The LCR Catch-22 — to Disclose, or Not to Disclose

By Bill Nelson and Brett Waxman | July 29, 2020

Approximately six weeks after the end of each quarter, bank holding companies are required to publish their average liquidity coverage ratio (LCR) over the quarter, as well as the granular components of the LCR. The LCR is calculated as the ratio of high-quality liquid assets (HQLA) to projected net cash outflows over a 30-day episode of systemic and idiosyncratic stress. Banks are required to maintain an LCR above 100 percent.

The LCR has several purposes: (1) it ensures a bank will have the resources it needs to meet nearly all short-term liquidity stress events without requiring emergency liquidity assistance from the Federal Reserve; (2) it maintains counterparty confidence that a bank subject to the LCR will be able to make payments when due even in stress; and (3) it allows a bank faced with a liquidity stress event to avoid actions that can turn a liquidity stress event into a full-blown financial crisis, such as ceasing to lend to other banks and selling illiquid assets at fire-sale prices.

Unfortunately, there is a Catch-22 inherent in the LCR. To serve each of these three purposes, banks must use their HQLA when under stress. At the same time, to accomplish #2 – maintaining counterparty confidence – banks must maintain HQLA to meet future needs. Banks must be able to eat their cake and have it too. LCR disclosure requirements are also subject to this dilemma. Requiring banks to disclose their LCRs increases investor confidence that banks have the HQLA needed to meet future contingencies but discourages banks from being willing to use their HQLA to meet those contingencies as they arise.

In this post, we review the nature and purpose of LCR disclosure requirements, draw some parallels to disclosure requirements associated with discount window lending, and argue that LCR disclosures should either be removed or subject to a substantially delayed release, similar to the discount window.

LCR DISCLOSURE REQUIREMENTS

The LCR disclosure rule requires a bank subject to the LCR to disclose, on a quarterly basis, its average daily LCR over the quarter,[1] in addition to quantitative and qualitative information about various components of a covered bank's LCR. For the quantitative disclosures, the rule specifies a disclosure template, which consists of the unweighted (without applying the relevant haircuts and caps) and weighted amounts of HQLA and cash outflows that constitute a bank's LCR. The disclosure form is provided as an appendix. For the qualitative disclosures, a bank must discuss the factors that have a significant effect on its LCR, which may include drivers of the LCR, changes in the LCR over time, HQLA composition and funding source concentration, among other things. Disclosures are considered timely if they are made within 45 days of the end of the quarter, or no later than the 10-K due date for disclosures at fiscal year-end. The U.S. LCR

[1] Certain institutions between $100B and $250B in total assets that do not meet other risk-based indicator thresholds are considered "Category IV" institutions and are only required to calculate their LCR on a monthly basis and therefore disclose a monthly average.

disclosure requirements also include certain unweighted requirements that are not mandated for disclosure under the Basel standard (such as HQLA, secured wholesale funding, and net cash outflows).[2]

OTHER SUPERVISORY DATA ON LIQUIDITY

Above and beyond the LCR data that is publicly disclosed, a bank must also provide a host of more granular data on its liquidity profile to its supervisors on a confidential basis. Liquidity supervisory data is primarily collected through the FR 2052a, which is used to monitor banks' overall liquidity profile. Banks that are subject to the full LCR are required to report the FR 2052a daily, while those subject to a reduced daily or monthly LCR are required to report the FR 2052a on a monthly basis.[3] The FR 2052a includes detailed information on potential liquidity risks within different business lines of the banks and provides timely information on firm-specific liquidity risks during periods of stress. The report is also utilized by the agencies to monitor compliance with LCR requirements.

In addition to the requirements of the FR 2052a, a bank with more than $100B in assets is also subject to enhanced prudential standards as required by the Dodd-Frank Act. Under these enhanced prudential standards, banks are required to conduct internal liquidity stress tests to assess the potential impact of liquidity stress scenarios on their cash flows, liquidity position, profitability and solvency, taking into account their idiosyncratic liquidity profile and business model. These tests must be conducted at least monthly[4] and include time horizons of overnight, 30-days, 90-days and one-year, along with any other planning horizon relevant to a bank's liquidity profile. Each liquidity stress test also must include at a minimum, a scenario reflecting adverse market conditions, a scenario reflecting idiosyncratic stress for the bank and a scenario reflecting combined market and idiosyncratic stress.

