



# Interim Prudential sourcebook: Building Societies

Financial Services Authority

*Final Rules – Building Societies*

**Part of:**

The Interim Prudential  
Sourcebook for  
Building Societies

January 2007

# **IPSB FOR BUILDING SOCIETIES**

## **CONTENTS LIST**

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### **X. INTRODUCTORY CHAPTER**

#### **PRUDENTIAL STANDARDS**

- 1. SOLVENCY [Deleted]**
  - 2. ISSUED CAPITAL [Deleted]**
  - 3. BOARDS AND MANAGEMENT [Deleted]**
  - 4. FINANCIAL RISK MANAGEMENT**
  - 5. LIQUIDITY**
  - 6. LENDING [Deleted]**
  - 7. LARGE EXPOSURES [Deleted]**
  - 8. MORTGAGE INDEMNITY INSURANCE [Deleted]**
  - 9. SYSTEMS [Deleted]**
  - 10. SECURITISATION [Deleted]**
  - 11. OUTSOURCING [Deleted]**
- 
- 1. ACCESS TO THE REGISTER [Deleted moved to BSOG]**
  - 2. MERGER PROCEDURES [Deleted moved to BSOG]**
  - 3. TRANSFER PROCEDURES [Deleted moved to BSOG]**
  - 4. MERGER CONFIRMATION PROCEDURES [Deleted moved to BSOG]**
  - 5. TRANSFER CONFIRMATION PROCEDURES [Deleted moved to BSOG]**



## Transitional Provisions

(1)	(2) Material which the transitional provision applies	(3)	(4) Transitional provision	(5) Transitional provision: dates in force	(6) Handbook provision: coming into force
1	<i>IPRU(BSOC) 4</i> and <i>IPRU (BSOC) 5</i>	R	<p>A society to which <i>SYSC 4</i> to <i>SYSC 10</i> do not apply must, in the material in column (2), treat:</p> <p>(a) the references generally to <i>SYSC 4</i>, <i>SYSC 5</i>, <i>SYSC 6</i>, or <i>SYSC 7</i> as references generally to <i>SYSC 3.2</i>; and</p> <p>(b) the references to specific rules in <i>SYSC 4</i>, <i>SYSC 5</i>, <i>SYSC 6</i>, or <i>SYSC 7</i> as references to the rules in <i>SYSC 3.2.23R</i> to <i>SYSC 3.2.37R</i> that correspond to those rules.</p>	1 January 2007 – 31 October 2007	1 January 2007



# **Interim Prudential Sourcebook for Building Societies**

## **X. Introductory Chapter**

### **X.1 [Deleted]**

### **X.2 Application**

**X.2.1 R** The Interim Prudential Sourcebook for building societies applies to all firms with permission from the Financial Services Authority (the "FSA") to take deposits which are also building societies as defined in the Building Societies Act 1986 ("the 1986 Act") and, in this sourcebook, "society" and "societies" are construed accordingly.

### **X.3 [Deleted]**

### **X.4 [Deleted]**

### **X.5 [Deleted]**

### **X.6 [Deleted]**

### **X.7 [Deleted]**

### **X.8 [Deleted]**

# **Interim Prudential Sourcebook for Building Societies**

## **1 Solvency [Deleted]**



## **Interim Prudential Sourcebook for Building Societies**

### **2 Issued Capital [Deleted]**

## **Interim Prudential Sourcebook for Building Societies**

### **3 Boards and Management [Deleted]**

# Interim Prudential Sourcebook for Building Societies

## 4 FINANCIAL RISK MANAGEMENT

### CONTENTS

	<b>SECTION</b>		<b>PAGE</b>
4.1	<b>Introduction</b>		<b>2</b>
4.2	<b>Rules</b>		<b>3</b>
4.3	<b>Financial Risks</b>		<b>4</b>
4.4	<b>Statutory Restrictions</b>	<b>8</b>	
4.5	<b>Supervisory Approach</b>		<b>10</b>
4.6	<b>[Deleted]</b>		<b>12</b>
4.7	<b>Risk Management Systems</b>		<b>12</b>
4.8	<b>Counterparty Risk</b>		<b>14</b>
4.9	<b>Operational Risk</b>		<b>17</b>
4.10	<b>Independent Review and Controls</b>		<b>18</b>
	<b>ANNEX</b>		
4A.	<b>Supervisory Approach Categories</b>		<b>19</b>
4B	<b>[Deleted]</b>		<b>27</b>

## 4.1 Introduction

4.1.1 G This chapter contains guidance for societies on financial risk management which supplements the high level requirement in the Senior Management Arrangements, Systems and Controls sourcebook (SYSC).

4.1.1A G As part of the implementation of the Capital Adequacy Directive (CAD), the Banking Consolidation Directive (BCD) and the Markets in Financial Instruments Directive (MiFID), provisions relating to a firm's organisational and risk systems and controls have been introduced in SYSC 4, SYSC 5, SYSC 6, and SYSC 7. The guidance in this chapter generally explains the application of the high level requirements in SYSC 4, SYSC 5, SYSC 6, and SYSC 7 (even if there may not be a specific cross reference) in the context of financial risk management.

4.1.2 G This chapter describes the key financial risks to which societies are exposed, explains the statutory restrictions on funding, market making, trading and use of derivative instruments, sets out the framework within which the FSA will supervise the treasury activities of societies, including details of the five “approach” categories (Administered, Matched, Extended, Comprehensive and Trading) applied, and emphasises the respective responsibilities of boards and management for monitoring and controlling financial risks. (Unless otherwise explicitly stated, references in this chapter to “societies” are to society groups, consolidated to include all subsidiary undertakings.)

4.1.3 G Rules and guidance on interest rate risk in the banking book are contained in chapter 2.3 of the Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU). Under these requirements a society should evaluate the effect of a standard interest rate shock specified by the FSA in that chapter. The result should be taken account of in the ICAAP (as defined in the Handbook Glossary).

4.1.4 G Societies with a trading book will also be subject to a market risk capital requirement calculated in accordance with BIPRU 7. This is unlikely to be applicable to any societies apart from those on the "Trading" approach – see 4A.6 below. A society with foreign currency exposures will however be subject to the foreign exchange capital requirements in BIPRU 7 whether or not it has a trading book.

## **4.2. General**

4.2.1 G In meeting the requirements of SYSC 4.1.1R and SYSC 7.1.2R in the context of financial risk management, a society should have an adequate system for managing and containing financial risks to the net worth of its business, and risks to its net income, whether arising from fluctuations in interest or exchange rates or from other factors.

4.2.2 G The arrangements, processes, and mechanisms required in SYSC 7.1.3R should include systems and procedures for identifying, monitoring and controlling all material maturity mismatch, interest rate, foreign exchange and similar (e.g. index related) risks, and for reporting exposures to senior management and the board of the society on a regular, and timely, basis. Societies should also have interest margin management systems in place to estimate the expected profitability of new mortgage and savings products, and to project forward the cumulative effect of mortgage incentives and loyalty schemes.

4.2.3 G Societies should have credit limits in place for all counterparties both for placing liquidity and for transacting derivative contracts (further guidance also in Chapter 5 (Liquidity) and in the General Prudential sourcebook (GENPRU) 1.2 and SYSC 11 – stress testing and scenario analysis, and contingency funding plans).

4.2.4 G [Deleted]

4.2.5 G In meeting the requirements in SYSC 7.1.4R in the context of financial risk management, the board of a society should approve and periodically review a policy statement on financial risk management.

**4.2.6 R [Deleted]**

4.2.7 G [Deleted]

4.2.8 G The policy statement establishes guidelines for the society's senior managers on the control of

financial risks, including: operational risk; structural risk; funding risk; and counterparty credit (including settlement) risk. Such documents should be consistent with the type of business undertaken by the society and compliant with sections 7 and 9A of the 1986 Act.

