BANK POLICY INSTITUTE

June 30, 2022

Via Electronic Mail

Victoria Saporta
Executive Director, Prudential Policy
Bank of England
Threadneedle Street,
London, EC2R 8AH

Re: Discussion Paper 1/22 - The prudential liquidity framework: Supporting liquid asset usability

To Whom it May Concern:

The Bank Policy Institute[1] appreciates the opportunity to comment on the discussion paper issued by the Bank of England and the Prudential Regulatory Authority on the usability of liquid assets.[2] Given the importance of this topic, BPI is responding to the discussion paper because while many of the member firms are domiciled in the U.S., they have subsidiary entities subject to PRA jurisdiction. As a result, some of the references to rules and regulations contained herein are those of regulatory bodies other than the PRA.

Banks' ability to utilize their stock of liquid assets to support the economy in times of stress is fundamental to the construct of the bank liquidity framework, including the Liquidity Coverage Ratio standard, which set forth a formative intent that "[d]uring periods of stress, however, it would be entirely appropriate for banks to use their stock of HQLA, thereby falling below the minimum."[3] As the discussion paper properly notes, the onset of the COVID pandemic corresponded with a reluctance of banks to utilize their liquid assets despite statement of intent by national regulators to permit banks to

---

1 The Bank Policy Institute is a nonpartisan public policy, research and advocacy group, representing the nation's leading banks and their customers. Our members include universal banks, regional banks and the major foreign banks doing business in the United States. Collectively, they employ almost 2 million Americans, make nearly half of the nation's small business loans, and are an engine for financial innovation and economic growth.

2 Bank of England and Prudential Regulatory Authority, Discussion Paper 1/22, The prudential liquidity framework: Supporting liquid asset usability (March 31, 2022).

3 Basel Committee on Banking Supervision, Liquidity Coverage Ratio LCR20 Calculation (December 15, 2019) at 4.

drop below an LCR of 100%.[4] A recent Federal Reserve working paper similarly found that when faced with the liquidity stress of COVID-19, banks did not respond by using their stocks of HQLA. In fact, the liquidity positions of large bank holding companies improved and they increased their LCR percentages by about 10 basis points,[5] in part due to defensive actions that were taken at the onset of the crisis.

The reasons why banks have maintained liquidity levels above their regulatory minimum requirements, and would likely do so again, are complex and interconnected. Regulators have long stated that it is desirable for banks to utilize their stocks of liquid assets during times of stress and BPI supports efforts to increase the likelihood of such actions. However, while theoretically the framework would allow banks to use their liquid assets and drop below an LCR of 100% when faced with liquidity stress, several practical considerations disincentivize banks from taking such actions. Inefficiencies in the existing regulatory liquidity framework to facilitate the utilization of liquidity buffers can result in the need for government intervention to support the flow of credit and liquidity in a market-wide stress event. This was evidenced during the COVID-19 crisis, whereby swift government intervention occurred through the establishment of government-sponsored funding facilities and interim capital and liquidity regulatory relief actions throughout March 2020 to May 2020 in order to alleviate liquidity and funding pressures across market participants and support the economy.

Our comment letter is focused on those areas that are most impactful to the broad universe of banks subject to these liquidity regulations that impede firms from using liquidity buffers. Section II of our letter highlights several factors that can prevent institutions from using their existing HQLA and Section III contains our recommendations to modify the framework and thereby improve the usability of liquid assets. Some of these recommendations would entail making changes to the underlying LCR framework and we would therefore encourage the Basel Committee and its member institutions to consider these LCR adjustments to better allow HQLA to function as intended in times of stress. We believe that the proposed modifications we have detailed herein would ensure that global regulators have an effective framework that can be enacted during periods of stress in order to efficiently support banks' ability to utilize liquidity buffers in stress.

I. Regulators have consistently emphasized the importance of usable liquid assets

As highlighted in the discussion paper, regulators have consistently made it clear that in order to reduce the risk of contractionary and destabilizing actions, firms need to be able to use their liquidity when appropriate.[6] The LCR framework requires that a firm's HQLA be available for use to address liquidity needs in times of stress and encourages banks to draw on their stock of HQLA even if that would result in falling below the 100% requirement to avoid potential negative effects on market participants.[7] During the onset of COVID-19, the Q&A on the use of Liquidity and Capital buffers issued by the Bank of England states that "[b]anks are expected to use their liquidity buffers in doing so, even if

---

4 *See* discussion paper at 6.

5 Divisions of Research & Statistics and Monetary Affairs Federal Reserve Board, COVID-19 as a Stress Test: Assessing the Bank Regulatory Framework (March 2021) at 18, *available at* https://www.federalreserve.gov/econres/feds/files/2021024pap.pdf.

6 Discussion paper at 5.

7 *See* 79 Fed. Reg. 61440 (October 10, 2014) (US LCR) at 61478.; Basel Committee on Banking Supervision, LCR Liquidity Coverage Ratio (Version effective as of 15 Dec 2019) (BCBS LCR) at chapter 20.5; Bank of England Prudential Regulation Authority, PRA Rulebook Liquidity Coverage Ratio (CRR) (BOE PRA Rulebook), Article 8.

it means LCR ratios go significantly below 100%" and further that "[b]anks should not hold back from supplying these funds because their LCR ratios decline as a consequence of assisting their customers." National regulators in other jurisdictions issued similar statements encouraging banks to use their existing liquid assets to support the economy.[8]

The emphasis on the importance of HQLA usability is also evident in the design of the LCR framework itself. While the LCR framework is clear on the steps firms must take in the event they fall below the 100% requirement, supervisory authorities have flexibility in how they respond to LCR shortfalls. Supervisors are expected to take factors related to both domestic and global frameworks and conditions into consideration when determining the appropriate response to a shortfall[9] and supervisory responses to an LCR shortfall are not required to include any particular supervisory action.[10] Additionally, all eligible HQLA is required to be under the control of the function within the bank charged with managing liquidity risk. This requirement is designed to demonstrate that HQLA is immediately usable as a source of contingent funds in times of stress, without exposing the firm to risks.[11] These principles make it apparent that the HQLA required under the LCR is intended to function as a buffer and is meant to be used, as needed, to meet unexpected changes in cash flows and continue to support the economy.

