BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Consultation Paper | CP24/19

Asset encumbrance

September 2019

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Responses are requested by Friday 17 January 2020.

Please address any comments or enquiries to:

Liquidity Team, Banking Policy TS03-CD
Prudential Regulation Authority
20 Moorgate
London
EC2R 6DA

Email: CP24_19@bankofengland.co.uk

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1 Overview

1.1 In this consultation paper (CP), the Prudential Regulation Authority (PRA) sets out its proposed expectations of firms when managing the key prudential risks associated with asset encumbrance, specifically in the contexts of managing liquidity and funding risks, recovery planning, and resolution. The PRA's proposed expectations relate both to firms' internal monitoring and management of these risks, and to the information that firms are expected to provide to the PRA through their periodic regulatory submissions, eg Internal Liquidity Adequacy Assessment Process (ILAAP) documents and recovery plans.

1.2 This CP is relevant to all PRA-authorised firms, except credit unions and insurance firms.

1.3 The proposals relate to expectations on firms' compliance with specific aspects of existing PRA rules, namely those in the Internal Liquidity Adequacy Assessment (ILAA), Recovery Planning, and Resolution Pack Parts of the PRA Rulebook. The PRA would give effect to the expectations proposed in this CP by way of amendments to the following Supervisory Statements:

- Supervisory Statement (SS) 24/15 'The PRA's approach to supervising liquidity and funding risks' (Appendix 1);[1]
- SS9/17 'Recovery planning' (Appendix 2);[2] and
- SS20/15 'Supervising building societies' treasury and lending activities' (Appendix 3).[3]

Background

1.4 For the purposes of this consultation, encumbered assets should be understood as those which are pledged or otherwise committed to counterparties to secure, collateralise or credit-enhance a transaction, such that the assets cannot be freely transferred, withdrawn, liquidated, sold or disposed. The counterparties to which the assets are pledged, such as secured creditors, have prior claim on encumbered assets in the event of insolvency. Firms can encumber assets whether they are recorded on- or off-balance sheet. In some circumstances, any residual value from over-collateralisation may not be released to other creditors for a long time period.

1.5 Firms encumber assets in a variety of circumstances, including when offering collateral to the Bank of England (Bank) in its role as central bank. The Bank offers liquidity insurance facilities that allow eligible firms to borrow cash (in the form of reserves) or to swap illiquid assets for more liquid ones (known as a collateral 'upgrade'). The Bank operates a range of published facilities that do this, on market-wide terms, at various frequencies including the routine Indexed Long-Term Repo (ILTR) and the on-demand bilateral Discount Window Facility (DWF).

1.6 Secured funding can increase the diversity of firms' funding sources, and acts as a resilient source of financing in stressed conditions when investors demand greater security. Therefore, secured funding has a key role to play in the stability of firms' funding, and the PRA does not

1 June 2019: www.bankofengland.co.uk/prudential-regulation/publication/2015/the-pras-approach-to-supervising-liquidity-and-funding-risks-ss.
2 December 2017: www.bankofengland.co.uk/prudential-regulation/publication/2017/recovery-planning-ss.
3 January 2017: www.bankofengland.co.uk/prudential-regulation/publication/2015/supervising-building-societies-treasury-and-lending-activities-ss.

consider asset encumbrance to be undesirable of itself. A certain amount of encumbrance in normal times can also reduce firms' funding costs and make it more likely that they will be able to scale up their secured funding in stress: they already have the systems, expertise and policies in place to be active in those markets.

1.7 But elevated asset encumbrance in normal times can pose certain prudential risks. The PRA proposes that it is essential that firms consider these risks appropriately, that they articulate tolerances for them and monitor them through clearly defined metrics, and that they set limits where appropriate.

1.8 In this CP, the PRA proposes to clarify its expectation that firms demonstrate that they have considered these factors appropriately, for example in the ILAAP document, the recovery plan and, for applicable firms, as part of their assessments of their preparations for resolution.

1.9 As well as the publication of this CP, the PRA also plans to enhance its monitoring of firms' asset encumbrance levels and the amounts of liquidity that they might be able to generate from unencumbered assets in a stress, in response to the report following HM Treasury's 'Independent review of the prudential supervision of The Co-Operative Bank Plc'.[4] In particular, this monitoring will draw on information held by the PRA and the Bank, including regulatory returns such as the Common Reporting Standards (COREP), Financial Reporting Standards (FINREP) and PRA110. The PRA expects that this work will assist the PRA in identifying potential concerns relating to firms' levels of asset encumbrance and to the amounts of liquidity which firms would be able to generate in stress. It will also assist in identifying firms which appear to be particularly susceptible to risks associated with excessive asset encumbrance, and those whose levels of asset encumbrance appear to be high given factors such as their business and funding models.

1.10 Firms will differ significantly in terms of the proportion of their assets which are encumbered in normal times, the types of assets which are encumbered, the means by which they are encumbered, and the counterparties to whom they are encumbered. Therefore, the PRA does not envisage a 'one-size-fits-all' approach. The risks will depend in part on firms' business and funding models, and on other factors such as their capital adequacy. Firms whose business is primarily focused on the UK residential mortgage market, for example, are likely to have a less diverse pool of assets to encumber as needed than firms with a more diverse balance sheet. Firms whose funding comprises a larger proportion of wholesale unsecured funding will be more vulnerable to the risks arising from the structural subordination of their unsecured creditors in the creditor hierarchy. Firms with smaller buffers to minimum capital requirements may be more vulnerable to a deterioration in market perception arising from increasing asset encumbrance. The PRA expects firms to consider appropriately how risks associated with asset encumbrance are relevant to them, with specific reference to these and other factors.

1.11 With the proposals in this CP, the PRA aims to support firms in demonstrating a consistently high standard of risk management practices, including through their periodic submissions to the PRA (eg in their ILAAP documents and recovery plans).

4 The 'Zelmer Report' published on 27 March 2019: www.gov.uk/government/publications/independent-review-of-the-prudential-supervision-of-the-co-operative-bank-plc.

