Finalised guidance

Individual Liquidity Systems Assessment (ILSA)

Simplified ILAS BIPRU Firms

April 2011

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Contents

1. Individual Liquidity Systems Assessment (ILSA)

Introduction

The Individual Liquidity Systems Assessment (ILSA) only concerns simplified Individual Liquidity Adequacy Standards (ILAS) BIPRU firms.[1] Any references to a 'firm' mean a simplified ILAS BIPRU firm.

The ILSA's aim is to help firms ensure they act in accordance with, and meet, the overall liquidity adequacy rule. The ILSA also enables us to assess firms' compliance with this rule more effectively.

What we expect

The ILSA must be proportionate to the nature, scale and complexity of a firm's activities. For a firm with a very simple business model, we would not expect the ILSA to be disproportionately lengthy and over-detailed. The information we have provided here about what format the ILSA submission may take is designed to embrace a wide range of firms of differing sizes and complexities. We do not expect all firms to cover all aspects described; firms must individually judge what is and is not appropriate to include.

Although some aspects of the ILSA are mandatory to ensure firms comply with BIPRU Chapter 12, other aspects are only relevant to firms with certain business models and risk profiles. We expect the scope of the ILSA, and the range of supporting information and documentation, to vary considerably from firm to firm.

In general, the ILSA:

- **must be proportional** to a firm's size, business model and risk appetite;
- should take into **account all sources of liquidity**[2] ; and
- must include a firm's own assessment and evaluation of its **compliance with the systems and control requirements of BIPRU 12.3 and 12.4, and the simplified quantitative requirements of BIPRU 12.6.**

Firms should conduct an ILSA at least annually, or more frequently if changes in a firm's business strategy, balance sheet, the nature or scale of its activities, or its operational environment suggest that the level of and access to liquidity resources are no longer adequate.

Firms must only submit their ILSA to us **when we request it. This will usually be part of our ongoing supervisory process.**

[1] The simplified ILAS conditions are defined in the Prudential sourcebook for Banks, Building Societies and Investment Firms BIPRU 12.6.6R to BIPRU 12.6.8R

[2] The ILSA must take into account group-wide liquidity resources through the granting on an intra-group modification, but only to the extent that reliance on these is permitted by the FSA

Its aim

The ILSA is used to:

(a) inform a firm's governing body of the firm's ongoing assessment of its compliance with liquidity risk management systems and controls, as required by BIPRU 12.3 and 12.4, including the results of the stress tests required by BIPRU 12.4.

(b) inform a firm's governing body of how the firm calculates and meets the simplified liquidity buffer requirements as set out in BIPRU 12.6.9R˜ 12.6.18R.

Although the ILSA may be based on, and incorporate, a firm's existing internal documentation (e.g. existing liquidity policies), we will expect a firm's governing body **to require a bespoke ILSA document to be prepared.** As the ILSA is a statement of how a firm complies with our liquidity risk management systems and controls requirements, we expect a firm's **governing body to have formally approved its contents.**

As the ILSA is produced for the firm's governing body, we expect it to be easily understood. It should contain relevant information, for both the governing body and us, to make an informed decision on the adequacy of a firm's liquidity risk management process and methodologies, as required in BIPRU 12.3, BIPRU 12.4 and BIPRU 12.6.

Importantly, in our **Supervisory Liquidity Review Process (SLRP)**[3] , we will conduct a review of a firm's compliance with BIPRU 12.3, 12.4 and 12.6. As a result of this review, we may give a firm individual liquidity guidance advising that its liquid assets buffer should be larger than the buffer resulting from applying the simplified buffer requirement in BIPRU 12.6.9R, 12.6.16R and 12.6.17G.

We would expect relevant information on stress testing and risk management methodologies, (including the validation of the approach and stress testing results, e.g. relevant Board papers), to be included in an ILSA. However, to ensure the ILSA remains a succinct and risk management-focused document, we recommend supporting information is attached as appendices.

We expect to see significant variations in the content of ILSAs across firms as business models and risk profiles differ and the ILSA must be proportionate to each firm's activities and operations. However, firms may find it useful to follow the ILSA format below. This covers matters that would be the subject of our ILSA review, where appropriate and relevant to firms.

Following this format may also help to demonstrate that firms have included points we would expect its governing body to have reviewed to approve its liquidity risk, management approach and methodology.

Quantitative liquidity data

The ILSA is a significant component of the SLRP (where undertaken) and the ongoing supervisory process, both of which rely on robust and accurate liquidity information.

