BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Supervisory Statement - **Supervising building societies' treasury and lending activities**

Contents

1 Introduction

1.1 The purpose of this supervisory statement is to set out the approach and expectations of the Prudential Regulation Authority (PRA) to its supervision of building societies' treasury and lending activities. This statement complements the requirements of the Building Societies Act 1986 (the 1986 Act). This supervisory statement is aimed at all building societies (societies).

2 Financial risks and treasury activities

2.1 This chapter describes the key financial risks to which societies are exposed and also sets out the framework within which the PRA will supervise the treasury activities of societies.

Supervisory standards for treasury activities

Setting risk limits

2.2 Under section 5 of the 1986 Act, a society's principal purpose is that of making loans that are secured on residential property and are funded substantially by its members, not undertaking, and trading in, financial risk for profit.

2.3 Societies should therefore adopt a risk-averse approach to maturity mismatch and to structural risk management. A degree of maturity mismatch and structural risk is inherent in normal society operations, but boards of societies (boards) should set risk limits that either:

a. ensure that, as far as possible, exposures to changes in interest rates are minimised; or

b. where interest rate positions are to be taken, restrict potential reductions in income or economic value, estimated under robust stress testing scenarios, to levels that would not compromise the current or future viability of their societies.

2.4 Societies should aim to eliminate, as far as is practicable, all exposures to risk arising from movements in currency exchange rates. A society's system for financial risk management should be adequate.

2.5 The PRA has devised five models for financial risk management and treasury operations, described as 'supervisory treasury approaches', of increasing sophistication, to assist societies. The approaches are described as 'Administered', 'Matched', 'Extended', 'Comprehensive' and 'Trading'.

2.6 The PRA expects societies to conduct its treasury activities in accordance with the most suitable (for it) of these five models, in order to demonstrate that it has complied with rule 2.1 of the General Organisational Requirements Part, rules 2.1 and 2.3 of the Risk Control Part of the PRA Rulebook in the context of financial risk management.

Supervisory standards for managing risks in the lending book

2.7 Under section 6 of the 1986 Act, societies are required to ensure that a minimum of 75% of their commercial assets is fully secured on residential property. Since residential lending will always be such a significant part of a society's business, it is essential that the risks arising from further concentrations within the total lending book are properly managed and mitigated to align with the board's risk appetite.

2.8 Societies should therefore adopt formal, board-approved lending policy statements that include limits on the type of lending that will be undertaken (both as a proportion of periodic flows and of stocks), as well as setting out the key underwriting policies and controls. As with financial risk limits, boards should aim to:

a. ensure that, as far as possible, credit risks arising from lending are aligned with management risk appetite through careful underwriting; and

b. ensure that any additional risk taken is appropriately priced and managed so that loss levels under stressed conditions would not compromise the current or future viability of their societies.

2.9 The PRA has devised three models for lending book management, described as supervisory lending approaches, of increasing sophistication, to assist societies. The approaches are described as 'Traditional', 'Limited' and 'Mitigated'.

2.10 The PRA expects societies to conduct its lending activities in accordance with the most suitable of these three models in order to demonstrate that it has complied with rule 2.1 of the General Organisational Requirements Part and rule 2.1 of the Risk Control Part of the PRA Rulebook, in the context of loan book management.

Supervisory discussions on change of approach

2.11 With regard to any of the five approaches to treasury risk and financial risk management, or the three approaches to managing the lending book, the PRA expects societies to develop their expertise, and change their approach if necessary.

2.12 The approach categories should be seen, not as discrete compartments, but rather as stages in the continuous evolution of risk management and systems, with a change of approach marking a milestone in that progress. Societies should develop their risk management and systems to the level appropriate to support the scale and nature of their business.

2.13 Any society that wishes to move between the five approaches to treasury risk and financial risk management, or the three approaches to managing the lending book, should contact the PRA at an early stage.

2.14 The PRA expects societies to demonstrate that it has the requisite expertise, management information systems, accounting systems and controls before any significant change in the society's treasury activities or lending policy is implemented.

Supervisory approaches to treasury management

2.15 Where societies have treasury operations in subsidiary undertakings, these should adopt the same approach category as the parent society.

Administered approach

2.16 Societies in the Administered approach category should have balance sheets where loan assets and funding liabilities are entirely in Sterling and predominantly (>95%) subject to administered rates.

2.17 It is anticipated that the ‘Administered’ approach will tend to suit small or very small societies where balance sheet management is typically undertaken by the Chief Executive in conjunction with the board.

2.18 Societies in this category should not hold any treasury investments, or issue any funding instruments, that contain complex structured optionality, whether this optionality relates to interest payable or receivable, instrument term or any other variable.

2.19 It is likely to be appropriate for a society that falls into this category to apply for a simplified ILAS waiver.

Matched approach

2.20 Societies adopting the Matched approach should have balance sheets where assets and liabilities are entirely in Sterling and use hedging contracts (or internal matching of assets and liabilities with similar interest rate and maturity features) to neutralise the risk arising from loans or funding other than at administered rates, on a tranche by tranche, product by product basis.

2.21 This approach is characteristic of small to medium sized societies, with limited treasury skills or resources. Typically the Chief Executive of such societies will be supported by a Finance Director or Finance Manager, and report direct to the board on treasury matters (or through an appropriate committee).

2.22 The policies of such societies can allow use of standard hedging products for transactions permitted by section 9A of the 1986 Act, for example interest rate swaps; and plain vanilla over the counter (OTC) options such as swaptions, caps, collars and floors (options purchased only);

for the purpose only of matching individual products and within the exemptions permitted by section 9A. Structural hedging of the whole balance sheet should not be permitted.

2.23 Risk management for such societies should be achieved internally through:

a. matching reports (detailing individual products and the hedging instruments associated with them); and

b. gap analysis. For gapping purposes, reserves will need to be treated as having no fixed repricing date, and gap limits should be set at the minimum level required to give flexibility in timing the hedges for individual mortgage and investment products, with some allowance for residual risks (those too small to be economic to hedge) and for holdings of fixed rate liquid assets. Basis risk should be minimised by setting cautious limits for fixed rate, bank base rate and any other market rate assets and liabilities.

2.24 Gap monitoring reports should be updated and considered by the board at least monthly. By implication, societies adopting this approach should not be taking an interest rate view for the purposes of determining a hedging strategy.

2.25 Societies in this category should not hold any treasury investments, or issue any funding instruments, that contain complex structured optionality, whether this optionality relates to interest payable or receivable, instrument term or any other variable.

2.26 It is likely to be appropriate for a society that falls into this category to apply for a simplified ILAS waiver.

Extended approach

2.27 The principal difference between the Matched and the Extended approaches lies in the capability to measure and hedge structural risk across the whole balance sheet, including reserves, rather than just hedging individual transactions.

2.28 The approach will thus allow a society to allocate reserves to specific repricing bands representing a considered view of the characteristics of those reserves, and/or the assets deemed to represent them, or to manage interest rate gaps as part of a strategy for hedging the endowment effect of interest free reserves against adverse interest rate movements. Risk analysis should also enable it to position its balance sheet to take advantage of a particular interest view.

2.29 The PRA expects that some societies on the extended approach will, subject to being able to satisfy the relevant conditions, elect to apply for a simplified ILAS waiver whilst others may choose to remain as standard ILAS BIPRU firms. For a society that is a standard ILAS BIPRU firm, the PRA will discuss with the society the maximum level of wholesale funding that the society should hold.

2.30 A society that wishes to operate the simplified ILAS approach will need to satisfy the relevant conditions in BIPRU 12.6, including those relating to the minimum percentage of total liabilities accounted for by retail deposits.

2.31 A society on the extended approach can potentially fund and hold assets denominated in Sterling, Euros or US dollars, whether it is a simplified ILAS BIPRU firm or a standard ILAS BIPRU firm.

2.32 A society adopting the extended approach should:

a. adopt policies and systems to enable it to undertake the hedging of individual transactions within the context of an overall strategy for structural hedging, based on detailed analysis of its balance sheet; and

b. use the output of that analysis to enable it to position its balance sheet to take advantage of a particular interest view.

2.33 Management of interest risk for such societies will typically be controlled by the board acting through an Assets and Liabilities Committee (ALCO) or equivalent sub-committee, which will normally be responsible for agreeing any interest rate view.

2.34 Reporting to the ALCO, there will typically be a Treasurer running a small treasury department with appropriate segregation between dealing and settlement activities. Hedging instruments available to be authorised by the board will be the same as for the Matched approach, with the addition of (as far as permitted by section 9A):

a. FRAs/futures; and

b. foreign exchange swaps/forward contracts/options (purchase only).

2.35 Risk management systems should be based on full balance sheet gap analysis, possibly supplemented by static simulation. Gap limits could allow leeway for risk positions, to be controlled by sensitivity limits covering potential changes in both earnings and economic value.

Comprehensive approach

2.36 The principal differences between the Extended and the Comprehensive approaches lie in:

a. the depth and quality of the risk management systems put in place to monitor and control structural risk;

b. the frequency of analysis undertaken; and

c. the currencies in which treasury operations would be undertaken.

2.37 Like the extended approach societies, comprehensive approach societies will manage risk using a board/ALCO/Treasurer reporting structure, but the latter will typically subdivide the treasury department further with a separate middle office risk management function, segregated from 'front office' (dealing) and back office (settlement/accounting).

2.38 Hedging instruments available for use under agreed board policy will include those for the extended approach plus (as far as permitted by section 9A):

a. complex interest rate swaps;

b. complex interest rate caps/collars/floors (purchase only);

c. House Price Index derivatives; and

d. credit derivatives.

2.39 Risk analysis should extend beyond static gap/static sensitivity analysis to, for example:

a. dynamic simulation (such as projecting forward balance sheet elements and simulating the impact of different interest rate scenarios)

b. duration for individual portfolio elements, or present value of a basis point move calculations, to highlight sensitivity to non-parallel shifts in the yield curve; and

c. value at risk, using correlation/historic simulation and/or Monte Carlo simulation;

The impact on both earnings and economic value should be assessed internally on a regular basis.

2.40 Risk positions could reflect an interest view, subject to sensitivity limits set by the board/ALCO and incorporating basis risk assessment/control. Foreign exchange mismatch (i.e. exchange rate exposure) should be subject to appropriate risk management over foreign exchange movements.