Summary of proposals

1.12 The policy proposals included in this CP involve amendments to existing SSs to make clear that:

(i) firms should consider appropriately and thoroughly the potential impacts that asset encumbrance can have on their funding profiles, and put in place adequate risk management processes which include monitoring key metrics at appropriate committees, with clearly defined accountability for risk management, setting limits where appropriate;

(ii) firms should document the above adequately in their ILAAP documents;

(iii) building societies should manage their asset encumbrance in line with the PRA's existing expectations and proposed expectations set out in SS20/15, as well as with the PRA's proposed expectations for all firms in SS24/15 and SS9/17;

(iv) firms should consider appropriately the effects that increased asset encumbrance might have on their abilities to maintain or restore their financial viability during a variety of stress scenarios; and

(v) firms should ensure that their levels of asset encumbrance do not unduly impair the amount and cash value of the assets which could be lent against in resolution, including by the Bank within its usual risk tolerance.

Responses and next steps

1.13 This consultation closes on Friday 17 January 2020. The PRA invites feedback on the proposals set out in this consultation. Please send any comments or enquiries to CP24_19@bankofengland.co.uk.

1.14 The PRA will keep its proposed approach and policy under review to assess whether any adjustments are required, including in light of the planned introduction of the Net Stable Funding Ratio (NSFR) standard. In particular, the PRA will monitor the quality of information provided by firms in their ILAAP documents, recovery plans and, for applicable firms, as part of their assessments of their preparations for resolution, to ensure it is sufficient to meet the expectations set out in these proposals.

1.15 The proposals set out in this CP have been designed in the context of the current UK and EU regulatory framework. In the event that the UK leaves the EU with no implementation period in place, the PRA has assessed that the proposals would not need to be amended under the EU (Withdrawal) Act 2018 (EUWA). Please see PS5/19 'The Bank of England's amendments to financial services legislation under the European Union (Withdrawal) Act 2018'[5] for further details. The draft amendments to SSs attached to this CP should also be read in conjunction with SS1/19 'Non-binding PRA materials: The PRA's approach after the UK's withdrawal from the EU'.[6]

5 June 2019: www.bankofengland.co.uk/paper/2019/the-boes-amendments-to-financial-services-legislation-under-the-eu-withdrawal-act-2018.

6 February 2019: www.bankofengland.co.uk/prudential-regulation/publication/2019/non-binding-pra-materials-the-pras-approach-after-the-uks-withdrawal-from-the-eu-ss.

2 Proposals

2.1 The following section sets out the PRA's proposed expectations of firms' management of the risks associated with asset encumbrance. The relevant areas are:

- Stability of funding.
- Recovery planning.
- Resolution.

Stability of funding

2.2 This section summarises the PRA's view of how risks associated with asset encumbrance may affect the stability of firms' funding profiles, and sets out the PRA's proposal for how firms should manage those risks. The PRA considers asset encumbrance to be relevant to the requirement that firms ensure that they maintain a prudent funding profile,[7] and that they act in a prudent manner and maintain adequate financial resources.[8]

2.3 A firm's funding stability refers to its ability to retain and roll over or renew its funding under both normal and stressed conditions. The stability of a firm's funding profile depends on the behavioural stability of its deposits, the maturity profile and behavioural stability of its other funding sources, and its ability to continue to access wholesale funding markets in stressed market conditions.

2.4 Secured funding increases banks' funding diversity and acts as a resilient source of funding in stressed conditions when investors demand greater security. Secured funding therefore has a key role to play in the stability of banks' funding.

2.5 But the PRA considers that excessive asset encumbrance in normal times may affect negatively the stability of a firm's funding profile. As a firm encumbers a higher proportion of its available assets in normal times, it will have less capacity remaining should a stress occur to encumber additional assets in order to raise cash to meet its obligations. This makes the firm less resilient to stress, which may cause creditors to charge higher spreads or respond more quickly to signs of stress. Therefore higher levels of asset encumbrance in normal times can negatively affect funding stability by making a firm less resilient to stress.

2.6 As the market's confidence in a firm diminishes, for example in a stress, creditors and counterparties may seek to apply larger haircuts on collateral and make margin calls. High levels of encumbrance may therefore give rise to an adverse feedback loop which could lead to yet higher encumbrance, diminishing the firm's capacity to generate additional liquidity even further. This risk may be particularly acute in certain arrangements, such as some derivative positions, where changes in the amount of collateral which the firm must provide are volatile and depend on a number of variables.

2.7 Secured creditors have prior claim on encumbered assets in the event of the borrower's insolvency. Encumbrance therefore subordinates other, unsecured creditors in the creditor

7 Internal Liquidity Adequacy Assessment (ILAA) Part, 2.2.
8 PRA Fundamental Rules 3 and 4.

hierarchy, which may increase their losses in the event of the firm's default. Consequently, unsecured creditors may react more quickly to signs of stress in firms with higher levels of encumbrance. This is an additional channel through which asset encumbrance can negatively affect funding stability.

2.8 The PRA proposes that firms would be expected to consider appropriately and thoroughly the potential impacts that asset encumbrance can have on the stability of their funding profiles. These impacts include, but are not necessarily limited to, the issues described above. As such, firms would be expected to consider how low levels of good quality unencumbered assets may reduce their capacity to withstand a funding stress. They would be expected to consider the impacts that this may have on market perceptions and therefore on the cost and stability of their funding sources. This would include the propensity of their deposits to run in stress, and the risk that the firm would need to encumber additional assets in stress to meet the demand for increased haircuts and margin calls. The PRA proposes that, as part of this, firms would ensure that they are able to measure and monitor the amounts and sources of encumbrance, and the likely liquidity value of assets that are unencumbered.

2.9 The PRA also proposes that firms would be expected to define their tolerance of those risks through clearly defined metrics that are monitored regularly, using good quality and timely data, at appropriate forums (eg board risk committees). Where appropriate, boards and risk functions would be expected to set limits which constrain the business to ensure that risks associated with asset encumbrance are kept within tolerance.