4.2.9 G Policy statements should set out the strategic framework for treasury operations, recording the rationale for that framework i.e. why and how treasury activities are expected to support the society's core business, and the "approach" category being followed, derived, where possible, from the results of a financial risk audit. They should clearly state the conditions under which authority is delegated to a board sub-committee, or to management. The documents should establish the operating limits and high level controls that will maintain exposures within levels consistent with the policy, and the procedures/controls on the introduction of new products or activities. Copies of the policy statements should be made available to, and read by, all personnel involved in treasury operations.

## **4.3 Financial risks**

### **Funding risks**

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

4.3.2 G Wholesale deposit funding, available from a range of sources, provides a useful supplement to the stocks, and inflows, of personal savings. Wholesale markets typically provide funding at longer and/or more definite maturity, often at advantageous rates, but may concentrate the refinancing risks societies face.

4.3.3 G The particular constitution of building societies means that the scale of deposit funding has a significant impact on the position of investor members. The public perceives building society share accounts to be as secure as (or even more secure than) bank deposits. However, unlike depositors with banks, share account investors are contributories, not creditors, so they rank after deposit funders, including suppliers of wholesale funding. A society which gears itself up significantly with wholesale funds thereby dilutes the security of its share account investors, whilst at the same time increasing its

refinancing and liquidity risks.

4.3.4 G Guidance on the management of short-term cashflow mismatches, and the liquidity requirements which flow from such positions, is given in Chapter 5 (Liquidity). Risks arising from the interest basis/structure or currency of the funding are covered later in this chapter.

### **Structural risks**

4.3.5 G Most societies are susceptible to interest rate exposure arising not only as a result of changes (or potential changes) in the general level of interest rates or the relationship between short term and long term rates, but also from divergence of rates for different balance sheet elements (“basis” risk), for example, the risk that it may not be possible to increase administered mortgage rates in line with increases in money market (LIBOR) rates, resulting in a margin squeeze where funding is LIBOR-based. In this chapter, risks which arise from the different interest rate or currency characteristics of assets and liabilities, and from transactions based on other financial reference rates or indices, are referred to as “structural” risks.

### **Operational risks**

4.3.6 G The extension of building society activities into new forms of funding, liquidity and off balance sheet instruments has dramatically increased the operational risks involved. The documentation, accounting treatment and settlement procedures for such instruments can be highly complex, with significant costs and penalties arising from operational mistakes. Societies involved in these areas of activity need rigorous management procedures and control systems to ensure that robust legal documentation is used, that compliance with market practice is achieved, and that deal recording and settlement systems are effective (with appropriate contingency arrangements in place).

### **Key risk categories**

4.3.7 G The key financial risks which, as envisaged in 4.2.1G, societies should manage and control, are:

- (1) Maturity mismatch, including the risks:
  - (a) that the society may be unable to refinance term wholesale borrowings on a rollover date due to general market conditions (which may or may not be related to the position of the society itself);
  - (b) associated with the bunching of roll-over dates for wholesale funding or maturities of term retail funding;
  - (c) from concentration on a limited number of funding providers, giving rise to increased dependence particularly on roll-over days; and
  - (d) arising from the prepayment (early redemption) profile of mortgages, and those inherent in the early withdrawal characteristics of retail savings products (i.e. behavioural v. contractual maturity risks);
  
- (2) Interest rate risk to a society's earnings (most significantly, to its interest margin) and to its economic value (the present value of future cashflows) arising from:
  - (a) repricing mismatches, e.g. where, in a rising interest rate environment, liabilities reprice earlier than the assets which they are funding, or, in a falling rate environment, assets reprice earlier than the liabilities funding them (in both cases leaving the society with a reduction in future income); repricing risk is inherent in fixed rate instruments, the market value of which will change with interest rate movements (e.g. Gilts), and unhedged fixed rate retail products (e.g. unhedged fixed rate mortgages funded by variable rate liabilities would yield less margin should the cost of the liabilities increase due to changes in market rates);
  - (b) yield curve risk, where unanticipated changes to the shape or slope of the yield curve will cause assets and liabilities to reprice relative to each other - possibly exposing positions which were hedged against a parallel shift in rates only;



- (c) interest basis mismatches, arising from the imperfect correlation of rates on instruments with similar repricing characteristics, e.g. between LIBOR rates and mortgage rates (both of which are variable but are subject to different market forces), or between LIBOR and reference Gilt rates, or between 3 and 12 month LIBOR rates etc. Risk can also arise where the underlying market rate is the same for matching assets and liabilities, but the margin paid relative to the offer rate diverges from the margin received relative to the bid rate;
- (d) balance sheet composition, where an increase in the proportion of assets and liabilities repricing at fixed or variable wholesale market rates implies a reduced administered rate element in the balance sheet - which will nevertheless have to bear (at least in the short term) the full brunt of any rate changes required in order for a society to widen its margins, if necessary for business or profitability reasons (e.g. in the event of a significant credit deterioration leading to rising provision levels);
- (e) optionality (i.e. explicit/contracted option contracts, such as “caps”, “collars” and “floors”, which confer the right, but not the obligation, to fix an interest rate for an agreed amount and for an agreed period. and embedded/implied options included within products, such as early withdrawal or redemption entitlements), magnifying the effect of other interest rate risks: in particular, societies may be subject to implied optionality in respect of retail savings rates (for which a minimum rate payable - a “floor” - above 0% may need to be assumed), and from prepayment of mortgages/pre-withdrawal of deposits (where the customer may effectively have an “option” which may not be adequately “hedged” by way of early redemption charges); and
- (f) product pricing, arising particularly where products are not immediately profitable and where longer term payback is dependent upon the achievement of specific cost and/or pricing assumptions.

- (3) Currency risk, arising from the effects of changing exchange rates on unmatched assets

and liabilities denominated in different currencies; and

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

4.3.8 G Societies' financial risk management policies should also cover:

- (1) Settlement risk: the risk of losses arising from failure to settle transactions accurately, or on a timely basis;
- (2) Counterparty risk: associated with settlement risk, where a counterparty cannot or will not complete a transaction;
- (3) [Deleted];
- (4) Operational risk in treasury and related activities: including failure of internal controls or procedures, and the risk arising from errors in legal documentation.
- (5) [Deleted]

## **4.4 Statutory restrictions**

### **Funding limit**

4.4.1 G Section 7 of the 1986 Act provides that at least 50% of the funds (excluding those qualifying as own funds) of a building society (or, if appropriate, of the society's group) must be raised in the form of shares held by individual members of the society (excluding share accounts held by individuals as bare trustees for corporate bodies).

### **Structural risk management restrictions**

4.4.2 G Section 9A prohibits a society or its subsidiary undertakings (subject to certain defined exemptions) from:

- (1) acting as a market maker in securities, commodities, or currencies;
- (2) trading in commodities or currencies; or
- (3) entering into any transactions involving derivative investments.

4.4.3 G Section 9A contains definitions of the above terms, and societies are directed particularly to section 9A(9) for the purposes of compliance monitoring.

4.4.4 G Section 9A also includes a “purpose” test for entering into derivatives contracts and a “safe harbour” clause for society counterparties stating that any transaction in contravention of the section 9A prohibitions is not, however, thereby invalid and may be enforced against the society.