2.41 It is likely to be appropriate for a society on the comprehensive approach to be a standard ILAS BIPRU firm.

Trading approach

2.42 The Trading approach is a category for those societies that wish to take advantage of the ability to trade in securities. Essentially, those societies will adopt the comprehensive approach for the purpose of managing interest risk arising in their banking book, but with additional policies, financial instruments, systems and expertise for managing the market risks inherent in running a separate trading book.

2.43 Such a society should control the additional market risks through a Market Risk Committee of the board and risk management systems should include complex portfolio management, option pricing and value at risk models.

2.44 It is likely to be appropriate for a society on the trading approach to be a standard ILAS BIPRU firm.

Supervisory approach to managing the lending book

2.45 This section outlines the three models, or supervisory approaches, to managing the lending book.

Traditional lending approach

2.46 Societies in the Traditional lending approach category should restrict their lending activities mainly to prime quality residential mortgages for owner-occupiers. The traditional approach should suit small or very small societies where lending decisions are fully underwritten on an individual basis, typically by the Chief Executive or a direct report, under clearly delegated mandates.

2.47 Societies adopting this approach should have board-approved lending policies that:

a. set a minimum limit of at least 85% of loan book for prime owner-occupied mortgages (subject to a mortgage indemnity guarantee or other recognised collateral for loan to values (LTV) in excess of 80%);

b. limit other types of lending within the maximum 15% balance to prime owner-occupied >80% to <90% LTV without external insurance, prime buy to let, shared ownership, social landlords and secured commercial lending (including fully secured on land) only;

c. require the use of approved independent valuers;

d. require stress tests to be undertaken at least annually to identify potential shortfalls in the value of security and allow it to review the appropriateness of its lending limits; and

e. limit exposure to connected counterparties to <10% capital resources.

Limited lending approach

2.48 The Limited lending approach is suitable for societies that have a slightly higher appetite for credit risk than those on the traditional approach. Societies adopting this approach should control the amount of risk assumed through a comprehensive system of policy limits. These limits will prevent the society from becoming over-exposed to non-traditional lending, and will take account of the differing risks associated with the type of lending and the type of security held.

2.49 In general it is anticipated that the limited approach will tend to suit medium-sized and larger societies where:

a. there is operational segregation between underwriting and the review/audit/compliance functions that check compliance with policy and legislation and that review lending/underwriting quality;

b. there is operational segregation between underwriting and the mortgage sales function;

c. lending decisions are fully underwritten on an individual or systematically credit-scored basis, under clearly delegated mandates; and

d. relevant specialist expertise is employed for non-traditional lending, with access to appropriate sources of external and internal information on how risks are developing.

2.50 Societies adopting this approach should have board-approved lending policies that:

a. set a minimum limit of at least 65% of total loan book for prime owner-occupied mortgages;

b. set sub-limits, both in terms of total loan book and lending in a twelve-month period, for other types of lending within the maximum 35% balance; and

c. require stress-testing and scenario analysis of outcomes to be undertaken at least semi-annually.

Mitigated lending approach

2.51 The Mitigated lending approach is suitable for societies that undertake a diverse range of lending. Societies adopting this approach should mitigate their risk through sophisticated credit risk management systems that control the amount of risk assumed, both through a comprehensive system of policy limits and through the operation of stochastic risk models.

2.52 In general, it is anticipated that the mitigated approach will tend to suit only the largest societies where:

a. there is a segregated and independent risk function reporting directly to the board (or a board-level committee);

b. there is full segregation between credit underwriting and the review/audit/compliance functions that check compliance with policy and legislation, and which review lending/underwriting quality;

c. underwriting is independent of mortgage sales function;

d. lending decisions are underwritten on an individual or systematically credit-scored basis (but subject to manual override), under clearly delegated mandates; and

e. relevant specialist expert teams are employed for non-traditional lending, with access to appropriate sources of external and internal information on how risks are developing.

2.53 Societies adopting this approach should:

a. have board-approved lending policies that set appropriate limits, both in terms of total loan book and lending in a twelve-month period, for each type of lending; and
b. undertake full econometric risk analysis, stress-testing and scenario analysis of outcomes at least quarterly.

Review of financial risk management approach and assessment of lending approach

2.54 Societies should perform an initial review of their current financial risk management approach in the light of this supervisory statement and undertake a self-assessment of controls over their lending book in the light of the lending criteria contained in this statement.

2.55 Having done so, the society should inform its supervisor at the PRA in writing of the approaches that it considers are the ones most suited to its systems and controls for managing financial and lending risks, provide details of any features of its systems, controls or activities that fall outside the parameters of those approaches, and discuss with its supervisor what, if any, actions are needed on the part of the society to address these.

2.56 The PRA recognises that, where the need to make changes to funding profile, treasury investments or lending profile to achieve compliance with the internal Parts of the Rulebook is identified, it is likely that the move to achieve this will be gradual. The PRA will discuss with each society an appropriate period of time over which any realignment should be undertaken.

2.57 Subsequent to this initial review, societies should continue to review the suitability of their allocated approaches as appropriate and speak to their supervisor at the earliest opportunity if they anticipate that their systems, controls or activities will fall outside the parameters of those approaches.

3 Lending

3.1 This chapter sets out expectations of the PRA on the management by societies of their lending, using the three approaches to lending, in order to enable them to comply with the requirements in the General Organisation Requirements and Risk Control Parts of the PRA Rulebook. The chapter also outlines factors the PRA will consider when assessing whether a society meets these requirements in relation to lending risk management.

Risks of mortgage lending

Affordability

3.2 The primary risk associated with mortgage lending is that the borrower will be unable or unwilling to service the loan. In this respect, some types of mortgage will present greater risks than others. In particular, risks are likely to be increased for lenders (and in some cases also for consumers):

a. where repayment commitments represent an unusually high percentage of disposable income; or

b. where an unusually large proportion of the borrower's income is variable; or

c. where the borrower has an impaired credit history.

3.3 The PRA expects societies to ensure that they consider the risk profile of the different types of lending that they undertake, put sub-limits and other mitigating controls in place where they consider it appropriate and price their lending to reflect the perceived residual risks.

3.4 Societies should also consider when product features such as fixed mortgage rates expire and whether to set a maturity profile. If large numbers of mortgage loans revert to, for example, another base rate or a standard variable rate (SVR) simultaneously the society may experience operational strain dealing with the associated administration and customer queries.

3.5 Also, if interest rates have changed significantly, societies may need to respond to a significant number of customers experiencing payment shock at the same time. In such a situation a society may experience a profitability strain resulting from abnormally high redemption levels.

3.6 Whilst non-sterling mortgages expose a society to foreign exchange risks as well as all other risks which normally attach to mortgage lending, it may also expose the borrower to exchange rate risk which, if it crystallises, impacts on their ability to afford the loan.

3.7 The PRA expects that societies (other than those with the most sophisticated lending risk management controls) should therefore set very conservative limits for such business, and confine such loans to borrowers with income denominated in the relevant currency.

3.8 Societies must also comply with the general law and other regulatory requirements relating to affordability and other aspects of granting a mortgage.

Valuation of security

3.9 If a mortgage fails to perform, a society ultimately relies upon the value of its security to safeguard its interests, so the reliability of the value is important. The integrity, competence and expertise of the valuer are important, particularly where experience in more complex valuation areas (for example, related to commercial lending) is needed.

3.10 In addition to general property price movements, significant local price variations can occur. Therefore lending outside a society's home area (or for larger societies lending on overseas property) can have an increased risk if local price drivers are not fully appreciated.

3.11 Societies should consider this in setting their lending policy, balancing the potential risks against the advantages of lowering the concentration risk to which they might be exposed.

Automatic valuation models (AVMs)

3.12 If a society proposes to use an automatic valuation model (AVM), either as part of its loan origination process or subsequent revaluation for credit decision purposes, it should do so within the terms of clear and well-considered policies.

3.13 In doing so it should note that, in the calculation of the credit risk capital component, in relation to risk weights assigned to exposures secured by mortgages on residential property, the property should be valued by an independent valuer at or less than market value.

3.14 An independent valuer is a person who possesses the necessary qualifications, ability and experience to execute a valuation and who is independent from the credit decision process.

3.15 This means that, for those purposes, the use of AVM output must always fall within a process leading to a valuation that can be ascribed to an independent valuer.

3.16 The society should also consider the limitations of AVMs before making a decision regarding whether an AVM is appropriate, particularly when the valuation plays an important role in the calculation of capital requirements.

3.17 In determining a reasonable approach to AVMs a society should consider that:

a. all AVMs have estimation errors;

b. there are strengths and weaknesses of various AVMs. For example, many AVMs could be well suited to urban areas with many similar properties, but most will find it difficult accurately to value a property with little in common to those close by, for example in rural areas;

c. AVMs should not be used to value non-domestic properties.

3.18 The higher the LTV, the greater the risk that an over-valuation of the property could result in the CRD risk weighting being misstated. Societies should be particularly careful in those situations.

3.19 If a society chooses to use AVMs, its lending policy should set out clearly when it intends to do so. For example, it may set a maximum LTV or loan amount. A society should also have procedures for reviewing its use of AVMs based on experience and market developments.

3.20 Statistical methods, such as house price indices or AVMs, can also be used to monitor the value of a property, identify property that needs revaluation and amend valuations assigned to a property. If AVMs are used in this way, the principles of AVM use are the same as for loan origination and societies should consider the appropriateness of AVMs to obtain a prudent value.

Non-traditional lending

3.21 Non-traditional lending can present additional risks, when compared with the more conventional prime owner-occupied lending model. The PRA expects societies to recognise this within their risk assessment and management processes, procedures and lending policy.

Sub-prime lending

3.22 Whilst the risk of default on sub-prime owner-occupied lending is initially greater than that for prime (all other things being equal) the PRA recognises that sub-prime borrowers may demonstrate affordability over time. In these circumstances, the PRA is content for societies to reclassify seasoned sub-prime lending as prime after five years (at the LTV at origination), if they wish to do so.