These internal liquidity stress tests are in addition to the LCR requirements and may impose a higher liquidity requirement (in the form of a larger liquidity buffer) than that required by the LCR; however, they are not required to be disclosed even if they are a binding liquidity constraint. While not subject to standardized reporting, the results of these liquidity stress tests are reviewed by bank regulators as part of the supervisory process, including as part of the comprehensive liquidity analysis and review (CLAR) for the largest banks in the Large Institution Supervision Coordinating Committee (LISCC) Supervisory Program,[5] and for the horizontal liquidity review for the other banks. Importantly, all bank supervisory liquidity information from the FR 2052a, as well as bank internal liquidity stress tests, would remain available to supervisors even in the absence of LCR public disclosure requirements or if such requirements were scaled down.

Lastly, and perhaps most importantly, two significant large-bank liquidity requirements are not publicly disclosed and are considered to be confidential supervisory information. These are resolution planning requirements, which are also required by Dodd-Frank's enhanced prudential standards, around Resolution Liquidity Adequacy and Positioning (RLAP) and Resolution Liquidity Execution Need (RLEN). RLAP requires the firm to estimate standalone liquidity needs for each material subsidiary over a minimum of 30 days of stress, and ensure sufficient liquidity is either pre-positioned in the subsidiary or otherwise available as HQLA at the parent (who must hold sufficient HQLA to cover the sum of all net liquidity deficits at its material subsidiaries). RLEN requires the firm to further account for the estimated liquidity needed post-bankruptcy filing to support the surviving or wind-down subsidiaries, which can lead to a requirement for even more liquid assets at the subsidiary level. These requirements are notable in that, for many large

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2 We have previously raised concerns with the U.S. LCR disclosure requirements in comment letters available here and here that were written by The Clearing House Association — a predecessor organization of BPI.

3 Category IV institutions must submit data by day T+10. All other firms must submit data by day T+2.

4 Category IV institutions are only required to run internal liquidity stress tests on a quarterly basis.

5 CLAR is the Federal Reserve's annual, horizontal, forward-looking program, with quantitative and qualitative elements, to evaluate the liquidity position and liquidity risk management practices of the LISCC firms.

banks, it is RLEN and RLAP that are their binding liquidity requirements and not the LCR. Despite that, public disclosure of the LCR is seen as critical information for the market to have.

REASONS FOR LCR DISCLOSURE

The Basel accord that sets the internationally agreed-upon standards that banks are subject to is premised on three so-called pillars – Pillar 1 consists of minimum regulatory capital and liquidity requirements; Pillar 2 is the supervisory review process, which in some jurisdictions can translate into additional capital and liquidity requirements; and Pillar 3 is market discipline, which refers to the public disclosure requirements.

When the Basel Committee first proposed liquidity disclosure standards, it noted that "[p]ublic disclosure improves transparency, reduces uncertainty in the markets and strengthens market discipline. It is important that banks adopt a common disclosure framework to help market participants consistently assess the liquidity risk position of banks."[6] The U.S. agencies included similar language in their proposal to implement the Basel standards stating "[s]uch public disclosures would facilitate transparency and help to promote market discipline by providing investors and other stakeholders with comparable information about the liquidity risk profiles of those companies."[7] While the verbiage is slightly different, both regulatory bodies highlight market discipline and market and counterparty confidence as the main impetuses behind public disclosure.

In discussing market discipline, supervisors are generally referring to the notion that by requiring banks to disclose comparable and meaningful pertinent information (including on their liquidity risk profiles), the transparency will lead to the market penalizing "weaker" banks, while permitting "stronger" banks to thrive, thereby incenting banks to have strong liquidity profiles. Even dating back to 1995 when discussing public disclosure of trading and derivatives activities, the Basel Committee noted that "[w]ell-informed investors, depositors, customers, creditors and counterparties can impose strong market discipline on an institution to manage its activities in a manner that is both prudent and consistent with its stated business objectives." The Federal Reserve similarly included significant discussion around the benefits of LCR disclosures on market discipline in the final rule. It stated that public disclosure could encourage safe and sound banking practices by causing banks to internalize the cost of their liquidity risk profile and, therefore, lower the risks to financial stability. As a result, companies with resilient liquidity profiles could obtain funding at lower costs, while companies with less resilient profiles would be encouraged to improve their liquidity profiles to lower funding costs. The overall goal of disclosures for market discipline purposes seems to encourage banks to amass large stockpiles of HQLA in order to ensure they can continually disclose high LCR figures to the market and signal that they are in a strong liquidity position.