4.4.5 G The exemptions in section 9A fall into two broad categories:

- (1) those which allow a society or subsidiary undertaking to provide certain retail services to its customers, including:
  - (a) acting as market maker in currency or securities transactions of less than £100,000;
  - (b) trading in currencies (but not commodities) up to a value of £100,000 per transaction;
  - (c) entering into “contracts for differences” in respect of customers who wish to hedge exposures arising from their own loans or deposits with, the society group; or
  - (d) acting as market maker or entering into “derivative investments” in its capacity as manager of a collective investment scheme; and

- (2) those which allow a society or subsidiary undertaking to use “derivative investments” in order to limit the extent to which it, or a connected undertaking, will be affected by changes in interest rates, exchange rates, any index of retail prices, any index of residential property prices, any index of the prices of securities, or the creditworthiness of any borrower(s).

4.4.6 G The Treasury may, by negative resolution order, amend the £100,000 transaction limit and may add factors to, or remove factors from, the list in 4.4.5(2) above. The factor relating to credit worthiness was added to the original list in section 9A(4)(b) by the Building Societies (Restricted Transactions) Order 2001 (SI 2001/1826). The Treasury may, by affirmative resolution order, make more significant amendments to section 9A.

4.4.7 G Boards should have procedures and controls to ensure that use of section 9A exemptions by their society (and subsidiary undertakings, if any) is within the law. The exemptions permitting transactions of up to £100,000 (as market-maker in currency or securities transactions, or trading currencies) may not be abused by artificially breaking up larger transactions into a number of smaller amounts falling within the £100,000 ceiling (section 9A(8) is the relevant anti-avoidance provision). Compliance with the 1986 Act may be assisted by specifying the purposes and circumstances in which hedging transactions may be undertaken, or derivatives used, both in the financial risk management policy documents and in the internal arrangements for delegation, identifying the specific authority in section 9A. Whatever the hedging policies adopted, and however the control and authorisation arrangements are organised, it is important that they should be accurately and fully documented.

## **4.5 Supervisory approach**

### **Funding limits**

4.5.1 G Whilst the section 7 funding limit is expressed as a minimum of 50% share account funding, societies should, for prudential monitoring purposes, draw up a funding policy which incorporates an internal policy limit based on a maximum level of deposit liabilities (i.e. an inversion of the “nature limit”). In order to avoid any possibility of an inadvertent breach of the 1986 Act, it is expected that

such internal limits will be set at levels below the 50% statutory maximum.

4.5.2 G In setting funding limits, the board should consider wholesale and other deposit funding requirements over the period of their society's current corporate plan, and avoid setting limits at levels where usage is either unplanned or highly unlikely. Where societies have significant levels of offshore deposit funding or commercial deposit funding, boards should set policy sub-limits for these sources (e.g., a society might set an overall deposit liabilities limit of 30%, with sub-limits of 25% for wholesale funding and 10% for offshore funding - the total of the sub-limits exceeding the overall limit only on the basis that both could not be used to their full extent simultaneously).

### **Supervisory standards for treasury activities**

4.5.3 G Under section 5 of the 1986 Act, a society's principal purpose is residential mortgage lending, financed by members' savings, not undertaking, and trading in, financial risk for profit. Societies should therefore adopt a risk-averse approach to maturity mismatch and to structural risk management. A degree of maturity mismatch and structural risk is inherent in normal building society operations, but boards should set risk limits which either:

- (1) ensure that, as far as possible, such exposures are minimised; or
- (2) where interest rate positions are to be taken, restrict potential reductions in income or economic value, estimated under robust stress testing scenarios, to levels which would not compromise the current or future viability of their societies.

4.5.4 G Societies should aim to eliminate, as far as is practicable, all exposures to risk arising from movements in currency exchange rates.

4.5.5 G As explained in 4.2.1G, a society's system for financial risk management should be adequate. The policy statement envisaged in 4.2.5G should be appropriate for the society's business needs and the complexity of its existing and proposed treasury activities. The FSA has devised five models, described as supervisory approaches, of increasing sophistication, to assist societies. The approaches are described as "administered", "matched", "extended", "comprehensive" and "trading". A society that conducts its

treasury activities in accordance with the most suitable (for it) of these five models, can readily demonstrate that it complies with the SYSC requirements referred to in 4.2.1G and 4.2.5G in the context of financial risk management. But these models are neither mandatory nor exhaustive. Guidance on the characteristics of each approach is set out in Annex 4A.

### **Supervisory discussions on change of approach**

4.5.6 G The FSA anticipates that societies will wish to develop further their treasury expertise, and that a change of “approach” may be necessary. In this respect, the “approach” categories should be seen, not as discrete compartments, but rather as stages in the continuous evolution of financial risk management, with a change of “approach” marking a milestone in that progress. Societies should develop their financial risk management and systems to the level appropriate to support the scale and nature of their business and the FSA will be encouraging societies to enhance their treasury capabilities where this is considered to be necessary.

4.5.7 G Whilst the “approach” benchmarks have no legal significance, the process of moving between approaches provides a useful opportunity for the FSA to review a society's progress, and to satisfy itself that policies, limits and systems are appropriate for the treasury activities planned.

4.5.8 G Any society which wishes to move between approaches should contact the FSA at an early stage. The FSA will wish to be satisfied that the society has the requisite expertise, management information systems, accounting systems and controls before any significant change in the society's treasury activities is implemented.

## **4.6 [Deleted]**

## **4.7 Risk management systems**

4.7.1 G The guidance in this section amplifies SYSC 7.1.2R and SYSC 7.1.3R specifically in the context of treasury management. A society should have in place information systems that are capable of:

- (1) measuring the level of maturity mismatch and structural risk inherent in its balance sheet;

- (2) assessing the potential impact of interest rate (and, if applicable, currency exchange rate) changes on its earnings and its economic value (including the effect of any standard interest rate shock as specified by the FSA in BIPRU 2.3);
- (3) reporting accurately, and promptly, on risk positions - to management, to the board and, if requested, to the FSA – including generating the information necessary to carry out its ICAAP and reporting the results of stress testing for interest rate risk in the banking book;
- (4) recording accurately, and on a timely basis, all new transactions and/or cashflows which will affect calculations of structural risk exposures;
- (5) managing the settlement timetable and processes for individual treasury instruments; and
- (6) monitoring credit risk and settlement risk positions incurred with individual and groups of counterparties.

4.7.2 G The scale and scope of the risk measurement system employed should reflect the sophistication of a society's treasury operations, those societies wishing to adopt the “Comprehensive” or “Trading” approaches requiring more complex techniques to capture different facets of risk.

### **Control limits**

4.7.3 G Control limits confine structural risk positions within levels considered by board and management to be prudent, given the size, complexity and capital needs of the society's business. Where applicable, limits should also be applied to individual instrument types, asset/liability portfolios, and to separate business activities or subsidiaries.

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

4.7.5 G The number and type of limits which should be applied will depend upon the relative sophistication of a society's treasury operations, and further guidance on the FSA's expectations for each policy approach is set out in Annex 4A.

4.7.6 G Where limits are set as part of the overall board policy, these should be treated as absolute, and therefore no excesses should be tolerated. Any limit exceptions should be reported immediately to executive managers, and the policy should make clear what action is expected of management in such circumstances (including arrangements for informing the board and the FSA of the breach). Limits set by management should similarly be subject to clear guidelines covering the circumstances and periods for which breaches may be permitted (if at all) and the arrangements for notification of exceptions.

### **Stress testing**

4.7.7 G The risk measurement systems put in place should evaluate the impact, on income or economic value as appropriate, of abnormal market conditions. The amount and type of such stress testing required will depend upon the sophistication of treasury operations undertaken, and the level of risk taken, but where required should be regular and systematic. Boards and management should, periodically, review the extent of such stress testing to ensure that any "worst case" scenarios remain valid. Contingency plans should be in place to deal with the consequences should such scenarios become reality. Rules and guidance on stress testing and scenario analysis are in GENPRU 1.2 and BIPRU 2.2. Material on this subject specifically relating to liquidity risk, including liquidity contingency plans, is in SYSC 11. Requirements for stress testing for interest rate risk in the banking book are set out in BIPRU 2.3.