Buy-to-let

3.23 Whilst buy-to-let (BTL) lending is secured on residential property and therefore falls within the Building Societies Act nature limit (the statutory requirement that 75% of lending should be secured on residential property), it presents different risks to those of conventional residential mortgages to owner-occupiers.

3.24 The PRA expects Boards and Management to recognise that existing experience and skills in residential mortgage lending do not simply transfer to buy-to-let and that the potentially significant differences in risk profile mean that different post-completion administration arrangements will be appropriate

3.25 A society undertaking BTL lending should, when determining its risk appetite, have regard to the underlying commercial nature of this type of business. Relevant factors which societies should consider and address within their lending policy include:

a. the degree to which the investor borrower is dependent on the cash flow performance of the investment property to service the loan;

b. the basis on which the security is valued and rental income is assessed for underwriting purposes (including how rental voids are treated);

c. what tenancy basis and kinds of BTL are acceptable;

d. information required to assess the extent of the investor-borrower's broader exposure to the BTL sector (e.g. total number of properties in portfolio and whether encumbered or unencumbered);

e. the maximum permitted exposure to an investor-borrower or connected investor-borrowers (which may be based on value and/or number of investment properties held); and

f. what post-completion loan administration is required (and the extent to which this is appropriate and proportionate to the underlying commercial nature of BTL lending) including:

    i. monitoring of exposure on a scheduled basis (e.g. annual review); and

    ii. requirements for the investor-borrower to provide financial information on a periodic basis which enables the lender to have an appropriate understanding of their overall exposure.

Equity release: Lifetime Mortgages and Home Reversion Plans

3.26 Lifetime mortgages create a residential mortgage exposure (and fall within the nature limit) and also carry a morbidity risk associated with the potential deterioration of health of the borrower. In addition, those with interest roll-up features carry a mortality risk associated with the longevity of the loan, so their risks differ from conventional lending risks.

3.27 Because of these risk characteristics the PRA would not expect limited approach societies to offer such products where any applicant is under 65, nor to extend loans greater than 25% LTV for borrowers of 65. If they wish to offer larger LTV advances to older borrowers they should ensure that they have appropriate actuarial expertise to enable them to assess the associated risks.

3.28 Home reversion plans are likely to carry even more complex risks, since they not only have an actuarial risk but also expose lenders directly to variations in the market value of the property with which the individual plan is associated. As such, societies should enter those markets only if they have more sophisticated lending management control structures. In these circumstances, societies should set very conservative limits on the amount of such business that can be done.

Commercial lending

3.29 Commercial property may require different valuation skills to domestic property, and historically has a higher default rate than conventional owner-occupied lending. It may or may not fall within the nature limits, depending on whether the business of the commercial enterprise is to provide residential property.

3.30 Commercial lending can be divided into three broad types, owner occupied, commercial developments and investments. Each of these broad types typically has different associated risk profiles and is likely to require different risk management capabilities.

3.31 Societies on different lending approaches are likely to have different risk management capabilities with respect to the three types. Societies on the traditional approach should restrict themselves to owner-occupied commercial lending. The PRA expects that societies on the limited approach might have the risk management capabilities to undertake small scale residential development (ten properties or less) or small scale commercial investments.

3.32 Commercial lending may be 'lumpy' in character, particularly that falling into the commercial investments category. When considering the risks associated with any commercial lending, societies should be mindful of the absolute size of individual loans, their absolute total exposure to commercial lending and the extent to which they are exposed to concentration risk, whether geographic concentration, concentration to particular counterparties or particular sectors of the economy.

3.33 Societies should also be mindful of the additional complexity that may attach where commercial property is owned by a special purpose vehicle or where it is financed by a syndicated loan. Societies on either the traditional or limited approach should not undertake any syndicated lending.

3.34 Societies should also ensure that when undertaking commercial lending they establish that a realistic alternative use exists for the property, in case they later have to enforce the security.

Social landlords (including Registered Social Landlords)

3.35 Lending to housing associations can be difficult to evaluate and for smaller societies these can represent significant sized loans. Whilst loans may be low LTV, the saleability of underlying properties varies and would usually not be with vacant possession.

3.36 As such, societies considering such lending should consider not only the portfolio valuation but also the financial management record of the landlord, including arrears management and losses through voids. The skills necessary to undertake such assessments are those of underwriting commercial lending rather than residential lending, combined with a good understanding of the sector and its risk profile.

3.37 As such, societies should ensure that they have appropriate underwriting skills for this type of lending and that they set a maximum proportion of their lending book for these loans, to ensure that they retain a balanced portfolio.

Shared ownership lending

3.38 Shared ownership lending can be more complex than mainstream mortgage lending. Societies will need to assess the borrower's ability to afford the loan, which may be more complicated than for traditional lending. In addition, the value of collateral may be affected by conditions imposed by the social landlord on resale, for example to market the property only to those groups identified as a priority by the local authority.

3.39 Also, administering such lending is likely to be more resource-intensive than conventional lending, since the mortgage agreement is three-way and relationships with both the borrower and social landlord need to be maintained. Particular matters that societies should consider include (but are not necessarily restricted to) the following.

3.40 In the event of default, if monies raised by repossession and sale of the share purchase are insufficient to cover the debt the society has protections allowing it to recoup certain losses from the social landlord's share of the property so long as they have complied with required procedures at the time of extending the original and any subsequent amounts, and before taking action for arrears. Societies should ensure that they understand what protection is available and have procedures to ensure compliance with procedural requirements.

3.41 Security is held over the leasehold on the owned portion of the property, not the freehold. If the borrower fails to pay rent to the social landlord, the lease may be terminated by the landlord; if terminated then security for the loan would be lost.

Whilst a social landlord must inform a society and give it time to remedy the breach to retain the security (costs recoverable under the mortgage protection scheme) the PRA expects societies to consider how they will manage such risk situations and decide as a matter of policy which if any costs they will consider paying.

3.42 Given the added complexity and costs of administering such lending, societies should set a maximum proportion of their lending book for such loans, to ensure that they retain a balanced portfolio.

Board and management responsibilities

3.43 To comply with rule 2.1 of the General Organisation Requirements Part and 2.1 of the Risk Control Part of the Rulebook, societies should have a lending policy. This should be agreed and formally approved by the board and be consistent with the society's strategic plan and its financial risk management policy statement.

3.44 The board and management should take steps to ensure that staff involved in all aspects of lending are aware of the lending policy, both on an ongoing basis and particularly where the lending policy has been changed. What steps would be most appropriate to achieve this will depend on the number of staff concerned and the complexity of the lending policy.

3.45 To comply with rule 2.8 of the General Organisation Requirements Part (Regular monitoring), the PRA expects societies to check, on a regular basis, that staff are complying with this lending policy.

Lending policy

3.46 This section sets out the expectations of the PRA on the issues which should be addressed in the lending policy. The list of issues is not exhaustive, not all points will be relevant to all societies and societies may wish to combine some of the subjects within sections of their policy.

Contents of policy

The introduction section should include:

a. background to the society's approach to the management of credit risk, including its high-level lending strategy and its risk appetite expressed in a clear and numeric way that can be easily understood by all staff;

b. ratification process for obtaining board approval, including amendments to the policy statement as well as complete revisions; and

c. arrangements for, and frequency of, review (which should be conducted at least on an annual basis).

3.47 The objectives of the policy should cross-refer to the society's general statement of risk appetite (as set out in its ICAAP for Pillar 2 capital adequacy purposes), and should set out the society's general philosophical approach to lending.

3.48 The policy should set out the society's business and operational characteristics, including:

a. board controls and organisational structure/reporting lines;

b. high level framework for ensuring compliance with MCOB and other regulatory requirements;

c. delegation process and authorities;

d. new product development process and approved sources of new lending business;

e. marketing and administration controls; and

f. processes for ensuring compliance with policy (including arrangements for internal audit review etc).

3.49 The risk management section should include a description of:

a. the risk management structure and reporting lines;

b. controls over underwriting quality and adherence to delegated limits;

c. how risks associated with untypical cash flow characteristics (including interest roll-up and payment holidays) are to be managed;

d. training and competence requirements for underwriters and mortgage sales staff;

e. the process for developing internal risk scoring systems and procedures for risk categorisation including monitoring of manual overrides;

f. large exposure limits for connected counterparties, by loan and borrower type;

g. exposure limits for individual portfolios, including BTL portfolios;

h. concentration risk exposure limits by product type, borrower type, security type, introducer and geographical area (expressed both in terms of the overall lending book and as a proportion of new lending in a given period);

i. limits on the acquisition of individual loans or portfolios of loans, either by way of sub-participation or syndication;

j. the processes for ensuring how the success of risk management is to be assessed and potential lessons captured and used to amend underwriting policy as necessary; and

k. the management information to be reported to the board.

3.50 The lending permitted section should include details of the lending which the society intends to undertake by borrower and property/security type and origination source, including (as applicable):

a. prime residential mortgage lending to individuals;

b. near/sub-prime residential mortgage lending to individuals;

c. buy-to-let mortgage lending to individuals and corporate bodies;

d. shared-ownership residential lending to individuals;

e. second-charge residential lending to individuals;

f. lifetime mortgage lending to individuals;

g. home reversion plans for individuals;

h. commercial mortgages for owner-occupiers;

i. commercial mortgages for investors (both individuals and corporate bodies);

j. commercial property development loans, both on residential and commercial real estate;

k. lending to registered social landlords; and

l. unsecured lending to individuals (by way of personal loan, overdraft, credit card or otherwise).

3.51 The policy should also set out the acceptable types of security, including:

a. which types of security are acceptable (title, tenure, construction, location etc);

b. the maximum original loan to value ratio permitted for each lending type;

c. requirements for additional security such as guarantees, charges over other assets, life cover, accident/sickness/unemployment cover or for additional credit insurance (mortgage indemnity guarantee or similar) (including procedures for checking that such cover can be relied upon and is effective and checking the credit worthiness of the provider);

d. requirements for buildings insurance cover; and

e. arrangements for obtaining a reliable security valuation (including procedures for appointing valuers, use of automated valuation models).

