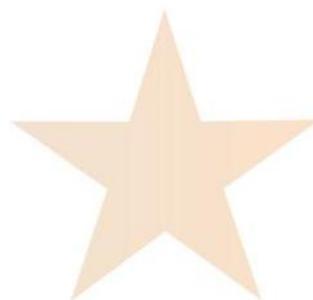


## Discussion paper

Draft methodology for assessment of liquidity and funding risk under  
SREP



# Discussion paper on draft methodology for assessment of liquidity and funding risk under SREP

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## 1. Responding to this discussion paper

The EBA invites comments on all proposals put forward in this paper and in particular on the specific question asked in the box at the end of the paper.

Comments are most helpful if they:

- respond to the question stated;
- indicate the specific point to which a comment relates;
- contain a clear rationale;
- provide evidence to support the view expressed;
- describe any alternatives the EBA should consider; and
- provide, where possible, data for a cost–benefit analysis.

### Submission of responses

To submit your comments, click on the ‘send your comments’ button on the consultation page by 28.02.2013. Please note that comments submitted after this deadline, or submitted via other means, may not be processed.

### Publication of responses

Please clearly indicate in the consultation form if you wish your comments to be disclosed or to be treated as confidential. A confidential response may be requested from us in accordance with the EBA’s rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the EBA’s Board of Appeal and the European Ombudsman.

### Data protection

The protection of individuals with regard to the processing of personal data by the EBA is based on Regulation (EC) No 45/2001 of the European Parliament and of the Council of 18 December 2000, as implemented by the EBA in the implementing rules adopted by its Management Board. Further information on data protection can be found under the [Legal notice section](#) of the EBA website.

### Disclaimer

The views expressed in this discussion paper are preliminary and will not bind in any way the EBA in the future development of the draft guidelines. They are aimed at eliciting discussion and gathering the stakeholders’ opinions at an early stage of the process.

## 2. Executive summary

### Reasons for publication

1. The EBA has a mandate under Article 107(3) of Directive No 2013/36/EU (CRD) to develop guidelines addressed to the competent authorities to further specify, in a manner that is appropriate to the size, the structure and the internal organisation of institutions and the nature, scope and complexity of their activities, the common procedures and methodologies for the supervisory review and evaluation process and the assessment of the organisation and treatment of the risks faced by institutions (SREP guidelines).
2. With the aim of helping competent authorities and colleges of supervisors to reach a joint decision on liquidity for the first time in 2014, the EBA publishes this discussion paper, which contains an advance version of the common methodology and process for assessing liquidity and funding risk that will be part of the final overall SREP guidelines.
3. This discussion paper expresses the EBA's preliminary views on the abovementioned topic and also aims to elicit discussion and gather the stakeholders' opinions at an early stage of the process. The input from stakeholders will assist in the development of the final SREP guidelines on this particular topic, which will be published for consultation at a later stage. The development of the final SREP guidelines will also require an analysis of the costs and benefits that those guidelines will imply. Input in this respect and any supporting data will be highly appreciated and kept confidential, where required.

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4. This paper aims to provide supervisors with a common understanding of the elements to be assessed regarding liquidity and funding risk and also the set of criteria to be used in this assessment, including a range of possible liquidity supervisory measures that can be applied, with the objective of increasing the consistency and quality of supervisory SREP practices and of their outcomes.

### Next steps

5. As provided for by Regulation No 1093/2010 of the European Parliament and Council establishing the EBA, before the final publication of the SREP guidelines, the EBA will conduct a public consultation and analyse the potential costs and benefits of the proposed guidelines. The Consultation Paper will include the proposed text of the draft guidelines and a cost-benefit analysis.

### 3. Background and rationale

6. The EBA has a mandate under Article 107(3) of Directive No 2013/36/EU (the CRD) to develop guidelines addressed to the competent authorities to further specify, in a manner that is appropriate to the size, the structure and the internal organisation of institutions and the nature, scope and complexity of their activities, the common procedures and methodologies for SREP and the assessment of the organisation and treatment of the major risks faced by institutions.
7. The Article 107 mandate covers common procedures and methodologies for SREP as defined in Article 97, building on the technical criteria listed in Article 98, including the assessment of the organisation and treatment of risks. In particular, it is expected that the guidelines should cover overall risk management and governance arrangements (Article 76), use of internal approaches for risk calculation (Articles 77 and 78), credit and counterparty risk (Article 79), residual risk (Article 80), concentration risk (Article 81), securitisation risk (Article 82), market risk (Article 83), interest rate risk from non-trading activities (Article 84), operational risk (Article 85) and liquidity risk (Article 86).
8. The EBA is currently developing these guidelines with the primary objective of increasing the consistency and quality of supervisory SREP practices, and hence of their outcomes.
9. The guidelines will feature a specific section on liquidity and funding risk, comprising the methodology to assess risk and risk management/controls and the adequacy of the arrangements, strategies, processes and mechanisms implemented by institutions and the liquidity held to ensure a sound management and coverage of liquidity risk. They will also include a range of possible liquidity supervisory measures that can be applied in order to address shortcomings identified. It is envisaged that the final overall SREP guidelines will be published by the end of 2014.
10. It should be noted that the CRD broadens the scope of the matters subject to a joint decision and, in accordance with Article 113 CRD, the liquidity joint decision shall be reached on measures to address any significant matters and material findings relating to liquidity supervision including relating to the adequacy of the organisation and the treatment of liquidity risk and relating to the need for institution-specific liquidity requirements. The joint decision shall be reached between consolidating supervisor and competent authorities responsible for the supervision of subsidiaries. These provisions relating to the liquidity joint decision will apply from 31 December 2013.
11. In order to promote best supervisory practices and supervisory convergence in the internal market, and as a complement to the single rulebook, the EBA also has a mandate to develop and keep up to date a European handbook on the supervision of financial institutions in the Union as a whole, setting out supervisory best practices for methodologies and processes. This mandate is envisaged in the regulation amending the EBA Regulation (EU) No 1093/2010.
12. With the aim of helping competent authorities and colleges of supervisors in reaching a joint decision on liquidity for the first time in 2014, the EBA publishes this discussion paper, which contains its current plans for the common methodology and process for assessing liquidity and

funding risk that will be part of the overall SREP guidelines, providing supervisors with a common understanding of the elements to be assessed and also the set of criteria to be used in this assessment. The methodology presented in the current document will, furthermore, be revised at a later stage, in order to embed it into the overall framework of the SREP guidelines and the single supervisory handbook and to ensure consistency with the wording of the SREP guidelines.

