PRA CP21/16, May 12th 2016

Pillar 2 Liquidity

Calls to Action

Governance,
Risk,
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A KnowCo regulatory digest: relevant to all PRA-regulated firms.

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May 2016

- Proposals in this CP relate to regulatory minima Pillar 2 Liquidity for
  - Debt buyback risk
  - Non-margin derivative risk and
  - Intraday liquidity risk
- A second CP will set out proposals for other Pillar 2 risks including
  - Intragroup Liquidity Risk and
  - Funding Risks, including ‘cliff risk’ and funding concentration risk
- Implementation dates are not yet determined; there may be an implementation ‘glide path’…

In the meantime firms must continue to fully address all relevant Pillar 2 liquidity risks in each ILAAP, irrespective of future guidance

Consultation Summary

Liquidity Risk Family	Liquidity Risk Category	Addressed in this CP	Addressed in the next CP
Franchise Viability Risks	Debt Buyback	X	
	Non-margined derivatives	X	
	Prime Brokerage		X
	Matched Books		X
	Settlement Failure Risk		X
Other Risks	Intraday Liquidity Risk	X	
	Cash-flow Mismatch Risk	X	X
	Underwriting Risk		X
	Inadequate Systems & Controls		X
	Risk relating to Derivative Outflows		X
	Risk in Securities Financing Margin Requirements		X
	Risks relating to Intragroup Outflows		X
	Funding Risk, including ‘Cliff’ Risk		X

Disclosure

- In line with legal requirements, firms report all HQLA within their publically disclosed LCR. This includes HQLA held for Pillar 1 requirements, Pillar 2 requirements, 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

- The PRA expects firms *not* to disclose publically their total ILG, composed of Pillar 1 and Pillar 2 requirements
  - The PRA expects that firms will notify the PRA in advance of any proposed disclosure announcement [over and above minimum requirements]

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- For the majority of smaller and mid-sized banks this first CP presents 2 clear calls to action, in respect of:
  - Cash-flow Mismatch Risk and
  - Intraday Liquidity Risk
- Cash-flow Mismatch Risk – 'the risk that a firm has insufficient cash from monetisation of liquid assets and other inflows to cover outflows on a daily basis'
  - Note 'the framework also enables the PRA to address liquidity risks in ways other than firms holding liquid assets, e.g. by requiring firms to limit the liquidity risks they are running'
  - Does this herald a return to floors under short-term maturity mismatch *à la* FSA010?
- Intraday Liquidity Risk - '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 payments or securities settlements systems'
  - Note 'double duty' comments (see slide 7)
  - Expect ring-fencing of intraday buffers

Cash-flow Mismatch Risk (1)

- The PRA intends to set out specific proposals…in the second CP
- Cash-flow mismatch risk is not captured in the LCR…granular modelling of cash-flows may highlight points at which a firm’s cumulative outflows position falls below zero. The PRA is focused on being able to monitor such shortfalls in a firm’s liquidity profile
- An alternative to liquid asset requirements is to require firms to reduce the amount of liquidity risk they run, through monitoring and setting limits on cash-flow mismatch risk
- Monitoring cash-flow mismatch risk requires, by construction, access to data on future profiles of inflows, outflows, and liquid assets, over a given horizon
  - While recognising that this may add to firms’ reporting requirements, the PRA believes that firms themselves should already be monitoring their day-by-day profile of net outflows

Cash-flow Mismatch Risk (2)

- The PRA will explore two possible approaches to evaluating cash-flow mismatch risk:
  - A quantity-based approach, e.g. looking at the largest shortfall between daily cumulative outflows and inflows, over a given horizon and for a given liquidity stress scenario
  - A time-based approach, e.g. looking at when a firm's cumulative net cash-flow first becomes negative, assuming a particular stress scenario and a particular set of available liquid assets
- In the second CP the PRA will include specific policy proposals [on] the reporting requirements needed to monitor cash-flow mismatch, taking into account…the exact assumptions on outflows, inflows, and liquid assets
- The PRA may design stress scenarios and evaluate cash-flow mismatch risk at a different horizon than that of the reporting requirements

Intraday Liquidity Risk (1)

- The risk that a firm fails to manage its intraday liquidity effectively, which could leave it unable to meet a payment or settlement obligation at the time expected, thereby affecting its own liquidity position and that of other parties

- All firms connected to payment or securities settlement systems, either directly or indirectly, are exposed to intraday liquidity risk

- The PRA's approach to assessing intraday liquidity risk will be based on
  - the firm's maximum net debits,
  - the firm's stress testing framework,
  - the firm's key characteristics such as whether it is a direct or indirect participant in payment and settlement systems, and
  - the markets it operates in

- Mitigating the risk of double duty is a primary reason for including a calibration of intraday liquidity risk in a firm's liquid asset buffer. Double duty is the use of a liquid asset buffer, held for wider liquidity resilience, to support also payments and securities settlement activities intraday

- The PRA considers that the mean average of maximum net debits, combined with a stress uplift, is the most appropriate measure to assess intraday liquidity risk
- The maximum net debit is calculated as the point at which the value of payments sent by a firm most exceeds the value received by that firm, for a given payment or securities settlement system…on a system by system basis
  - ‘A firm should not assume that a reduction in the maximum net debit profile will necessarily lead to a reduction in the PRA’s assessment of intraday liquidity risk’ [I think this means we will be allowed to make a case, over time…]
- The PRA encourages indirect participants that are currently unable to calculate their maximum net debit position 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 so
- The stress uplift will be subject to supervisory judgement. Factors taken into account will include
  - the sophistication of the firm’s intraday liquidity management systems,
  - how the firm connects to the respective payment and securities settlement systems it uses, and
  - the business model of the firm

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- Early days, but 2 clear requirements thus far:

1. Capture of time-stamp for each individual intraday flow and calculation of daily max net debit (and mean) over *n* days
   - For the time being daily retrospective capture is sufficient

2. Ability to project daily cumulative cash-flows out to *n* days for FSA010-style analysis & reporting (post-FSA047)

3. Etc… To be updated when second CP published

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- Risk Appetite Statement development and enhancement
- Regulatory Disclosure
- Business Planning and Modelling and
- Governance Policies, Processes and Assurance

Our intuitive and transparent stress-testing and business modelling software facilitates compliance with regulatory requirements for:

- Credit risk capital stress-testing and management (Pillars 1 and 2A)
- IRRBB stress-testing and management
- Liquidity risk stress-testing and management
- Funds Transfer Pricing
- Strategic business modelling
- Regulatory Metrics such as LCR, HHI and ALMM

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