### **Board information reporting**

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



## 4.8 Counterparty risk

4.8.1 G Counterparty limits should cover:

- (1) full risk exposures (e.g. deposits or marketable instruments);
- (2) market risk exposures (e.g. mark to market positive value of swaps, plus appropriate addition for potential future exposure increases arising from changes in market rates);  
and
- (3) settlement risk exposures (e.g. currency deals where amounts are paid out before funds are received).

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

4.8.3 G Limits should be established on the basis of a robust methodology, which should be fully documented and reviewed regularly. For societies with more active treasury operations, a separate credit risk committee with responsibility for preparing a credit policy statement and counterparty list may be appropriate - less active societies may incorporate a section on credit risk within their liquidity policy statements, with appropriate cross-references to other policy and procedures statements. In all cases, the counterparty list and individual limits should be subject to formal credit review at least annually, with interim arrangements in place to add, amend or remove limits as appropriate.

4.8.4 G Where reliance is placed on sources of information or opinion external to both the society and the counterparty (e.g. rating agencies), the nature of the source, and arrangements for ensuring that the information relied upon is kept up to date, should be made explicit in the credit risk policy document and in procedures manuals. Where ratings are reduced (or put on “watch” with “negative implications”), or where a society becomes aware of information on a counterparty which might affect

its perceived creditworthiness, it should have systems for reviewing individual counterparty limits and, possibly, suspending/removing individual names from authorised lists in an expeditious manner. Arrangements for obtaining published information on counterparties should also be included in procedures manuals.

4.8.5 G Exposures to counterparties should be monitored on a consolidated basis, aggregating exposures of the society and any subsidiaries (where applicable), and setting total exposure limits for groups of connected counterparties (e.g. a commercial bank and its merchant bank subsidiary). Similarly, country, sector and market concentrations should be monitored continuously against agreed limits.

4.8.5A G The guidance in this section complements the high level rules and guidance on credit and counterparty risk in SYSC 7.1.9R to SYSC 7.1.11R.

### **Large shareholdings and deposits**

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

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

- (1) obtaining funding from a single shareholder or depositor which exceeds 1% of shares, deposits and loans; and
- (2) allowing the aggregate total of funding, from those single shareholders or depositors which individually represent more than one-quarter of 1% of shares, deposits and loans, to exceed 5% of shares, deposits and loans.

## **Committed facilities**

4.8.8 G A society with high levels of maturing funding, or vulnerability to withdrawal of individual deposits, should consider arranging committed facilities (or maintain higher than average levels of liquidity). In arranging committed facilities, a society should consider:

- (1) the credit standing and capacity of the provider of the facility;
- (2) the documented basis of the commitment (i.e. is it an unconditional commitment or a “best endeavours” arrangement); and
- (3) the cost/fee structure compared to alternatives.

In extreme cases , there remains a risk that a provider may renege on a contractual commitment to provide funding, or purport to rely on widely drawn “events of default” or “material adverse change” clauses, and face the legal consequences (if any) rather than lend money to a society in difficulties. Societies should not, therefore, become over reliant on committed facilities to plug short term cashflow difficulties.

## **4.9 Operational risk**

4.9.1 G [Deleted]

4.9.2 G [Deleted]

4.9.3 G [Deleted]

4.9.4 G [Deleted]

4.9.5 G [Deleted]

#### 4.9.6 G [Deleted]

### **IT security**

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

- (1) [Deleted];
- (2) ensure that treasury IT systems access, both physical and logical, is subject to robust security;
- (3) exercise strong control over the development and modification of treasury IT systems; and
- (4) involve internal audit in reviewing the development or modification of treasury IT systems.

## **4.10 Independent review and controls**

### **Internal audit**

4.10.1 G The guidance in this section amplifies SYSC 6.2.1R in the context of treasury management. Each board should ensure that its society's internal audit department (if it has one) has the skills and resources available to undertake an audit of the treasury function. Internal audit should evaluate, on a continuing basis, the adequacy and integrity of the society's controls over maturity mismatch, over the level of structural risk taken and should assess the effectiveness of treasury management procedures.

4.10.2 G Societies with complex treasuries or lacking internal auditors with treasury expertise may outsource treasury audit to an audit firm with the appropriate expertise and experience. The work of outsourced internal audit should be fully integrated into the society's overall audit procedures and plans,

with appropriate reporting lines into the audit committee. However, in order to avoid conflicts of interest, internal audit should not be contracted out to the society's own external auditors – even if the function were to be performed by a completely different branch of the audit firm.

#### 4.10.3 G [Deleted]

## 4A.1 Supervisory approach categories

4A.1.1 G This Annex provides guidance on the five models, or supervisory approaches, to financial risk management described in paragraph 4.5.5G. Where societies have subsidiary treasury operations, it is expected that these will fall into the same approach category as that of the parent society. An outline description of each approach is set out below, and table 4A.7G “Summary of the five approaches” at the end of this Annex summarises the key features.

## 4A.2 “Administered” approach

4A.2.1 G Societies in this category are expected to have balance sheets where loan assets and funding liabilities are entirely in Sterling and predominantly (>95%) subject to administered rates. In general, it is anticipated that the “Administered” approach will:

- (1) tend to suit small or very small societies;
- (2) where balance sheet management is typically undertaken by the Chief Executive in conjunction with the board - existence of a specific finance function (and Finance Director) being unlikely.

4A.2.2 G Societies adopting this approach:

- (1) should not offer fixed rate products (defined as repricing more than one year and one day later than the current date) on either side of the balance sheet;
- (2) should have policies limiting the levels of deposit funding to less than 10% of share and deposit liabilities unless a higher limit of up to 35% has been discussed with the FSA to accommodate those societies who take significant commercial deposits but funding from the wholesale markets will be limited to 10% of share and deposit liabilities;

- (3) will hold a simple range of liquid assets (whether counting as prudential liquidity or not), with marketable fixed rate instruments held only provided that these have a residual maturity of 5 years or less; and
- (4) should place no fixed rate time deposits having a maturity greater than 1 year.

4A.2.3 G Societies adopting the “Administered” approach do not need specific risk management reporting, but the market value of fixed rate investments with maturities of more than one year, as compared to their purchase price, will be monitored by the monthly monitoring returns.

### **4A.3 “Matched” approach**

4A.3.1 G Societies adopting this approach should have balance sheets where assets and liabilities are entirely in Sterling and use hedging contracts (or internal matching of assets and liabilities with similar interest rate and maturity features) to neutralise the risk arising from loans or funding other than at administered rates, on a tranche by tranche, product by product basis. Characteristic of small to medium sized societies, with limited treasury skills or resources, typically the Chief Executive of such societies will be supported by a Finance Director or Finance Manager, and report direct to the board on treasury matters (or through a board sub-committee).

4A.3.2 G Societies adopting this approach should:

- (1) have in place policy statements covering the intention to offer fixed rate (i.e. >1 year to repricing date) products on one or both sides of the balance sheet;
- (2) set limits (as a % of total assets) for fixed rate loan assets and share or deposit liabilities, and for holdings of fixed rate liquid assets (whether counting as prudential liquidity or not);
- (3) set an overall limit for hedging transactions (nominal value of transactions %SDL); and

- (4) have in place policies limiting the levels of deposit funding to less than 25% of share and deposit liabilities unless a higher limit of up to 35% has been discussed with the FSA to accommodate those societies who take significant commercial deposits but funding from the wholesale markets will be limited to 25% of share and deposit liabilities.