13. While the purpose of this document is to provide a set of common elements to be considered when assessing liquidity and funding risk and the risk management relating to those risks, it is not intended to be exhaustive and it allows supervisors leeway to take into account other, additional criteria that may be deemed relevant according to their experience and the specificities of the credit institution.
14. Article 97(4) CRD introduces the principle of proportionality with respect to the SREP process, by stating that competent authorities shall establish the frequency and intensity of the review and evaluation process having regard to the size, systemic importance, nature, scale and complexity of the activities of the institution concerned and taking into account the principle of proportionality. Therefore, competent authorities, using their supervisory judgement, should apply this methodology taking into account that not all the elements have the same relevance for all the institutions, and that it may be interpreted as applying with a lesser degree of granularity to non-systemically important institutions. This paper provides, in some cases, additional elements and examples, with the purpose of providing supervisors with additional details for the application of the methodology. These additional details are highlighted in italics within the text.
15. The proposed guidelines set out in this discussion paper do not include any direct link with Pillar 1 liquidity and funding requirements, given that, in accordance with the CRD and Regulation (EU) No 575/2013 (CRR), there will not be specific Pillar 1 liquidity and funding requirements in place in 2014, other than the generic requirements envisaged in Articles 412(1) and 413 CRR. Competent authorities could nevertheless benefit in this regard from the liquidity risk reporting that institutions are obliged to provide pursuant to Article 415 CRR. When Pillar 1 liquidity and/or funding requirements are introduced, compliance with these requirements should be taken into account when performing the supervisory review.
16. The outcomes of the liquidity risk assessment, funding risk assessment and liquidity and funding risk management assessment will converge into an overall liquidity SREP score. While the overall SREP guidelines will provide a methodology on the overall SREP score, the present discussion paper introduces only the meaning of the score and what it should reflect. Until the final guidelines are released, competent authorities should come to the overall liquidity SREP score following the definitions of scores provided by CEBS (Committee of European Banking Supervisors) GL39 ('Guidelines for the joint assessment of the elements covered by the SREP process and the joint decision regarding the capital adequacy of cross-border groups').

## 4. Definitions

17. For the purposes of this discussion paper, the following definitions apply:

- ▶ Liquidity risk is the risk that an institution cannot meet its financial obligations, such as payments and collateral needs, as they fall due in the short term and medium term, either at all or without incurring unacceptable losses.
- ▶ Intraday liquidity is defined as the funds which can be accessed during the business day, usually to enable financial institutions to make payments in real time <sup>(1)</sup>.
- ▶ Intraday liquidity risk is the liquidity risk within the day or the risk that an institution will fail to manage its intraday liquidity effectively, which could leave it unable to meet a financial obligation, such as payments and collateral calls, at the time expected, thereby affecting its own liquidity position and that of other parties.
- ▶ Funding risk is the risk that an institution cannot meet its financial obligations, such as payments and collateral needs, as they fall due in the medium to long term, either at all or without increasing funding costs unacceptably. Funding risk can also be seen as the risk that the business is not stably funded in the medium and long term.
- ▶ Counterbalancing capacity is an institution's ability to hold, or have access to, excess liquidity over the short-, medium- and long-term time horizons in response to stress scenarios <sup>(2)</sup>.
- ▶ The liquidity buffer is the amount of liquid assets available outright to be used in liquidity stress situations within a given period <sup>(3)</sup>.
- ▶ The survival period is the period during which an institution can continue operating under stressed conditions and still meet all its payments due <sup>(4)</sup>.
- ▶ Liquidity contingency plan is the group of policies, procedures and action plans for responding to severe disruptions to an institution's ability to fund some or all of its activities in a timely manner and at a reasonable cost <sup>(5)</sup>.
- ▶ Liquidity risk tolerance is the level of liquidity risk that an institution is willing to assume <sup>(6)</sup>.
- ▶ Material currency is a currency in which an institution has material balance-sheet or off-balance-sheet positions.
- ▶ The funding plan is an institution's plan for how it will fund itself.
- ▶ Short term – a period of up to 3 months, including intraday, and with a strong focus on the first month.
- ▶ Medium term – a period of 3 to 12 months.

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<sup>(1)</sup> Basel Committee on Banking Supervision (BCBS) paper 'Monitoring tools for intraday liquidity management' (April 2013).

<sup>(2)</sup> CEBS 'Guidelines on liquidity buffers and survival periods' (December 2009).

<sup>(3)</sup> CEBS 'Guidelines on liquidity buffers and survival periods' (December 2009).

<sup>(4)</sup> CEBS 'Guidelines on liquidity buffers and survival periods' (December 2009).

<sup>(5)</sup> In line with the definition of contingency funding plan included in Principle 11, Paragraph 110 of the BCBS paper 'Principles for sound liquidity risk management and supervision' (September 2008).

<sup>(6)</sup> BCBS paper 'Principles for sound liquidity risk management and supervision' (September 2008).

- ▶ Long term – a period over a 1-year time horizon.

## 5. Methodology for assessment of liquidity risk under SREP

18. The assessment of liquidity risk, as one of the elements of the SREP, consists of three main components:

- a. assessment of liquidity risk (5.1);
- b. assessment of funding risk (5.2); and
- c. assessment of liquidity and funding risk management (5.3).

19. Competent authorities should assess all three components to come to a view on the level of liquidity and funding risk and the quality of the institution's management of those risks, taking into account the complexity, risk profile and scope of operation of the institution, the risk tolerance set by the management body and the institution's importance in each Member State in which it carries out business. The outcome of the assessment should feed into the overall view of the institution's risk profile taken under SREP, and in particular to any supervisory decision on a need to apply supervisory measures relating to liquidity, a decision that, in the case of cross-border banking groups, should be jointly reached by the consolidated supervisor and the competent authorities responsible for the supervision of subsidiaries.

20. In conducting the liquidity SREP process, competent authorities may use a combination of information sources, including the following:

- ▶ outcomes from the analysis of the institution's business model, in particular those that may help in understanding the key sources of liquidity risk (overall SREP guidelines will provide a specific methodology for the business model analysis);
- ▶ regulatory returns and particularly the information provided by the institutions in their liquidity risk reporting requirements in accordance with Article 415 CRR and developed by the EBA in two implementing technical standards (ITS) (the ITS on supervisory reporting for liquidity coverage and stable funding, and the ITS on additional liquidity monitoring metrics);
- ▶ other national regulatory returns, where relevant;
- ▶ outcomes of the various supervisory actions that competent authorities may carry out during the supervisory cycle;
- ▶ information provided by the institution and, when available, the institution's own assessment of the adequacy of its liquidity and funding resources and of its risk management arrangements <sup>(7)</sup>.

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<sup>(7)</sup> Information collected in this way may be particularly important in those areas not properly covered by regulatory reporting.

## 5.1 Methodology for supervisory evaluation of liquidity risk

21. Competent authorities should assess the institution's short- and medium-term liquidity risk over an appropriate set of time horizons, including intraday, in order to ensure that institutions maintain adequate levels of liquidity buffers. This assessment includes following elements:

- a. evaluation of liquidity needs in the short and medium terms (5.1.1);
- b. evaluation of intraday liquidity risk (5.1.2);
- c. evaluation of liquidity buffer and counterbalancing capacity (5.1.3);
- d. supervisory liquidity stress testing (5.1.4);

### 5.1.1 Evaluation of liquidity needs in the short and medium terms

22. Competent authorities should assess the institution's liquidity needs in the short and medium terms under both normal and stressed conditions (shocks). They should take into account:

- ▶ the institution's stressed liquidity needs at different horizons, notably before 30 days, and after 3 to 12 months;
- ▶ specifically, the effect on the institution's liquidity needs (net cash outflows) of severe but plausible stresses, to cover idiosyncratic, market-wide and combined shocks <sup>(8)</sup>;
- ▶ the size, location and currency of the liquidity needs and, where an institution operates in different material currencies, the separate impacts of shocks in the different currencies, to reflect currency convertibility risk.

23. In evaluating the impact of shocks on the institution's liquidity needs, competent authorities should take into account all material sources of liquidity risk for the institution. In particular, they should take into account:

- ▶ The possibility that any applicable Pillar 1 requirements <sup>(9)</sup> do not adequately identify the institution's liquidity needs in the event of the type of stress scenario used for the requirement, including at maturities shorter than 30 days.