Building societies

2.10 The PRA acknowledges that there are currently a number of specific expectations for building societies in relation to asset encumbrance set out in SS20/15. The PRA proposes that its expectations for building societies should be brought into line with those of other firms. As such, the PRA is consulting on a number of amendments to SS20/15 to bring it in line with the expectations that the PRA proposes to set out in SS24/15 and SS9/17.

2.11 SS20/15 sets out the PRA's expectations that societies set a board-level limit on market encumbrance, excluding central bank funding and asset swaps.[9] The PRA proposes that societies would be expected to set limits as they consider appropriate for all kinds of encumbrance, including encumbrance with central banks.

2.12 The PRA proposes to include in its expectations of societies using the 'administered approach' that they should set board-approved limits on their funding from, and encumbrance with, central banks (recognising that the PRA does not expect those societies to have access to wholesale funding from other sources).[10]

2.13 Societies using the 'matched' approach would set board-approved internal limits on asset encumbrance, and would set sub-limits by type of exposure as appropriate.[11]

2.14 Regarding the PRA's expectations of societies using the 'extended approach', the PRA currently expects that those societies set a limit on encumbrance to counterparties other than central banks

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9 Paragraph 4.93 of SS20/15.
10 Paragraph 4.140 of SS20/15.
11 Paragraph 4.147 of SS20/15.

which does not normally exceed 20% of total assets.[12] The PRA expects that societies treat the suggested limits in SS20/15 as indicative only. It is for each society to determine its own individual approach, based on its specific risk appetite, corporate plan and risk management capabilities. The 'extensions' arrangements set out in Chapter 5 of SS20/15 apply in the normal way to setting limits on asset encumbrance. The PRA proposes that societies also set limits on total encumbrance (including to central banks).

2.15 The PRA also proposes to redraft paragraph 4.94 of SS20/15 to clarify the PRA's expectations. Namely, the PRA proposes to make clear that societies should not count encumbrance twice if they receive government bonds from a central bank in exchange for collateral, and then re-hypothecate those bonds for cash by way of a repurchase agreement ('repo'). The PRA considers that this is already the meaning of the paragraph, but that minor redrafting would make the point clearer for firms.

Recovery planning

2.16 This section summarises the PRA's proposed expectations of how firms should consider asset encumbrance for the purpose of their recovery planning.

2.17 The PRA already requires firms to undertake recovery planning so that they are ready for periods of financial stress, can stabilise their financial position and can recover from financial losses.[13] The PRA also currently expects firms to:

- have a number of recovery options, and maintain and test their plans;[14] and
- ensure they have sufficient credible options to restore their capital and liquidity positions to appropriate levels in, or following, a stress.[15]

2.18 It is important that firms are aware of the total liquidity they could credibly generate in a range of stresses if they needed to do so, and that they demonstrate to the PRA that there is sufficient recovery capacity to maintain or restore their financial viability. Firms may seek to encumber assets for part of this capacity. This liquidity may be raised from central banks (eg through the Bank's sterling liquidity facilities) and/or the private market.

2.19 Where encumbrance forms part of a firm's recovery strategy, the PRA considers that a necessary part of this assessment is determining what assets could be pledged to secure funding, how much liquidity could be raised by doing so, and over what period.

2.20 The PRA proposes that firms consider at least the following factors in making that assessment:

(a) Firms' assessments are sensitive to the specific characteristics of the stress scenarios they employ (for example, the amount of funding which can be secured against a given pool of UK residential mortgage assets may be significantly reduced if the stress scenario in question affects, in particular, the UK housing market). As stated in SS9/17, those stress scenarios should be relevant to the firm's business model and be sufficiently severe to test the plan.

12 Paragraph 4.163 of SS20/15.
13 Paragraph 1.6 of SS9/17.
14 Paragraph 1.6 of SS9/17.
15 Paragraph 2.42 of SS9/17.

(b) Firms consider the possible effect of elevated asset encumbrance during stress on the availability, cost and stability of its other sources of funding, such as in the wholesale unsecured market. Firms articulate how the evolving profile of asset encumbrance compares against their tolerance for the risks that encumbrance poses in normal times. Given these, firms are able to articulate the profile of key asset encumbrance metrics throughout each scenario in the plan.

(c) Firms identify how they plan to return their levels of asset encumbrance to within appetite following the stress. They consider how the evolving profile of asset encumbrance can affect their recovery strategy (eg cost of issuing new capital) in a scenario where the firm is aiming to restore both its liquidity and capital position.

2.21 The PRA already expects firms' Individual Capital Adequacy Assessment Process (ICAAP), ILAAP, recovery plan, and (where applicable) concurrent stress testing documents to be consistent with each other.[16] As such, the analysis on asset encumbrance in a firm's recovery plan should be consistent, where relevant, with that in its ILAAP and ICAAP.

Resolution

2.22 The Bank as UK resolution authority is responsible for taking action to manage the failure of financial firms in the UK. This includes developing strategies in normal times to resolve individual firms in the event of their failure, and assessing and removing potential barriers to resolution. The PRA works with the Bank in its resolution capacity to ensure that any PRA-regulated firms that fail do so in an orderly manner. This derives from the PRA's statutory obligation to advance its general objective – to promote the safety and soundness of the firms it regulates – in part by seeking to minimise the adverse effect that the failure of one of those firms could be expected to have on the stability of the UK financial system.[17]

2.23 One potential barrier to resolution is inadequate financial resources, which includes inadequate access to liquidity to continue to meet obligations as they fall due throughout a resolution. The amount and nature of a firm's available (unencumbered) assets at the point of entry into resolution clearly affects how much liquidity it could raise if needed.

