

The LCR Trap

And how not to fall into it.

“It follows that a firm cannot rely solely on meeting the LCR in order to satisfy the OLAR.”

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- Stress-testing liquidity outside of and incremental to regulatory minima has been a constant PRA theme for the last 6 years, and survives into the post-BIPRU 12, CRDIV-CRR regime
- However some CROs and Treasurers have come to focus on the LCR and 'stressed' LCR alone, at the expense of a broader liquidity stress-testing palette
- The following slides condense the many references in Policy Statement 11/15 and Supervisory Statement 24/15 (which begin to implement the new regime) to the continued requirement for firms to think outside the LCR box...

- 5.6 ...the PRA intends to revoke BIPRU 12. However, in the CP [27/14], it set out the rules that it intended to carry forward...These included rules covering...stress testing. ('BIPRU rules carried forward and deleted')
- 5.10 The PRA expects firms to articulate for themselves the amount of risk they are willing to take...and
- 5.13 ...to analyse their own liquidity risk...Firms should make their own assumptions about...what are appropriate stress horizons. ('OLAR and liquidity risk management')

- 2.1 The ILAA rules require firms to identify, measure, manage and monitor liquidity...across different time horizons and stress scenarios, consistent with the risk appetite established by the firm's management body. ('The Internal Liquidity Adequacy Assessment Process')
- 2.15 ...Central to this [ILAAP] process is...a risk appetite statement defining the duration and type of stress or stresses that the firm aims to survive...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. ('Overall liquidity adequacy')

- 2.17 The LCR is distinct from and does not replace the concept of overall liquidity adequacy. The LCR...could fail to capture firm-specific risks [and] does not capture any of the qualitative arrangements that the PRA requires a firm to implement to ensure compliance with the OLAR. It follows that a firm cannot rely solely on meeting the LCR in order to satisfy the OLAR ('Overall liquidity adequacy')
- 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...Stress testing scenarios should include a macroeconomic stress. ('Stress Testing')

- 2.40 ...These arrangements should also be informed by the results of firms' liquidity stress testing. ('Liquidity contingency plan')

- 3.2 In carrying out the L-SREP, the PRA will as a minimum...evaluate the further liquidity and funding risks revealed by stress testing ('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 ('L-SREP')

- In this section...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 ('Evaluation of liquidity needs in the short and medium term' from the ILAAP framework)
- 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...('Firm's liquidity specific stress testing' from the ILAAP framework)

- Identifying why, even over a 30-day horizon, the LCR alone is an inadequate metric (e.g. intra-group liquidity risk, intraday liquidity risk, funding concentration risk...)
- Determining via iterative stress-testing, combining idiosyncratic and external factors:
 - the institution's appetite for survival under severe liquidity stress and
 - the impact of such stress scenarios on viability, as well as solvency
- Documenting the liquidity stress-testing process and responsibilities, and providing assurance to the ALCO/BRC that the process is 'live'
- Specifically charging informed, senior persons with the requirement to critically examine and challenge the assumptions underlying scenario composition and parameters

- “...requirements are broadly unchanged compared to BIPRU 12” (PRA CP27/14)
- OLAR is not ‘proportional’: the requirements do not diminish for smaller banks
- The L-SREP will be a judgmental appraisal of the extent to which each institution has applied the spirit, as well as the letter, of the OLAR rules and principles
- Stressed LCR forecasts are valuable indicators of the potential for certain scenarios to threaten regulatory breach and/or breach of risk appetite...
- ...but, for OLAR compliance, much more is needed.

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