4A.3.3 G The policies of such societies can allow use of standard hedging products for transactions permitted by section 9A, e.g.:

- (1) swaps (including FTSE index swaps);
- (2) Forward Rate Agreements; and
- (3) plain vanilla over the counter (“OTC”) options such as swaptions, caps, collars and floors (options purchased only);

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

4A.3.4 G Risk management for such societies will be achieved internally through:

- (1) matching reports (detailing individual products and the hedging instruments associated with them); and
- (2) gap analysis - for gapping purposes, reserves will need to be treated as having no fixed repricing date, and gap limits should be set at the minimum level required to give flexibility in timing the hedges for individual mortgage and investment products, with some allowance for residual risks (those too small to be economic to hedge) and for holdings of fixed rate liquid assets. Basis risk should be minimised by setting cautious limits for fixed rate and market rate assets and liabilities.

4A.3.5 G Gap monitoring reports should be updated and considered by the board at least monthly. By implication, societies adopting this approach should not be taking an interest rate view for the purposes



of determining a hedging strategy.

#### **4A.4 “Extended” approach**

4A.4.1 G The principal difference between the “Matched” and the “Extended” approaches lies in the capability to measure and hedge structural risk across the whole balance sheet, including reserves, rather than just hedging individual transactions. The approach will thus allow a society to allocate reserves to specific repricing bands representing a considered view of the characteristics of such reserves and/or the assets deemed to “represent” such reserves, or to manage interest rate gaps as part of a strategy for hedging the endowment effect of interest free reserves against adverse interest rate movements. Risk analysis should also enable it to position its balance sheet to take advantage of a particular interest view. Societies adopting this approach will have the capability to fund in currency and to hold a limited range of currency liquid assets (see Chapter 5, Liquidity), subject to aiming for elimination of all currency exchange mismatch, within an expected maximum limit of 2% of own funds.

4A.4.2 G As a result, a society adopting the “Extended” approach will:

- (1) adopt policies and systems to enable it to undertake the hedging of individual transactions within the context of an overall strategy for structural hedging, based on detailed analysis of its balance sheet; and
- (2) use the output of such analysis to enable it to position its balance sheet to take advantage of a particular interest view.

4A.4.3 G Management of interest risk for such societies will typically be controlled by the board acting through an Assets and Liabilities Committee (ALCO) or equivalent sub-committee, which will normally be responsible for agreeing any interest rate view. Reporting to the ALCO, there will typically be a Treasurer running a small treasury department with appropriate segregation between dealing and settlement activities.

4A.4.4 G Hedging instruments available to be authorised by the board will be the same as for the “Matched” approach, with the addition of (as far as permitted by section 9A):

- (1) exchange traded futures/options and FTSE (or similar) OTC swaps/options (options to be purchased only);
- (2) foreign exchange swaps and forward contracts, used to hedge currency funding; and
- (3) credit derivatives.

4A.4.5 G Risk management systems should be based on:

- (1) full balance sheet gap analysis;
- (2) possibly supplemented by static simulation.

4A.4.6 G Gap limits could allow leeway for risk positions - to be controlled by sensitivity limits covering potential changes in both earnings and economic value.

4A.4.7 G Basis risk should be controlled through limits on the minimum levels of administered rate assets and liabilities, and limits on the extent of mismatch between LIBOR-based and administered rate balances.

4A.4.8 G Positions should be monitored internally by way of frequent updates (monthly minimum).

## **4A.5 “Comprehensive” approach**

4A.5.1 G The principal differences between the “Extended” and the “Comprehensive” approaches lie in:

- (1) the depth and quality of the risk management systems put in place to monitor and control structural risk;
- (2) the frequency of analysis undertaken; and

- (3) the currencies in which treasury operations would be undertaken.

4A.5.2 G Like the “Extended” approach societies, “Comprehensive” approach societies will manage risk using a board/ALCO/Treasurer reporting structure, but the latter will typically subdivide the treasury department further with a separate “middle office” risk management function, segregated from “front office” (dealing) and “back office” (settlement/accounting).

4A.5.3 G Hedging instruments available for use under agreed board policy will include those for the “Extended” approach plus (as far as permitted by section 9A):

- (1) currency options.

4A.5.4 G Risk analysis should extend beyond static gap/static sensitivity analysis to:

- (1) dynamic simulation (projecting forward balance sheet elements and simulating the impact of different interest rate scenarios);
- (2) possibly duration (modified or dollar, reflecting the change in percentage or money value of positions for a given change in interest rates) for individual portfolio elements, or present value of a basis point move (PVBP) calculations, to highlight sensitivity to non-parallel shifts in the yield curve; and
- (3) possibly value at risk (VaR), using correlation/historic simulation and/or Monte Carlo simulation;

the impact on both earnings and economic value being assessed internally on a very regular basis.

4A.5.5 G Risk positions could reflect an interest view, subject to sensitivity limits set by board/ALCO and incorporating basis risk assessment/control. Foreign exchange mismatch ( i.e. exchange rate exposure) is expected to be limited to less than 2% of own funds.

## **4A.6 “Trading” approach**

4A.6.1 G A category for those societies which wish to take advantage of the ability to trade in securities. Essentially, such societies will adopt the “Comprehensive” approach for the purpose of managing interest risk arising in their “banking books”, but with additional policies, financial instruments, systems and expertise for managing the market risks inherent in running separate “trading books”. Currency positions exceeding 2% of own funds are permitted, but are expected to be subject to overall board limits.

4A.6.2 G Such a society should control the additional market risks through a Market Risk Committee of the board and risk management systems should include complex portfolio management, option pricing and VaR models.

4A.6.3 G [Deleted]

#### 4A.7G Summary of the five approaches

POLICY APPROACH	RISK MANAGEMENT	RISK ANALYSIS	HEDGING INSTRUMENTS	FUNDING	PRUDENTIAL & OTHER LIQUIDITY	LOAN ASSETS
ADMINISTERED	CE (+FD) & board Dealing/settlement segregation (minimum 2 persons)	None (But, if fixed rate liquid assets held, then mark to market value and sensitivity analysis required)	None	Sterling only Deposit Liabilities < 35%SDL No fixed rate (> 1 Year) provided that funds received from the wholesale market do not exceed 10% SDL	Sterling only No non-marketable > 1 Yr. No marketable > 5 Yrs	No fixed rate (1 Yr. +)
MATCHED	CE/FD (or FM), (ALCO) & board Dealing/settlement segregation (minimum 2 persons)	Matching report & Monthly (minimum) Gap analysis (Reserves NFR) - No structural hedging No Interest View Minimal limits (to cover residual balances + pipeline products only)	Interest rate & FTSE index Swaps/FRAs/ Caps/Collars/ Floors (purchase only)	Sterling only Deposit Liabilities <35%SDL provided that funds received from the wholesale market do not exceed 25% SDL	Sterling only	Limit on fixed rate (1 Yr. +)
EXTENDED	(CE)/FD/Treasurer + ALCO & board Treasury segregation (front office/back office)	Monthly (minimum) Static Gap (& Static Simulation) - Reserves hedged Interest view Sensitivity limits (earnings, economic value & basis risk)) No FX mismatch	Interest Rate & FTSE index Swaps/FRAs/ Caps/Collars/ Floors/Futures/FTSE Options (purchase only) FX Swaps/Forward Contracts Retail derivatives & FX contracts permitted. Credit derivatives	Sterling + Currency Minimum level of administered rate liabilities	Sterling + Currency (limited range of currency instruments)	Minimum Level Of administered Rate Assets
COMPREHENSIVE	FD/Treasurer/Risk Manager + ALCO & board Treasury segregation (front office/middle office/back office)	Very frequent Gap (Reserves Hedged)+ Duration/ Simulation/ (VaR.) Sensitivity limits (earnings & economic value) Basis risk limits FX mismatch <2% Own Funds	Interest Rate & FTSE index Swaps/FRAs/ Caps/Collars/ Floors/Futures/FTSE Options Exotic Options FX Swaps/Forward Contracts/ Options Retail derivatives & FX contracts permitted. Credit derivatives	Sterling + Currency	Sterling + Currency	Sterling + Currency
TRADING	FD/Treasurer/Risk Manager +/- Market Risk Committee/ ALCO & board Treasury segregation (front office/middle office/back office) + banking book/ trading book	Banking Book: Daily (minimum) Gap (Reserves Hedged)+ Duration/ Simulation/ (VaR) Trading Book: VaR - CAD capability	Interest Rate & FTSE index Swaps/FRAs/ Caps/Collars/ Floors/Futures/FTSE Options/ Exotic Options Retail derivatives/FX permitted. FX Swaps/Forward Contracts/ Options Equity Options Credit derivatives	Sterling + Currency	Sterling + Currency	Sterling + Currency