2.24 To facilitate developing each firm's resolution strategy, the Bank conducts a regular resolvability assessment. As part of this, the Bank considers, among other things, whether limited access to liquid resources during resolution might present a barrier to an effective resolution. The Bank expects to see that firms can estimate, anticipate and monitor their potential liquidity resources and needs, and to be able to model their liquidity needs in the approach to, and throughout, a resolution.[18] Under the Resolution Assessment Part of the PRA Rulebook, the PRA requires firms with retail deposits equal to or greater than £50 billion on an individual or consolidated basis to assess their preparations for resolution, and to submit a report of their assessment to the PRA every two years starting by Friday 2 October 2020.[19] As part of this assessment, the PRA expects firms to assess whether they have the capabilities, resources and arrangements to ensure that they have adequate funding to meet obligations as they fall due.[20]

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16 Paragraph 2.95 of SS9/17.
17 Section 2B (1), (3)(b) FSMA 2000.
18 Paragraph 4.8 of Policy Statement 'The Bank of England's approach to assessing resolvability' July 2019: www.bankofengland.co.uk/paper/2019/the-boes-approach-to-assessing-resolvability.
19 Resolution Assessment Part, 1.1, 3.1.
20 Paragraph 2.11 of SS4/19.

Firms should identify any risks which could prevent this outcome from being achieved and detail the steps they intend to take to reduce or remove those risks.[21]

2.25 The PRA considers that one such potential risk is that a firm's asset encumbrance profile in normal times unduly impairs the amount and cash value of the assets which the firm could encumber with market counterparties, or the Bank within its usual risk tolerance, to allow for the effective implementation of the firm's resolution strategy.

3 The PRA's consultation process

3.1 The PRA has a statutory duty to consult when introducing new rules and, when not making rules, has a public law duty to consult widely where it would be fair to do so. When doing so, the PRA provides the following in relation to the proposed policy:

- a cost benefit analysis;
- an explanation of the PRA's reasons for believing that making the proposed policy is compatible with the PRA's duty to act in a way that advances its general objective, insurance objective (if applicable), and secondary competition objective;
- an explanation of the PRA's reasons for believing that making the proposed policy is compatible with its duty to have regard to the regulatory principles; and
- a statement as to whether the impact of the proposed rules will be significantly different to mutuals than to other persons.

3.2 The Prudential Regulation Committee (PRC) should have regard to aspects of the Government's economic policy as recommended by HM Treasury.[22]

3.3 The PRA is also required by the Equality Act 2010[23] to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services and functions.

Cost benefit analysis

3.4 The proposals contained in this CP fall into three categories: (i) expectations of firms to develop adequate frameworks, processes and accountabilities to manage the risks associated with asset encumbrance; (ii) expectations of firms to take steps to ensure that the risks associated with asset encumbrance remain within an appropriately defined appetite; and (iii) expectations of firms to demonstrate the adequacy of their frameworks, processes and accountabilities to the PRA through regulatory submissions and continuous assessment.

Expectations of firms to develop adequate frameworks, processes and accountabilities to manage the risks associated with asset encumbrance

3.5 The PRA already requires firms to 'act in a prudent manner and maintain adequate financial resources'.[24] In addition, firms must already put in place risk management policies that define their

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21 Paragraph 2.6 of SS4/19.
22 Section 30B of the Bank of England Act 1998.
23 Section 149.

approach to asset encumbrance, as well as procedures and controls that ensure that the risks associated with collateral management and asset encumbrance are adequately identified, monitored and managed.[25] Firms must already ensure that their liquidity risk and funding risk appetites are appropriate for their business strategies and reflect their financial conditions and funding capacities.[26] Firms must already produce timely information for their management bodies on, among other things, the amount, expected level and credit quality of unencumbered assets that are capable of being encumbered, specifying the volume of assets available for encumbrance and the expected amount, level and types of additional encumbrance that may result from stress.[27]

3.6 The proposed expectations set out in this consultation only expand on specific aspects of the existing rules above; they do not create any new rules. The PRA believes that firms do not all currently meet all expectations proposed in this consultation. Following this consultation (and upon publication of the Policy Statement with finalised expectations), the PRA expects that some firms will need to incur some cost to design and implement adequate risk management frameworks, policies and accountabilities. The PRA expects this cost to be limited, especially for firms whose business and funding models give rise to fewer and less significant risks associated with asset encumbrance, and for firms which already demonstrate better risk management practices.

Expectations of firms to ensure that risks associated with asset encumbrance remain within an appropriately defined appetite

3.7 The PRA already requires firms to 'act in a prudent manner and maintain adequate financial resources'.[28] The PRA also already requires that firms' liquidity resources must remain 'adequate, both as to amount and quality' to ensure that there is no significant risk that the firm's liabilities cannot be met as they fall due.[29] Firms must maintain a 'prudent funding profile'.[30]

3.8 As above, the proposed expectations set out in this consultation only expand on specific aspects of the existing rules above; they do not create any new rules. If a firm meets the expectations proposed in this consultation, as well as the broader framework of rules and expectations currently in place, and then determines that some risks associated with asset encumbrance are beyond its appropriately-defined appetite, then the PRA would expect the firm to return those risks to within appetite over a reasonable timeframe, as part of the PRA's requirement that firms act in a prudent manner.

3.9 Firms might do this by changing their approach to asset encumbrance (eg by reducing the amount of encumbrance or the assets encumbered), or by otherwise mitigating the risks that are associated with asset encumbrance. The PRA expects that either action will incur some cost. The extent of this cost will depend on the size of the firm, the complexity of its funding profile, and the extent to which it is outside of its appetite for risks associated with asset encumbrance. But the PRA considers that any additional cost would be exceeded by the benefits of the firm having brought prudential risks to within its own appetite. The PRA expects that this will make the firm more resilient to stress and have a more stable funding profile.

24 PRA Fundamental Rules 3 and 4.
25 Internal Liquidity Adequacy Assessment Part of the PRA Rulebook, 3.4.
26 Internal Liquidity Adequacy Assessment Part of the PRA Rulebook, 4.1(2).
27 Internal Liquidity Adequacy Assessment Part of the PRA Rulebook, 10.2(2)(b-c).
28 PRA Fundamental Rules 3 and 4.
29 Internal Liquidity Adequacy Assessment Part of the PRA Rulebook, 2.1.
30 Internal Liquidity Adequacy Assessment Part of the PRA Rulebook, 2.2.