However, in practice, the LCR does not in fact function as a usable buffer to be drawn down in times of stress. Instead, as demonstrated during the COVID-19 related market stress, the LCR acts a bright line minimum such that no institution is willing to breach the 100% threshold or even approach it. When supervisory or regulatory constraints are the binding constraints, such is the case with the LCR, banks are unwilling to operate at lower levels even if those constraints are meant to be used, which in turn could effectively lead to a liquidity crisis.**[12]** Commentary from the regulators in discussions around the LCR rule have and continue to be supportive of HQLA use below the 100% requirements under certain circumstances, but if regulators truly intend for buffers to be used in times of stress, the framework of the rule itself needs to provide the necessary flexibility to allow for such use. As Douglas J. Elliott aptly notes in his 2019 article on the regulatory framework, "it's possible that the key to predicting actions by banks and their key constituencies is not the total level of capital and liquidity but the margin of capital and liquidity above regulatory minimums."[13]

---

8 Bank of England Prudential Regulatory Authority, Q&A on the use of Liquidity and Capital Buffers (updated July 6, 2020) at 2, *available at* https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/publication/2020/qanda-on-the-use-of-liquidity-and-capital-buffers.pdf?la=en&hash=151DF13BD8CA7E3755D515BC5A44F9A299C1235D.

9 *See* BCBS LCR Chapter 20.6.

10 Preamble to U.S. LCR at 61518.

11 *See* Preamble to U.S. LCR at 61467.

12 For more details, see Greg Baer, Has the enhanced resilience and resolvability of large banks reduced the likelihood of another financial crisis or increased it? (March 12, 2019), *available at* https://www.bankingperspectives.com/the-next-financial-crisis-and-the-great-buffer-fallacy/.

13 Douglas J. Elliot, Oliver Wyman, Bankers and regulators must carefully consider how the many changes in the financial system could affect us in the next recession. We should take actions now that would reduce those impacts. (March 12, 2019), *available at* https://www.bankingperspectives.com/banks-and-the-next-recession/.

II. Factors that prevent or limit HQLA Usability

A. HQLA Usability Issues Related to the Regulatory and Supervisory Frameworks

Although the preamble to the U.S. LCR states that "[s]upervisory actions should not discourage or deter a banking organization from using its HQLA when necessary to meet unforeseen liquidity needs arising from financial stress that exceeds normal business fluctuations," the LCR's supervisory framework acts as a powerful deterrent. Firms are required to notify their supervisors if their LCR falls below 100%.[14] Additionally, under certain conditions that may vary by jurisdiction, the firm must promptly submit a plan for remediation of the shortfall.[15] These requirements serve to reinforce the LCR as a bright line minimum requirement and further discourage banks from using their available HQLA under stress.

Similarly, while the supervisory framework does not dictate any particular response, firms lack clarity as to how supervisors would view banks' use of HQLA if doing so resulted in an LCR below 100%. These supervisory concerns remain despite the explicit encouragement by national authorities to use HQLA buffers, as occurred in March and April 2020. While policymakers may desire banks to utilize their HQLA to continue to support lending, those views may not be shared by individual examiners responsible for supervising institutions. This potential disconnect between principals at the banking agencies and those individuals engaged in the daily supervision of firms serves to further suppress banks' use of HQLA under stress. An LCR shortfall could result in any number of supervisory actions, but would include an institution receiving, at a minimum, heightened supervisory monitoring.[16] Even if supervisors accept the shortfall during the periods of stress, there are concerns that supervisors would subsequently point to the shortfall as an indication of a liquidity planning deficiency.[17] As a result of the open-ended potential for supervisory response, banks make every effort to avoid a "liquidity ratio crisis," in which their LCR or other liquidity metrics appear less favorable than a firm's view of their actual liquidity, and maintain their stock of HQLA in times of stress. While a "liquidity ratio crisis" may not correspond to a liquidity crisis, since banks are reluctant to drop below the required minimum for the former, they would be unwilling to allow themselves to drop below the minimums during liquidity stress unless absolutely necessary and would take decisive actions to defend against it.

Importantly, several regulatory requirements beyond the LCR and NSFR can drive bank liquidity requirements above those imposed by the two international quantitative standards. In the U.K., beyond the Pillar 1 LCR requirements, there is also the potential for Pillar 2 "add-on" requirements that would increase overall liquidity to address salient risks not captured in the LCR.[18] In several jurisdictions like the U.S. and the U.K., internal liquidity stress tests are required and may result in additional tangible

---

14 *See* BCBS LCR chapter 20.6, Preamble to US LCR at 61517, 12 CFR 249.40(a), PRA Rulebook Article 414.

15 In the U.S., any firm below 100% LCR for three consecutive business days would need to submit a remediation plan. *See* 12 CFR 249.40(b)(2).

16 Preamble to U.S. LCR at 61517.

17 *See* BPI, Bank Treasurers' Views on Liquidity Requirements and the Discount Window (October 12, 2021) *available at* https://bpi.com/bank-treasurers-views-on-liquidity-requirements-and-the-discount-window/.