While not harmful in good times, these same disclosures can prevent banks from adjusting their liquidity profiles or using their available liquidity to continue lending in times of market stress, as discussed in more detail below.

While market discipline focuses on the benefits of providing transparency to the market as a whole, market/counterparty confidence is another key stated benefit of additional disclosure. Viewed from the lens of the market as a whole, disclosure of strong liquidity positions can increase investor and counterparty confidence that they will be paid when due, or be able to borrow when necessary, potentially limiting the risk that a liquidity event leads to a curtailment of interbank lending and fire sales of less liquid assets that can spread contagion throughout the financial sector. Moreover, investors and counterparties may be less likely to withhold funding during a time of market liquidity stress from a bank that has been disclosing a strong liquidity condition, even in the face of negative news about the bank.

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[6] Basel LCR Disclosure Consultation Paragraph 7.

[7] U.S. LCR Disclosure NPR at 75011.

As nearly universally recognized, including by the Basel Committee for Banking Supervision, which designed the LCR, and the Federal Reserve Board, OCC and FDIC, which implemented it in the United States, there is no point in requiring banks to maintain large stockpiles of HQLA (as opposed to making loans to businesses and households) unless that HQLA can and will be used by banks to help meet liquidity needs under stress. The Basel LCR standard indicates:

> The standard requires that, absent a situation of financial stress, the value of the ratio be no lower than 100% (ie the stock of HQLA should at least equal total net cash outflows) on an ongoing basis because the stock of unencumbered HQLA is intended to serve as a defence against the potential onset of liquidity stress. During a period of financial stress, however, banks may use their stock of HQLA, thereby falling below 100%, as maintaining the LCR at 100% under such circumstances could produce undue negative effects on the bank and other market participants. (paragraph 17)

Indeed, if banks won't use their HQLA when faced with a liquidity shock, they will instead sell non-HQLA assets at fire sale prices and pull back from lending to each other at term, precisely the actions that the LCR is intended to prevent that amplify a liquidity shock into a liquidity crisis. Indeed, the Basel standard indicates that, in determining how to respond to an LCR below 100%, supervisors should consider "[t]he potential for contagion to the financial system and additional restricted flow of credit or reduced market liquidity due to actions to maintain an LCR of 100%."

Nevertheless, in the United States, any bank whose LCR goes below 100% must immediately report the breach to its supervisor, and if its LCR remains below 100% for 3 days, the bank must provide supervisors a remediation plan. Even in the worst of the coronavirus financial strains in March, each bank was still required to submit a remediation plan if it used its HQLA, as confirmed in the agencies' Q&As on buffer usability.[8] It is difficult to imagine any institution using its liquidity buffer to "to support the economy in adverse situations and allow banking organization to continue to serve households and businesses" as intended by the agencies, if these same institutions would then need to turn around and quickly detail to it regulator how it will then rebuild the stock of HQLA they just depleted.

Similarly, requiring public disclosure of LCRs to promote market discipline and encourage banks' confidence in one another runs directly contrary to the objective of making banks willing to use their HQLA under stress. It's not that there is a tradeoff, it's that the two are incompatible. "Promoting market discipline" means encouraging banks to maintain large stocks of HQLA. "Maintaining market confidence" means encouraging banks to maintain large stocks of HQLA. However, market discipline and market confidence don't help creditworthy borrowers obtain funding when banks are holding HQLA to avoid breaching minimum requirements. Unless policymakers are content that HQLA be simply a lockbox of assets required of banks to participate in the business of banking—a concrete airbag as one banker called it—they need to consider alternative ways to promote discipline and maintain confidence.

We also note that all companies subject to the LCR disclosure rule are public companies already subject to a comprehensive framework under applicable securities laws that mandate public disclosure of material information, including trends, events and uncertainties that could have a material impact on their liquidity position. The existing framework has long attempted to balance the value of potential disclosure in terms of market discipline with the need to protect commercially sensitive details the disclosure of which could undermine competition in a given market. The federal banking agencies have not explained why the existing disclosure requirements applicable to all companies are not sufficient to meet any perceived disclosure needs for the LCR. Indeed, to the extent that the banking agencies are seeking to serve the interests of investors through their LCR disclosure requirement, there is a good argument that they are

[8] Q&As on Statement Regarding the Use of Capital and Liquidity Buffers available at: https://www.federalreserve.gov/supervisionreg/srletters/SR2005a1.pdf.

intruding on the jurisdiction of the SEC, which has a legal mandate and long history of determining what events are material and, therefore, must be disclosed.