[3] May be undertaken either as part of the ongoing supervision of the firm, or as part of the Arrow process, or if appropriate, as a one-off specific review. Refer to Section 4 for further details.

Our reporting requirements call for FSA 047 and FSA 048 liquidity returns to be submitted, among others, which provide us with the key liquidity information necessary to undertake detailed analysis of a firm's liquidity position.

Simplified ILAS BIPRU firms[4] are required to follow the same liquidity reporting requirements as all other ILAS BIPRU firms, although the frequency of the reporting will vary for some of the regulatory returns.

[4] See BIPRU 12.6.6R to BIPRU 12.6.8R

2. Structure and format

The ILSA should be structured as follows:

1. **Executive Summary:** examines the liquidity risk management governance and processes, and gives an overview of compliance with the rules on liquidity systems and controls, and liquid asset buffer amounts and composition (see BIPRU 12.3, 12.4, 12.6 and 12.7).

2. **Systems and controls:** this discusses in detail how a firm meets the liquidity risk management and stress testing requirements in BIPRU 12.3 and 12.4, assesses the firm's overall liquidity and liquidity buffer requirements, and the ILSA processes. It will include qualitative and quantitative dimensions[5], and:

   - reviews the firm's liquidity position, access to liquidity, composition of its liquid assets, contractual and behavioural wholesale and retail deposit assumptions, secured and unsecured funding profiles under business-as-usual conditions and the stress tests required under BIPRU 12.4;
   - reviews liquidity risk governance and a statement of the firm's liquidity risk tolerance (consistent with BIPRU 12.3);
   - liquidity stress testing policies, process, and methodologies (consistent with BIPRU 12.4 requirements) and includes details of assumptions used and the extent of management actions;
   - stress testing and contingency funding plans (CFP), which should set out the scope and results of the stress testing the firm is required to regularly conduct to identify and manage their liquidity risk and discuss how the results of their stress tests are used in developing their CFP;
   - management information and reports, with the processes and procedures used to identify, measure, monitor and manage liquidity risk within the firm;
   - review and justify the firm's assessment of its overall liquidity and liquidity buffer requirements;
   - review the firm's funding sources and assess whether its access to funds is adequately diversified; and
   - record the internal challenge and approval ILSA processes and the extent to which liquidity risk management is embedded within the firm.

3. **Appendices:** these should include any information necessary for the firm's governing body to conclude on its liquidity risk management.

[5] See BIPRU 12.3, 12.4, and 12.6

Each section is discussed in further detail below.

Section 1: Executive Summary

The Executive Summary:

- presents an overview of a firm's liquidity risk management processes, how they are implemented, and how the firm meets the systems and controls requirements in BIPRU 12.3 and 12.4; and
- demonstrates how the firm complies with the liquid asset buffer calculations set out in BIPRU 12.6 and the buffer asset composition requirements set out in BIPRU 12.7.

The summary would typically include, as appropriate, but not be limited to:

- the composition and amount of liquid asset buffer the firm considers it should hold, as calculated in accordance with BIPRU 12.6;
- the firm's assessment of the adequacy of its liquidity risk management processes;
- an overview of the firm's financial position, balance sheet strength and projected future profitability;
- a description of the liquidity risk management governance, and how the firm manages liquidity on an ongoing basis;
- a summary of the firm's liquidity risk appetite and current liquidity position;
- an overview of the most material liquidity risks the firm faces and how risks are managed;
- a commentary on how the ILSA process and results have been challenged, who has approved the ILSA; and
- if the ILSA is being completed on a group basis, which regulated entities it covers.

Section 2: ILSA Systems and Controls

Part 1 Background

The background covers the firm's relevant organisational and historical financial data.

Where appropriate - to fully inform a firm's governing body areas addressed could include, but not be limited to:

- liquidity resources held, and as compared with regulatory requirements (under BIPRU 12);
- retail, small and medium-sized enterprises (SME) and wholesale accounts, split by Type A and Type B where appropriate;
- total assets; and
- any future implications for the firm's funding and liquidity needs, shown by trends in profitability, and balance sheet size and structure.

Part 2 Current and projected financial and liquidity positions

This section will explain the firm's present financial position and any expected changes to its current business profile, the environment in which it operates, planned future sources and liquidity uses. Current financial information underpinning the ILSA should be based on the firm's balance sheet and business/corporate plan at the effective date of the ILSA.