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<sup>(8)</sup> When introduced (indeed when specified through the delegated act), the liquidity coverage ratio (LCR) – defined as it is by an idiosyncratic and market-wide stress scenario – will provide a natural reference point for supervisory evaluation of short-term liquidity risk. These guidelines will reflect this new quantitative element. For a reliable reference point, supervisors should review whether the firm is correctly reporting its LCR position. They will also need to assess whether the LCR adequately identifies the firm's liquidity needs. Where supervisors have implemented local liquidity requirements, these can be used as a reference point until the LCR is (fully) implemented.

<sup>(9)</sup> This would apply to the LCR once it is introduced as a binding minimum requirement. During the phase-in of the LCR, particular attention may be paid to the possibility that banks may increase their LCR by engaging in very short-term borrowing and lending. As long as the requirement is less than 100%, such activity may increase the LCR without reducing the liquidity risk.

- ▶ Risks arising in respect of wholesale counterparties regarding on-balance-sheet items and funding concentrations, and taking into account actions the institution might take to preserve its reputation/franchise.
- ▶ Risks arising in respect of contingent cash flows/off-balance-sheet items (*for example, credit lines*) and activities (*for example, liquidity support for unconsolidated special purpose vehicles beyond contractual obligations*), taking into account actions the institution might take to preserve its reputation/franchise.
- ▶ Inflows and outflows on a gross basis as well as a net basis. *For example, where there are very high inflows and outflows, competent authorities should pay specific attention to the risk to the institution when inflows are not received when expected, even when the net outflow risk is limited.*
- ▶ Risks arising in respect of retail counterparties, taking into account actions the institution might take to preserve its reputation/franchise. For this purpose, competent authorities should make use of the methodology on the classification of retail deposits into different buckets of riskiness, as set out in the EBA Consultation Paper on draft guidelines on retail deposits subject to different outflows for purposes of liquidity reporting under the CRR for the purposes of liquidity reporting <sup>(10)</sup>. *Examples of these kinds of risks are risks arising specifically from new products offered to retail clients, where material, in particular from deposit-like debt instruments that are not covered by a deposit guarantee scheme and from retail deposits with structured features (such as embedded options to withdraw or automatic maturity extensions before the contractual maturity is reached that influence the expected outflow rate) <sup>(11)</sup>.*
- ▶ The risk that excessive risks in the medium- to long-term funding profile will adversely affect the behaviour of counterparties relevant to the short-term liquidity position.

### 5.1.2 Evaluation of intraday liquidity risk

24. Competent authorities should assess the institution's exposure to liquidity risk on an intraday basis. This assessment should take into account <sup>(12)</sup>:

- ▶ availability of liquidity which can be accessed during the business day (funds) or can be used within the day (collateral) to meet the intraday liquidity needs;
- ▶ the extent to which, in the event that the institution suffers financial or operational stress, the institution may need additional liquidity to avoid having to defer its own payments (bearing in mind that counterparties may defer payments and/or withdraw intraday credit lines, including those provided by the institution's correspondent bank or banks);

<sup>(10)</sup> This requirement is valid only if and when the abovementioned Consultation Paper is a part of the formal guidelines issued by the EBA.

<sup>(11)</sup> Noting the European Systemic Risk Board's (ESRB) recommendations on funding of credit institutions, recommendation A.1(b) (that national supervisory authorities 'monitor the level, evolution and behaviour of uninsured deposit-like financial instruments, which are sold to retail customers, and their potentially negative effects on traditional deposits').

<sup>(12)</sup> For those jurisdictions where no reporting on intraday risk is yet available, the institution's own analysis may be particularly important as a source of information for this evaluation. Refer also to the Basel paper 'Monitoring tools for intraday liquidity management' (April 2013).

- ▶ the possible effect on the institution's liquidity position intraday should a major counterparty suffer an intraday stress event which prevents it from making payments;
- ▶ where the institution provides correspondent banking services, the possible effect on its liquidity position intraday if a customer institution's stress results in other institutions deferring payments to the customer;
- ▶ the potential impact on the institution's intraday liquidity position in the event that a market-wide credit or liquidity stress reduces the value of liquid assets that an institution uses to generate liquidity on an intraday basis, whether from the central bank or from correspondents.

### 5.1.3 Evaluation of liquidity buffer and counterbalancing capacity

25. Competent authorities should assess the adequacy of the institution's liquidity buffer and counterbalancing capacity to meet its liquidity needs within a month as well as over different time horizons, potentially up to 1 year and including overnight <sup>(13)</sup>. This assessment should take into account:

- ▶ the directly available liquidity buffers or the institution's survival period under different stress scenarios;
- ▶ the overall counterbalancing capacity available to the institution over the full horizon of the relevant stress scenario;
- ▶ the characteristics, such as severity and duration, of different stress scenarios and horizons considered in evaluating the institution's liquidity needs;
- ▶ the amount of assets which would need to be liquidated over the relevant time horizons;
- ▶ the degree of consistency between the actual liquidity buffer and counterbalancing capacity and the institution's liquidity risk tolerance.

26. Competent authorities should assess the institution's ability to monetise its liquid assets in a timely fashion to meet its liquidity needs during a stress period. They should take into account:

- ▶ whether the institution tests its market access by selling or repoing on a periodic basis;
- ▶ whether there are high concentrations that may represent a risk of overestimation of the liquidity buffer and counterbalancing capacity;
- ▶ Whether the assets in the buffer are unencumbered, under the control of the relevant staff and readily available to a liquidity management function, and are in an appropriate location relative to where liquidity needs may arise.

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<sup>(13)</sup> Once the LCR is a formal minimum requirement, supervisors can take the classification of liquid assets as specified in the LCR as a reference point for evaluating the adequacy of the institution's liquidity buffer. They are free to deviate from this where justified, e.g. by the nature of the risk being addressed or the length and type of the stress in question.

- ▶ whether the denomination of the liquid assets is consistent with the distribution by currency of liquidity needs;
- ▶ where the institution has borrowed liquid assets, whether it has to return them within the horizon of a short-term liquidity stress, which would mean that the institution would no longer have them available to meet its stressed outflows;
- ▶ where competent authorities determine that committed liquidity facilities can to some extent be included in the counterbalancing capacity, they should have a view on the likely liquidity value of such facilities.
  - *Regarding committed facilities, competent authorities can take into account, for example, the likelihood that the corresponding counterparty or counterparties will not honour their obligations (taking into account the legal ramifications and financial and reputational risk to the institution providing funding) as well as the reputational risks to the institution using the facility.*

#### 5.1.4 Supervisory liquidity stress testing

27. Competent authorities should use liquidity stress tests<sup>(14)</sup>, defined and run by the competent authorities, as a tool to assess short- and medium-term liquidity risks<sup>(15)</sup>, with the purpose of:

- ▶ Identifying liquidity risks over different time horizons and under various stress scenarios.
- ▶ Informing their own view of liquidity risks in addition to the information from the institution's internal stress tests.
- ▶ Identifying and quantifying specific areas of liquidity risk<sup>(16)</sup>.
- ▶ Informing their view on the overall liquidity risk the institution is exposed to, which will enable them to compare the relative riskiness of institutions. This should include at least a supervisory stress test combining institution-specific and market-wide stress<sup>(17)</sup>.
- ▶ *Competent authorities may also consider the use of supervisory stress testing to assess the likelihood of the institution falling below the minimum requirements, by using stress scenarios under which they would not expect the institution to fall below the minimum requirements<sup>(18)</sup>.*

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<sup>(14)</sup> Stress testing has two dimensions within the liquidity part of the SREP: first, the institution is expected to perform internal stress tests (covered in section 5.1.4); then the supervisor is expected to perform stress tests as part of evaluating liquidity risk, including to identify risks and to compare the institution with its peers (covered in this part, relating to Article 97 CRD).

