clearly its assumptions regarding the transferability of funds and collateral. A *firm* should expect that the *appropriate regulator* will scrutinise those assumptions.

Funding diversification and market access

12.3.29 R In complying with BIPRU 12.3.4 R, a *firm* must ensure that it has access to funding which is adequately diversified, both as to source and tenor.

12.3.30 R A *firm* must ensure that its *governing body*:

(1) is aware of the composition, characteristics and degree of diversification of its assets and funding sources; and

12

(2) regularly reviews its funding strategy in the light of any changes in the environment in which it operates.

12.3.31 G Funding diversification should not be considered an end in its own right. Rather, the purpose of diversification is to ensure that a *firm* has in place alternative sources of funding that strengthen its capacity to withstand a variety of severe yet plausible institution-specific and market-wide liquidity shocks.

12.3.32 E

(1) A *firm* should ensure that funding diversification is taken into account in that *firm*'s business planning process.

(2) A *firm* should ensure that its funding arrangements take into account correlations between market conditions and the ability to access funds from different sources.

(3) A *firm* should ensure that in establishing adequate diversification it sets limits on its funding according to the following variables:

(a) maturity;

(b) nature of depositor or counterparty;

(c) levels of secured and unsecured funding;

(d) instrument type;

(e) securitisation vehicle;

(f) currency; and

(g) geographic market.

(4) A *firm* should ensure that it maintains an ongoing presence in its chosen funding markets and strong relationships with its chosen providers of funds.

(5) A *firm* should regularly test its capacity to raise funds quickly from its chosen funding sources to provide short, medium and long-term liquidity.

(6) A *firm* should ensure that its *senior managers* identify the main factors that affect its ability to raise funds and should monitor those factors closely to ensure that their estimates of fund raising capacity remain valid.

(7) Contravention of any of (1) to (6) may be relied upon as tending to establish contravention of BIPRU 12.3.4 R.

Asset encumbrance

12.3.33 R

12.3.34 R

12.3.35 G