Expectations of firms to demonstrate the adequacy of their frameworks to the PRA through regulatory submissions and continuous assessment

3.10 The PRA already requires firms to produce ILAAP documents which contain firms' assessments of the adequacy of their liquidity and funding.[31] The PRA will assess whether a firm, in its ILAAP document, has adequately identified its liquidity needs across appropriate time horizons in severe but plausible stresses for all relevant risk drivers and whether its liquidity resources are adequate to meet those needs.[32] The PRA also already requires firms to draw up and maintain a recovery plan providing for measures to be taken by firms to restore their financial positions following a significant deterioration of their financial situations.[33] Firms must already submit their recovery plans to the PRA.[34] The PRA already requires that in-scope firms prepare and maintain a resolution pack, and provide it to the PRA.[35]

3.11 As above, the expectations set out in this consultation only expand on specific aspects of the existing rules above; they do not create any new rules. The PRA believes that not all firms currently meet all expectations proposed in this consultation. Following this consultation (and upon publication of the Policy Statement with finalised expectations) some firms will incur some limited costs to ensure that the risk management policies, frameworks and accountabilities set out above are documented adequately in the submissions that firms make to the PRA. This cost will be higher for firms whose risk management policies, frameworks and accountabilities are particularly extensive or complex.

3.12 Overall, the cost of firms becoming compliant with our proposed expectations should be low, but non-zero. The PRA expects that a handful of firms will incur higher costs as they take action to bring the risks associated with their levels of asset encumbrance to within their appetite. The PRA expects that most other firms will need to take some action to enhance their risk management processes, and to document them in their regulatory submissions to the PRA, as a result of these proposed expectations.

3.13 The PRA considers that the likely costs of these actions will be exceeded by the likely benefits for all firms. The expectations that the PRA proposes in this CP relate to what the PRA considers to be an essential component of the prudent management of firms' funding profiles, and so too of financial stability. The cost of failing to manage adequately the risks associated with asset encumbrance is likely to be high in a stress, for firms for which the risks are most severe. By meeting the expectations proposed in this CP, firms should be more resilient to stress, and also therefore better able to manage their funding profiles in normal times.

Compatibility with the PRA's objectives

3.14 As noted, the PRA has a statutory objective to promote the safety and soundness of banks, building societies, credit unions, insurers and PRA-designated investment firms. The PRA intends for the proposals in this CP to further that objective by ensuring that the PRA has an appropriate framework to ensure that risks associated with asset encumbrance are managed appropriately, and to improve the PRA's supervision of firms' encumbering their assets and managing associated risks.

31 ILAA Part of the PRA Rulebook, 13.1, 13.2.
32 Paragraph 3.5 of SS24/15.
33 Recovery Plans Part of the PRA Rules, 2.2.
34 Recovery Plans Part of the PRA Rules, 2.3.
35 Resolution Pack Part of the PRA Rules, 2.3, 2.4.

3.15 Asset encumbrance can impact negatively the stability of a firm's funding profile by reducing its financial resilience and by subordinating unsecured creditors. The more assets a firm encumbers, the less it has available to encumber in order to raise the liquidity resources it needs in a stress, including as part of the effective execution of its recovery plan. Encumbrance also limits the assets that might be available as collateral to the Bank to lend against within its usual risk tolerance in the event of the firm's resolution. Asset encumbrance and the risks associated with it can therefore affect the safety and soundness of PRA-regulated firms both directly (for firms who encumber their assets) and indirectly (for other firms operating in a financial system where high levels of encumbrance are present).

3.16 The proposed framework expects firms to consider appropriately the risks associated with asset encumbrance and to manage them effectively through clearly-defined processes and accountabilities. It expects firms to take steps to ensure that asset encumbrance does not unduly impair the amount of assets that could be available to the firm to encumber in a stress, or available to the Bank to lend against within its usual risk tolerance in the event of the firm's resolution. The proposed framework expects firms to document adequately these risk-management practices in the information they submit to the PRA, such as ILAAP documents and recovery plans. This would allow the PRA to identify good and bad practices, provide feedback to firms, and challenge them when they fall short of expectations. The PRA expects that all of the above contribute to the safety and soundness of firms.

3.17 When discharging its general function in a way that advances its primary objectives, the PRA has, as a secondary objective, a duty to facilitate effective competition in the markets for services provided by PRA-authorised persons. The proposals in this consultation have no adverse impact on the PRA's secondary objective. They are designed not to propose a 'one-size-fits-all' approach, but rather to ask firms to determine for themselves the prevalence and severity of risks associated with asset encumbrance, to define for themselves what their tolerance for those risks are, and to take the necessary action to bring the risks within tolerance where necessary. As such, the proposed expectations are proportionate and accommodate a broad diversity of business models, sizes and complexities.

Regulatory principles

3.18 In developing the proposals in this CP, the PRA has had regard to the regulatory principles. Three of the principles are particularly relevant:

- The principle that a burden or restriction which is imposed on a person should be proportionate to the benefits, which are expected to result from the imposition of that burden. The PRA does not seek to rule out firms' use of asset encumbrance. Indeed, the PRA considers some asset encumbrance in normal times to contribute to the diversity of firms' funding sources and increase the availability of further funding through encumbrance in a stress. Further, the PRA would usually support firms increasing their asset encumbrance in a stress to receive the funding they need at a reasonable cost. In the above proposals, firms would define for themselves their appetite for the risks associated with asset encumbrance, and would be expected to demonstrate to the PRA that that appetite is well-reasoned, and that the risks are well-managed. As such, the PRA does not consider that the costs of the policies proposed above are disproportionate to the benefits. The PRA expects that costs on firms will be proportionate to the complexity of their business and funding models, and their appetite for risks associated with asset encumbrance (and therefore will be proportionate with the level of risk for each firm).

- The principle that the PRA should exercise its functions as transparently as possible. The PRA judges that the proposals set out in this CP will make clearer the PRA's expectations of firms in managing these risks, which the PRA assesses periodically eg in firms' ILAAP documents and recovery plans.