## ANNEX 4B

### 4B Credit Derivatives

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# Interim Prudential Sourcebook for Building Societies

## 5 LIQUIDITY

### CONTENTS

SECTION	PAGE
5.1 Introduction	2
5.2 Rules	3
5.3 The Prudential Regime for Liquidity	3
5.4 Short-term Liquidity	5
5.5 Supervisory Approach to Liquidity	6
5.6 Board and Management Responsibilities	7
5.7 Society-only Approach to Liquidity	8
5.8 Brokers' Advice	8
ANNEXES	
5A Prudential Liquidity	10
5B Policy Statement on Liquidity	14
5C Inter-society Holdings	17



# Interim Prudential Sourcebook for Building Societies

## 5 Liquidity

### 5.1 Introduction

5.1.1 G This chapter now sets out the FSA's quantitative regime for building societies' prudential liquidity, and further guidance specific to building societies on the management of their liquidity in accordance with the five approaches to financial risk management set out in chapter 4. This chapter complements GENPRU 1.2 and BIPRU 2.2 (which contain rules and guidance for systems and controls relating to adequacy of financial resources generally) and SYSC 11 (which sets out the high level requirements for liquidity). The chapter outlines factors the FSA will take into account in assessing whether a society meets the rules set out in section GENPRU 1.2 and SYSC 11 so far as liquidity risk is concerned. A list of types of asset suitable for inclusion in prudential liquidity for societies on each of the approaches to financial risk management is set out in Annex 5A. "Prudential liquidity" has the meaning set out in paragraph 5.3.4G.

5.1.1A G As part of the implementation of the Capital Adequacy Directive (CAD), the Banking Consolidation Directive (BCD) and the Markets in Financial Instruments Directive (MiFID), provisions relating to a firm's organisational and risk systems and controls have been introduced in SYSC 4, SYSC 5, SYSC 6 and SYSC 7. Whilst some of the material in SYSC applies to all societies, some applies only to societies that are subject to MiFID. The guidance in this chapter generally explains the application of the high level requirements in SYSC 4, SYSC 5, SYSC 6, and SYSC 7 (even if there is no specific cross reference) in the context of managing liquidity.

5.1.2 G Some material on liquidity systems and controls, previously in this chapter and superseded by SYSC 11, has been deleted, but the original numbering has been retained: where an entire section has been deleted this is noted alongside the original section number. The new material in SYSC 11 covers requirements for stress testing and scenario analysis, as well as contingency funding plans and their documentation.

## **5.2 Rules**

**5.2.1 R [Deleted]**

5.2.2 G [Deleted]

5.2.3 G [Deleted]

**5.2.4 E (1) A society should keep at least 3.5%SDL in 8 day liquidity.**

**(2) Contravention of 5.2.4(1) may be relied upon as tending to establish contravention of GENPRU 1.2.26R.**

5.2.5 G “SDL” is defined in paragraph 5.3.2.

5.2.6 G A list of assets acceptable as 8 day liquidity is set out in paragraph 5.4.3.

**5.2.7 R A society must maintain a board-approved policy statement on liquidity.**

5.2.8 G Guidance on the content of a liquidity policy statement is set out in 5.6.2 to 5.6.4 and in Annex 5B. Societies may, for convenience, wish to combine their liquidity policy statement with their documentation meeting these general requirements for contingency funding plans and documentation referred to in paragraph 5.1.1 and the other material in GENPRU, BIPRU and SYSC referred to in section 5.1. However, if they do so, societies need to be clear how any combined document meets the separate requirements.

**5.2.9 R [Deleted]**

## **5.3 The Prudential Regime for Liquidity**

5.3.1 G A building society specialises in long-term mortgage lending which is financed mainly by liabilities which are contractually short-term. This feature of societies’ business creates maturity mismatches which can give rise to cash flow imbalances. To ensure that it can meet its

obligations as they fall due, a society should therefore keep an appropriate amount and mix of liquidity to meet any sudden adverse cash flow; the level of liquidity held should be sufficient to maintain public confidence that the society can meet its commitments.

5.3.2 G The amount of liquid assets held by a society should be expressed as a percentage of its share and deposit liabilities (SDL). For the purposes of this chapter, SDL is defined as the total of share and deposit liabilities, excluding amounts that qualify as own funds but including accrued interest not yet payable. Societies should show the board-approved range for liquidity expressed as a percentage of SDL in their liquidity policy statement.

5.3.3 G Funds borrowed from the wholesale money markets have a specified maturity date on which they have to be repaid or rolled over and thus carry the risk that they will be unable to be refinanced on that maturity date on terms acceptable to the society. Societies should take this risk into account in planning the maturity profile of their prudential liquidity. The same consideration applies to large positions in retail funds where, for example, fixed-rate bonds or Tessa accounts are due to mature. Societies should not run large exposed funding positions without having sufficient liquidity to re-finance part or all of the position on maturity. An effective maturity diary should be established for both funding and prudential liquidity.

5.3.4 G Liquid assets should be genuinely liquid i.e. they should be capable of being realised at very short notice. Only instruments or assets that are marketable (i.e. realisable in a secondary market) or have three months or less to run to maturity should (subject to the guidance in Annex 5A and in paragraph 5.5.2) be included in the calculation of liquidity for prudential purposes. Societies may hold other assets, but as an investment rather than liquidity (although such assets might still fall within the “liquid assets” heading in the annual accounts, which has no restriction on maturity). The treatment in the annual accounts determines whether an asset is a liquid asset for the purposes of calculating the society’s position in relation to the statutory limit in section 6 of the 1986 Act (the “lending limit”).

5.3.5 G Committed standby facilities form an important element of societies’ funding strategy and can be used to boost liquidity when needed. Societies should ensure that the lines are truly committed and that a diary is kept noting when the lines expire, allowing the facilities to be

renewed on a timely basis. Societies not using committed standby facilities should increase their level of liquidity to compensate.

## **5.4 Short-term Liquidity**

5.4.1 G The FSA operates a short-term liquidity regime for building societies from sight to 8 calendar days forward.

5.4.2 G An asset maturing on a non-business day should be regarded as maturing on the succeeding business day.

5.4.3 G The following liquid assets may be counted as short-term liquidity:

- (1) cash, current account balances, and Treasury bills;
- (2) deposits with relevant authorities (as defined in Annex 5A), banks and building societies with not more than 8 days' notice, or within 8 days of maturity;
- (3) all gilt-edged securities, subject to discounting according to maturity (see paragraph 5.4.4);
- (4) CDs (banks and building societies) with 3 months or less to maturity, commercial paper with residual maturity up to 1 month; and
- (5) holdings in a qualifying money market fund (the meaning given to the term in the Glossary of definitions in the Handbook applies).