18 *See* Bank of England Prudential Regulation Authority, Statement of Policy: Pillar 2 liquidity (June 2019), available *at* https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/statement-of-policy/2019/pillar-2-liquidity-sop-update-june-2019.pdf?la=en&hash=78618B0A466B17BCF86952AAD06AC14AEE3E4FDE.

liquidity requirements that differ slightly from the LCR.[19] These internal liquidity stress testing requirements may differ from the LCR. Ffor example, the U.S. liquidity stress tests utilize the concept of "highly liquid asset," which may result in a change in what liquid assets are available for use under the LCR. Some of these variances may increase bank liquidity requirements, particularly if banks have a more stringent definition of a highly liquid asset or more conservative view on potential outflows. Similarly, the U.S. liquidity framework also establishes resolution liquidity requirements, such as Resolution Liquidity Execution Need (RLEN) and Resolution Liquidity Adequacy and Positioning (RLAP). RLAP requires a 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 after filing for bankruptcy to support the surviving or wind-down subsidiaries, which can lead to a requirement for even more liquid assets at the subsidiary level. In many cases, these requirements are the binding requirements for banks as opposed to the LCR itself and can further perpetuate firms' unwillingness to use HQLA in times of stress.

There are potentially other disclosure requirements that may be triggered in the event of a firm breaching their minimum LCR requirement, which serve as a further deterrent of HQLA usability in times of stress. For example, the Securities Exchange Act of 1934 could be read to mandate disclosure by an institution if such institution's LCR dropped below 100%. Such information could be deemed to be material non-public information necessitating disclosure within four business days. Further, under the SEC's Order Granting Conditional Substituted Compliance, certain firms subject to regulation in the UK conditionally may satisfy liquidity requirements under the Exchange Act by complying with comparable UK requirements.[20] In order to be eligible, such firms need to meet their local regulatory requirements dictated by the UK Capital Requirements Regulation in addition to the SEC's new "liquid asset' tests."[21] The Order therefore establishes a link between UK liquidity requirements and those of the U.S. and in the event that a firm fails to meet the new tests, or UK CRR requirements, which include both Capital and Liquidity minimums, would require a notification to the SEC to "alert the Commission of potential issues with the Covered Entity's financial condition that could pose risks to the firm's customers and counterparties."[22] These potential disclosure requirements may also play a role in banks' willingness to use their HQLA under stress.

B. HQLA Usability Issues Related to Market Reactions

The potential reactions of market participants to decreases in banks' stock of liquid assets are another significant concern, which is exacerbated by the liquidity framework's extensive disclosure

---

19 12 CFR § 252.35.

20 *See* Securities and Exchange Commission, Order Granting Conditional Substituted Compliance in Connection with Certain Requirements Applicable to Non-U.S. Security-Based Swap Dealers and Major Security Based Swap Participants Subject to Regulation in the United Kingdom (July 30, 2021), *available at* https://www.sec.gov/rules/other/2021/34-92529.pdf.

21 The liquid assets tests are additional capital conditions that are designed to promote liquidity that is separate from Basel liquidity standards to supplement UK requirements.

22 Securities and Exchange Commission, Order Granting Conditional Substituted Compliance in Connection with Certain Requirements Applicable to Non-U.S. Security-Based Swap Dealers and Major Security Based Swap Participants Subject to Regulation in the United Kingdom (July 30, 2021), at 97, *available a*t https://www.sec.gov/rules/other/2021/34-92529.pdf.

requirements. Banks are required to disclose their LCRs, along with certain qualitative and quantitative information about various components of the calculation. The LCR rule specifies a disclosure template, consisting of the unweighted and weighted amounts of HQLA and cash outflows that constitute a bank's LCR. For the qualitative disclosures, a bank must include the factors that significantly affect its LCR, such as drivers of the LCR and HQLA composition.[23]

In implementing these disclosure requirements, national authorities and international standard setters emphasized the importance of LCR transparency to increase investor confidence that banks have the liquid assets necessary to meet future contingencies, enhance market discipline, and encourage sound risk-management practices.[24] However, this transparency inherently encourages firms to amass and maintain large stockpiles of HQLA, so that they are continuously indicating a strong liquidity position through disclosure of high LCR figures. As a result, firms are unwilling to merely allow their LCR to dip below the 100% requirement, as doing so has the potential to negatively influence market perception of the firm. As noted in the discussion paper, there is further concern about a bank being a "first" or even an "early" mover in this regard and dropping below the 100% requirement compared to the timing of such actions among peers, as the market has come to expect firms to always maintain an LCR of more than 100% and any breach is likely to be perceived as a negative.

In addition, another acute area of concern is the potential reactions from rating agencies. Even under stress, if a bank were to drop below an LCR of 100%, it could result in a credit rating downgrade with substantial consequences. Specifically, a credit rating downgrade can reduce a firm's access to external borrowing, including making it more difficult to sell their commercial paper, and could result in higher collateral requirements, all of which can ultimately lead to a decline in lending. Maintaining a larger stock of liquid assets reduces the risk of a potential downgrade under stress and could also serve to temper the impact that a change in rating could have on a firms' loan supply, in the event a firm's rating is downgraded. Even in the absence of a credit rating downgrade, the negative perception of an institution's credit resulting from a breach of its 100% LCR requirement could affect credit spreads and the cost of funding in a similar fashion.

If banks are unwilling to use their stockpile of HQLA in stress, the alternatives are to sell non-HQLA assets (potentially at fire sale prices) to maintain their liquidity buffer while covering outflows, to reduce lending to each other at term, or a combination of the two. These are the precise actions that the LCR is intended to prevent as they could amplify a liquidity shock into a liquidity crisis. Therefore, public disclosure of an institution's LCR has the potential to precipitate or accelerate a significant liquidity event rather than promoting market discipline as intended. Even in the absence of such disclosure requirements, if regulators were to rescind or lessen the current requirements, it is likely that market expectations with respect to transparency and insight into firms' LCR calculations would remain. Market participants such as analysts would undoubtedly continue to ask for such information and similarly, banks may continue to provide that information to illustrate how strong their positions are.

These concerns regarding public disclosure do not apply to banks reporting their liquidity positions to their supervisors. In fact, the historical policy rationale embedded within the concept of

---

[23] *See* 12 CFR 249.91(d) and Basel Committee on Banking Supervision, Liquidity coverage ratio disclosure standards LCR (January 2014), *available at* https://www.bis.org/publ/bcbs272.pdf.