- The desirability in appropriate cases of the PRA exercising its functions in a way that recognises differences in the nature of, and objectives of, business carried on by different persons. In the above proposals, the PRA recognises that firms have a wide range of business and funding models. Further, firms have different capabilities to engage in certain types of funding that involves encumbrance (eg issuing covered bonds, entering into repurchase agreements, securitising assets), and firms have different other sources of funding available to them in a stress.

Impact on mutuals

3.19 The PRA proposed expectations apply to all firms, including building societies, and so will have an impact on building societies that is commensurate to their current profile of risks associated with asset encumbrance, their appetite for those risks, and their ability to manage those risks. More specifically, this CP proposes amendments to SS20/15 which relate only to building societies. These proposals more closely align the PRA's expectations of building societies with those proposed for all firms.

HM Treasury recommendation letter

3.20 HM Treasury has made recommendations to the Prudential Regulation Committee about aspects of the Government's economic policy to which the Committee should have regard when considering how to advance the objectives of the PRA and apply the regulatory principles as set out in FSMA.[36]

3.21 The aspects of the Government's economic policy most relevant to the proposals in this CP are set out below.

Competitiveness

3.22 The PRA believes that these proposals are consistent with robust institutions and a resilient system, and will not materially affect the United Kingdom's position as an international financial centre. This is because the proposals are aimed at enhancing the quality of firms' risk management practices, which should make the sector generally more resilient to stress and contributes to a stable environment in which to do business.

Innovation

3.23 The PRA considers that the proposals contained in this CP are consistent with this economic policy aim. The PRA's approach to supervising firms' management of risks associated with asset encumbrance is sensitive to the size, complexity, business model, funding model, and capabilities of the firm. The PRA recognises that more novel business models may have different approaches to asset encumbrance (eg by encumbering a higher proportion of their assets for funding). The PRA does not consider that such approaches are inappropriate *per se*. Rather, the PRA expects that firms are able to manage the risks associated with such approaches adequately.

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36 Available at: https://www.bankofengland.co.uk/about/people/prudential-regulation-committee.

Equality and diversity

3.24 The PRA has performed an assessment of the policy proposals and does not consider that the proposals give rise to equality and diversity implications.

Appendices

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Appendix 1: Draft amendments to Supervisory Statement 24/15 'The PRA's approach to supervising liquidity and funding risks'

This appendix outlines proposed amendments to SS24/15. Underlining indicates new text and striking through indicates deleted text.

…

2 The Internal Liquidity Adequacy Assessment Process

…

Overall liquidity adequacy

…

2.15 As part of the ILAAP, a firm should undertake a regular assessment of the adequacy of its liquidity resources to cover its liabilities as they fall due in stressed conditions. Central to this process is an appropriate and clearly articulated risk appetite statement defining the duration and type of stress or stresses that the firm aims to survive. This risk appetite should be cascaded throughout the firm in the form of appropriate limits, which may include gap limits or concentration limits around currency, funding sources, the makeup of liquid asset buffers, encumbrance of assets, and the firm's structural liquidity position. The PRA also expects firms to articulate for themselves the amount of risk they are willing to take across different business lines to achieve their strategic objectives. This risk appetite should be consistent with the PRA's duty to advance its general objective of promoting the safety and soundness of firms.

…

Prudent funding profile

2.17A As part of the overall liquidity adequacy requirement, the PRA requires firms to ensure that they maintain a 'prudent funding profile'.[x] A firm's funding profile is prudent if it demonstrates sufficient access to an appropriate diversity of funding sources which are highly likely to continue to be sufficient and available at reasonable cost in a variety of normal and stressed market conditions. Firms should ensure that areas of heightened risk in their funding profiles are not excessive in terms of potentially leading to an increased cost of funding, vulnerability to stress, or outflows during stress, beyond acceptable boundaries. Such areas might include: maturity mismatches, concentrations of funding sources, levels of asset encumbrance, or unstable funding of long-term assets.

2.17B The ILAA Part of the rules requires firms to put in place risk management policies to define their approach to asset encumbrance, as well as procedures and controls that ensure that the risks associated with collateral management and asset encumbrance are adequately identified, monitored and managed. Such policies are also essential for firms to meet the broader requirement of ensuring a prudent funding profile.

[x] Internal Liquidity Adequacy Assessment (ILAA) Part, 2.2(1)(b),

2.17C As a firm encumbers a higher proportion of its available assets in normal times, it will have less capacity remaining, should a stress occur, to encumber additional assets to raise cash to meet its obligations. This makes the firm less resilient to stress, which may cause creditors to charge higher spreads or respond more quickly to signs of stress. Therefore higher levels of asset encumbrance in normal times can negatively affect funding stability. In addition, unsecured creditors become increasingly subordinated as a firm encumbers more of its assets. As such, excessive encumbrance may affect the losses of a firm's unsecured creditors, given the firm's default. Consequently, unsecured creditors may react more quickly to signs of stress in firms with higher levels of encumbrance. This is an additional channel through which asset encumbrance can negatively affect funding stability.

2.17D The PRA expects that firms consider appropriately these and other impacts of asset encumbrance on the stability of their funding profiles. Firms should articulate a tolerance for the risks that excessive encumbrance poses through clearly defined metrics which are reported both internally and to the PRA in firms' ILAAP documents. They should monitor these metrics against their appetite regularly at appropriate forums (eg as part of their board risk committees' regular monitoring of financial risks) and where appropriate, should set limits to constrain the business and keep risks to tolerance.

…

2.18A The PRA expects firms to consider the effects of the stress scenario on the stability of their funding. Firms should consider the impacts that the stress is likely to have on their asset encumbrance. Firms should also consider, for example, the effects that increasing asset encumbrance, or reduced profitability or solvency, might have on their credit rating or market perception of their creditworthiness, their cost of funding, and the behaviour of unsecured creditors throughout the stress.