5.4.4 G All gilt-edged securities can be included within 8 day liquidity, but discounted back to sight according to maturity. Such discounting should help to offset the greater price volatility which can affect gilts at the longer end of the maturity range. The discount factors which should be applied to market value of holdings of gilt-edged securities are as follows:

**maturities**

**maturities**

**maturities**

<b>less than 1 year</b>	<b>1 to 5 years</b>	<b>over 5 years</b>
Zero	5%	10%

5.4.5 G Societies on the “Administered” approach (as described in chapter 4 on Financial Risk Management) should not hold marketable fixed-rate instruments, including gilts, unless their residual maturity is 5 years or less. Where such societies have historic holdings of such investments, they may continue to be counted as prudential liquidity subject to the discount factor for gilt-edged securities.

5.4.6 G Societies with extensive treasury operations and large holdings of gilts will typically mark-to-market their gilt book daily. Societies with less sophisticated treasury operations which hold gilts as liquidity should mark-to-market their holdings at least once a week and more often during times of market volatility. Where such holdings are held as 8 day liquidity, market valuations should be taken daily to obtain an accurate value for purposes of discounting and to establish the amount of prudential liquidity at any given time.

5.4.7 G Societies should not include excessive amounts of inter-society holdings in their 8 day liquidity calculation. Societies should include sub-limits for the 8 day liquidity band within their overall sector limits in the liquidity policy statement.

## **5.5 Supervisory Approach to Liquidity**

5.5.1 G Societies should adopt a risk-averse approach to the management of liquid assets. Societies should ensure that treasury systems and controls are adequate for the scale of activity undertaken. Chapter 4 suggests that dealings in certain categories of liquid assets should be confined to societies on an advanced approach to financial risk management.

5.5.2 G Annex 5A sets out the range of assets considered appropriate for societies to hold as prudential liquidity although each society should satisfy itself that any particular kind of asset is suitable to its needs. If a society wishes to hold an asset as prudential liquidity that is not listed in Annex 5A, it should consider the following factors:

- (1) the suitability of the asset for the structure of the society's balance sheet, taking into account, inter alia, interest rate risk and any currency risk;
- (2) the marketability of the asset i.e. the "depth" of its liquidity;
- (3) credit risk and market risk (price volatility);
- (4) the adequacy of the society's expertise and systems in the treasury area.

## **5.6 Board and Management Responsibilities**

5.6.1 G Chapter 4 on Financial Risk Management refers to the potential risks to societies of treasury activities. In particular, the size and complexity of some transactions can make them vulnerable to losses and fraud, and the impact of losses on individual transactions in the treasury area can be significant and immediate. Boards have ultimate responsibility for deciding the degree of risk taken by their societies, including all categories of liquid assets and risks arising from the management of liquidity.

5.6.2 G Rule 5.2.7 requires each society to have a liquidity policy statement. This should be approved by the society's board and be consistent with the society's strategic plan and its financial risk management policy statement. Societies should also have regard to the rules and guidance in GENPRU 1.2 and SYSC 4, SYSC 5, SYSC 7, and SYSC 11.

5.6.3 G Policy statements should set out the board's objectives for liquidity, the limits within which liquidity should be maintained, the range of instruments in which liquidity can be invested and conditions under which authority is exercised. The document should establish the framework for operating limits and high level controls, and should set out the board's policy on credit assessment, ratings and exposure limits. Guidance on the content of liquidity policy statements is set out in Annex 5B.

5.6.4 G A liquidity policy statement should be a working document and personnel in the treasury and settlement areas should be familiar with its contents, as should members of ALCO

or Finance Committee. When aspects of the policy or limits become out of date, the policy document should be amended.

5.6.5 G Boards should establish the objectives for liquidity including meeting obligations as they fall due (including any unexpected adverse cash flow), smoothing out the effect of maturity mismatches and the maintenance of public confidence. The need to earn a return may also be recognised as an objective, although this should be secondary to the security of the assets. Societies should also have regard to the rules and guidance in GENPRU 1.2 and SYSC 11.

5.6.6 G [Deleted]

5.6.7 G [Deleted]

5.6.8 G [Deleted]

## **5.7 Society-only Approach to Liquidity**

5.7.1 G Societies need not calculate liquidity on a group basis for prudential purposes. Each subsidiary undertaking will have its own liquidity requirements reflecting the particular nature of its business and it will not normally be appropriate to combine these with the parent society or with each other. Liquidity held offshore, for example, may be managed with a degree of autonomy and subject to the rules of another regulator. In either case, this can lead to a loss of control and there may be circumstances where liquid assets are not immediately callable overnight. Liquid assets which are held offshore or in a subsidiary undertaking (or both) should be excluded from a society's calculation of its prudential liquidity. For the avoidance of doubt, this paragraph refers to liquid assets that are held by an offshore branch or subsidiary of the society. This paragraph does not refer to liquid assets established offshore or with offshore obligors that are held by the society's main treasury function in the UK.

## **5.8 Brokers' Advice**

5.8.1 G [Deleted]

5.8.2 G Most societies take advice from brokers regarding investment of their liquidity. Some, however, enter into a more formal arrangement where securities are delivered to and from the broker and a customer agreement between the broker and the society is completed. If so, societies should differentiate between advice and discretionary fund management. If the society has entered into an agreement involving the provision of advice, it should ensure that no transaction is undertaken without its prior consent. As with discretionary fund management, societies should make certain that all transactions are within the terms of its liquidity policy statement.



## Prudential Liquidity

5A.1 G The following list of assets is available to societies for the management of prudential liquidity, according to the society's approach to financial risk management, as set out in chapter 4.

	Administered	Matched	Extended	Comprehensive	Trading
1.1 Bank notes or coinage of any country or territory or electronic money issued by a credit institution.	√	√	√	√	√
1.2 Deposits with:	√	√	√	√	√
(1) the central bank of any member country of the EEA and of Canada, Japan, Switzerland and the USA (sterling only);					
(2) National Savings Bank;	√	√	√	√	√
(3) any credit institution authorised by the competent authorities of any member country of the EEA and Switzerland (sterling only);	√	√	√	√	√
(4) wholly owned subsidiaries of UK banks and building societies in the Channel Islands and the Isle of Man;	√	√	√	√	√
(5) any gilt-edged market maker or participant in the UK gilt market supervised by a regulatory authority in the EEA.	√	√	√	√	√

1.3 Loans to:	√	√	√	√	√
(1) the Department of Finance and Personnel (Northern Ireland);					
(2) any relevant authority ("relevant authority" is defined in section 49 of the Local Government Act 2000, as may be amended from time to time).	√	√	√	√	√
1.4 UK Government money market instruments (e.g., Treasury bills) and securities (gilts)					
(1) up to 5 years residual maturity;	√	√	√	√	√
(2) over 5 years residual maturity	X	√	√	√	√
1.5 Securities issued or fully guaranteed by the government of any other member country of the EEA and of Australia, Canada, Japan, New Zealand, Switzerland and the USA (sterling securities only).					
(1) either floating rate (of any maturity) or fixed-rate up to 5 years;	√	√	√	√	√
(2) fixed-rate over 5 years.	X	√	√	√	√
1.6 Securities issued, guaranteed or, in the case of bills of exchange, accepted by any credit institution authorised by the competent authorities of any member country of the EEA and Switzerland (sterling securities only).					
(1) either floating rate (of any maturity) or					