[24] *See* 81 FR 94922 (December 27, 2016) at 94923 and 94925; European Banking Authority, Guidelines on LCR disclosure to complement the disclosure of liquidity risk management under Article 435 of Regulation (EU) No 575/2013 (March 2017) at 32; Basel Committee on Banking Supervision, Liquidity coverage ratio disclosure standards LCR (January 2014) at 5.

confidential supervisory information is premised on a recognition that, in certain circumstances, supervisory care should be exercised to minimize the risk of fostering destabilizing market responses.[25] The disclosures required under the LCR framework are at odds with this tenet, as they can lead to negative market reactions precisely when circumstances are fragile. Public disclosures can serve to prevent banks from adjusting their liquidity profiles or using their available liquidity to continue lending in times of market stress. Further, providing the market with granular information related to a bank's liquidity management and strategies can ultimately constrain a bank's ability to respond to severe market conditions or may even facilitate anti-competitive and potentially predatory market behavior in some circumstances.[26]

C. Aspects of the LCR Framework that Limit HQLA Usability

The construct of the liquidity framework, unlike the capital rules, does not contain an explicit buffer on top of minimum requirements. The capital rules utilize this construct of minimum requirements as well as explicit buffers and there are clearly defined consequences of breaching the buffers that are distinct from those associated with falling below the minimum requirements.[27] As discussed in Section II.A above, while the 100% LCR requirement is meant to provide a liquidity buffer that firms should hold during normal business conditions, it acts as a bright line threshold and breaching this minimum requirement triggers a requirement for a bank to notify its supervisor and to submit a remediation plan under certain circumstances. This design of the framework, which establishes consequences for a breach even in times of stress, further contributes to the limiting nature of the LCR and deters banks from using their HQLA, even when doing so might be viewed as be beneficial from a macroprudential perspective.

Certain aspects of the LCR framework are themselves procyclical and in turn limit firms' ability to use their existing stockpiles of HQLA. One such area, highlighted in the discussion paper, is the historical look-back approach (HLBA). The HLBA requires firms to project as outflows the largest 30-consecutive calendar day cumulative net mark-to-market outflow realized during the prior 24 months from derivative transaction valuation changes.[28] This approach tends to increase the procyclicality of the LCR's requirements during times of stress as the requirement generated by the HLBA is likely to increase, potentially significantly, during market stress. As a result of the pandemic, some jurisdictions noted that the HLBA materially impacted the LCR as asset repricing and increased trading volumes led to large flows of variation margin and that the HLBA may lead to an overcalibration of liquidity

---

25 *See generally* Michael E. Collins, Supervisory Insights on Transparency in Bank Supervision, SRC Insights, Federal Reserve Bank of Philadelphia (Q1 2011), at 2.

26 The level of detailed information put forth in the disclosure template specified in the LCR framework has the potential for market participants to anticipate firms' planned liquidity management actions. See The Clearing House Association L.L.C., the American Bankers Association, the Securities Industry & Financial Markets Association and the Financial Services Roundtable Comment letter re: Notice of Proposed Rulemaking; Comment Request: Liquidity Coverage Ratio: Public Disclosure Requirements; Extension of Compliance Period for Certain Companies to Meet the Liquidity Coverage Ratio Requirements (February 2, 2016) for further details.

27 We note that there are also appropriate concerns regarding the usability of the capital buffers; however, these concerns are beyond the scope of this response.

28 *See* 12 CFR 249.32(f)(3); BCBS LCR paragraph 123.

requirements following a period of stress.[29] Chart 1 from the discussion paper demonstrates that the HLBA impacted large foreign subsidiary bank LCRs by nearly 15 percentage points and the HLBA is cited as one of the factors that materially contributed to pressures on the LCRs of UK banks in mid-March during the COVID pandemic, exactly when regulators were encouraging banks to use their liquid assets to support the economy.[30] Even after the period of market stress has passed, banks will need to continue to hold sufficient liquid assets to account for the requirements generated by the HLBA approach for at least two years.

Another procyclical aspect of the LCR framework is the fixed assumptions regarding outflows. The LCR assumes that any pool of liabilities is uniform and should be expected to flow out at a constant rate over any 30 days of stress based only on the current amount of the liability item.[31] The discussion paper properly notes that if an institution experiences outflows for liabilities assigned low outflow rates under the LCR, such institution may experience a pronounced fall in their LCR. This occurs because the LCR assumes the remaining liabilities of the same type, will necessarily experience outflows in line with the LCR's assigned outflow rate and does not account for the possibility that the remaining liabilities are more "sticky".[32] For example, if a bank has $1000 in operational deposits, the LCR assumes that 25 percent ($250) will run and requires the bank to hold $250 in HQLA. If $100 then run, the LCR assumes that 25 percent of the remaining $900 will run ($225) and requires the bank to hold $225 in HQLA. Assuming the bank had used $100 in HQLA to meet the $100 run, it now has $150 in HQLA and so must raise an additional $75 in HQLA during the stress period. Here again, the current framework creates the need for banks to maintain additional HQLA during times of stress, precisely when it would be beneficial to allow banks to use their HQLA to allow for the markets to continue functioning properly.

III. Potential Improvements to the LCR Framework to allow increased usability of HQLA

We strongly believe that the policy objectives of the LCR have successfully improved the resilience of banking institutions to withstand periods of persistent stress and to continue to support the economy across all market conditions. This was evidenced in March 2020 by the strong liquidity positions held by banks at the onset of the COVID-19 crisis. However, liquidity buffers are held to ensure firms pre-fund for potential market-wide and idiosyncratic needs in a stress period for use as these needs materialize. While global regulators have also acknowledged that the intention of the LCR Framework is to allow firms to use buffers in stress, the impediments described above result in the 100% LCR requirement becoming a bright line minimum and therefore a de facto floor. We believe there are sensible adjustments that could be made to the current LCR framework that would help alleviate these concerns.