3.52 The underwriting requirements for each type of loan should be specified in the policy, including:

a. minimum required levels of income (or rent) to confirm affordability of the loan for the borrower (including at higher rates of interest);

b. information requirements for verifying stated income/outgoings levels (for both individuals and corporate borrowers);

c. credit checks, credit scoring requirements, manual override flexibility arrangements;

d. requirements for face-to-face interviews, site visits, use of specialist advisers;

e. evidential requirements to establish the previous track record of the borrower; and

f. any requirements for third party references.

3.53 The policy should set out the basis for pricing new lending, including:

a. the required hurdle rate of return for new lending products;

b. requirements for adjusting pricing to reflect risk;

c. the approach to setting fees, routine charges and early repayment charges, etc; and

d. the methodology for setting and collecting early repayment charges.

3.54 The policy should be consistent with the provisions relating to conduct of business that apply to the society.

Lending risk management structures

3.55 Appendix 1 sets out the type of controls that the management of societies should put in place (and where appropriate clearly document within their lending policy documentation) in each of the three lending models to manage lending risk.

3.56 It sets out the expectations of the PRA on credit risk management processes and procedures in accordance with the three lending approaches. It shows the criteria which societies should use in assessing the controls over their lending book.

3.57 It is designed to draw management and supervisory attention to areas of a society's credit risk management which are different from the PRA's general expectation for societies on their respective lending approach.

3.58 Societies should expect their supervisors to focus in greater detail on those areas of difference, to identify whether business risks and controls are aligned and if not to develop plans to address the misalignment. As such, these expectations should not be interpreted as hard limits but as input into establishing appropriate policies and the basis for supervisory dialogue.

Lending types and lending limits

3.59 Given the lending risk management controls and processes, the lending limits which societies following one of the three lending models have in their lending policy should resemble the above table.

3.60 If a society plans to become exposed to mortgages of sub-types not covered in the above table, they should speak to their supervisor before entering the market, and again if their exposure reaches an agreed threshold to be set by the supervisor based on the perceived risk characteristics of the sub-type.

3.61 The table in Appendix 2 sets out the criteria which societies should use in assessing the controls over their lending book. It is designed to draw management and supervisory attention to areas of a society's business model which are different from the PRA's general expectation for societies on their lending approach.

3.62 Societies should expect their supervisors to focus in greater detail on those areas of difference, to identify whether business risks and controls are aligned and if not to develop plans to address the misalignment. As such, these expectations should not be interpreted as hard limits but as input into establishing appropriate policies and the basis for supervisory dialogue.

4 Treasury investments and liquidity risk management

Introduction

4.1 This chapter sets out the expectations of the PRA's specific to societies on management of their treasury investments, using the five approaches to financial risk management in order to enable them to comply with BIPRU 12, GENPRU 1.2 and General Organisational Requirements, Skills, Knowledge and Expertise, Compliance and Internal Audit and Risk Controls Parts of the PRA Rulebook. It outlines factors the PRA will consider when assessing the adequacy of a society's treasury investment risk management.

4.2 Treasury investments may be held for a variety of purposes which broadly fall into three categories:

a. assets held for inclusion in a society's liquid assets buffer as required by BIPRU 12.7;

b. other assets held operationally for matching and cash flow management purposes; and

c. assets which management have decided to hold in order to generate income.

Board and management responsibilities over treasury activities

Degree of risk

4.3 Financial risk management refers to the potential risks to societies of treasury activities. In particular, the size and complexity of some transactions can make them vulnerable to losses, and the impact of losses on individual transactions in the treasury area can be significant and immediate.

4.4 Boards have ultimate responsibility for deciding the degree of risk taken by their societies, including all categories of treasury assets and risks arising from the management of treasury activities.

4.5 A society specialises in long-term mortgage lending which is financed mainly by liabilities which are contractually short-term.

This feature of societies' business creates maturity mismatches which can give rise to cash flow imbalances.

4.6 To ensure that it can meet its obligations as they fall due, a society is required to hold an adequate liquid assets buffer of the kind described in BIPRU 12.7. In addition to cash flow mismatches which occur over time, societies can face intra-day mismatches, as outflows may precede inflows. Societies should ensure that they manage this risk in full compliance with the intra-day liquidity management provisions of BIPRU 12.3.17R to BIPRU 12.3.21E.

Liquidity policy statement

4.7 Societies should have a liquidity policy statement, which, among other things, includes the strategies, policies, processes and systems to manage liquidity risk, and the liquidity risk tolerance, required by BIPRU. The provisions on the responsibilities placed on a society's governing body to approve these strategies, policies, processes and systems and to establish and document a liquidity risk tolerance are set out in BIPRU 12.3.8R to BIPRU 12.3.13G.

4.8 The liquidity policy should be approved by the society's board and be consistent with the society's strategic plan and its financial risk management policy statement. Societies should also have regard to the provisions in GENPRU 1.2, and General Organisational Requirements, Skills, Knowledge and Expertise, Compliance and Internal Audit and Risk Controls Parts of the PRA Rulebook.

4.9 Where a society chooses to hold treasury investments other than for the purposes of its BIPRU 12 liquid assets buffer, then the society's liquidity policy statement should include all such investments.

4.10 Liquidity policy statements should set out the board's objectives for liquidity risk management, the limits within which liquidity should be maintained, the range of treasury investments in which the society can invest and conditions under which authority is exercised.

4.11 The document should establish the framework for operating limits and high level controls, and should set out the board's policy on credit assessment, ratings and exposure limits.

4.12 A liquidity policy statement should be a working document and personnel in the treasury and settlement areas should be familiar with its contents, as should members of ALCO and/or the Finance Committee. When aspects of the policy or limits change, the policy document should be amended as frequently as necessary. The board should agree all substantive changes.

4.13 Boards should establish the objectives for liquidity risk management, including meeting obligations as they fall due (including any unexpected adverse cash flow), smoothing out the effect of maturity mismatches and the maintenance of public confidence. The need to earn a return on treasury investments may also be recognised as an objective, although this should be secondary to the security of the assets. Societies should also have regard to the provisions in BIPRU 12.

4.14 If a society enters into a formal arrangement with a broker where securities are delivered to and from the broker and a customer agreement between the broker and the society is completed, the society should differentiate between advice and discretionary fund management.

4.15 If the society has entered into an agreement involving the provision of advice, it should ensure that no transaction is undertaken without its prior consent. As with discretionary fund management, societies should make certain that all transactions are within the terms of its liquidity policy statement.

4.16 Societies may, for convenience, wish to combine their liquidity policy statement with documentation required to satisfy the provisions of BIPRU 12.4 relating to contingency funding plans. If they do so, societies need to be clear how any combined document meets the separate requirements.

4.17 The liquidity policy statement should include a number of points which includes the following non-exhaustive list:

4.18 The introduction section should include:

a. background to the society's approach to liquidity risk management;

b. the ratification process for obtaining board approval, including amendments to the policy statement as well as complete revisions; and

c. arrangements for, and frequency of, review (which should be conducted at least on an annual basis).

4.19 The objectives section should set out whether the PRA has granted the society a simplified ILAS waiver of the kind described in BIPRU 12.6. A simplified ILAS BIPRU firm should still have a full liquidity policy statement.

4.20 The operational characteristics section should set out the society's business and operational characteristics, which impact on the amount and composition of liquidity and treasury investments, and the intended range for liquidity and liquidity net of mortgage commitments as a percentage of SDL.

4.21 The risk management section should include:

a. exposure policies, including controls and limits as appropriate, for countries, sectors and counterparties, including exposure to brokers;

b. the policy adopted for the use of credit ratings, stating the minimum quality acceptable and procedures for ensuring credit ratings are up to date, together with other information such as market intelligence which should also be reviewed when considering how to make treasury investments;

c. the policy of assessment to be adopted towards sectors that are non-rated;

d. operational and settlement risk, including: framework of board authorisation, delegations and operating limits (including, inter alia, dealer limits, transaction and day limits); deal authorisation, confirmation checking, segregation of duties;

e. the policy in regard to use of repo and reverse repo facilities and the potential encumbrance of treasury investments held;

f. procedures and criteria for exceptional overrides in relation to dealing, operational rules, limits and authorisation; and

g. the policy for liquidity risk management information and reporting to the board.

4.22 The maturity structure section should include the policy for maturity mismatch and a 'maturity ladder' of treasury investments. This should give a clear view of the maturity pattern of treasury investments to be followed, showing the maximum proportions to mature within each time band.

4.23 In relation to a society which is a simplified ILAS BIPRU firm, there should be a clear policy with regard to managing the peak cumulative wholesale net cash outflow over the next 3 months in order that an adequate liquid assets buffer is maintained.

4.24 The categories of assets and activities section should set out the society's policy for the following:

a. assets held in the liquid assets buffer;

b. inter-society and local authority deposits;

c. repo/reverse repo (both gilt-edged stock and non-gilt-edged securities);

d. stock lending;

e. mortgage backed securities (including, where applicable, US) mortgage backed securities and covered bonds;

f. foreign currency securities and the handling of foreign currency exposures (for those on the extended, comprehensive or trading approaches);

g. commercial paper;

h. bank deposits, certificates of deposit and other bank securities; and

i. collateral eligible for use in the Bank of England's open market operations and discount window facility

4.25 The society's policy for membership and use of any clearing system or depository should be set out clearly, including a section dealing with authorisation and operational controls. Liquidity implications and the role of standby facilities should be included in the policy statement.

4.26 The role of external professional advisers should be clearly stated, where applicable. Custody arrangements should be clearly set out. If the arrangement is to use services provided by a broker then a society should ensure that it retains legal ownership of the investments.

Appendix 3 sets out the criteria which societies should use in developing the review of financial risk management. It is designed to draw management and supervisory attention to areas of a society's business model which are different from the PRA's general expectation for societies on their respective treasury management approach.

4.27 Societies should expect their supervisors to focus in greater detail on those areas of difference, to identify whether business risks and controls are aligned and if not to develop plans to address the misalignment. As such, these expectations should not be interpreted as hard limits but as input into establishing appropriate policies and the basis for supervisory dialogue.

5 Funding

Funding risks

5.1 Societies' core business, financing long-term residential mortgages with short-term personal savings, necessarily involves a high degree of maturity transformation, and this constitutes a major financial risk that all societies need to manage.

5.2 Wholesale markets may provide funding at a more definitive maturity than deposit funding, but may concentrate the refinancing risks societies face. Exposure to re-financing risk needs careful management, and an awareness of the risk of over-reliance on an assumption of continued access to the wholesale market.