The ILSA should set out the firm's projected liquidity positions as driven by the firm's business/corporate plan. Conducting the ILSA against the future-state balance sheet will provide necessary and important liquidity risk information on key liquidity risk drivers. The analysis should indicate the amount of liquidity required to finance the firm's growth or shrinkage objectives. A copy of the approved business /corporate plan should be included in the appendices.

A summary of the liquid asset resources the firm relies on as a source of liquidity should be provided. These will primarily be buffer assets, as defined in BIPRU 12.7; however the firm should also give details of non-buffer qualifying assets held that are also expected to contribute to the adequacy of liquidity resources.

Part 3 Liquidity control environment

This section should:

- set out the approach, methodology and results of the firm's liquidity stress testing under the firm's BIPRU 12.4 stress test assumptions;
- discuss the total amount of liquidity necessary, including liquidity held as qualifying buffer assets.

- describe the firm's liquidity risk appetite and discuss how it is used to define and assess liquidity levels and limits, how the liquidity stress test scenarios required under BIPRU 12.4 have been developed and how they relate to and incorporate the liquidity risk components set out in BIPRU 12.3.
- review and analyse the liquidity adequacy of the firm, to include the liquid asset buffer amount as calculated under BIPRU 12.6.

The information provided for this section could include, as appropriate, the following:

a) Risk appetite, liquidity risk limits, and position against limits

- a clear articulation of the firm's liquidity risk appetite and why the risk appetite is appropriate for the firm;
- an outline of the relevant liquidity risk management limits as derived from the risk appetite, and confirmation that the risk appetite is consistent with that managed by holding sufficient buffer assets as calculated in accordance with BIPRU 12.6.17; and
- confirmation that the liquidity position described in the firm's FSA 047 and FSA 048 as at the effective date of the ILSA is consistent with the firm's liquidity risk limits.

b) Timing

This section sets out the timeframe covered by the ILSA, for example:

- the effective date of the ILSA and the impact of any subsequent events that materially impact the ILSA after the effective date, but before submitting the ILSA to us.
- details of, and the rationale for, the time period over which the adequacy of liquidity has been assessed.

c) Risk analysis

This section discusses the firm's approach, methodology and liquidity analysis undertaken to develop the ILSA. Areas to be covered could include, among others, where relevant and appropriate:

- the effectiveness of diversification across its chosen sources of funding;
- access to central bank open market operations and/or liquidity facilities;
- a discussion of the impact of the BIPRU 12.4 stress tests, with and without the application of management actions;
- the firm's ability to meet the cash outflows that will likely occur following the onset of the liquidity stresses;
- for the stress test, the ILSA should provide a clear assessment of whether or not the firm's liquidity remains within its risk appetite under the BIPRU 12.4 stresses, and if not, what actions the firm would take;
- where a firm uses a model or a PC-based spreadsheet to quantify liquidity risk under BIPRU 12.4 stress testing, the ILSA would explain:

- o the key assumptions and background information on the assumptions, including those about the behaviour of liabilities;
- o how and why the stress testing parameters have been chosen and are appropriate;
- o the sensitivity of the stress testing to changes in its key assumptions or parameters; and
- o any validation work conducted (or to be conducted in future) to ensure the continuing validity and adequacy of the stress testing methodology.

d) Stress testing

BIPRU 12.4.1R requires firms to conduct liquidity stress testing on a regular basis. BIPRU 12.6 requires a simplified ILAS BIPRU firm to report the results of the stress test requirements in BIPRU 12.4 in its ILSA. The aim of stress testing is to identify the sources of potential liquidity strain for the firm, ensure that liquidity exposures under 'normal' and stressed economic conditions continue to be with the firm's liquidity risk appetite, and to identify the effect of liquidity costs on product pricing.

A firm's ILSA should set out how it undertakes its stress testing and how it has incorporated the requirements and guidance from BIPRU 12.4 into its stress testing methodology.

In a firm's ILSA, we expect to see analysis which shows the separate and combined impact of possible future liquidity stresses on its:

- cash flows;
- liquidity positions;
- profitability; and
- solvency.

To adequately and appropriately make these assessments, the stress testing should consider the firm's assumed potential changes in market conditions, changes in the nature, scale and/or complexity of the firm's business model and activities, and its practical experience in periods of stress.

A firm must consider the potential impact of institution-specific, market-wide and combined alternative scenarios. Different time horizons and varying degrees of stressed conditions must also be considered.