To facilitate the utilization of HQLA in a stress, the LCR standard should be revised to provide national regulators with explicit authority to lower regulatory liquidity requirements in exigent circumstances (i.e., a stress period), based on their assessment of macroeconomic and financial-market factors. Once regulators have identified a period of stress, such as the one that occurred during March 2020, there should be a clear, coordinated, and public, regulatory pronouncement detailing the beginning of a stress period. As part of the public announcement, regulators could formally adjust the

---

29 BCBS, Early lessons from the Covid-19 pandemic on the Basel reforms (July 2021) at 46, *available at* https://www.bis.org/bcbs/publ/d521.pdf.

30 *See* Discussion Paper at 19.

31 *See* 12 CFR 249.32.

32 Discussion paper Box 1.

LCR framework during the stress period to include a minimum stress LCR requirement and an ongoing buffer requirement similar to the existing capital framework. For example, the minimum LCR requirement would remain 100% in ordinary times, but during the regulatory-declared stress period, the minimum requirement would be amended to a specified floor, and banks would be permitted to manage to the lower "Stress LCR" requirement. Any supervisory or regulatory consequences would then be tied to any breach of the new "Stress LCR" by banks. Following the stress period and once deemed appropriate, the regulators should then make a second pronouncement ending the use of the "Stress LCR" and allowing for a period of time for firms to rebuild their buffers to return their LCR to pre-stress levels. A "Stress LCR" framework would allow the LCR to be appropriately counter cyclical by allowing banks to use liquidity buffers to meet liquidity needs that are pre-funded for in the LCR as they materialize, without adverse supervisory consequences. While there are a variety of ways implementation of a "Stress LCR" could be accomplished, the following section details our suggested approach and how it would reduce or eliminate the concerns described in this letter and in the discussion paper.

A. Adjusted Net Cash Outflows in Time of Stress

One viable option to achieve the goal of increased usability of HQLA in line with these abovementioned principles, would be a reduction in net cash outflow requirements during a publicly declared stress period. The principle of this approach is to recognize that during a stress period, firms will need to use their HQLA to meet net cash outflows as they materialize by effectively lowering the minimum LCR requirement, alleviating the need to immediately replenish HQLA that is deployed to meet liquidity outflows, support the economy and intermediate market activity, while still maintaining HQLA in excess of their net cash outflows. The structure of such a framework could be modelled to be consistent with the application of the existing liquidity tailoring framework in the U.S., which defines a scaling factor for outflows (such as 70% - 85%) for certain Category III and IV institutions that are not subject to the full LCR requirement.[33] The "Stress LCR" would prescribe a similar adjustment to reduce net cash outflows for institutions up to 70%-85% of their calculated net cash outflows during the stress period. Under the framework, supervisors would coordinate with banks to determine the appropriate adjustment factor, in order to properly tailor the net cash outflow reduction based on the severity and timing of the stress and other factors that supervisors may wish to consider when setting the adjustment factor. This "Stress LCR" requirement would apply to firms' existing business-as-usual requirements with respect to net cash outflows.[34]

Reducing the net cash outflow requirement during a stress is a conceptually sound approach, as the requirement is designed to model potential outflows in a short-term liquidity stress. Once regulators identify a stress period, firms would already be actively experiencing stress, and it stands to reason that they have already experienced some of the outflows modelled under the LCR scenario.[35] Therefore, the requirement for incremental net cash outflows projected over the next 30 days under the LCR should be lowered, reducing the inherent cyclicality in the existing LCR calculation during the stress period.

---

33 85 Fed. Reg 59230 (November 1, 2019).

34 In the U.S., certain Category III and Category IV institutions are permitted to operate under a reduced LCR and the adjustment factor of the "Stress LCR" would also apply to such institutions.

35 *See* BPI, A Modest Change to the LCR That Could Substantially Improve Financial Stability (March 21, 2019), *available at* https://bpi.com/a-modest-change-to-the-lcr-that-could-substantially-improve-financial-stability/.

Calculation Details

The proposed net cash outflow adjustment would apply to both the consolidated bank, and any of its consolidated depository institution subsidiaries that are required to manage to a standalone LCR requirement. Consistent with the existing U.S. tailoring framework, the adjustment to reduce net cash outflows would be applied at the consolidated subsidiary level, whereby for each consolidated subsidiary, its contribution to eligible HQLA would be equal to: 1) the amount of net cash outflows of the consolidated subsidiary, adjusted by the supervisory-determined factor, plus 2) any additional amount of HQLA that would be available for transfer to the top-tier bank during times of stress.

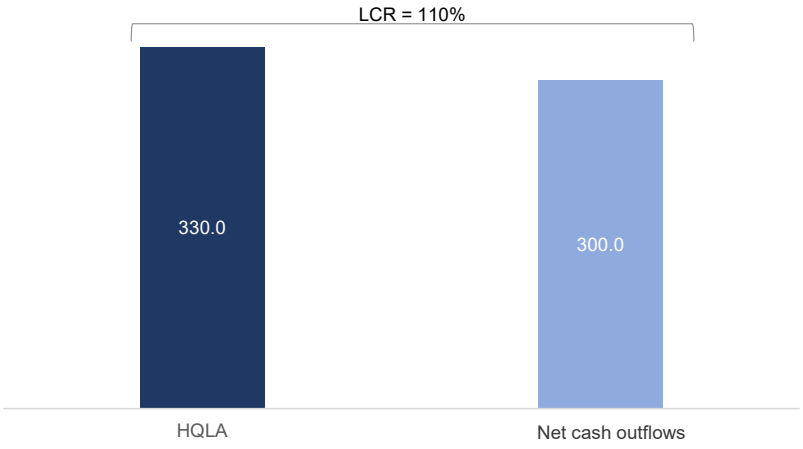
Illustrative Example: Application of the "Stress LCR" Framework

In the Exhibits below, we have included an illustrative and simplified example for a top-tier bank (referred to as the "Bank"). For purposes of this example, we assume that the Bank's consolidated subsidiaries do not have any restrictions against the transfer of HQLA to the top-tier Bank during a time of stress.