5.3 The particular constitution of societies means that the scale of deposit funding has a significant impact on the position of investor members. The public perceives society share accounts to be as secure as (or even more secure than) bank deposits although they hold a subordinated creditor rank.

5.4 A society which gears itself up significantly with wholesale funds thereby dilutes the security of its members, whilst at the same time increasing its refinancing and liquidity risks.

5.5 To access the wholesale markets some societies have been credit-rated by external agencies. Obtaining such a rating exposes the society to the danger of a change in market view of the sector or the society, and the process of obtaining and continuing management of the rating needs careful consideration and monitoring.

5.6 The PRA would not expect societies on the Administered or Matched approaches to have external ratings, and would expect societies on the extended approach, if they have external ratings at all, to confine them to covered bond issues only.

Wholesale maturity structure for a society which is a simplified ILAS BIPRU firm

5.7 For simplified ILAS BIPRU firms BIPRU 12.6.10 R sets out how they should calculate the wholesale net cash outflow component of their simplified buffer requirement

5.8 Whilst a society which is a simplified ILAS BIPRU firm may choose to fund lending activities with wholesale funding of duration greater than three months, such funding will still influence the peak cumulative wholesale cash outflow position (and thus the simplified buffer requirement) when it is within three months from maturity.

5.9 Societies using wholesale funding should therefore manage their wholesale maturity profile so that it does not cause excessive volatility to their liquid assets buffer.

5.10 To achieve this, a society which is a simplified ILAS BIPRU firm should ensure that its maturity profile of wholesale funding, net of any maturing treasury assets held to redeem the funding, resembles the respective profiles set out above.

5.11 Whilst the section 7 funding limit is expressed as a minimum of 50% share account funding, societies should, for prudential monitoring purposes, draw up a funding policy which incorporates an internal policy limit based on a maximum level of funds raised by means other than the issue of shares (i.e. an inversion of the ‘nature limit’).

5.12 In order to avoid any possibility of an inadvertent breach of the 1986 Act, these internal policy limits should be set at levels below the 50% statutory maximum.

5.13 Similarly, one of the conditions in BIPRU 12.6 to be satisfied by a firm for it to be eligible for a simplified ILAS waiver is that a minimum percentage of the firm's total liabilities are accounted for by retail deposits.

5.14 The funding policy drawn up by a simplified ILAS BIPRU firm should include an internal policy limit referring to a maximum percentage of the firm's total liabilities accounted for by liabilities other than retail deposits (i.e. an inversion of the condition in BIPRU 12.6). This maximum percentage should be set at a level below that necessary to satisfy the conditions in BIPRU 12.6.

5.15 In setting funding limits, the board should consider all funding requirements over the period of their society's current corporate plan, and avoid setting limits at levels where usage is either unplanned or highly unlikely.

5.16 Wholesale funding can be divided into three broad types originating from different sources: offshore/overseas retail deposits up-streamed to the society, deposits from non-financial /non-individuals and wholesale funding from the financial markets.

5.17 Boards should set policy sub-limits for each of these sources as well as an overall limit (e.g. a society might set an overall deposit liabilities limit of 30%, with sub-limits of 25% for wholesale deposit funding and 10% for offshore/overseas funding, the total of the sub-limits exceeding the overall limit only on the basis that both could not be used to their full extent simultaneously or to the extent that some of the funding is both wholesale and offshore/overseas).

5.18 The PRA would expect that societies adopting the extended, comprehensive or trading approaches to treasury management are likely to have the systems and capabilities to transact repo business. The PRA would expect that their boards would obtain full legal advice before agreeing counterparty documentation.

5.19 Whilst societies on the matched treasury risk management approach may have appropriate treasury risk management controls and procedures to undertake repo transactions, they should discuss any such plans with their supervisor before undertaking those transactions.

Funding risk management table

5.20 Appendix 4 sets out information on wholesale funding in accordance with the five approaches. It shows the criteria which societies should use in developing the review of financial risk management.

5.21 It is designed to draw management and supervisory attention to areas of a society's business model which are different from the PRA's general expectation for societies on their respective treasury management approach.

5.22 Societies should expect their supervisors to focus in greater detail on those areas of difference, to identify whether business risks and controls are aligned and if not to develop plans to address the misalignment.

5.23 As such, these expectations should not be interpreted as hard limits but as input into establishing appropriate policies and the basis for supervisory dialogue.

6 Financial risk management

Introduction

6.1 This chapter sets out the expectations of the PRA on financial risk management. As part of the implementation of the Capital Adequacy Directive (CAD), the Banking Consolidation Directive (BCD) and the Markets in Financial Instruments Directive (MiFID), provisions relating to a society's organisational and risk systems and controls have been introduced in General Organisational Requirements, Skills, Knowledge and Expertise, Compliance and Internal Audit and Risk Controls Parts of the PRA Rulebook.

6.2 This chapter generally explains the application of the high level requirements in General Organisational Requirements, Skills, Knowledge and Expertise, Compliance and Internal Audit and Risk Controls Parts of the PRA Rulebook (even if there may not be a specific cross reference) in the context of financial risk management.

General

Systems for controlling and managing financial risks

6.3 In meeting the requirements of rule 2.1 of General Organisational Requirements and rule 2.1 of Risk Control Part of the PRA Rulebook, in the context of financial risk management, a society should have an adequate system for managing and containing financial risks to the net worth of its business, and risks to its net income, whether arising from fluctuations in interest or exchange rates or from other factors.

Systems for controlling index-related risks

6.4 The arrangements, processes, and mechanisms required in rule 2.2 of Risk Control should include systems and procedures for identifying, monitoring and controlling all material maturity mismatch, interest rate, base rate, foreign exchange and similar (e.g. index-related) risks, and for reporting exposures to senior management and the board of the society on a regular, and timely, basis.

6.5 Societies should also have interest margin management systems in place to estimate the expected profitability of new mortgage and savings products, and to project forward the cumulative effect of mortgage incentives and loyalty schemes.

Credit limits for counterparties

6.6 Societies should have credit limits in place for all counterparties both for making treasury investments and for transacting derivative contracts.

Policy statement on financial risk management

6.7 In meeting the requirements in rule 2.3 of Risk Control Part of the Rulebook in the context of financial risk management, the board of a society should approve and periodically review a policy statement on financial risk management.

6.8 The policy statement establishes guidelines for the society's senior managers on the control of financial risks, including: operational risk; structural risk; funding risk; and counterparty credit risk (including settlement).

6.9 These documents should be consistent with the type of business undertaken by the society and compliant with sections 7 and 9A of the 1986 Act.

Policy statements on strategic framework for treasury operations

6.10 Policy statements should set out the strategic framework for treasury operations, recording the rationale for that framework, i.e. why and how treasury activities are expected to support the society's core business, and the ‘approach’ category being followed, derived, where possible, from the results of a financial risk review (either by the society's internal audit function or using external resources).

6.11 They should clearly state the conditions under which authority is delegated to a board sub-committee, or to management, and should establish the operating limits and high level controls that will maintain exposures within levels consistent with the policy, and the procedures/controls on the introduction of new products or activities.

6.12 Copies of the policy statements should be made available to, and read by, all personnel involved in treasury operations.

Structural risks

6.13 Most societies are susceptible to interest rate exposure arising not only as a result of changes (or potential changes) in the general level of interest rates or the relationship between short term and long term rates, but also from divergence of rates for different balance sheet elements (basis risk), for example, the risk that it may not be possible to decrease administered savings rates in line with decreases in money market (LIBOR) rates, resulting in a margin squeeze where lending is LIBOR-based.

6.14 In this chapter, risks which arise from the different interest rate or currency characteristics of assets and liabilities, and from transactions based on other financial reference rates or indices, are referred to as ‘structural’ risks.

Operational risks

6.15 The extension of society activities into more complex forms of funding, liquidity and off balance sheet instruments has dramatically increased the operational risks involved.

6.16 The documentation, accounting treatment and settlement procedures for such instruments can be highly complex, with significant costs and penalties arising from operational mistakes.

6.17 Societies involved in these areas of activity need rigorous management procedures and control systems to ensure that robust legal documentation is used, that compliance with market practice is achieved, and that deal recording and settlement systems are effective (with appropriate contingency arrangements in place).

Key risk categories

6.18 The key financial risks which societies should manage and control, are:

a. maturity mismatch, including the risks:

   i. that the society may be unable to refinance term wholesale borrowings on a rollover date due to general market conditions (which may or may not be related to the position of the society itself);

ii. associated with the bunching of roll-over dates for wholesale funding or maturities of term retail funding;

iii. from concentration on a limited number of funding providers, giving rise to increased dependence particularly on roll-over days; and

iv. arising from the prepayment (early repayment) profile of mortgages, and those inherent in the early withdrawal characteristics of retail savings products (i.e. behavioural as opposed to contractual maturity risks);

b. interest rate risk to a society's earnings (most significantly, to its interest margin) and to its economic value (the present value of future cash flows) arising from:

i. repricing mismatches, e.g. where, in a rising interest rate environment, liabilities reprice earlier than the assets which they are funding, or, in a falling rate environment, assets reprice earlier than the liabilities funding them (in both cases leaving the society with a reduction in future income); repricing risk is inherent in fixed rate instruments, the market value of which will change with interest rate movements (e.g. gilts), and unhedged fixed rate retail products (e.g. unhedged fixed rate mortgages funded by variable rate liabilities would yield less margin should the cost of the liabilities increase due to changes in market rates);

ii. yield curve risk, where unanticipated changes to the shape or slope of the yield curve will cause assets and liabilities to reprice relative to each other - possibly exposing positions which were hedged against a parallel shift in rates only;

iii. interest basis mismatches, arising from the imperfect correlation of rates on instruments with similar repricing characteristics, e.g. between LIBOR rates and mortgage rates (both of which are variable but are subject to different market forces), or between LIBOR and reference gilt rates, or between 3 and 12 month LIBOR rates etc. Risk can also arise where the underlying market rate is the same for matching assets and liabilities, but the margin paid relative to the offer rate diverges from the margin received relative to the bid rate

iv. balance sheet composition, where an increase in the proportion of assets and liabilities repricing at fixed or variable wholesale market rates implies a reduced administered rate element in the balance sheet, which will nevertheless have to bear (at least in the short term) the full brunt of any rate changes required in order for a society to widen its margins, if necessary for business or profitability reasons (e.g. in the event of a significant credit deterioration leading to rising provision levels);

v. optionality (i.e. explicit/contracted option contracts, such as ‘caps’, ‘collars’ and ‘floors’, which confer the right, but not the obligation, to fix an interest rate for an agreed amount and for an agreed period and embedded/implied options included within products, such as early withdrawal or redemption entitlements), magnifying the effect of other interest rate risks: in particular, societies may be subject to implied optionality in respect of retail savings rates (for which a minimum rate payable - a ‘floor’ - above 0% may need to be assumed), and from prepayment of mortgages/pre-withdrawal of deposits (where the customer may effectively have an ‘option’ which may not be adequately ‘hedged’ by way of early repayment charges); and

vi. product pricing, arising particularly where products are not immediately profitable and where longer term payback is dependent upon the achievement of specific cost and/or pricing assumptions;

c. currency risk, arising from the effects of changing exchange rates on unmatched assets and liabilities denominated in different currencies; and

d. index-related risk, arising from the effects of movements in an index of financial assets (e.g. the FTSE 100), or similar reference rate, on unmatched assets or liabilities paying or receiving a return based on that index/rate.