fixed-rate up to 5 years;	√	√	√	√	√
(2) fixed-rate over 5 years.	X	√	√	√	√
1.7 Securities issued by any relevant authority (as in 1.3(2)).					
(1) either floating rate (of any maturity) or fixed-rate up to 5 years;	√	√	√	√	√
(2) fixed-rate over 5 years.	X	√	√	√	√
1.7A Holdings in a qualifying money market fund (the meaning given to the term in the Glossary of definitions in the handbook applies)	√	√	√	√	√
1.8 National Savings Bonds.	√	√	√	√	√
1.9 Foreign currency deposits with:					
(1) the central bank of any member country of the EEA and of Canada, Japan, Switzerland and the USA;	X	X	√	√	√
(2) any credit institution authorised by the competent authorities of any member country of the EEA and Switzerland.	X	X	√	√	√
1.10 Foreign currency securities issued or fully guaranteed by the government of any member country of the EEA and of Australia, Canada, Japan, New Zealand, Switzerland and the USA (this category does not apply to mortgage backed securities).	X	X	√	√	√
1.11 Foreign currency securities issued, guaranteed or, in the case of bills of exchange, accepted by any credit institution authorised by the competent authorities of any member country of the EEA and Switzerland.	X	X	√	√	√
1.12 Securities issued by international					

organisations the capital of which is subscribed in whole or in part by any member state of the EEA (known as “supranationals”).					
(a) securities in sterling	√	√	√	√	√
(b) securities in foreign currencies	X	X	√	√	√
1.13 Securities in the form of commercial paper (which should be redeemed before the first anniversary of the date of issue) issued or guaranteed by:					
(1) public companies whose registered office is domiciled in the EEA;	X	X	X	√	√
(2) by public companies incorporated in Canada, Japan, Switzerland and the USA	X	X	X	√	√
1.14 Mortgage backed securities.	X	X	√ <sup>1</sup>	√	√
1.15 Stocklending rights arising from the lending of securities issued in the UK by HM Government.	X	√	√	√	√
1.16 Gilt repo	X	√	√	√	√
1.17 Repo in non-gilt-edged securities.	X	X	X	√	√
1.18 Stocklending rights arising from the lending of securities under the rules of any depository or clearing agent.	X	X	X	√	√

Note 1: Foreign currency deposits and foreign currency securities:

Societies should aim to hedge or match their foreign currency exposures. Any residual currency position should not exceed 2% of own funds, unless the society is on the Trading approach.

Note 2: Equities, or equity related stocks are excluded as prudential liquidity.

Note 3: Any guarantee should be unconditional in respect of the payment of both principal and of interest on all securities.

Note 4: Non-marketable assets (i.e., items 1.2, 1.3 and 1.9) are restricted to those with three months or less to residual maturity.

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<sup>1</sup> STERLING ONLY

Note 5: A society may still hold a non-qualifying money market fund as prudential liquidity in accordance with 5.5.2G but this holding may not be counted as short-term liquidity.

## Policy Statement on Liquidity

### 5B.1 Overview

5B.1.1 G This Annex provides guidance on the issues which should be addressed in a liquidity policy statement. The list of issues is not exhaustive and not all points will be relevant to all societies.

### 5B.2 Policy Statement Contents

5B.2.1 G The introduction section should include:

- (1) Background to the society's approach to liquidity management;
- (2) Ratification process for obtaining board approval, including amendments to the policy statement as well as complete revisions;
- (3) Arrangements for, and frequency of, review (which should be conducted at least on an annual basis).

5B.2.2 G The objectives section should set out the Board's objectives for liquidity (see section 5.6.5 of this chapter).

5B.2.3 G The operational characteristics section should set out the society's business and operational characteristics, which impact on the amount and composition of liquidity, and the intended range for liquidity and liquidity net of mortgage commitments as a percentage of SDL.

5B.2.4 G The risk management section should include:

- (1) Exposure policies, including controls and limits as appropriate, for countries, sectors (with sub-limits for 8 day liquidity) and counterparties, including exposure to brokers;

- (2) The policy adopted for credit ratings, stating the minimum quality acceptable and procedures for ensuring credit ratings are up to date;
- (3) Policy of assessment to be adopted towards sectors that are non-rated, e.g., local authorities;
- (4) Operational and settlement risk, including: framework of board authorisation, delegations and operating limits (including, inter alia, dealer limits, transaction and day limits); deal authorisation, confirmation checking, segregation of duties;
- (5) Limits for pre-approved free of payment (FOP) exposures (NB: all FOP exposures should be pre-approved);
- (6) Procedures and criteria for exceptional overrides in relation to dealing, operational rules, limits and authorisation;
- (7) Policy for liquidity management information and reporting to the board.

5B.2.5 G The maturity structure section should include the policy for maturity mismatch and a “maturity ladder” covering prudential liquidity. This should give a clear view of the maturity pattern of the liquidity portfolio to be followed, showing the maximum proportions of liquidity to be included within each time band.

5B.2.6 G The categories of assets and activities section should set out the society’s policy for the following:

- (1) inter-society holdings;
- (2) repo/reverse repo (both gilt-edged stock and non-gilt-edged securities);
- (3) stocklending;

- (4) mortgage backed securities (including, where applicable, US MBS);
- (5) foreign currency securities and the handling of foreign currency exposures;
- (6) commercial paper.

5B.2.7 G The society's policy for membership and use of any clearing system or depository should be set out clearly, including a section dealing with authorisation and operational controls.

5B.2.8 G Liquidity implications and the role of standby facilities should be included in the policy statement.

5B.2.9 G The role of external professional advisers should be clearly stated, where applicable.



## Inter-society Holdings

5C.1 G Societies may hold other societies' liabilities as prudential liquidity. Such holdings may include deposits and holdings of all forms of securities and money market instruments issued by other societies, including commercial paper, but should exclude Permanent Interest Bearing Shares and other forms of issued capital.

5C.2 G A society's aggregate holding of other societies' liabilities should not exceed 7.5% SDL or £5m whichever is the higher, including liquid assets which, although not counting as prudential liquidity (i.e., deposits with longer than 3 months to run to maturity) are held as other investments and fall within the "liquid assets" heading in the annual accounts. The total should also include undrawn as well as drawn amounts under committed facilities provided to other societies. This measure is to be continuous.

5C.3 G The FSA expects societies to invest no more than 30% of their prudential liquidity or £5m, whichever is the higher (up to a limit of 7.5% SDL or £5m whichever is the higher) in aggregate holdings of other societies' liabilities.

5C.4 G Committed facility agreements with other societies should be reported to the FSA in the MFS1 return (table D2). Only the amount drawn down (lent) will constitute a liquid asset, but the whole amount counts towards the aggregate exposure to other societies' liabilities as explained above.

5C.5 G Smaller societies (with total assets of less than £1 billion), can be, as a sub-sector, exposed to collective funding risk. Such risk would be exacerbated if smaller societies relied on committed facilities from each other. Accordingly, it would not, in the FSA's view, be prudent for smaller societies to rely on, or to provide, committed loan facilities from, or to, other smaller societies.

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### **6 Lending [Deleted]**

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### **7 Large Exposures [Deleted]**

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### **8 Mortgage Indemnity Insurance [Deleted]**

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## **9 Systems [Deleted]**

# **Interim Prudential Sourcebook for Building Societies**

## **10 Securitisation [Deleted]**

## **Interim Prudential Sourcebook for Building Societies**

### **11 Outsourcing [Deleted]**

## **1.1 Introduction [Deleted moved to BSOG]**



## **MERGER PROCEDURES**

- 1. INTRODUCTION [Deleted moved to BSOG]**

## TRANSFER PROCEDURES

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## **4 MERGER CONFIRMATION PROCEDURES**

### **4.1 Introduction [Deleted moved to BSOG]**

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## **5 TRANSFER CONFIRMATION PROCEDURES**

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