

**PRA RULEBOOK: CRR FIRMS: INTERNAL LIQUIDITY ADEQUACY ASSESSMENT
INSTRUMENT 2015**

Powers exercised

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

Pre-conditions to making

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

PRA Rulebook: CRR Firms: Internal Liquidity Adequacy Assessment Instrument 2015

- D. The PRA makes the rules in the Annex to this instrument.

Commencement

- E. This instrument comes into force on 1 October 2015.

Citation

- F. This instrument may be cited as the PRA Rulebook: CRR Firms: Internal Liquidity Adequacy Assessment Instrument 2015.

By order of the Board of the Prudential Regulation Authority

4 June 2015

Annex

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

Part

INTERNAL LIQUIDITY ADEQUACY ASSESSMENT

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1 APPLICATION AND DEFINITIONS

1.1 This Part applies to a *CRR firm*.

1.2 In this Part, the following definitions shall apply:

consolidation group

means the undertakings included in the scope of consolidation pursuant to Articles 18(1), 19(1), 19(3), 23 and 24(1) of the *CRR*.

Delegated Regulation

means 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.

funding risk

means the risk that a *firm* does not have stable sources of funding in the medium and long term to enable it to meet its financial obligations, such as payments or collateral calls, as they fall due, either at all or only at excessive cost.

Internal Liquidity Adequacy Assessment Process (ILAAP)

means the process for the identification, measurement, management and monitoring of liquidity implemented by the *firm* in accordance with 3 – 13.

liquidity contingency plan

a plan for dealing with liquidity crises as required by 12.1.

liquidity coverage ratio

means the ratio calculated in accordance with Article 4(1) of the *Delegated Regulation*.

liquidity risk

means the risk that a *firm*, although solvent, does not have available sufficient financial resources to enable it to meet its obligations as they fall due.

overall liquidity adequacy rule

means the rule in 2.1.

1.3 Unless otherwise defined, any italicised expression used in this Part and in the *CRR* has the same meaning as in the *CRR*.

2 OVERALL LIQUIDITY ADEQUACY RULE

2.1 A *firm* must at all times maintain liquidity resources which are adequate, both as to amount and quality, to ensure that there is no significant risk that its liabilities cannot be met as they fall due.

- 2.2 For the purposes of the *overall liquidity adequacy rule*:
- (1) a *firm* also must ensure that:
 - (a) its liquidity resources contain an adequate buffer of high quality, unencumbered assets; and
 - (b) it maintains a prudent funding profile; and
 - (2) a *firm* may not include liquidity resources that may be made available through emergency liquidity assistance from a central bank.

3 OVERALL STRATEGIES, PROCESSES AND SYSTEMS

- 3.1 As part of the *overall liquidity adequacy rule*, a *firm* must have in place robust strategies, policies, processes and systems that enable it to identify, measure, manage and monitor *liquidity risk* and *funding risk* over an appropriate set of time horizons, including intra-day, so as to ensure that it maintains adequate levels of liquidity buffers and an appropriate funding profile. 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: Art. 86(1) of the CRD]

- 3.2 The strategies, policies, processes and systems referred to in 3.1 must be proportionate to the complexity, risk profile and scope of operation of the *firm*, and the *liquidity risk* appetite and *funding risk* appetite set by the *firm's management body* in accordance with 4, and must reflect the *firm's* importance in each country in which it carries on business.

[Note: Art. 86(2) (part) of the CRD]

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

[Note: Art. 86(3) of the CRD]

- 3.4 A *firm* must put in place risk management policies to define its approach to asset encumbrance, as well as procedures and controls that ensure that the risks associated with collateral management and asset encumbrance are adequately identified, monitored and managed.

4 LIQUIDITY RISK APPETITE AND FUNDING RISK APPETITE

- 4.1 A *firm* must ensure that:
- (1) its *management body* establishes the *firm's liquidity risk* appetite and *funding risk* appetite and that this is appropriately documented;
 - (2) its *liquidity risk* appetite and *funding risk* appetite are appropriate for its business strategy and reflect its financial condition and funding capacity; and

- (3) its *liquidity risk* appetite and *funding risk* appetite are communicated to all relevant business lines.

[Note: Art. 86(2) (part) of the CRD]

5 INTRA-DAY MANAGEMENT OF LIQUIDITY

- 5.1 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.
- 5.2 For the purposes of 5.1, a *firm* must ensure that its intra-day liquidity management arrangements enable it:
- (1) to meet its payment and settlement obligations on a timely basis under both normal financial conditions and under the stresses required by 11.3;
 - (2) to identify and prioritise the most time-critical payment and settlement obligations; and
 - (3) in relation to the markets in which it is active and the currencies in which it has significant positions, to measure, monitor and deal with intra-day *liquidity risk*. A *firm* must in particular be able 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; and
 - (b) manage the timing of its liquidity outflows such that priority is given to the *firm's* most time-critical payment obligations.

6 TRANSFER PRICING SYSTEM

- 6.1 A *firm* must implement an adequate transfer pricing system to ensure that it accurately quantifies liquidity and funding costs, benefits and risk in relation to all significant business activities.