6.19 Societies' financial risk management policies should also cover:

a. settlement risk: the risk of losses arising from failure to settle transactions accurately, or on a timely basis;

b. counterparty risk: associated with settlement risk, where a counterparty cannot or will not complete a transaction; and

c. operational risk in treasury and related activities: including failure of internal controls or procedures, and the risk arising from errors in legal documentation.

IT security

6.20 Reliance on computerised dealing, information, treasury management and risk assessment systems renders societies particularly vulnerable to software or hardware failure. Boards of societies should:

a. ensure that treasury IT systems' access, both physical and logical, is subject to robust security;

b. exercise strong control over the development and modification of treasury IT systems; and

c. involve internal audit in reviewing the development or modification of treasury IT systems.

Risk management systems

6.21 This section amplifies rule 2.1 and rule 2.2 of Risk Control Part of the Rulebook specifically in the context of treasury management. A society should have in place information systems that are capable of:

a. measuring the level of maturity mismatch and structural risk inherent in its balance sheet;

b. assessing the potential impact of interest rate (and, if applicable, currency exchange rate) changes on its earnings and its economic value (including the effect of any standard interest rate shock as specified by the PRA in BIPRU 2.3);

c. reporting accurately, and promptly, on risk positions (to management, to the board and, if requested, to the PRA) including generating the information necessary to carry out its ICAAP and reporting the results of stress testing for interest rate risk in the banking book;

d. recording accurately, and on a timely basis, all new transactions and/or cash flows which will affect calculations of structural risk exposures;

e. managing the settlement timetable and processes for individual treasury instruments; and

f. monitoring credit risk and settlement risk positions incurred with individual and groups of counterparties.

6.22 The scale and scope of the risk measurement system employed should reflect the sophistication of a society's treasury operations, those societies wishing to adopt more sophisticated approaches requiring more complex techniques to capture different facets of risk.

Control limits

6.23 Control limits confine structural risk positions within levels considered by board and management to be prudent, given the size, complexity and capital needs of the society's business.

6.24 Where applicable, limits should also be applied to individual instrument types, asset/liability portfolios, and to separate business activities or subsidiary undertakings. Limits should also cover both the quantum and term/run-off of positions and should take due account of the extent to which margins are constrained, limiting business flexibility.

6.25 The structure of limits should enable the board and management to monitor actual levels of sensitivity, under different pre-defined market index, interest rate and exchange rate scenarios, against the policy specified maxima, to ensure that corrective action can be taken if required.

6.26 The number and type of limits which should be applied will depend upon the relative sophistication of a society's treasury operations.

6.27 Where limits are set as part of the overall board policy, these should be treated as absolute. Therefore any limit exceptions should be reported immediately to executive managers, and the policy should make clear what action is expected of management in those circumstances.

6.28 Limits set by management should similarly be subject to clear guidelines covering the circumstances and periods for which breaches may be permitted (if at all) and the arrangements for notification of exceptions.

Stress testing

6.29 The risk measurement systems put in place should evaluate the impact, on income or economic value as appropriate, of abnormal market conditions. The amount and type of the stress testing required will depend upon the sophistication of treasury operations undertaken, and the level of risk taken, but where required should be regular and systematic.

6.30 Within the range of scenarios tested, it is good practice for the scenario to reflect the events that would cause the society's business model to fail without any mitigating management action. Boards and management should, periodically, review the extent of that stress testing to ensure that any 'worst case' scenarios remain valid. Contingency plans should be in place to deal with the consequences should those scenarios become reality.

Board information reporting

6.31 The PRA attaches considerable importance to the quality, timeliness, and frequency of the management information which the board uses to satisfy itself that treasury activities are being undertaken in accordance with its policies and guidelines. Information obtained by the board should include regular and systematic stress testing, as described above, which should be taken into account when policies and limits are established or reviewed.

Counterparty risk

6.32 Counterparty limits should cover:

a. risk exposures (e.g. deposits or marketable instruments);

b. market risk exposures (e.g. mark to market positive value of swaps, plus appropriate addition for potential future exposure increases arising from changes in market rates); and

c. settlement risk exposures (e.g. currency deals where amounts are paid out before funds are received).

6.33 Boards should determine the extent to which authority to set counterparty limits is delegated to management, but delegation to a single individual should not be permitted. Personnel with dealing mandates should not be given authority to set new or increased counterparty limits. No dealings should take place with counterparties which do not have a pre-approved limit.

6.34 Limits should be established on the basis of a robust methodology, which should be fully documented and reviewed regularly. For societies with more active treasury operations, a separate credit risk committee with responsibility for preparing a credit policy statement and counterparty list may be appropriate; less active societies may incorporate a section on credit risk within their liquidity policy statements, with appropriate cross-references to other policy and procedures statements.

6.35 In all cases, the counterparty list and individual limits should be subject to formal credit review at least annually, with interim arrangements in place to add, amend or remove limits as appropriate.

6.36 If reliance is placed on sources of information or opinion external to both the society and the counterparty (e.g. rating agencies), the nature of the source, and arrangements for ensuring that the information relied upon is kept up to date, should be made explicit in the credit risk policy document and in procedures manuals.

6.37 Where ratings are reduced (or put on 'watch' with 'negative implications'), or where a society becomes aware of information on a counterparty which might affect its perceived creditworthiness (whether or not this results in a rate change), it should have systems for reviewing individual counterparty limits and, possibly, suspending or removing individual names from authorised lists in an expeditious manner.

6.38 Arrangements for obtaining information on counterparties where this is in the public domain should also be included in procedures manuals.

6.39 Exposures to counterparties should be monitored on a consolidated basis, aggregating exposures of the society and any subsidiary undertakings (where applicable), and setting total exposure limits for groups of connected counterparties. Similarly, country, sector and market concentrations should be monitored continuously against agreed limits.

Large shareholdings and deposits

6.40 Undue dependence on individual funding sources that account for a large proportion of a society's overall liabilities will involve risk of liquidity problems should those funds be withdrawn or not be available for roll-over. These potential problems apply whether the funds in question are raised from the retail or the wholesale markets.

6.41 A small society is relatively more exposed to this type of risk, and should consider the implications of concentration on individual shareholders or depositors when assessing its liquidity levels and need for committed facilities. In the management of large retail investment accounts, a society should normally avoid:

a. obtaining funding from a single shareholder or depositor which exceeds 1% of shares, deposits and loans; and

b. allowing the aggregate total of funding, from those single shareholders or depositors which individually represent more than one-quarter of 1% of shares, deposits and loans, to exceed 5% of shares, deposits and loans.

Committed facilities

6.42 A society with high levels of maturing funding, or vulnerability to withdrawal of individual deposits, may consider arranging committed facilities (or maintain higher than average levels of liquidity).

6.43 In arranging committed facilities, a society should consider:

a. the credit standing and capacity of the provider of the facility;

b. the documented basis of the commitment (i.e. is it an unconditional commitment or a ‘best endeavours’ arrangement); and

c. the cost/fee structure compared to alternatives.

6.44 In extreme cases, there remains a risk that a provider may renege on a contractual commitment to provide funding, or purport to rely on widely drawn ‘events of default’ or ‘material adverse change’ clauses, and face the legal consequences (if any) rather than lend money to a society in difficulties.

6.45 Societies should not, therefore, become over reliant on committed facilities to plug short term cash flow difficulties and should be cautious on how any such facilities should be treated in stress testing.

Independent review and controls

Internal audit

6.46 This section amplifies rule 3.1 of the Compliance and Internal Audit Part of the PRA Rulebook in the context of treasury management. Each board should ensure that its society's internal audit department (if it has one) has the skills and resources available to undertake an audit of the treasury function.

6.47 Internal audit should evaluate, on a continuing basis, the adequacy and integrity of the society's controls over maturity mismatch, over the level of structural risk taken and should assess the effectiveness of treasury management procedures.

6.48 Societies with complex treasuries or lacking internal auditors with treasury expertise may outsource treasury audit to an audit firm with the appropriate expertise and experience.

6.49 The work of outsourced internal audit should be fully integrated into the society's overall audit procedures and plans, with appropriate reporting lines into the audit committee. However, in order to avoid conflicts of interest, internal audit should not be contracted out to the society's own external auditors, even if the function were to be performed by a completely different branch of the audit firm.

6.50 Appendix 5 sets out information on financial risk management processes and procedures in accordance with the five approaches. It shows the criteria which societies should use in developing the review of financial risk management. It is designed to draw management and supervisory attention to areas of a society's treasury risk management which are different from the PRA's general expectation for societies on their respective treasury management approach.

6.51 Societies should expect their supervisors to focus in greater detail on those areas of difference, to identify whether business risks and controls are aligned and if not to develop plans to address the misalignment. As such, these expectations should not be interpreted as hard limits but as input into establishing appropriate policies and the basis for supervisory dialogue.