LESSONS FROM DISCOUNT WINDOW TRANSPARENCY

As we've noted before, (see the BPI blog post "Unlocking the Liquidity Coverage Ratio"), there is a tight connection between promoting HQLA usability and reducing discount window stigma. Both actions – using HQLA and borrowing from the discount window – entail tapping a backup source of liquidity and so signal some degree of liquidity distress. During periods of market-wide liquidity concerns, any indication of distress can be astronomically costly. In a seminal article on central bank lender of last resort lending (LOLR), Freixas et al. (1999) recommend that the central bank be transparent about its policies for LOLR lending, because such transparency can increase market confidence in the liquidity of banks with access, but keep lending secret in real-time, because news that a bank is borrowing can be destabilizing for that bank and the banking system generally. In 2009, for instance, Ben Bernanke stated "Releasing the names of [the borrowing] institutions in real-time, in the midst of the financial crisis, would have undermined the effectiveness of the emergency lending and the confidence of investors and borrowers " (p. 1). Similarly, 25 years earlier, Eddie George, Governor of the Bank of England stated

> "…we usually try to keep the fact that we are providing systemic support secret at the time… If people know that we are so concerned about systemic fragility that we have judged it necessary to provide support, that could lead to a wider loss of confidence. They would wonder how far that support would be extended, and we could rapidly find ourselves in the position where we were in practice underwriting all the liabilities of the banking system." (George, 1994).

Nor is this just conjecture. When the Bank of England revealed that it was providing liquidity assistance to Northern Rock, the news precipitated a run.

The same conclusion was reached more recently by the Committee on the Global Financial System (CGFS), a BIS-committee of senior central bankers that study systemic risks and central bank operations. A CGFS group studying central bank liquidity assistance (LA) in 2017 stated:

> "Transparency about LA operations while they are taking place (ie in real time) may raise particular challenges. Often, especially in the case of LA to a single firm, the public announcement or the revelation (sometimes unintended) that a firm is receiving LA may create, or exacerbate, uncertainty about the true health of the firm, undermining market and depositor confidence. This could, in turn, worsen or accelerate any liquidity stress at the firm, and potentially tip it from illiquidity into insolvency/default …In such circumstances, real-time transparency about LA could end up undermining the objective of providing LA in the first place."

Not only can releasing information on borrowing be destabilizing, but it can also defeat the purpose of the lending. As discussed in Logan et al. (2019):

> "Financial institutions are often reluctant to draw on lender-of-resort facilities because they do not want to become stigmatized or be seen as being financially troubled…Even the prospect of delayed public disclosure may cause financial institutions to conclude that curtailing credit or selling assets is preferable to being identified as the recipient of a bailout, all of which could defeat the purpose of the program."[9]

[9] First Responders, p. 105.

In the middle of the Global Financial Crisis, the President's Working Group and the Financial Stability Forum (later the Financial Stability Board (FSB)) identified reducing discount window stigma as a critical change needed to enhance authorities' ability to respond to a financial crisis.[10] In April 2008, the FSB indicated:

> "If anonymity is not well preserved, or if senior bank management and bank regulators are not completely familiar with the role of standing loan facilities for meeting frictional needs, as uncertainty mounts there is a greater risk that borrowing from a central bank loan facility would be regarded as a sign of weakness. If that were to occur, the effectiveness of the loan facility as a liquidity backstop would be severely impaired."

Currently, in the United States, while the Federal Reserve is transparent about the terms and conditions on which it provides regular discount window loans and emergency credit, and publishes each week aggregate information on the amount of such lending, it only releases information about the details of discount window lending with a two-year lag and emergency-lending with a one-year lag.[11]

RECOMMENDATIONS

What are the lessons of the near-global consensus on transparency about emergency central bank lending and LCR disclosures? First, disclosures cannot be used to promote market discipline without eliminating the benefits of the enhanced liquidity brought about by the requirements. Second, the regulatory agencies can maintain a high level of counterparty confidence in banks through clarity about the liquidity requirements to which banks are subject. Third, *ex-post* disclosures, if necessary, should only take place after a long lag.