7 MANAGEMENT OF COLLATERAL

- 7.1 A *firm* must actively manage collateral positions.
- 7.2 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: Art. 86(5) of the CRD]

8 MANAGING LIQUIDITY ACROSS LEGAL ENTITIES, BUSINESS LINES, COUNTRIES AND CURRENCIES

- 8.1 A *firm* must actively manage its *liquidity risk* exposures and related funding needs and take into account:
- (1) existing legal, regulatory and operational limitations to potential transfers of liquidity and unencumbered assets amongst entities, both within and outside the *EEA*; and
- [Note: Art. 86(6) of the *CRD*]**
- (2) any other constraints on the transferability of liquidity and unencumbered assets across business lines, countries and currencies.

9 FUNDING DIVERSIFICATION AND MARKET ACCESS

- 9.1 A *firm* must ensure that it has access to funding which is adequately diversified, both as to source and tenor.
- 9.2 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: Art. 86(4) of the *CRD*]

10 MANAGEMENT OF ASSET ENCUMBRANCE

- 10.1 A *firm* must actively manage its asset encumbrance position.
- 10.2 For the purpose of 10.1 a *firm* must ensure that:
- (1) its risk management policies take into account:
 - (a) the *firm's* business model;
 - (b) the countries in which it operates;
 - (c) the specificities of the funding markets; and
 - (d) the macroeconomic situation; and
 - (2) its *management body* receives timely information on:
 - (a) the current and expected level and types of asset encumbrance and related sources of encumbrance, such as secured funding or other transactions;
 - (b) the amount, expected level and credit quality of unencumbered assets that are capable of being encumbered, specifying the volume of assets available for encumbrance; and
 - (c) the expected amount, level and types of additional encumbrance that may result from stress scenarios.

- 10.3 For the purpose of this Chapter a *firm* must treat an asset as encumbered if it is subject to any form of arrangement to secure, collateralise or credit enhance any transaction.

11 STRESS TESTING

- 11.1 A *firm* must consider different *liquidity risk* mitigation tools, including a system of limits and liquidity buffers in order to be able to withstand a range of different stress events and an adequately diversified funding structure and access to funding sources. It must review those arrangements regularly.

[Note: Art. 86(7) of the CRD]

- 11.2 A *firm* must consider alternative scenarios on liquidity positions and on risk mitigants and must review the assumptions underlying decisions concerning the funding position at least annually. For these purposes, alternative scenarios must address, in particular, off-balance sheet items and other contingent liabilities, including those of *securitisation special purpose entities* or other special purpose entities, as referred to in the *CRR* in relation to which the *firm* acts as *sponsor* or provides material liquidity support.

[Note: Art. 86(8) of the CRD]

- 11.3 A *firm* must:
- (1) conduct on a regular basis appropriate stress tests so as to:
 - (a) identify sources of potential liquidity strain;
 - (b) ensure that current liquidity exposures continue to conform to the *liquidity risk* and *funding risk* appetite established by that *firm's management body*; and
 - (c) identify the effects on that *firm's* assumptions about pricing; and
 - (2) analyse on a regular basis the separate and combined impact of possible future liquidity stresses on its:
 - (a) cash flows;
 - (b) liquidity position;
 - (c) profitability; and
 - (d) solvency.
- 11.4 A *firm* must consider the potential impact of institution-specific, market-wide and combined alternative scenarios. Different time periods and varying degrees of stressed conditions must be considered.

[Note: Art. 86(9) of the CRD]

- 11.5 In carrying out the liquidity stress tests required by 11.3, a *firm* must make appropriate assumptions around the major sources of risk, including the major sources of risk in each of the following categories where they are relevant to the *firm* given the nature and scale of its business:
- (1) retail *funding risk*;

- (2) wholesale secured and unsecured *funding risk*;
 - (3) risks arising from the correlation between funding markets and lack of diversification between funding types;
 - (4) off-balance sheet *funding risk*;
 - (5) risks arising from the *firm's* funding tenors;
 - (6) risks associated with a deterioration of a *firm's* credit rating;
 - (7) cross currency *funding risk*;
 - (8) risk that liquidity resources cannot be transferred across entities, sectors and countries;
 - (9) *funding risks* resulting from estimates of future balance sheet growth;
 - (10) franchise risk;
 - (11) marketable assets risk;
 - (12) non-marketable assets risk;
 - (13) internalisation risk; and
 - (14) intra-day risk.
- 11.6 A *firm* must ensure that its *management body* reviews regularly the stresses and scenarios tested to ensure that their nature and severity remain appropriate and relevant to the *firm*.
- 11.7 A *firm* must ensure that the results of its stress tests are:
- (1) reviewed by its *senior management*;
 - (2) reported to that *firm's management body*, specifically highlighting any vulnerabilities identified and proposing appropriate remedial action;
 - (3) reflected in the processes, strategies and systems established in accordance with 3.1;
 - (4) used to develop effective *liquidity contingency plans*;
 - (5) integrated into that *firm's* business planning process and day-to-day risk management; and
 - (6) taken into account when setting internal limits for the management of that *firm's liquidity risk* exposure.
- 11.8 A *firm* must report the results of its liquidity stress tests to the *PRA* in a timely manner.