7 Business model diversification

Pre-notification of business model diversification

7.1 Any society which proposes to embark on any diversification into an area (whether regulated or unregulated, associated with the retail housing market or otherwise):

a. which is not covered by the tables in the Appendices; and

b. where the investment (of any form) to set it up exceeds 5% of own funds or the projected post implementation income within any of the 3 years following the diversification exceeds 10% of projected net interest margin plus other income net of commission paid for that year;

should pre-notify the PRA and provide a board-approved best/worst case analysis of the risks and potential exit costs, together with a revised ICAAP for supervisory review and evaluation before proceeding, whether the proposed diversification is by acquisition or by investment to enter an area or facilitate organic growth.

7.2 Societies should also note the provisions of section 92A of the 1986 Act in relation to acquisition or establishment of a business.

Appendix 1 – Credit risk management processes and procedures

	Traditional	Limited	Mitigated
Asset characteristics - high level	Mainly restricted to high quality lending to individuals, secured on residential property for owner-occupation purposes: • LTV <= 80% or with external insurance cover on higher LTV exposures or other recognised collateral • Fully underwritten • Restricted affordability criteria	A minimum of 50% of total loan assets to comprise high quality lending to individuals, secured on residential property for owner-occupation purposes: • LTV <= 80% or with external insurance cover on higher LTV exposures or other recognised collateral • Fully underwritten • Restricted affordability criteria Other lending controlled through structure of board-approved limits set at levels comfortably within statutory maxima.	Exposures to non-traditional lending allowed up to statutory maxima but controlled through: • Structure of board-approved limits (subject to PRA agreement) • Credit risk mitigation
Lending policy statement	Approved by board and reviewed at least annually		
Pricing model	Board to set clear hurdle return on new lending and articulate this through key operational plans Clear delegated responsibility for monitoring actual return achieved v hurdle on regular periodic basis		Board or appropriate committee to set clear hurdle return required on loan book as minimum approach - use of economic capital and risk-based return modelling encouraged
Risk appetite statement	Approved by board at least annually Reviewed to consider continued applicability at least semi-annually	Approved by board at least annually Reviewed to consider continued applicability quarterly	Approved by board or credit risk committee (or similar) at least annually Reviewed to consider continued applicability at least quarterly
Risk management structure	If no dedicated risk management function, CEO/FD will fulfil this role	Risk management function (fully independent of lending and sales functions) reporting direct to CEO	Head of Risk function (senior executive) supported by risk management team, reporting to credit risk committee (or similar)
Loan exposure restrictions	Lending policy restricts exposure to connected counterparties to <= 10% of capital resources	Lending policy restricts exposure to connected counterparties absolutely to <= 15% of capital resources	Lending policy does not restrict exposures within statutory or regulatory limits
Underwriting	Cases fully underwritten on an individual basis Limited delegation under mandates	Independent underwriting function Cases underwritten individually or	Independent underwriting function Cases systematically credit scored (with manual over-

	Traditional	Limited	Mitigated
	Board to approve all loans where aggregate exposure to borrower and/or connected clients => 2.5% of capital resources	systematically credit scored Hierarchy of fully delegated mandates (with exception reporting to senior management) Appropriate specialist expertise for all categories of non-residential lending May use specialist anti-fraud systems	ride where appropriate) Hierarchy of fully delegated mandates PD/LGD modelling Portfolio underwriting Appropriate specialist expertise for all categories of non-residential lending Use specialist anti-fraud systems
Risk mitigation	Risks mitigated by combination of: • conservative LTV or external insurance on exposures > 80% LTV • other recognised collateral • restricted affordability criteria	Risks mitigated by combination of: • conservative LTV or external insurance on exposures > 80% LTV • other recognised collateral • stop-loss/excess of loss insurance	Risks mitigated by combination of: • external insurance (where used) • other recognised collateral • stop-loss/excess of loss insurance (or similar) at pool or portfolio level • credit default swaps • loan book sales
Valuations	Undertaken by independent valuer AVMs within parameters recorded in policy statement	Undertaken by external or staff valuer AVMs within parameters recorded in policy statement	Undertaken by external or staff valuer AVMs within parameters recorded in policy statement
Segregation of duty between:			
Underwriting function and mortgage sales function (providing 'four-eyes' check over lending)	Segregation at executive manager level	Segregation at an operational level	Full segregation
Underwriting function and the lending review/audit/ compliance functions which check (1) compliance with underwriting and fraud policy and legislation; and (2) lending/ underwriting quality (by review of MI, live fraud cases, bad debt cases etc).	Segregation at executive manager level	Segregation at an operational level	Full segregation
Stress testing	Simple stress testing (changes in security values based on	Stress testing and scenario analysis (at level of individual asset	Econometric analysis and full stress testing/scenario analysis on at least

	Traditional	Limited	Mitigated
	appropriate HPI movements) undertaken on annual basis, or more frequently if market conditions warrant	pools) on semi-annual basis	quarterly basis
In this table: AVMs = automated valuation models HPI = house price index LTV = loan to value		Other recognised collateral = charge over acceptable assets, 3rd party guarantees etc	

Appendix 2 – Lending limits

	Lending types	**Normal loan to value at origination and other limits applying**	**Asset limits**	
			as % total loan book	as lending in rolling 12 month period
Traditional	Prime owner-occupier	<= 80% LTV, or >80% to 95% LTV with external insurance	Min 85%	Min 80%
		> 80% to <= 90% LTV without external insurance	Max 7.5%	Max 10%
	Prime Buy to Let	<= 70% LTV (min rental cover 130%, calculated assuming no void periods)	Max 15%	Max 20%
	Shared ownership	<= 90% of share purchased by borrower	Max 10%	Max 15%
	Social Landlords	<= 80%	Max 7.5%	Max 7.5%
	Commercial/FSOL	<= 50%	Max 5%	Max 10%
Limited	Prime owner-occupier	In total of which:	Min 65%	Min 55%
		<= 80% LTV, or >80% to 100% LTV with external insurance	Min 55%	Min 40%
		> 80% to <= 95% LTV without external insurance	Max 10%	Max 15%
	Prime Buy-to-Let	In total (min rental cover 125%, calculated assuming no void periods) Of which no lending > 80% LTV and	Max 25%	
		LTV between 60% and 80%	Max 20%	Max 20%
	Impaired credit history (all types)	<= 70%	Max 10%	Max 10%
	Lifetime mortgages	<= 25% (min age of youngest applicant => 65)	Max 10%	Max 15%
	Shared ownership	<= 95% of share purchased by borrower	Max 15%	Max 20%
	Social Landlords	<= 80%	Max 15%	Max 15%
	Commercial/FSOL	<= 60%	Max 10%	Max 15%
	Non-sterling mortgages	Only permitted where borrower also has income in relevant currency	Max 5%	Max 5%
Mitigated	Any lending permitted subject to statutory constraints and to lending policy set by management.			

In this table:

FSOL = fully secured on land

Shared ownership = part-owned by the occupier and part by a social housing provider. This does not include shared equity arrangements where the *society* takes part of the equity interest.

LTV is based at loan to value at origination and should be calculated after taking into account any alternative recognised collateral.

Appendix 3 – Treasury Investments

ADMINISTERED APPROACH		
TREASURY INVESTMENTS	Bank of England reserve account	No max
	Call deposits: bank	No max
	Term deposits: bank (includes CDs)	Max 15% SDL
	Term deposits: societies	Max 10% SDL
	Term deposits: Local Authorities/Regional Gvt	Max 10% SDL
	Gilts <3 years	No max
	Treasury bills	No max
	Designated money market funds	No max
	Qualifying money market funds	No max
Bank of England CAPACITY	Reserve account Standing deposit facility (if eligible)	
MINIMUM LIQUIDITY LIMITS	Simplified buffer requirement	
CURRENCY	Sterling only	
MATCHED APPROACH		
TREASURY INVESTMENTS	Bank of England Reserve account	No max
	Call deposits: bank	No max
	Term deposits: bank (includes CDs)	Max 15% SDL
	Term deposits: societies	Max 10% SDL
	Term deposits: Local Authorities/Regional Gvt	Max 10% SDL
	Gilts <5 years	No max
	Treasury bills	No max
	Designated money market funds	No max
	Qualifying money market funds	No max
	Reverse repo (Gilts only, after agreement with supervisor)	Up to limits above
Bank of England CAPACITY	Reserve account Standing deposit facility (if eligible)	
MINIMUM LIQUIDITY LIMITS	Simplified buffer requirement	
CURRENCY	Sterling only	
EXTENDED APPROACH		
TREASURY INVESTMENTS	Bank of England Reserve account	No max
	Call deposits: banks	No max
	Term deposits: banks (includes CDs)	Max 15% SDL
	Term deposits: societies	Max 10% SDL
	Term deposits: Local Authorities/Regional Gvt	Max 10% SDL
	Gilts <5 years	No max
	Gilts >5 years	Max 5% SDL

	Supranational Bonds <5 years	Max 5% SDL
	Treasury bills	No max
	FRNs, MTNs or fixed rate bonds <5 years	Max 5% SDL
	UK RMBS (senior securitised position only)	Max 5% SDL
	UK covered bonds (CRD compliant only)	Max 5% SDL
	Designated money market funds	No max
	Qualifying money market funds	No max
	Reverse repo	Up to limits above
Bank of England CAPACITY	Reserve account Standing deposit facility OMO counterparty (optional, subject to BoE acceptance)	
MINIMUM LIQUIDITY LIMITS	Simplified buffer requirement or individual liquidity guidance if a standard ILAS BIPRU firm	
CURRENCY	No less than 99.5% of total balance sheet assets and liabilities denominated in Sterling, US$ or € (whether on simplified buffer requirement or individual liquidity guidance if a standard ILAS BIPRU firm)	
COMPREHENSIVE and TRADING APPROACHES		
TREASURY INVESTMENTS	Self-defined list based on market depth and marketability (subject to satisfying the requirements of BIPRU 12)	Own defined limits
Bank of England CAPACITY	Reserve account Standing deposit facility OMO counterparty (subject to BoE acceptance)	
MINIMUM LIQUIDITY LIMITS	individual liquidity guidance	
CURRENCY	Any traded currency	

In this table:

CDs = certificates of deposit
FRN = floating rate note issued by bank or building society
ILAS = individual liquidity adequacy standards
MTNs = medium term notes
OMO = open market operations
RMBS = residential mortgage backed securities
Treasury Investments - all treasury investments including those held within the liquid assets buffer as required by BIPRU 12.7

In relation to minimum liquidity limits, a society that is a simplified ILAS BIPRU firm should note that the simplified ILAS approach does not relieve a simplified ILAS BIPRU firm from the obligation to hold liquidity resources which are adequate for the purpose of meeting the overall liquidity adequacy rule or from the obligation in BIPRU 12.3.4 R to assess and maintain on an ongoing basis the adequacy of its liquidity resources.