…

Stress testing

…

2.20 In analysing the key risk drivers set out in Chapter 11 of the ILAA rules, the PRA expects firms to make appropriate assumptions, both quantitative and qualitative. In particular, firms should include the following assumptions, discussed in detail in the EBA SREP Guidelines, where appropriate (the PRA's presumption is that these are consistent with existing internal liquidity management policies adopted by firms).

…

(ii) The reduction of secured and unsecured wholesale funding

This includes an assessment of the type and geographical location of the counterparty, the level of creditor seniority, the nature of the relationship the firm has with the counterparty, the type of underlying collateral (if applicable), and the speed of outflow. The risk of shortening tenors should also be assessed. Excessive levels of asset encumbrance and/or insufficient quantities of unencumbered high quality assets before or during a stress may act as a risk factor in this assessment.

(iii) The correlation and concentration of funding

Firms should include an assessment that takes into account instrument type, markets, currency, liability term structure, counterparty and market access, as appropriate. A firm should also consider the effectiveness of its diversification strategy, including in relation to the diversity of the assets which it could encumber to generate liquid resources if needed.

…

2.21 In addition, the PRA also expects firms to consider the quantitative and qualitative assumptions for the following risk drivers which are not explicitly addressed in the EBA SREP Guidelines, where appropriate:

…

(ii) Non-marketable asset risk

The PRA defines non-marketable assets as being those assets which cannot be monetised via repo or immediate outright sale. They could be monetised, for example, via the securitisation market or as covered bonds. Firms should include an assessment of how factors affecting the liquidity of those assets (eg counterparty stress, whether market access is frequent and established, early amortisation triggers, or financing of warehoused assets) may change under stress. This assessment should be sensitive to factors including the proportion of the firm's assets which become encumbered throughout the stress, the nature of the stress, the types of assets the firm holds, and the sophistication of the firm's capabilities to monetise similar assets. Firms should consider the effects that this monetisation could have on their overall levels of asset encumbrance.

…

3 The Liquidity Supervisory Review and Evaluation Process (L-SREP)

…

3.2 In carrying out the L-SREP, the PRA will as a minimum undertake the following:

…

- evaluate the liquidity and funding risks to which the firm is or might be exposed, for example as a result of the proportion of the firm's assets that are encumbered;

…

L-SREP

3.5 The PRA will assess whether a firm, in its ILAAP document, has adequately identified its liquidity needs across appropriate time horizons in severe but plausible stresses for all relevant risk drivers and whether its liquidity resources are adequate to meet those needs. [Footnote: Including the amount of liquidity resources which could be generated by encumbering other assets.] In addition, the L-SREP will also review the governance arrangements of the firm, its risk management culture, and the ability of members of the management body to perform their duties. The degree of involvement of the management body will be taken into account, as will the appropriateness of the internal processes and systems underlying the ILAAP. Examples of review topics might cover the firm's risk appetite, liquidity contingency plans, ~~and~~ non-stressed funding plans, collateral management, the ability to monetise HQLAs and wider liquidity in a timely fashion, intraday arrangements, market access and the firm's management of risks associated with asset encumbrance, including how asset encumbrance might develop over time during and absent stress.

…

Appendix 2: Draft amendments to Supervisory Statement 9/17 'Recovery planning'

This appendix outlines proposed amendments to SS9/17. Underlining indicates new text and striking through indicates deleted text.

…

2 Key recovery plan components and considerations

…

(i) Recovery options

…

(b) Quantification and impact

…

2.16 The options should support the recovery of the firm without making the post-recovery business model unviable. Firms should provide evidence that they have considered the impact of the option on the firm and, if applicable, the wider group. This should include quantitative, operational and business model impacts, including the impact on the franchise, ratings, ongoing business operations<u>, the reaction of providers of funding (such as wholesale unsecured creditors)</u> and support functions. The execution of each option should be credible. Firms should consider the systemic implication of each option – and potential combinations of options – on both the UK and international financial systems.

…

<u>2.21A Firms should consider the options available to them to raise liquidity by encumbering assets in each stress scenario. When quantifying the impact of such actions, firms should consider the full range of potential secondary impacts, including on the cost and stability of its other sources of funding (eg wholesale unsecured) and on the firm's credit rating. Firms' assessments should be sensitive to the characteristics of each stress scenario and the types of assets that the firm could encumber. For each scenario, firms should articulate how the evolving profile of asset encumbrance compares against their tolerance for the risks that encumbrance poses. Firms should identify how they plan to return their levels of asset encumbrance to within appetite following the stress. Firms should consider how the evolving profile of asset encumbrance can affect their recovery strategy (eg cost of issuing new capital) in a scenario where the firm is aiming to restore both its liquidity and capital position.</u>

…

(iv) Scenario testing

…

(a) Design

…

2.59 Firms should clearly set out the detail of each scenario to explain the size of the impact on the firm and relevant context (eg macroeconomic environment) that might impact on the firm’s ability to execute – or affect the benefits of – recovery options needed to respond to the stress. The firm should consider the impacts (both immediate and future) on capital, liquidity, risk profile, profitability and franchise. <u>This includes any impacts that each scenario is likely to have on the stability of the firm’s funding profile, for example as a result of increasing levels of asset encumbrance.</u> There should be an explanation in each scenario of the dependencies that arise from the stress, identifying how that stress could feed through to impact different business lines, including CFs.

…

(b) Use of scenarios for testing the plan

…

2.68 Firms should include a granular breakdown of liquidity needs, where appropriate by currency, in each stress over time. Firms should consider the options for obtaining (and if appropriate repaying) these funds. <u>As part of this, firms should project relevant metrics of their asset encumbrance throughout each scenario, and consider appropriately the impact that increasing levels of asset encumbrance might have on the stability and cost of their funding profile in a stress.</u>

…

Appendix 3: Draft amendments to Supervisory Statement 20/15 'Supervising building societies' treasury and lending activities'

This appendix outlines proposed amendments to SS20/15. Underlining indicates new text and striking through indicates deleted text.