<sup>(15)</sup> Under Article 100 CRD, the EBA is required to issue guidelines to ensure that competent authorities use common methodologies for annual supervisory stress tests on institutions they supervise, to facilitate the review and evaluation process. These liquidity SREP guidelines will need to reflect or refer to those stress testing guidelines.

<sup>(16)</sup> Please also refer to headings 1.4.1 - Guidance for evaluating liquidity risk; 1.4.2 - Intraday liquidity risk and 1.4.3 – Counterbalancing capacity,

<sup>(17)</sup> When the LCR is introduced, these stress scenarios may be anchored to the 30-day LCR stress assumptions, but competent authorities can extend the scope of the LCR by exploring risks within 30 days as well as over 30 days in addition to altering the LCR assumptions to reflect risks not adequately covered in the LCR.

<sup>(18)</sup> As Articles 412(3) and 414 CRR provide the basis for banks using their buffer and temporary falling below the minimum requirement, supervisors should be aware of the likelihood of such an event when coming to a view

## 5.2 Methodology for supervisory evaluation of risk arising from the institution's funding profile

28. Competent authorities should assess the institution's funding risk and whether the medium- and long-term obligations are adequately met with a diversity of stable funding instruments under both normal and stressed conditions. This assessment includes the following elements:

- a. evaluation of the funding profile (5.2.1);
- b. evaluation of risks to the stability of the funding profile (5.2.2);
- c. evaluation of market access (5.2.3);
- d. evaluation of expected change in funding risks based on the institution's funding plan (5.2.4).

### 5.2.1 Evaluation of funding profile

29. Competent authorities should assess the appropriateness of the institution's funding profile, including both medium- and long-term contractual and behavioural mismatches, in relation to its business model, strategy and risk tolerance. More specifically, they should take into account:

- ▶ whether the institution's medium- and long-term obligations are adequately met with a diversity of stable funding instruments <sup>(19)</sup>, and whether its actual mismatches are within acceptable boundaries in relation to the specific business model of the institution;
- ▶ whether the institution's actual funding profile falls short of the desired profile, in the light of competent authorities' view also on the institution's desired funding profile;
- ▶ (local) regulatory and contractual factors affecting the behavioural characteristics of funding providers (*such as regulations regarding clearing, bail-in, DGS, etc., as they may influence the behaviour of funding providers*), in particular when there are material changes or differences between jurisdictions in which the institution operates;
- ▶ that maturity transformation will lead to a certain level of mismatches but that these must remain within manageable and controllable boundaries to avoid collapse of the business model during stress or changes in market circumstances.

### 5.2.2 Evaluation of risks to the stability of the funding profile

30. Competent authorities should consider factors that may reduce the stability of the funding profile in relation to the type and characteristics of both assets and liabilities. They should take into account:

- ▶ That specific asset classes will be more significant than others to the firm and/or the system. *Competent authorities may, for example, want to form a view on what would be a*

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on the overall level of liquidity risk. Supervisors may consider it undesirable for an institution to fall below the minimum requirement under very mild market stress.

<sup>(19)</sup> Article 413 CRR (general requirement): institutions should ensure that their 'long term obligations are adequately met with a diversity of stable funding instruments'.

*desired funding profile for each of the asset classes which are more significant to the institution and/or the system and relate this to the characteristics and location of the funding that is actually available.*

- ▶ The structural maturity mismatch between assets and liabilities in different significant currencies, where applicable, as well as in aggregate and how currency mismatches overlaying structural maturity mismatches, affects the overall risk to the stability of the funding profile.
- ▶ Appropriate structural funding metrics (appropriate to the institution's business model). Examples of structural funding metrics can include loan/deposit ratio, customer funding gap and behaviourally adjusted maturity ladder (of which the net stable funding ratio [NSFR] metric is a particular example).

31. Competent authorities should assess risks to the sustainability of the funding profile arising from concentrations in funding sources. They should take the following factors into account:

- ▶ Concentrations in different respects, notably and where applicable: the type of funding instruments used, specific funding markets, single or connected counterparties and other concentration risks that may affect access to funding in the future (focusing on the markets and instruments relevant to the long-term funding profile and noting that their view on concentration risk in the short-term liquidity profile may be relevant).
- ▶ The risk that asset encumbrance may have an adverse effect on the markets' appetite for the unsecured debt of the institution. Factors for this assessment may include:
  - the total amount of encumbered and/or borrowed assets compared with the balance-sheet;
  - the availability of free assets (unencumbered but possible to encumber) especially when considered in relation to total unsecured wholesale funding;
  - the level of overcollateralisation <sup>(20)</sup> relative to the capital base;
  - the implications of the level of overcollateralisation for the deposit insurance scheme, in the event that the institution fails;
  - all in the context of the specific characteristics of the market(s) the institution operates in and the institution's business model.

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<sup>(20)</sup> Overcollateralisation refers to those assets used to obtain secured funding that are in excess of the notional amount of funding obtained (so, if 120 EUR of assets are used for 100 EUR of secured funding, the overcollateralisation is 20).

### 5.2.3 Evaluation of actual market access

32. Competent authorities should be aware of the institution's actual market access and current and future threats to this market access. Several factors need to be taken into account:

- ▶ Any information they are aware of, including from the institution itself, indicating that the institution makes high demands on particular markets that are important to it, relative to those markets' capacity; *for example, the absolute size of transactions in relation to common market practice, or the relative share of funding the institution takes from the market.*
- ▶ Any significant or unexpected changes in the issuance of debt that competent authorities become aware of in each significant market (including in significant currencies); note that competent authorities would expect firms to alert them to any such changes. They should also assess whether any such changes are due to the strategic choices of the institution or whether they are signs of reduced market access.
- ▶ The risk that news about the institution may negatively influence the market (perception/confidence) and thus market access. Such news may or may not yet be known to the market. *Examples of such news could be risks identified elsewhere in the SREP, including excessive short-term liquidity risk, portfolios with high or uncertain credit risk, materialised or (perceived) high operational risk, legal risk, an unclear strategy, (potential for) downgrade of the credit rating or reputational risk.*
- ▶ *Additional elements that competent authorities may take into account include:*
  - *The current and potential future use of public funding (funding obtained from the central bank or guaranteed by a sovereign), in relation to its possible impact on market confidence and market access.*
  - *Signs that short-term liquidity risks (e.g. when short-term liquidity risk is assessed as high) may reduce the access the institution has to its major funding markets. Competent authorities may consider the spreads on new debt issuance in primary markets as well as the development of spreads in secondary markets and, where appropriate, discuss any negative trends in spreads (e.g. increases) with the institution. Even when no signs of reduced market access are currently visible, competent authorities may conclude that excessive short-term liquidity risks are likely to influence market access in the future and take a more negative stance on the stability of the institution's funding profile.*

### 5.2.4 Evaluation of expected change in funding risks based on the institution's funding plan

33. Competent authorities should assess the expected change in funding risks based on the institution's funding plan. This assessment should take into account the following aspects:

- ▶ the way the institution's funding plan, when executed in full, will affect the institution's funding risks, noting that the execution of the funding plan may increase or decrease the risks in the funding profile;
- ▶ the supervisory view on the feasibility of the plan (as detailed in section 5.3.6 below).