Appendix 4 – Wholesale Funding from Financial Markets

ADMINISTERED APPROACH		
WHOLESALE FUNDING FROM FINANCIAL MARKETS - OVERALL & SECTORAL LIMITS	Total Wholesale	Max 10% SDL
	Any single sector source	Max 5% SDL
MATURITY STRUCTURE OF WHOLESALE NET CASH OUTFLOW FROM FINANCIAL MARKETS	< 3 mths	Max 5% SDL
	< 12 mths	Max 10% SDL
FUNDING INSTRUMENTS	Term deposits and facilities	
EXTERNAL RATINGS	No	
Bank of England CAPACITY	Standing lending facility (if eligible) Discount window (if eligible)	
CURRENCY	Sterling only	
MATCHED APPROACH		
WHOLESALE FUNDING FROM FINANCIAL MARKETS - OVERALL & SECTORAL LIMITS	Total Wholesale	Max 15% SDL
	Any single sector source	Max 7.5% SDL
MATURITY STRUCTURE OF WHOLESALE NET CASH OUTFLOW FROM FINANCIAL MARKETS	< 3 mths	Max 5% SDL
	< 12 mths	Max 10% SDL
FUNDING INSTRUMENTS	Term deposits and facilities Repo (after agreement with supervisor)	
EXTERNAL RATINGS	No	
Bank of England CAPACITY	Standing lending facility (if eligible) Discount window facility (if eligible) OMO counterparty (optional, subject to BoE acceptance)	
CURRENCY	Sterling only	
EXTENDED APPROACH		
WHOLESALE FUNDING FROM FINANCIAL MARKETS - OVERALL & SECTORAL LIMITS		
For societies **wishing to operate the** simplified ILAS **approach**	Total Wholesale	See conditions in BIPRU 12.6
	Any single sector source	Max 7.5% SDL
For standard ILAS BIPRU firms	Total wholesale and sector limits as agreed individually	
MATURITY STRUCTURE OF WHOLESALE NET CASH OUTFLOW FROM FINANCIAL MARKETS		
For societies **wishing to operate the** simplified ILAS **approach**	< 3 mths	Max 5% SDL
	< 12 mths	Max 15% SDL
	< 2 years	Max 20% SDL
For standard ILAS BIPRU firms	As agreed individually	
FUNDING INSTRUMENTS	Term deposits and facilities CDs FRNs Fixed rate bonds Covered bonds Securitisations CP	

	Repo
EXTERNAL RATINGS	Covered bonds only
Bank of England CAPACITY	Standing lending facility Discount window facility OMO counterparty (optional, subject to BoE acceptance)
CURRENCY	No less than 99.5% of total balance sheet assets and liabilities denominated in Sterling, US$ or €
COMPREHENSIVE APPROACH	
W/SALE FUNDING FROM FINANCIAL MARKETS - OVERALL & SECTORAL LIMITS	Total wholesale and sector limits as agreed individually
MATURITY STRUCTURE OF WHOLESALE NET CASH OUTFLOW FROM FINANCIAL MARKETS	As agreed individually
FUNDING INSTRUMENTS	Term deposits and facilities CDs FRNs Fixed rate bonds Covered bonds Securitisations CP Repo
EXTERNAL RATINGS	Yes
Bank of England CAPACITY	Standing lending facility Discount window facility OMO counterparty (subject to BoE acceptance)
CURRENCY	Any traded currency
TRADING APPROACH	
WHOLESALE FUNDING FROM FINANCIAL MARKETS - OVERALL & SECTORAL LIMITS	Total wholesale and sector limits as agreed individually
MATURITY STRUCTURE OF WHOLESALE NET CASH OUTFLOW FROM FINANCIAL MARKETS	As agreed individually
FUNDING INSTRUMENTS	Bank loans B Soc loans LA loans CDs FRNs Fixed rate bonds Covered bonds Securitisations CP Repo
EXTERNAL RATINGS	Yes
Bank of England CAPACITY	Standing lending facility Discount window facility OMO counterparty (subject to BoE acceptance)
CURRENCY	Any traded currency
In this and subsequent tables: **CDs = certificates of deposit** **CPs = commercial paper** **FRNs = floating rate notes** **ILAS = individual liquidity adequacy standards**	

LA loans = local authority loans

Appendix 5 – Financial Risk Management

ADMINISTERED APPROACH	
RISK MANAGEMENT	CEO (+FD/FM) & Board Dealing / settlement segregation (4 eyes)
RISK ANALYSIS	None (but MTM fixed rate liquid assets at least monthly)
FIXED RATE LENDING/FUNDING	Commercial assets: Minimum 95% on administered rates Liabilities: Minimum 95% SDL on administered rates No fixed rate lending > 1 year
COUNTERPARTY LIMITS	Single name/connected group limits UK Counterparties only Instrument type and maturity limits
HEDGING INSTRUMENTS	None
TREASURY SYSTEMS/CONTROLS	Management accounting system Internal Audit
MATCHED APPROACH	
RISK MANAGEMENT	CEO + FD (or FM) & Board Dealing / settlement segregation (4 eyes)
RISK ANALYSIS	Matching Report + (min mthly) Gap Analysis Minimal gap/NPV limits (to cover residuals, prepayment and pipeline only) No structural hedging (incl reserves) No interest rate view Basis risk report
FIXED RATE LENDING/FUNDING	Commercial assets: A minimum of 65% either on administered rates or due to revert to administered rates in the next 12 months and of that a minimum 50% already on administered rates. Liabilities: Minimum 65% SDL on administered rates Fixed rate lending/funding max 5 years to reprice date (subject to limits). Max stock fixed rate (> 1 yr) 20% commercial assets + 20% SDL Max fixed rate lending/funding 25% loans advanced/retail funding p.a.
COUNTERPARTY LIMITS	Single name/connected group limits Country limits Instrument type and maturity limits
HEDGING INSTRUMENTS	Match funding Vanilla interest rate swaps Vanilla interest rate caps/collars/floors (purchase only) FTSE swaps (receive only)
TREASURY SYSTEMS/CONTROLS	Management accounting system Simple treasury matching system Internal Audit
EXTENDED APPROACH	
RISK MANAGEMENT	(CEO)/FD + Treasurer ALCO Front Office + Back Office
RISK ANALYSIS	Monthly (min.) static gap (+ static simulation modelling) Gap limits Sensitivity limits (NPV & NII) Structural hedging

	Reserves hedging (strategic) Interest rate view No FX mismatch Basis risk modelling
FIXED RATE LENDING/FUNDING	Commercial assets: A minimum of 50% either on administered rates or due to revert to administered rates in the next 12 months, and of that a minimum 30% already on administered rates. Liabilities: Minimum 45% SDL on administered rates
COUNTERPARTY LIMITS	Single name/connected group limits Country limits Sector limits Instrument type limits Currency limits
HEDGING INSTRUMENTS	Match funding Vanilla interest rate swaps Vanilla interest rate caps/collars /floors (purchase only) Swaptions (purchase only) FRAs / Futures (purchase only) FTSE swaps (receive only) FX swaps/forward contracts (purchase only) FX options (purchase only)
TREASURY SYSTEMS/CONTROLS	Treasury IT system capable of modelling optionality in static balance sheet. Specialist IT and Treasury Internal Audit
COMPREHENSIVE APPROACH	
RISK MANAGEMENT	FD + Treasurer (+Risk Director) ALCO + Daily Treasury Committee Front + Middle + Back Office
RISK ANALYSIS	Very frequent dynamic balance sheet modelling (future flows) Multiple scenario & yield curve simulation modelling with sensitivity limits (NPV & NII) Basis risk modelling Internal transfer pricing systems Structural hedging Reserves hedging (strategic) Interest view FX mismatch < 2% own funds
FIXED RATE LENDING/FUNDING	Commercial assets: Minimum 30% on administered rates Liabilities: Minimum 30% SDL on administered rates
COUNTERPARTY LIMITS	Comprehensive limit structure
HEDGING INSTRUMENTS	Match funding Complex interest rate swaps Complex interest rate caps/collars/floors (purchase only) Swaptions (purchase only) HPI derivatives (purchase only) Credit derivatives (purchase only) FRAs/Futures (purchase only) FTSE swaps (receive only) FX swaps/forward contracts (purchase only) FX options (purchase only)
TREASURY SYSTEMS/CONTROLS	Treasury IT system capable of projecting forward balance sheet and simulating different interest rate environments, plus measuring embedded optionality, basis risk etc. Specialist IT and Treasury Audit

TRADING APPROACH	
RISK MANAGEMENT	FD + Treasurer (+Risk Director) ALCO + Daily Treasury Ctee Front + Middle + Back Office Banking + Trading books
RISK ANALYSIS	Banking book: daily (min) duration / simulation analysis. Multiple yield curves and interest rate basis. Structural & reserve hedging Interest rate view. Trading book: Valuation at risk and equivalent measures. Daily P&L (MTM). Product, currency, counterparty limits. Dealing position limits etc.
FIXED RATE LENDING/FUNDING	No limits
COUNTERPARTY LIMITS	Comprehensive limit structure, including cross banking and trading book limits
HEDGING INSTRUMENTS	Any available (subject to the 1986 Act s9A restrictions on use)
TREASURY SYSTEMS/CONTROLS	Treasury IT system capable of projecting forward balance sheet and simulating different interest rate environments, plus measuring embedded optionality, basis risk etc. Trading book systems Specialist IT and Treasury Audit
In this table: ALCO = Assets and Liabilities Committee HPIs = house price indices MTM = mark to market NII = net interest income NPV = net present value	