Consequently, the banking agencies should cease requiring LCR disclosures. Just as with the discount window, a bank will never use its HQLA if such usage is revealed relatively quickly, even on a quarterly-average basis. At times of liquidity stress, any hint of liquidity challenges can lead to a destabilizing run. Rather than risk a loss of investor confidence, a bank will take extreme steps to preserve its liquidity including by ceasing to lend to other banks for maturities longer than overnight or by selling assets at fire-sale prices. Those actions are directly contrary to the systemic objectives of the LCR. "Market discipline through disclosure" means deliberately exposing banks to a loss of confidence if its LCR is too low; it is the opposite of encouraging usability.

Instead of requiring potentially destabilizing disclosures, the banking agencies should provide the public more information about the robust framework that exists to ensure banks are liquid. Indeed, perhaps the best step that the Federal Reserve and FDIC could take to increase market confidence in a stabilizing rather than destabilizing way would be to provide more details *ex-ante* on the secret framework for resolution liquidity requirements. As we describe, in addition to the resolution requirements, the liquidity framework also requires banks to provide their supervisors daily information on their liquidity position and conduct extensive internal liquidity stress tests each month. The more bank investors know about the regime, the more confident they will be.

Lastly, if banks' LCR information must be disclosed, it should be disclosed long after any circumstances under which a bank should use its HQLA have become irrelevant. The last financial crisis began with serious liquidity strains in August 2007 and those strains did not fully dissipate until roughly March 2009. Judging by that experience, a two-year lag, the same lag applied to discount window borrowing, would be appropriate. That said, it is not clear what purpose would be served by disclosure after two years, let alone at the detailed levels currently required, since they would not be relevant for counterparty confidence.

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10 See The President's Working Group on Financial Markets, March 2008, p.9, FSF Working Group on Market and Institutional Resilience, April 7, 2008, p.47, and FSF Working Group on Market and Institutional Resilience, October 10, 2008, p.35.

11 Borrowing details on emergency lending in programs financed in part by CARES Act funds will be released with a 30-day lag, consistent with the reporting requirements established in the Act.

The public policy argument for disclosing central bank lending to the public do not apply to use by a bank of its own resources.

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APPENDIX: DISCLOSURE TEMPLATE FROM LCR FINAL RULE (AVAILABLE HERE)

Table 1 to § 249.91(a) – Disclosure Template

XX/XX/XXXX to YY/YY/YYYY In millions of U.S. Dollars		Average Unweighted Amount	Average Weighted Amount
HIGH-QUALITY LIQUID ASSETS			
1	Total eligible high-quality liquid assets (HQLA), of which:		
2	Eligible level 1 liquid assets		
3	Eligible level 2A liquid assets		
4	Eligible level 2B liquid assets		
CASH OUTFLOW AMOUNTS			
5	Deposit outflow from retail customers and counterparties, of which:		
6	Stable retail deposit outflow		
7	Other retail funding outflow		
8	Brokered deposit outflow		
9	Unsecured wholesale funding outflow, of which:		
10	Operational deposit outflow		
11	Non-operational funding outflow		
12	Unsecured debt outflow		
13	Secured wholesale funding and asset exchange outflow		
14	Additional outflow requirements, of which:		
15	Outflow related to derivative exposures and other collateral requirements		
16	Outflow related to credit and liquidity facilities including unconsolidated structured transactions and mortgage commitments		
17	Other contractual funding obligation outflow		
18	Other contingent funding obligations outflow		
19	**TOTAL CASH OUTFLOW**		

CASH INFLOW AMOUNTS			
20	Secured lending and asset exchange cash inflow		
21	Retail cash inflow		
22	Unsecured wholesale cash inflow		
23	Other cash inflows, of which:		
24	Net derivative cash inflow		
25	Securities cash inflow		
26	Broker-dealer segregated account inflow		
27	Other cash inflow		
28	**TOTAL CASH INFLOW**		
			Average Amount[1]
29	**HQLA AMOUNT**		
30	**TOTAL NET CASH OUTFLOW AMOUNT EXCLUDING THE MATURITY MISMATCH ADD-ON**		
31	**MATURITY MISMATCH ADD-ON**		
32	**TOTAL NET CASH OUTFLOW AMOUNT**		
33	**LIQUIDITY COVERAGE RATIO (%)**		

[1] The amounts reported in this column may not equal the calculation of those amounts using component amounts reported in rows 1-28 due to technical factors such as the application of the level 2 liquid asset caps, the total inflow cap, and for depository institution holding companies subject to subpart G, the application of the modification to total net cash outflows.