…

4 Financial risk management

…

Encumbrance limits

4.90 Certain types of funding (eg covered bonds, non-recourse finance such as securitisations, and repurchase agreements - repo) involve pledging assets as security for loans. In addition, collateral may be pledged in respect of 'out of the money' derivative positions, either under credit support annex arrangements or as initial/variation margin. Such pledged assets are referred to as 'encumbered'. <u>Encumbrance can be short term (eg overnight repo) or long term (eg covered bonds).</u>

4.91 Typically the assets pledged will be subject to a 'haircut', ie more collateral will be required than the value of the funding, and the extent of such over-collateralisation will reflect the credit quality and liquidity of the pledged assets. Hence, availability of secured funding (both secured (covered) bonds and through repo) is limited by the availability and quality of collateral. Consequently, societies involved in all types of secured funding markets are expected to ~~plan~~ <u>measure, monitor and control</u> their collateral generation and usage, to ensure that <u>they have a comprehensive forward view of collateral availability and that</u> a spread of suitable assets will be available to raise secured funds as and when required. In planning future secured fundraising, societies will need a considered strategy for pledging different qualities of collateral <u>for different periods</u> in a way that will deliver market consistency and reliable funding results: pledging progressively declining collateral quality will result in rising haircuts, to a point where secured funding becomes unavailable, uneconomic, or both. Moreover, as the level of encumbrance increases, the position of senior creditors of the societies is weakened, and the availability of unsecured funding will reduce – or its price will increase – to a point where it too becomes unavailable or uneconomic.

4.92 Societies that wish to operate in secured funding markets<u>, including central bank facilities,</u> are expected to therefore have in place robust systems for identifying and monitoring collateral (available for future use, pre-positioned, currently pledged and received), and to set internal limits to control the level of encumbrance i<u>n normal times and the risks associated with it</u> to within their risk appetite. <u>Societies' management of risks associated with asset encumbrance should be in line with the PRA's Supervisory Statements 24/15 'The PRA's approach to supervising liquidity and funding risks'[x] and 9/17 'Recovery planning'.[x]</u>

[x] June 2019: https://www.bankofengland.co.uk/prudential-regulation/publication/2015/the-pras-approach-to-supervising-liquidity-and-funding-risks-ss.

4.93 A society's board is also expected to set ~~an~~ encumbrance limits if appropriate to ensure that ~~market~~ funding ~~(excluding central bank funding/asset swaps)~~ secured on the society's assets is undertaken in a controlled way that limits the risks to members and retains balance sheet management flexibility, including under stress. The wholesale funding policy needs to set out the board's risk appetite for:

(a) Assets encumbered under securitisation/repo funding arrangements with financial markets counterparties, including amounts encumbered under central bank facilities in return for HQLA which are then re-hypothecated to market counterparties;

(b) Amounts encumbered for derivatives margining purposes~~.~~; and

(c) Assets encumbered under central bank liquidity facilities.

Societies should ensure that they have capacity to raise sufficient liquidity resources in stress, including through encumbrance.

4.94 In the case of re-hypothecation, where collateral / securities are pledged to the Bank of England (or other central bank) in return for Treasury Bills/gilts (or equivalent government bonds) which are then repo'd with a wholesale market repo counterparty in exchange for cash, the internal encumbrance limit would normally include the original amount of collateral encumbered only, rather than double-counting. Therefore, w~~W~~here the Treasury Bills (T-Bills)/gilts/other government bonds received are then themselves repo'd ~~with the central bank, or central bank reserves/deposits are received~~, there would be no need to include this additional encumbrance in the overall internal limit.

…

Supervisory approaches to treasury management

Administered approach

…

4.140 The PRA would not expect societies on the administered approach to access wholesale funding from financial markets, nor to have external ratings of their debt. Funding from business deposit sources would be limited to a maximum of 10% of funding liabilities. ~~Apart from facilities provided by the central bank, s~~ Societies on this approach would not be expected to undertake repo or reverse repo activities, or to encumber their assets, with market counterparties. Administered approach societies are expected to have access to facilities provided by central banks, subject to board-approved internal limits covering both maximum funding and encumbrance levels.

…

Matched approach

…

x December 2017: www.bankofengland.co.uk/prudential-regulation/publication/2017/recovery-planning-ss.

4.147 The PRA would not expect societies adopting the matched approach to access significant wholesale funding from financial markets, nor to have external ratings of their debt. Funding from wholesale and business deposit sources would each be limited to a maximum of 15% of funding liabilities. Societies on this approach would not be expected to encumber their assets, except for collateral pledged in support of central bank facilities, derivative contracts and small scale market repo activity in respect of liquid assets. Societies are expected to set board-approved internal overall encumbrance limits to apply in normal market conditions. Firms should set sub-limits by type of exposure as appropriate.

…

Extended approach

…

4.163 Under the extended approach, societies would set internal limits on the level of encumbrance (including to central banks) that they are prepared to accept in normal market conditions ~~may be subject to~~. ~~– n~~Normally, extended approach societies would not be expected to encumber more than ~~this would not be expected to exceed~~ 20% of balance sheet assets with market counterparties ~~(excluding assets encumbered under facilities provided by the central bank), and there may be sub-limits by type of exposure~~. But it is for each society to determine its own individual approach, based on its specific risk appetite, corporate plan and risk management capabilities, as set out in the 'extensions' process in Chapter 5 of this SS. Firms should set sub-limits by type of exposure as appropriate.

…

Appendix 5 – Funding – indicative limits

…

	Administered	Matched	Extended	Comprehensive
ENCUMBRANCE (normal market conditions)	Bank of England only	Bank of England + Market Repo / posted margin only	~~Max 20% TA (excluding central bank encumbrance). Own sub-limits.~~ – Normally, extended approach societies would not be expected to encumber more than 20% of balance sheet assets with market counterparties. But it is for each society to determine its own	Board determined overall limits and sub-limits.

			individual approach, based on its specific risk appetite, corporate plan and risk management capabilities, as set out in Chapter 5 of this SS.	