## 5.3 Methodology for supervisory evaluation of liquidity and funding risk management

34. Pursuant to Article 86 CRD competent authorities should ensure that institutions have robust strategies, policies, processes and systems for the identification, measurement, management and monitoring of liquidity and funding risk over an appropriate set of time horizons, including intraday, in order to ensure that institutions maintain adequate levels of liquidity buffers. Strategies, policies, processes and systems should be proportionate to the complexity, risk profile and scope of operation of the institutions and the risk tolerance set by the management body and reflect the institution's importance in each Member State in which it carries out business. Those strategies, policies, processes and systems shall be tailored to business lines, currencies, branches and legal entities and shall include adequate allocation mechanisms of liquidity costs, benefits and risks.

35. Assessment of strategies, processes and systems for the identification, measurement, management and monitoring of liquidity and funding risk includes:

- a. review of the institution's liquidity risk strategy and liquidity risk tolerance (5.3.1);
- b. review of the institution's organisational framework, policies and procedures (5.3.2);
- c. review of the institution's risk measurement and reporting (5.3.3);
- d. review of the institution's internal control framework for liquidity risk management (5.3.4);
- e. review of the institution's liquidity contingency plans (5.3.5);
- f. review of the institution's funding plans (5.3.6).

### 5.3.1 Review of the institution's liquidity risk strategy and liquidity risk tolerance

36. Competent authorities should assess whether the institution appropriately defines and communicates its liquidity risk strategy and liquidity risk tolerance. They should take into account:

- ▶ whether the liquidity risk strategy and liquidity risk tolerance are established, approved and updated by the management body;
- ▶ whether the liquidity risk strategy and tolerance are clearly defined, properly documented, effectively implemented and communicated to all relevant staff;
- ▶ whether the liquidity risk tolerance is appropriate for the institution considering its business model, overall risk tolerance, role in the financial system, financial condition and funding capacity.
- ▶ *Examples of what competent authorities may consider when making this assessment include:*

- *whether the institution calibrates liquidity risk tolerance and makes it operational, for example by setting minimum requirements and group core levels and relating it to stress test outcomes;*
- *whether the institution differentiates between target risk and maximum acceptable risk;*
- *whether the institution has appropriate rules and procedures on how to allocate liquidity risk by business, by product, by currency, by region, by country and by legal entity;*
- *whether the institution has in place procedures for determining the frequency of liquidity strategy meetings and updating or revising liquidity strategies.*

### 5.3.2 Review of the institution's organisational framework, policies and procedures

37. Competent authorities should assess whether the institution has appropriate arrangements for the governance and management of liquidity and funding risk. For this assessment, competent authorities should take into account:

- ▶ whether the management body approves the governance and policies for managing liquidity and funding risk and discusses and reviews them regularly;
- ▶ whether the senior management is responsible for developing and implementing the policies and procedures for managing liquidity and funding risk;
- ▶ whether senior management ensures monitoring of respective management body decisions;
- ▶ whether the liquidity and funding risk management framework is internally coherent and ensures a comprehensive internal liquidity adequacy assessment process (ILAAP), when available, and is well integrated into the institution's wider risk management process;
- ▶ whether the policies and procedures are appropriate for the institution, taking into account its liquidity risk tolerance;
- ▶ whether the policies and procedures are properly defined, formalised and effectively communicated throughout the institution;
- ▶ whether the policies and procedures include remuneration for key personnel influencing the liquidity and funding profile, such as treasury staff, and whether the policies and procedures ensure the incentives of individual staff members do not conflict with the best interests of the institution. *For example, supervisors may form a view on the appropriateness of treasury function as part of a profit-oriented environment, as this could lead to a conflict of interest between individual staff members' incentives and the best interests of the institution.*

38. Competent authorities should assess whether the institution has an appropriate organisational framework for liquidity and funding risk management, measurement and control functions, with sufficient human and technical resources for the development and implementation of these functions and to carry out the required monitoring tasks. They should take into account:

- ▶ whether the liquidity risk control and monitoring systems are controlled by independent control functions (the 'three lines of defence' model);
- ▶ whether the risk management, measurement and control functions cover liquidity risk in the entire institution (including branches) and in particular all areas where liquidity risk can be taken, mitigated or monitored;
- ▶ whether the institution has a set of liquidity and funding policy documents that appear adequate in promoting prudent behaviour by the institution's staff and in allowing for an efficient operation of the control functions;
- ▶ whether the institution has appropriate internal written policies and procedures for the management of liquidity and funding risk, as well as the adequacy of the institution's liquidity and funding risk management framework.

39. Competent authorities should assess the adequacy of the institution's approach to maintaining market access in its significant funding markets. They should take into account:

- ▶ The institution's approach to maintaining an ongoing presence in the markets (testing market access <sup>(21)</sup>). *In this regard, competent authorities may, for example, analyse the institution's actual practice and its policy and relate this to current market practice (e.g. average size and frequency of issuance). Different sources of information can be used for this assessment, in particular information obtained from the institution as well as information taken directly from the markets (e.g. average size and typical market activity) for each significant market.*
- ▶ The institution's approach to developing strong relationships with funds providers to lower the risk that its access is reduced.
- ▶ Any evidence of which they are aware regarding whether the institution would continue to have an ongoing presence in times of stress (even though at such times it may be more expensive for the institution to do so).

### 5.3.3 Review of the institution's liquidity risk measurement and reporting

40. Competent authorities should assess whether the institution has an appropriate framework for identifying and measuring liquidity and funding risk, in line with the institution's size, complexity, risk tolerance and risk-taking capacity. They should take the following factors into account:

- ▶ Whether the institution has implemented appropriate methods for projecting its cash flows over an appropriate set of time horizons, assuming business as usual and stress situations, and comprehensively across material risk drivers.
- ▶ Whether the institution uses appropriate key assumptions and methodologies, which are regularly reviewed. *Factors for this assessment may include, for example:*

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<sup>(21)</sup> For specific small institutions or specialised business models the testing of access to professional markets may not be relevant.

- *Whether the institution considers the interaction between liquidity risk and the other types of risk to which it is exposed (financial, operational, reputational and legal risks).*
  - *Whether the information the institution uses for its analysis of expected cash inflows and outflows in business as usual conditions is adequate. For example, in the case of complex institutions that rely to a large extent on wholesale funding, competent authorities, in forming their view, may want to take into account whether the maturity ladder the institution uses for internal measurement is more granular than the maturity ladder it is required to report by the EBA Consultation Paper on draft implementing technical standards on additional liquidity monitoring metrics under Article 403(2) CRR.*
  - *Whether, in connection with foreign currency operation and non-domestic operations, the major risk drivers (for example, transferability, operational and legal risks) are identified and adequately incorporated into the liquidity risk measurement system.*
  - *Whether the institution has adequate methodologies for estimating expected flows arising from all material types of off-balance-sheet items (for example, instruments which incorporate triggers which can generate cash flows, margin calls from derivatives operation and securities financing activities, liquidity lines and credit lines, non-contractual commitments to sustain special purpose entities, commitments linked to securitisation operation) and from those on-balance-sheet items without a contractual defined and certain maturity (for example, sight deposits from retail and wholesale clients, bonds sold to retail customers that the institution could be forced to reimburse before the contractual maturity for reputational reasons).*
- ▶ When relevant, whether all material legal entities, branches and subsidiaries in the jurisdiction in which the institution is active are included.
  - ▶ Whether the institution understands its ability to access financial instruments wherever they are held, having regard to any legal, regulatory and operating restriction on their use, including, for example, the real encumbrance of assets on different time horizons.