LCR in Ordinary Times

In ordinary times, the Bank has an LCR of 110%, based on HQLA of $330B and minimum net cash outflow requirement of $300B (see Exhibit 1 below).

Exhibit 1: HQLA, Net Cash Outflows, LCR in "Ordinary Times"



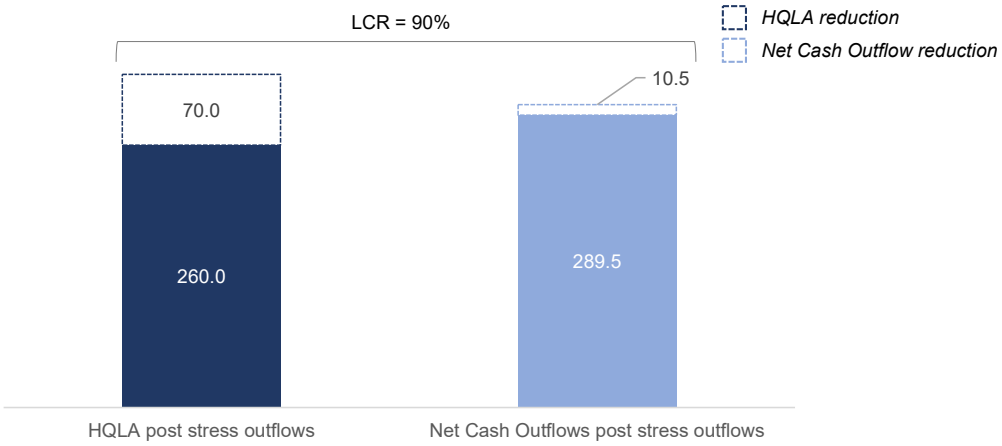
Values in $BNs

LCR in "stress period" under the current framework

The Bank enters a period of market-wide stress, which leads to $70B of HQLA outflows over a 30-day period. The outflows that materialize during the period are across on and off-balance sheet liabilities that have a weighted net cash outflow risk density of 15%.

Given the calibration of net cash outflow risk factors remain constant during both business-as-usual and stress periods, net cash outflows only decline by 15%, or $10.5B of the outflows that materialized. This leads to a reduction in the Bank's LCR from 110% to 90% based on HQLA of $260B and net cash outflows of $289.5B, breaching the minimum 100% requirement (see Exhibit 2 below).

Exhibit 2: LCR post stress period under current framework

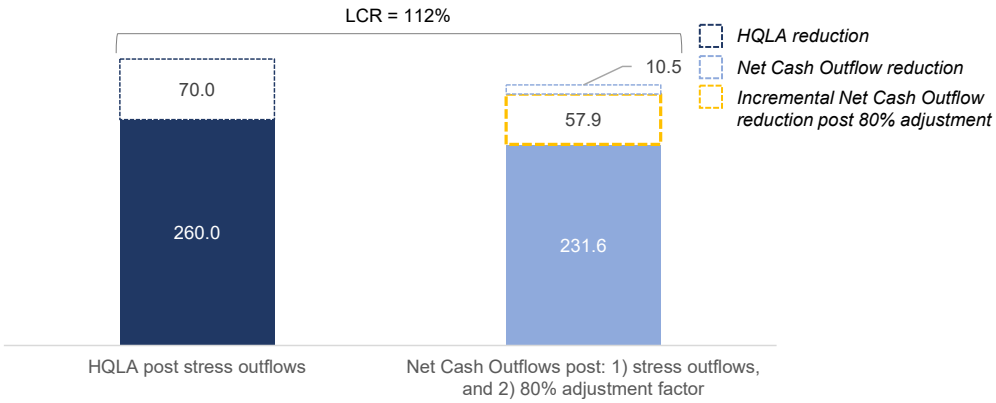


LCR in "stress period" under the "Stress LCR" framework

The calibration of the "Stress LCR" framework is designed such that as outflows materialize throughout the stress event, firms are able to use their HQLA buffers that were "pre-funded" under the LCR in ordinary times. For the purpose of this example, we have assumed an adjustment factor of 80%; however, in a stress, supervisors should evaluate the appropriate scalar for net cash outflows, which may be higher or lower.

In accordance with the "Stress LCR" framework, regulators publicly declare a stress period, and announce the reduction in the LCR minimum net cash outflow requirement to 80% for the 30-day LCR calculation. Therefore, through the end of the 30-day period, the Bank's net cash outflow requirement is reduced to 80% of the calculated total. This would result in an incremental $57.9B decrease to $231.6B. Together the outflow reduction of $10.5B previously discussed, combined with the net cash outflow scalar reduction constitute a combined $68.4B decline in net cash outflows over the course of the 30-day period, consistent with the magnitude of HQLA outflows that the Bank experienced. The Bank's ending LCR is 112% (see Exhibit 3 below).

Exhibit 3: LCR post stress period under "Stress LCR" Framework



While we acknowledge that every stress event is different, and liquidity outflows that a Bank experiences in a stress will not materialize exactly as the LCR scenario prescribes, this illustrative example demonstrates how the "Stress LCR" framework would adjust the minimum net cash outflow

requirement during a defined stress period to be appropriately countercyclical, facilitating the ability to utilize HQLA buffers as outflows materialize.

Benefits of this approach

The approach of adjusting net cash outflows after regulators have publicly identified a period of stress has the potential to help alleviate the issues raised herein and in the discussion paper that would otherwise impede firms from using their liquidity buffers under the current framework.

