Supervisory Statement | LSS4/13

Liquidity and capital regime for UK banks and building societies: adjustments in relation to interim FPC statement

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From its commencement on 1 April 2013, the Prudential Regulation Authority (PRA) has adopted a number of legacy FSA policy publications relevant to the advancement of its objectives. This document, initially issued by the FSA, has been adopted by the PRA as a Supervisory Statement as part of this process. The PRA may choose to review this legacy publication at a later stage.

This document sets out further detail on the adjustments made to the prudential liquidity and capital regimes for UK banks and building societies. This follows the interim Financial Policy Committee's (FPC's) recommendation in June 2012 that the regulator 'makes clearer to banks that they are free to use their regulatory liquid asset buffers in the event of a liquidity stress' and that it 'considers whether adjustments to microprudential liquidity guidance are appropriate, taking some account of the additional liquidity insurance' made available to banks by the Bank.

In June, HM Treasury and the Bank of England announced a series of measures to provide additional liquidity and support lending. These included the Extended Collateral Term Repo (ECTR) Facility(1) and the Funding for Lending Scheme (FLS).(2) At the same time, the interim FPC noted in the *Financial Stability Report* (*FSR*) that the additional liquidity being held by some banks in excess of current regulatory guidance could be used to support additional lending to the real economy.

To ensure that the microprudential framework does not counteract the provision of lending throughout the European Economic Area (EEA), adjustments were made to the liquidity and capital regimes for UK-authorised banks and building societies. These changes have been communicated to these firms and reported to the interim FPC.

Liquidity requirements

The prudential liquidity guidance regime is designed such that liquid asset buffers (LAB) can be drawn down in the event of a liquidity stress and used for the duration of the period of stress; and indeed certain banks have used their buffers when needed. All of their buffer can be used in a stress and they will be given reasonable time to rebuild their buffers subsequently.

Furthermore, to help reduce any excess liquid asset holdings that are caused by uncertainty over how the PRA would react if firms use their LABs, we have defined two different tiers — an 'upper' and a 'lower' tier — of current individual liquidity guidance (ILG):

- Upper tier: banks which, as a result of stresses, enter the 'upper tier' of their ILG, will be allowed a significant period of time (ie linked to the expected duration of the stress) before the PRA will seek (or indeed expect) a return to the 'normal times' guidance.
- Lower tier: firms which enter the lower tier of their ILG remain free to use the liquidity buffers in this way. In line with the microprudential risk posed by the running down of liquidity buffers, the PRA will pursue a more intensive monitoring regime and will seek to agree with the firm in question a somewhat more rapid return to at least meet the lower-tier requirement. The top of the lower tier is set at

(1) The ECTR Facility is designed to mitigate risks to financial stability arising from a market-wide shortage of short-term sterling liquidity. There is currently no shortage of short-term sterling liquidity in the market. But should that position change, the new Facility gives the Bank additional flexibility to offer sterling liquidity in an auction format against the widest range of collateral. The introduction of the ECTR Facility underlines the Bank's commitment to take appropriate measures to maintain UK monetary and financial stability.
(2) The FLS is designed to incentivise banks and building societies to boost their lending to UK households and non-financial companies. It will do this by providing funding to banks and building societies for an extended period, at below current elevated market rates, with both the price and quantity of funding provided linked to their performance in lending to the UK non-financial sector.

40% of the full requirement arising from the ILG stress scenario.[1]

In addition, the activation by the Bank of England of the ECTR Facility (part of its permanent Sterling Monetary Framework) has demonstrated that additional liquidity will be made available in response to actual or prospective market-wide stress to mitigate risks to financial stability arising from a shortage of sterling liquidity. Further, the Discount Window Facility (DWF) will provide liquidity to any solvent and viable bank, with pre-positioned collateral, on demand. Together, these measures should imply that banks' need to self-insure by holding larger liquid asset buffers is lower. Therefore, for those banks that have pre-positioned collateral at the DWF, and hence are able to access this additional public insurance, 50% of this value will be able to count towards liquidity buffers up to a maximum of 10 percentage points of the firm's ILG ratio. The details are being discussed with firms taking into account their specific circumstances.[2] These changes do not absolve banks of their need to determine their own level of adequate liquidity resources. The PRA expects this to be an assessment independent of regulatory guidance.

Capital requirements

Where there is net new lending, there will be an allowance for the resulting increase in the minimum Pillar 1 capital requirements by reducing the Pillar 2 capital planning buffer requirements; thereby ensuring that no bank will be required to hold the additional capital requirements of the increased lending.

For lending in the UK by UK authorised banks, the metric to be applied will be the FLS — irrespective of whether the firm is participating in the Scheme or not.

For lending elsewhere in the EEA, the offset will be applied on a per country, per currency basis for net new lending to households and non-financial corporates by UK-authorised banks.

The precise amount of this offset will be determined in the context of discussions with firms on their capital adequacy and forward-looking capital plans, and will be consistent with FPC recommendations relating to capital.

(1) The ILG stress scenario requires firms to calculate the net outflows that they would experience in a two-week firm-specific and three-month market-wide liquidity stress scenario.
(2) The PRA will, as soon as is reasonably practical, outline a transition path from our current regime to the new international liquidity standard, the Liquidity Coverage Ratio.