41. Competent authorities should assess whether institutions have an appropriate reporting framework for liquidity and funding risk. They should take into account:

- ▶ whether there is a set of reporting criteria agreed by the senior management, specifying the scope, manner and frequency of liquidity and funding risk reporting and who is responsible for preparing the reports;
- ▶ the quality and appropriateness of information systems, management information and internal information flow supporting liquidity and funding risk management and whether the data and information used by the institution are understandable for the target audience, accurate and usable (*for example, timely, not overly complex, with correct scope, etc.*);
- ▶ whether specific reports and documentation containing comprehensive and easily accessible information on liquidity risk are submitted regularly to the appropriate recipients (such as the management body, senior management or an asset-liability committee).

42. Competent authorities should assess whether an institution has implemented adequate liquidity-specific stress testing to understand the impact of adverse events on its risk exposure and on the quantitative and qualitative adequacy of its liquid assets <sup>(22)</sup>. They should take into account:

- ▶ Whether the extent and frequency of stress tests are appropriate to the nature and complexity of the institution, its liquidity risk exposures and its relative importance in the financial system.
- ▶ Whether the outcomes of stress testing are integrated into the institution's strategic planning process for liquidity and funding and to increase the effectiveness of liquidity management in the event of a crisis, including in the institution's liquidity recovery plan.
- ▶ Whether the assumptions underlying the scenarios are realistic and plausible but at the same time sufficiently prudent in severity and duration. *An example of aspects that competent authorities may consider for this assessment is whether the institution takes into account the potential drying up of previously liquid markets in relation to the prudent estimation of the liquidity value (sales proceeds or haircuts for repoing) of assets in its counterbalancing capacity under stressed conditions.*
- ▶ Whether the institution has an adequate process for identifying suitable risk factors for conducting stress tests, having regard to all material vulnerabilities that can undermine the liquidity position of the particular institution.
- ▶ Whether assumptions and scenarios are reviewed and updated sufficiently frequently. *As a specific example of a factor to consider, competent authorities may want to take into account whether the institution carries out reviews and updates more frequently in times of market volatility.*
- ▶ Where the liquidity management of a group is being assessed, whether the institution pays adequate attention to any potential obstacles to the transfer of liquidity within the group.
- ▶ *Additional elements that competent authorities may take into account for this assessment include:*
  - *whether the assumptions and outcomes are appropriately assessed by senior management, and whether they are appropriately integrated into strategic planning etc.;*
  - *whether the stress test process is sufficiently defined and formalised (e.g. frequency of tests, techniques to be used, risk factors, relevant scenarios and time horizons);*
  - *whether the simulation techniques are periodically reviewed to permit the detection of potential weaknesses and vulnerabilities.*

43. Competent authorities should assess the adequacy of the process of measurement of intraday liquidity risk, especially for those institutions that participate in payment, settlement and clearing systems. They should take into account:

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<sup>(22)</sup> Note here CEBS 'Guidelines on stress testing' (GL32), with which the SREP guidelines are consistent.

- ▶ whether the institution adequately monitors and controls cash flows and liquid resources available to meet intraday requirements and forecasts when cash flows will occur during the day <sup>(23)</sup>;
- ▶ whether the institution carries out adequate specific stress testing for intraday operations (where the institution should consider similar scenarios to those set out in paragraph 42 above).

44. Competent authorities should assess whether the institution has in place an adequate set of indicators regarding the liquidity and funding position, appropriate to the business model and nature, scale and complexity of the institution. They should take into account:

- ▶ whether the indicators adequately cover the institution's key structural funding vulnerabilities, covering the following aspects, where appropriate:
  - the degree of dependence on a single market or an excessively small number of markets/counterparties,
  - the 'stickiness' of funding sources and behaviour driving factors,
  - the concentration of particular instruments,
  - the concentration of activities in different currencies,
  - major maturities concentration and maturity gaps over the longer horizon;
- ▶ whether the indicators are adequately documented, periodically revised, used as inputs to define the risk tolerance of the institution, integrated in management reporting and used for setting operating limits.

#### 5.3.4 Review of the institution's liquidity risk internal control framework

45. Competent authorities should assess whether the institution has in place a strong and comprehensive internal limit and control framework and sound safeguards to mitigate or limit its liquidity risk in line with its risk tolerance. They should take into account whether:

- ▶ the limit and control framework is adequate for the institution's complexity, size and business model and reflects the different material drivers of liquidity risk, such as maturity mismatches, currency mismatches, derivatives transactions, off-balance-sheet items and intraday liquidity risk;
- ▶ the institution has implemented adequate limits and monitoring systems that are consistent with its liquidity risk tolerance and that make use of the outcomes of liquidity stress tests;
- ▶ the risk limits are regularly reviewed by the competent bodies of the institution and clearly communicated to all relevant business lines;

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<sup>(23)</sup> For more information, supervisors may want to see the Basel Committee's 'Monitoring tools for intraday liquidity management' (April 2013), <http://www.bis.org/publ/bcbs248.htm>.

- ▶ there are clear and transparent procedures regarding how individual liquidity risk limits are approved and reviewed
- ▶ there are clear and transparent procedures regarding how compliance with individual liquidity risk limits is monitored and how to handle limit breaches (including clear escalation and reporting procedures);
- ▶ the limit and control framework helps the institution to ensure the availability of a diversified funding structure and sufficient and accessible liquid assets.

46. Competent authorities should assess whether the institution has implemented an adequate transfer pricing system as part of the liquidity risk control framework. They should take into account:

- ▶ whether the institution's transfer pricing system covers all material business activities;
- ▶ whether the transfer pricing methodology and its calibration are reviewed and updated appropriately given the size and complexity of the institution;
- ▶ whether the transfer pricing system and its methodology are communicated to the relevant staff;
- ▶ as an additional factor, competent authorities may consider whether the institution's policy on incorporating the funds transfer pricing (FTP) methodology into the internal pricing framework is used for assessing and deciding on transactions with customers (this includes both sides of the balance-sheet, for example granting loans and taking deposits).

47. Competent authorities should assess whether the institution has adequate controls regarding the buffer of liquid assets. They should take into account whether:

- ▶ the control framework covers the timely monitoring of the buffer of liquid assets, including the quality of the assets, their concentration and their location and immediate availability;
- ▶ the institution has an appropriate policy on monitoring market conditions that can affect its ability to quickly sell or repo assets in the market.

### 5.3.5 Liquidity contingency plans

48. Competent authorities should assess whether the institution's liquidity contingency plan (LCP) adequately sets out the policies, procedures and action plans for responding to severe potential disruptions to the institution's ability to fund itself. They should take into account the content and scope of contingency funding measures included in the LCP, and in particular factors such as:

- ▶ Whether the LCP appropriately reflects the institution's liquidity-specific and wider risk profile. *As an example, when intraday risk is significant to the institution, and in order to assess whether there are appropriate arrangements for addressing intraday risk in the LCP, competent authorities may take into account whether the LCP includes clear procedures for dealing with critical intraday payments, taking into account that critical settlement needs arise not only from the institution's own transactions but also from those of its customers.*

- ▶ Whether the institution has a framework of liquidity early warning indicators which are likely to be effective in enabling the firm to identify deteriorating market circumstances in a timely manner and to determine quickly what actions need to be taken.
- ▶ Whether the LCP clearly articulates all material (potential) funding sources, including the estimated amounts available for the different sources of liquidity and estimated time needed to obtain funds from them.
- ▶ Whether the measures are in line with its overall risk strategy and liquidity risk tolerance.
- ▶ The appropriateness of the role of central bank funding in the institution's LCP. Examples of factors competent authorities might consider could include the institution's views on:
  - the current and future availability of potential alternative funding sources connected to central bank lending programmes;
  - the types of lending facilities, the acceptable collateral and the operational procedures for accessing central bank funds;
  - the circumstances under which central bank funding would be needed and to what amount and for what duration such use of central bank funding would probably be required.