As noted above, even if the existing LCR framework allowed firms to drop below an LCR of 100% in periods of stress, the regulation does not define the minimum level of which firms can manage in a stress period. Our suggested approach would differentiate between a minimum LCR requirement in ordinary times and in stress, such that in ordinary times, firms need to manage to 100% of their net cash outflow requirement and in a "stress period" the net cash outflow requirement is reduced by the supervisory-specified scalar amount. This would address the lack of clarity around the firms' LCR requirements in a period of stress.

Similarly, the current framework does not a provide a specified period during which institutions can maintain an LCR below 100% as they utilize their liquid assets during stress. Under our proposed adjustment to the framework, regulators would explicitly declare a "stress period" based on an assessment of macroeconomic factors and financial market conditions. The declaration of the "stress period" would be publicly announced, and the effective net cash outflow requirement would reduce immediately, thus allowing firms to utilize their HQLA buffers. Once regulators have determined that conditions have normalized and the economy is returning to a business-as-usual environment, regulators can publicly provide a clearly defined time frame with advanced notice to allow firms to rebuild liquidity buffers to meet their LCR obligations accounting for a 100% net cash outflow requirement. As periods of stress can be highly nuanced, such a rebuild period should correspond to the severity of the stress that was just experienced, available actions that firms have to rebuild liquidity buffers, and provide firms with sufficient notice and a reasonable amount of time to meet their standard LCR requirements.

To increase the potential for firms to use their HQLA buffers during a stress period, supervisory expectations should be aligned to the effective minimum LCR requirement during the stress period. Under our proposed approach, nothing would change in ordinary times and firms would need to manage to a minimum 100% LCR requirement. If a firm's LCR dropped below 100% and remained below 100% for three consecutive business days (in the U.S. framework), the firm would need to submit a remediation plan to their supervisors. However, following the public announcement of a stress period by regulators, although firms would need to manage to a minimum 100% LCR, this "Stress LCR" would be calculated based on a lower net cash outflow requirement. If a firm's LCR drops below 100% for three consecutive business days (in the U.S.) *after* adjusting net cash outflows to a lower requirement, only then would firms be required to submit a remediation plan. To make this change in supervisory expectations effective, supervisors should clearly state that under the "Stress LCR" framework, the supervisory assessment and rating of a banking organization will not change solely on the basis of managing to the lower "Stress LCR" requirement, during a stress period.[36]

By reducing the net cash outflow requirement of the calculated total, our proposed approach would alleviate concerns regarding market perception as it would allow firms to maintain a reported LCR of greater than 100% even during times of stress, making it a pivotal component of this proposed

[36] Such an approach would also be consistent with the "Q&As on Statement Regarding the Use of Capital and Liquidity Buffers" issued by the U.S. agencies during the onset of COVID.

framework. Although both the public announcement by regulators and the resulting reduction in regulatory requirements can reduce concerns regarding market reactions to changes in banks' liquidity levels, granular liquidity data reported in the LCR public disclosure template could still result in pro-cyclical effects if a firm discloses a larger decline in HQLA relative to peers or reports a material quarter-over-quarter decline in LCR.

This would particularly be the case if the "Stress LCR" framework is not widely understood and accepted by the market and rating agencies. In such a scenario, these sensitivities will continue to inhibit firms from utilizing the proposed "Stress LCR" framework and discount the effectiveness by which it could facilitate the usage of buffers, unless further changes are made to the LCR's public disclosure requirements. Therefore, for the "Stress LCR" framework to be effective, it is crucial that LCR disclosure requirements are amended in a way that alleviates market reaction concerns and mitigates pro-cyclical risks associated with disclosure in a stress. Specifically, following regulators' public announcement of a "stress period," the LCR public disclosure requirement would continue, but would only require firms to reflect the reduced requirements established by supervisors under the proposed metrics of the "Stress LCR" as opposed to the normal business as usual disclosure requirements. Once the time period determined by regulators during which firms are rebuilding their buffers has elapsed, the LCR disclosure regime would operate as it does in ordinary times.

Alternatively, national regulators could instead consider other modifications to the disclosure requirements to ease concerns over market reactions. One approach would be to modify the regulation to provide for a greater lag in disclosures. This change would still provide insight into liquidity condition that offers adequate information to the market while limiting the unintended negative systemic risks and effects that the current broad disclosures perpetuate and that contributes to firms' hesitation with respect to using their stocks of HQLA. Such a modification would be similar to the delayed disclosures provided by the Federal Reserve with respect to use of the discount window. Currently the Federal Reserve only releases information about the details of discount window lending with a two-year lag.[37] Another alternative would be permitting firms to disclose LCR over a longer period of averaging. For example, consistent with European Banking Authority LCR disclosure requirements, firms should be allowed to disclose their average LCR over a 12-month period.[38] In general, longer disclosure averaging periods are more beneficial to combatting market reactions and therefore we are supportive of the U.K.'s current 12-month period of averaging for LCR disclosures.

B. Freezing the HLBA during official stress period

An additional adjustment to the current framework that could help alleviate some of the procyclicality and buffer usability issues and would work in conjunction with the suggested "Stress LCR" framework outlined in this Section, is establishing a pause in the use of the HLBA during the designated period of stress. In the official pronouncement of the stress period, in addition to announcing a "Stress LCR" the regulators would "freeze" the liquidity time horizon required by the HLBA to the period of time

---

[37] *See* Federal Reserve, Discount Window | Payment System Risk Frequently Asked Questions, *available at* https://www.frbdiscountwindow.org/pages/general-information/faq.

[38] *See* EBA, Guidelines on LCR disclosure to complement the disclosure of liquidity risk management under Article 435 of Regulation (EU) No 575/2013 (March 2017) at 59, *available at* https://www.eba.europa.eu/sites/default/documents/files/documents/10180/1807490/1fb42708-17dd-4415-be69-c79d628a516b/Guidelines%20on%20LCR%20disclosure%20to%20complement%20the%20disclosure%20of%20liquidity%20risk%20management%20%28EBA-GL-2017-01%29.pdf.

immediately preceding the onset of liquidity stress. This pause would stay in effect until the end of the buffer rebuilding period announced by the regulators following the period of stress. Once banks have reached the end of the rebuilding period, the HLBA requirement would then revert to its normal form and timeframe, accounting for any additional liquidity required under the LCR from the recent stress period. This practice would thus eliminate the need for firms to account for the HLBA during the period of stress thus reducing its impact on the LCR and therefore the procyclicality of the framework.