12 LIQUIDITY CONTINGENCY PLAN

- 12.1 A *firm* must adjust its strategies, internal policies and limits on *liquidity risk* and *funding risk* and develop an effective *liquidity contingency plan*, taking into account the outcome of the alternative scenarios referred to in 11.2.

[Note: Art. 86(10) of the CRD]

- 12.2 The *liquidity contingency plan* must include strategies to address the contingent encumbrance resulting from relevant stress events including downgrades in the firm's credit rating, devaluation of pledged assets and increases in margin requirements.
- 12.3 The *liquidity contingency plan* must also set out adequate strategies and proper implementation measures in order to address possible liquidity shortfalls, including in relation to *branches* established in another *EEA State*. Those plans must be tested at least annually, updated on the basis of the outcome of the alternative scenarios set out in 11.2, and be reported to and approved by the *firm's senior management*, so that internal policies and processes can be adjusted accordingly.

[Note: Art. 86(11) (part) of the CRD]

- 12.4 A *firm* must take the necessary operational steps in advance to ensure that *liquidity contingency plans* can be implemented immediately, including holding collateral immediately available for central bank funding. This includes holding collateral where necessary in the currency of another *EEA State* or currency of a *third country* to which the *firm* has exposures, and where operationally necessary within the territory of an *EEA State* or *third country* to whose currency it is exposed.

[Note: Art. 86(11) (part) of the CRD]

13 INTERNAL LIQUIDITY ADEQUACY ASSESSMENT PROCESS

- 13.1 A *firm* must ensure that:
- (1) it regularly, but at least annually, reviews its *ILAAP*;
 - (2) it regularly carries out an internal assessment of the adequacy of its liquidity and funding in accordance with its *ILAAP*;
 - (3) the assessment in (2) is proportionate to the nature, scale and complexity of its activities and includes an assessment of:
 - (a) the adequacy of its liquidity and funding resources to cover the risks identified in accordance with this Part;
 - (b) the methodologies and assumptions applied for risk measurement and liquidity management;
 - (c) the results of the stress tests required by 11.3; and
 - (d) the *firm's* compliance with this Part;
 - (4) its *ILAAP* identifies those of the measures set out in its *liquidity contingency plans* that it would implement.
- 13.2 A *firm* must make a written record of its *ILAAP* and the assessments required under this Part and maintain such record for at least three years.
- 13.3 A *firm* must ensure that its *management body* approves the *firm's ILAAP*.

14 APPLICATION OF THIS PART ON AN INDIVIDUAL BASIS AND A CONSOLIDATED BASIS

14.1 This Part applies to a *firm* on an individual basis whether or not it also applies to the *firm* on a *consolidated basis*.

[Note: Art 109(1) of the CRD]

14.2 Where a *firm* is a member of a *consolidation group*, the *firm* must ensure that the arrangements, processes and mechanisms at the level of the *consolidation group* of which it is a member comply with the obligations set out in 3 – 13 on a *consolidated basis*.

14.3 Compliance with 14.2 must enable the *consolidation group* to have arrangements, processes and mechanisms that are consistent and well integrated and that any data relevant to the purpose of supervision can be produced.

[Note: Art 109(2) (part) of the CRD]

14.4 A *firm* which is an *EEA parent institution* must comply with this Part on the basis of its *consolidated situation*.

14.6 A *UK bank* or *building society* controlled by an *EEA parent financial holding company* or by an *EEA parent mixed financial holding company* must comply with this Part on the basis of the *consolidated situation* of that holding company if the *PRA* is responsible for supervision of the *UK bank* or *building society* on a *consolidated basis* under Article 111 of the *CRD*.

14.7 A *UK designated investment firm* controlled by an *EEA parent financial holding company* or by an *EEA parent mixed financial holding company* must comply with this Part on the basis of the *consolidated situation* of that holding company if:

- (1) there is no *subsidiary* of the holding company which is a *credit institution* to which 14.6 applies; and
- (2) the *PRA* is responsible for the supervision of the *UK designated investment firm* on a *consolidated basis* under Article 111 of the *CRD*.

14.8 If this Part applies to a *firm* on a *consolidated basis*, the *firm* must carry out consolidation to the extent and in the manner prescribed in Articles 18(1), 19(1), 19(3), 23 and 24 (1) of the *CRR*.

15 INTRODUCTION OF THE LIQUIDITY COVERAGE RATIO

15.1 The applicable *liquidity coverage ratio* for the purpose of Article 38(2) *Delegated Regulation* shall be:

- (1) 80% as from 1 October 2015;
- (2) 90% as from 1 January 2017; and
- (3) 100% as from 1 January 2018.

16 TRANSITIONAL PROVISION

16.1 In 14.4 – 14.7 any reference to *EEA* is to be read as a reference to *EU*.