49. Competent authorities should assess whether the actions described in the LCP are feasible in relation to the stress scenarios in which they are meant to be taken. They should take into account factors such as:

- ▶ The level of consistency and interaction between the institution's liquidity-related stress tests, its LCP and its liquidity early warning indicators.
- ▶ Whether the actions defined in the LCP appear likely to enable the institution to adequately react to a range of possible scenarios of severe liquidity stress, including institution-specific and market-wide stress, as well as the potential interaction between them. *Competent authorities may want to consider, for example:*
  - *the institution's methodology for assessing:*
    - *the impact of stressed market conditions on its ability to sell or securitise assets,*
    - *second-round and reputational effects relating to the execution of contingency funding measures,*
    - *the transferability of liquidity obtained from contingency measures between the institution's legal entities, where relevant;*
  - *the feasibility of measures such as the transfer of cash and collateral across borders and entities;*

- *where institutions are planning to generate liquidity from the central bank, the time it would take to move collateral to the central bank as well as the collateral value the institution assumes the central bank would apply;*
- *the institution's approach to regular review and testing, which are necessary to ensure the LCP's effectiveness and operational feasibility;*
- *the institution's policy with respect to:*
  - *roles and responsibilities for all relevant staff and the communication of these roles within the firm,*
  - *testing of the ability to sell or repo certain assets or periodically draw down credit lines in relation to the stress scenario envisaged,*
  - *regular testing of the marketability of the liquid asset buffer, notably by selling small parts of the liquid asset buffer from all material asset classes.*

50. Competent authorities should assess the appropriateness of the institution's governance framework with respect to its LCP. They should take into account factors such as:

- ▶ The appropriateness of escalation and prioritisation procedures detailing when and how each of the actions can and should be activated. *Competent authorities might, for example, consider:*
  - *the allocation of responsibilities to relevant staff;*
  - *the decision-making processes on what actions to take at what time and at what level of management (including escalation procedures);*
  - *a policy that relates day-to-day monitoring of the institution's liquidity position, including intraday liquidity risk, to the process for activating the LCP.*
- ▶ Whether the institution has adequate policies and procedures with respect to communication within the institution and with external parties, *for example supervisors, market participants, clients, creditors and shareholders, and whether the institution will ensure timely, clear, consistent and frequent communication in an emergency situation.*
- ▶ The degree of consistency between the LCP and the institution's business continuity plans.

#### 5.3.6 Review of funding plans

51. Competent authorities should assess whether the funding plan is feasible and appropriate in relation to the nature, scale and complexity of the institution, its current and projected activities and its liquidity and funding profile. They should take into account factors such as:

- ▶ Whether the funding plan is robust in terms of its ability to support the projected business activities under adverse scenarios. *As part of this, they may want to consider, for example, the firm's own analysis of vulnerabilities to any (changes in) market circumstances that would affect the execution of the funding plan.*

- ▶ The institution's expected funding profile arising from the execution of the funding plan and whether this is acceptable.
- ▶ Whether the funding plan supports any required or desired improvements in the institution's funding profile.
- ▶ Their own view on the (changes in) market activity planned by institutions in their jurisdiction on an aggregated level, and what that means for the feasibility of individual funding plans <sup>(24)</sup>. *For example, when institutions all aim to grow their market share in the same market, the supervisor could deduct that the individual funding plans are not feasible if the market could not accommodate such growth.*
- ▶ Whether the funding plan is:
  - integrated with the overall strategic plan of the institution (*for example, whether it can support the intended development of the activities under the strategic plan*);
  - consistent with its business model;
  - consistent with its liquidity risk tolerance.
- ▶ Other, additional, elements that competent authorities may consider include:
  - Whether the institution adequately analyses and is aware of the appropriateness and adequacy of the funding plan given the institution's current liquidity and funding positions and their projected development. As part of this, competent authorities may consider whether the institution's senior management can explain why the funding plan is feasible and where its weaknesses lie.
  - The institution's policy for determining what funding dimensions and what markets are significant to the institution (and whether it is adequate).
  - The time horizon which the firm envisages for migration to a different funding profile, if required or desired, noting that there can be risks in both a too quick and a too slow migration towards the end state.
  - Whether the funding plan contains different strategies and clear management procedures for a timely implementation of strategy changes.

52. Competent authorities should assess whether the firm's funding plan is appropriately implemented. They should take into account factors such as:

- ▶ whether the funding plan is properly documented and communicated to all the relevant staff;

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<sup>(24)</sup> Note here recommendation A.1 (a) of the ESRB's recommendations on funding of credit institutions: 'assess the funding plans provided by credit institutions and their feasibility for each national banking system, on an aggregated basis'.

- ▶ whether the funding plan is embedded in the day-to-day operations of the institution, especially in the funding decision-making process;
- ▶ in addition, competent authorities may take into account whether the institution is able to reconcile the funding plan with the data provided to competent authorities in the funding plan template ('Consultation Paper on draft guidelines on harmonised definitions and templates for funding plans of credit institutions under ESRB Recommendation 2012/02 A.4').

53. Competent authorities should consider the quality of the institution's processes for monitoring the execution of the funding plan and its ability to react to deviations in a timely manner. For this assessment, competent authorities should take into account factors such as:

- ▶ the quality of the updates to (senior) management regarding the current status of the execution of the funding plan (*for example, with regard to their content, frequency and timeliness*);
- ▶ whether the funding plan envisages alternative fallback measures in case of changes in the market conditions;
- ▶ the policy and practice of the institution regarding the regular review and updating of the funding plan when the actual funding raised significantly differs from the funding plan.
- ▶ *Other, additional, elements that competent authorities may take into account include:*
  - *whether the execution of the funding plan is consistent with the development of the balance-sheet (including new activities) and the condition of funding markets.*

## 6. Overall liquidity and funding risk assessment

Pursuant to Article 97(3) CRD, competent authorities shall determine, on the basis of the SREP process, whether the arrangements, strategies, processes and mechanisms of liquidity and funding risk implemented by the institution and the liquidity held by it ensure a sound management and coverage of liquidity and funding risk.

54. To reach this conclusion, competent authorities should combine their assessment of liquidity risk, funding risk and liquidity and funding risk management, augmenting their own quantitative assessment with their assessment of the quality of the institution's risk management. They should take into account:

- ▶ how well the institution controls liquidity and funding risks and whether it takes responsibility for managing its business prudently;
- ▶ how the institution's risk tolerance and overall stance on risk-taking may affect the likelihood of liquidity and funding risks materialising in the future;

- ▶ whether the particular weaknesses identified in the liquidity and funding positions are likely to be compounded by the weaknesses identified in risk management, and vice versa;
- ▶ the relative importance of the risks identified to the institution's safety and soundness.

55. Competent authorities should translate this overall assessment into an overall liquidity SREP score (individual and/or combined) <sup>(25)</sup>, which should reflect competent authorities' combined view on the threats to the institution's safety and soundness that may arise from either liquidity and funding risk or liquidity and funding risk management.