It is important to note that in some circumstances the BIPRU 12.5 stress testing scenarios can be applied to the BIPRU 12.4 stress testing scenarios, but firms will need to consider whether other scenarios may also be relevant to their business, and in that case they will have to perform additional stress tests to fully comply with the requirements of BIPRU 12.4.

e) Contingency funding plans

BIPRU 12.4.10R and 12.4.11R establish the requirement for firms to have an adequate, up-to-date and approved contingency funding plan (CFP) in place. Furthermore, BIPRU 12.4.13R sets out 11 key points that at a minimum, a firm must ensure its CFP covers in sufficient and adequate detail. These are:

1. it outlines strategies, policies, and plans to manage a range of stresses;
2. it establishes a clear allocation of roles and clear lines of management responsibility;

3. it is formally documented;

4. it includes clear invocation and escalation procedures;

5. it is regularly tested and updated to ensure it remains operationally robust;

6. it outlines how the firm will meet its time-critical payments on an intra-day basis in circumstances where intra-day liquidity resources become scarce;

7. it outlines a firm's operational arrangements to manage a retail funding run;

8. in relation to each of the sources of funding identified for use in emergency situations, it is based on a sufficiently accurate assessment of:

   a. the amount of funding that can be raised from that source; and

   b. the time needed to raise funding from that source.

9. it is sufficiently robust to withstand simultaneous disruptions in arranging payment and settlement systems;

10. it outlines how the firm will manage internal communications and those with its external stakeholders; and

11. it establishes mechanisms to ensure the firm's governing body and senior managers receive relevant and timely management information.

To demonstrate how a firm meets all requirements, a full and complete copy of the CFP should be included in the Appendix to the ILSA. A thorough review of the CFP will be a key part of our review of a firm's ILSA.

f) Management information

This section should cover the management information systems and reports a firm has put in place to provide its governing body, senior management and other relevant individuals with timely and forward-looking information on the firm's liquidity position. We would expect to see the relevant management reports included in the Appendices.

Part 4 Liquidity adequacy

The ILSA should discuss the total amount of liquidity the firm holds and describe how it supports the overall liquidity adequacy rule. The ILSA should also discuss why the firm thinks its liquid asset portfolio (to include its liquidity buffer requirements) is appropriate to ensure the firm meets the overall liquidity adequacy rule and is sufficiently marketable to provide liquidity as and when required. This section should clearly explore whether holding the quantum defined in BIPRU 12.6.9R is sufficient to meet all liabilities as they fall due. Additional liquidity may need to be held, and that can be held in non-qualifying buffer assets.

The amount of liquid assets buffer a simplified ILAS BIPRU firm must hold in its liquid asset buffer is set out in BIPRU 12.6.9R to 12.6.16R (these requirements are restated as a mathematical formula in BIPRU 12.6.17G). BIPRU TP 29 defines the transitional provisions which apply concerning the build up of the liquid assets buffer for a simplified ILAS firm.

BIPRU 12.7.2R - 12.7.6R and 12.7.9R describe the types of securities and cash accounts that qualify as buffer assets. Accordingly, only qualifying assets will count towards a firm's liquidity buffer requirement.

The ILSA should present and discuss the firm's approach and methodology for calculating its liquidity buffer amount, consistent with the BIPRU 12 rules and guidance noted above, and to provide sufficient supporting documentation to validate the results of its liquidity buffer calculations and the make-up and structure of the buffer asset portfolio.

BIPRU 12.7.11R requires firms to regularly realise their buffer assets to ensure their marketability. Moreover, firms are also required to regularly access all sources of liquidity they rely on to meet liquidity requirements as determined by its liquidity policies, stress testing methodologies, and CFP. We expect the ILSA to provide documentation confirming the firm is actively and routinely accessing liquidity from all available sources and setting out the firm's policies for doing so.

Finally, this section should discuss how the results of the BIPRU 12.4 and the liquid assets buffer calculated under BIPRU 12.6 are brought together and an overall view is taken on liquidity adequacy. At a technical level, this requires using some form of quantitative methodology to combine the risks.

Part 5 Diversification

In complying with BIPRU 12.3.4R, a firm must ensure that it has access to funding which is adequately diversified, both as to source and tenor. The purpose of diversification is to ensure a firm has in place alternative sources of funding that strengthen its capacity to withstand a variety of severe yet plausible firm-specific and market-wide liquidity shocks. Therefore, the ILSA should discuss how its BIPRU 12.4 stresses affect and impact diversification in its liquidity resources.