Such an approach would be similar to the Federal Reserve's decision to maintain discount window haircuts during the Global Financial Crisis (GFC). Ordinarily, discount window haircuts are recalibrated periodically to reflect recent financial market volatility, but during the GFC the Federal Reserve suspended that practice out of concern that raising haircuts would be procyclical.

C. Other potential LCR framework improvements to allow for greater use of HQLA

In addition to the suggestions set forth in Sections III.A and III.B above, there are a variety of viable adjustments to the LCR framework that would also serve to mitigate the issues associated with HQLA usability described in this letter and in the discussion paper. We describe a few of these potential improvements to the LCR framework in this section, and also include links to prior BPI publications that contain additional details with respect to these suggestions:

- **HQLA credit for unused capacity at the discount window:** As noted in the discussion paper, the LCR does not account for all of the liquidity risks that banks are potentially faced with, such as central bank access.[39] The LCR framework could be modified in such a way that would consider banks' central bank eligible collateral and would provide firms with HQLA credit for unused capacity at the discount window.

  Under this approach, regulators should permit firms to hold liquid assets sufficient to meet their liquidity needs after 30 days of stress rather than their peak need over 30 days of stress (i.e., maturity mismatch add-on), provided that they have collateral pledged to the Fed's discount window that is sufficient to cover the difference. This revision to the framework would be most relevant in the U.S., which includes a maturity mismatch add-on to the LCR. Such an adjustment would comply with the Basel standard and would relax the need for banks to replenish HQLA they have expended and provide them with an incentive to be prepared to borrow from the discount window if necessary, enhancing financial stability. This approach would also encourage an increase in credit supply for businesses and households as firms would be able to replace HQLA in the form of lending to the government with HQLA in the form of loans to businesses and households pledged to a central bank facility.[40]

- **Create committed liquidity facilities that would count as HQLA and modify the LCR's terms for use for such facilities to make it less punitive:** While the LCR does allow for committed liquidity facilities (CLFs), the restrictions established are so punitive, an above market fee and requirement that the CLF only make up a small part of each bank's HQLA, that apart from a few central banks with special circumstances, central banks have not chosen to create CLFs because they would not be used. If the framework

---

39 *See* discussion paper.

40 For further details see BPI, Give Banks Credit For Robust Contingent Liquidity Arrangements, *available at* https://bpi.com/give-banks-credit-for-robust-contingent-liquidity-arrangements/ for further details.

were adjusted so that the terms on CLFs could be less punitive, central banks could create workable CLFs. Recognizing CLFs as HQLAs would make liquidity assessments, including the LCR, more accurate. A bank with greater capacity to borrow, such as via a CLF, is more liquid than an otherwise identical bank with less capacity. As this difference is not recognized in regulatory liquidity assessments, banks do not currently have the appropriate incentive to establish and maintain the capacity.[41] Though this approach would be most useful as a permanent adjustment, it should be considered as at least a stress period accommodation because it would enable banks to report this capacity as HQLA, reducing the need to raise other sources of HQLA. To the extent that there are concerns regarding short term loans from CLFs, regulators could determine an appropriate minimum tenor, such as a period of time that approximates historical stress periods.

- **Dynamic LCR:** As noted above, the current LCR framework assumes that a pool of liabilities is uniform and flows out at a constant rate in each period when conditions remain constantly stressed. A potential improvement to this assumption, would be to move to a dynamic LCR, which would assume that within any pool of liabilities, some are flightier than others (owing to different characteristics of the investors) so that when some flow out, the average "stickiness" of the remaining pool of investors increases. Modifying the LCR framework to change outflow assumptions for the remaining liabilities after an institution has already experienced outflows would combat a procyclical aspect of the LCR.[42] This approach would have a similar impact to the "Stress LCR" framework proposed in Section III.A. in terms of decreasing the procyclicality of the framework and therefore increase banks' ability to draw down their HQLA under stress.

While the recommendations contained in this letter would reduce the impediments to banks utilizing their HQLA under stress, the decision as to the management of liquidity resources at any particular institution will ultimately be based on such institution's judgment considering the totality of the particular facts and circumstances. Further, as discussed in Section II.A above, there are a number of regulatory requirements outside of the LCR that can impact liquidity requirements. In order for any solution to achieve the goal of increasing the likelihood of improving HQLA usability, including the recommendations contained herein any relief, adjustments, or improvements to the LCR would need to apply to these other liquidity requirements, such as those related to Pillar II, internal liquidity stress testing, and resolution liquidity requirements.

* * * * *

41 For further details see Bill Nelson, Show them the money: why the Fed should adopt CLFs, *available at* https://www.risk.net/comment/7944216/show-them-the-money-why-the-fed-should-adopt-clfs.

42 For further details see BPI, A Modest Change to the LCR That Could Substantially Improve Financial Stability, *available at* https://bpi.com/a-modest-change-to-the-lcr-that-could-substantially-improve-financial-stability/.

The Bank Policy Institute appreciates the opportunity to comment on the discussion paper. If you have any questions, please contact the undersigned by phone at 347.237.7368 or by email at brett.waxman@bpi.com.

Respectfully submitted,

Brett Waxman
Senior Vice President and
Senior Associate General Counsel
Bank Policy Institute

cc: Philip Evans
Bank of England

Michael Gibson
Mark Van Der Weide
Board of Governors of the Federal Reserve System

Benjamin McDonough
Grovetta Gardineer
Office of the Comptroller of the Currency

Doreen Eberley
Harrel Pettway
Federal Deposit Insurance Corporation