## 7. Liquidity SREP outcomes: measures to mitigate liquidity and funding risks

### 7.1 Determining the need for supervisory measures

56. Based on the outcomes of the SREP and on their overall liquidity and funding risk assessment, competent authorities should determine the need to adopt measures. For the purpose of Article 113(1)(b) CRD (joint decision on liquidity), matters should be considered significant and/or the findings should be considered material at least where:

- ▶ the risk of significant impact on the prudential elements of an institution or group of institutions was assessed as medium-high or high <sup>(26)</sup>; or
- ▶ the liquidity and funding risk management was assessed as inadequate or weak <sup>(27)</sup>.

57. In order to make a decision on the specific measures that could effectively mitigate the identified excessive liquidity and funding risks and related risk management shortcomings, competent authorities should:

- ▶ take into account their findings with respect to risks or shortcomings identified in liquidity risk, funding risk and the management of those risks, the severity of the risks and their overall view on the risks identified through the SREP process;
- ▶ ensure that the supervisory measures are consistent with their overall view on liquidity and funding risks in terms of severity and immediacy;
- ▶ articulate how important each mitigating measure is, and define its scope of application, permanence and other relevant characteristics;
- ▶ take into account the possibility that risks and vulnerabilities identified may exacerbate each other, which may lead competent authorities to further increase the severity of supervisory measures;

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<sup>(25)</sup> Until the final guidelines are released, competent authorities and colleges of supervisors are expected to come to the overall liquidity SREP score using the same approach followed so far combined with the scoring provided by CEBS GL39 in Table 2 ('Common scores for the assessment of risk factors') and Table 3 ('Common scores for the assessment of risk controls').

<sup>(26)</sup> Refer to CEBS GL39 Table 2, 'Common scores for the assessment of risk factors'.

<sup>(27)</sup> Refer to CEBS GL39 Table 3, 'Common scores for the assessment of risk controls'.

- ▶ take into account whether concerns about the institution's capital position, which may influence the institution's accessibility to liquidity in the near future, could justify the adoption of supervisory specific liquidity measures (such as additional liquidity requirements);
- ▶ if structural, long-term mitigating measures are adopted, consider the need for additional short-/medium-term measures as an interim solution, in order to mitigate the risks that persist while the structural decision produces the desired effects.

58. The set of specific mitigating measures agreed by competent authorities can be combined, prioritised or otherwise aggregated to come to a supervisory decision. The overall severity of the measures should be commensurate with the overall assessment of liquidity risk and funding risk.

- ▶ When deciding on supervisory measures, competent authorities can make use of the non-exhaustive list of supervisory measures provided in Annex I.

## 7.2 Communication of supervisory measures

59. Competent authorities should decide on communication to the credit institution of the agreed supervisory measures.

### *Communication of supervisory measures <sup>(28)</sup>*

- Supervisors should communicate the measures to the institution in a way which is clearly specified and where the supervisor describes at least (but not limited to):
  - the nature of the measure, for example:
    - ▶ whether it is quantitative or qualitative; in case of quantitative measures it should be clear whether the measure is absolute (e.g. minimum buffer size) or relative (e.g. survival period) and what the relevant thresholds are (e.g. reduction of concentration to a specified level),
    - ▶ whether it is permanent or temporary,
    - ▶ whether it is a supervisory additional liquidity requirement or a mitigating action the supervisor requires the institution to take, in which case there should be clear deadlines;
  - the scope of application (in what part of the institution the action should be implemented);
  - relevant boundaries (minimum, maximum, range, FTP, level of involvement of management, etc.);
  - its importance (e.g. specifying those actions that would contribute most to a reduction in risks and have the highest priority); i.e. the reasoning for taking the

<sup>(28)</sup> This issue will be included in a separate part of the SREP guidelines and this text is indicative.

measure is clearly explained.

60. In the case of cross-border European banking groups, the communication of the liquidity decision jointly agreed by a consolidating supervisor and the competent authorities responsible for the supervision of subsidiaries should follow the procedure envisaged in the ITS developed in accordance with Article 113(5) CRD:

### Annex I: Supervisory measures (non-exhaustive list)

61. Articles 104 and 105 CRD define the competent authorities' supervisory powers to impose supervisory measures on institutions, measures that, pursuant to Article 103 CRD, should be applied in a similar or identical manner to those institutions with similar risk profiles and that are or might be exposed to similar risks or pose similar risks to the financial system. The following provides a non-exhaustive list of supervisory measures.

#### Liquidity risk

62. Pursuant to Article 104(1)(k) CRD, competent authorities may:

- ▶ impose requirements on the institution regarding its holdings of liquid assets, for example regarding:
  - the quality of liquid assets to be held by the institution,
  - the quantity of liquid assets held by the institution in terms of absolute or market value or by reference to net cash outflows (where the liquidity coverage ratio may be used as a point of reference);
- ▶ impose requirements on the concentration of the liquid assets held, for example regarding:
  - the composition of the institution's liquid assets profile, including in respect of counterparties, currency, etc.;
- ▶ impose restrictions on short-term contractual or behavioural maturity mismatches between assets and liabilities, for example regarding:
  - limits on maturity mismatches (in specific time buckets) between assets and liabilities; limits on minimum survival periods,
  - limits on dependency on certain short-term funding sources, such as money market funding.

63. Pursuant to Article 104(1)(j) CRD, competent authorities may:

- ▶ Impose a requirement for the institution to provide more frequent reporting on liquidity positions, for example regarding:

- the frequency of liquidity coverage and/or net stable funding reporting;
- the frequency and granularity of other liquidity reports, such as 'additional monitoring metrics'.

64. Pursuant to Article 104(1)(b) CRD, competent authorities may:

- ▶ Require action to be taken to address deficiencies identified with regard to the institution's ability to identify measure, monitor and control liquidity risk, for example:
  - enhance its stress testing capacity and hence its ability to identify and quantify material sources of liquidity risk to the institution;
  - enhance its ability to monetise its liquid assets;
  - enhance its liquidity contingency plan and liquidity early warning indicators framework.
  - enhance reporting of the liquidity management information to the institution's governing body.

### Funding risk

65. Pursuant to Article 104(1)(k) CRD, competent authorities may:

- ▶ require action to be taken to amend the institution's funding profile. Requirements could, for example, include that the institution take action regarding:
  - its dependency on certain (potentially volatile) funding markets, such as wholesale funding;
  - the concentration of its funding profile, with respect to counterparties, peaks in the long-term maturity profile, (mismatches in) currencies, etc.;
  - the amount of its assets that are encumbered, potentially differentiating between total encumbrance and overcollateralisation (e.g. for covered bonds, margin calls, etc.).

66. Pursuant to Article 104(1)(j) CRD, competent authorities may:

- ▶ require additional or more frequent reporting on the institution's funding positions, for example regarding:
  - the frequency of regulatory reporting relevant for the monitoring of the funding profile (such as the NSFR report and 'additional monitoring metrics');
  - the frequency of reporting on the institution's funding plan to the supervisor.

67. Pursuant to Article 104(1)(b) CRD, competent authorities may:

- ▶ Require actions to be taken to address deficiencies identified with regard to the institution's ability to identify, measure, monitor and control funding risk. For example, the institution could be required to:
  - enhance reporting of management information regarding funding risk to the institution's governing body;
  - restate or enhance the funding plan.
- ▶ Enhance its stress testing capabilities, for example by requiring the firm to cover a longer stress horizon.

### Question for discussion

1. Is the methodology included in these draft guidelines sufficiently clear and detailed for the purpose of providing competent authorities with a practical tool for assessing liquidity under Pillar 2 and does it enhance the process of reaching a joint decision in 2014?