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

- maturity;
- the nature of depositor or counterparties used;
- levels of secured and unsecured funding
- See BIPRU 12.3, 12.4, and 12.6the type of liquidity instruments held;
- securitisation vehicle;
- currency; and
- geographic market.

A firm will need to demonstrate in its ILSA the extent to which its funding diversification is integrated within its business planning process and provide evidence of its capacity to raise funds quickly from its chosen funding sources to provide short, medium and long-term liquidity.

Part 6 Internal challenge and approval

This section will describe the extent of internal challenge and testing applied to the ILSA process and results. It will include the testing and control processes applied to the ILSA risk models or spreadsheets, and the Board review and sign off procedures along with details of the challenge.

In addition, copies of any relevant reports obtained from internal audit should also be included.

Part 7 Using the ILSA in the firm

This section discusses and demonstrates the extent to which liquidity risk management is embedded within the firm, including stress testing and contingency funding plans.

While the ILSA is a document prepared by a firm for its governing body, we will review the ILSA with a view to concluding on the firm's liquidity risk management capabilities and the requirements under the relevant sections of BIPRU 12. Accordingly, it would be helpful for firms to provide us with details of anticipated or planned future liquidity management changes as part of the ILSA.

Section 3 – Appendices

This section contains information a firm thinks necessary to validate and substantiate the conclusions on liquidity risk management, liquidity amounts, types, and access as set out in the ILSA.

We would expect to see in the appendices, among other items where relevant and appropriate, PC-based spreadsheets and cash flow forecasts, assumptions used, any available validation of the behavioural assumptions used, relevant committee reports and minutes, management information and reports used in day-to-day liquidity management, full and complete details covering access the funding portfolio, types of funding (secured and unsecured) and full and complete details of the liquid assets portfolio.

3. Individual liquidity guidance and regulatory intervention points for simplified ILAS BIPRU firms

Supervisory Liquidity Review Process (SLRP)

Periodically, we will conduct a SLRP (which may be undertaken either as part of the ongoing supervision of the firm, or as part of the ARROW process, or if appropriate, as a one-off specific review), to review and assess a firm's quantitative and qualitative liquidity risk management processes and operations. In conducting a SLRP, we will take a risk-based and proportionate view, focusing on how a firm deals with the liquidity risks it faces. The SLRP has the primary aim of forming our view of any Individual Liquidity Guidance (ILG) to be given to a firm in place of the simplified buffer requirement. In undertaking a SLRP we will request and review the firm's most recent ILSA and other documentation we consider relevant and necessary to form a clear understanding of a firm's liquidity position and risk management, including a review of the firm's systems and controls for liquidity risk as set out in BIPRU 12.3 and the firm's internal stress testing and contingency funding plan as set out in BIPRU 12.4.

Individual Liquidity Guidance (ILG)

We will not ordinarily expect to give ILG to a simplified ILAS BIPRU firm. However, if based on the findings of a SLRP, we find that the simplified buffer requirement does not deliver an adequate amount and quality of liquidity resources given its liquidity risk profile, we will provide ILG to a firm. We will communicate ILG, along with our conclusions from the SLRP, to the firm's governing body. ILG will contain guidance on the quantity of a firm's liquid asset buffer and the firm's funding profile.

A simplified ILAS BIPRU firm is required to monitor its conformity with the simplified buffer requirement or ILG (where it has been set) on a daily basis.[6] This is a dynamic requirement and is measured against the firm's daily liquidity risk profile. We will also monitor the firm's liquidity risk profile, and therefore its conformity with its simplified buffer requirement or ILG, on a regular basis through our reporting regime (FSA 047 and FSA 048 among others).

Regulatory Intervention Points

BIPRU 12.9 puts in place a number of regulatory intervention points that define the actions a firm needs to undertake should it deviate from its simplified buffer requirement or ILG it has issued to the firm. While a failure to meet the simplified buffer requirement or ILG does not, in and of itself, imply a failure to meet Threshold Conditions, these regulatory intervention points further clarify how we will assess Threshold Conditions in such situations.

[6] BIPRU 12.9.24R

If a simplified ILAS BIPRU firm fails to meet its liquid asset buffer requirements under BIPRU 12.6, or its liquidity risk management systems and controls fail to adequately meet the standards set out in BIPRU 12.3 and 12.4, we may pursue the regulatory intervention points as set out in BIPRU 12.9.