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# What Regulators Should Consider When Rethinking Liquidity Rules Post-SVB

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In recent years, bank liquidity rules have taken a back seat to other parts of the regulatory framework, such as capital. The most recent major overhauls to the post-Global Financial Crisis liquidity framework were finalized at the Basel level in 2014 and were subsequently implemented around the world. That framework consists of the net stable funding ratio, the liquidity coverage ratio, and in the U.S. also includes internal liquidity stress testing requirements. Following implementation of the framework, policymakers' attention has focused mostly on other elements of regulation; remarks in September 2022 by Federal Reserve Vice Chair for Supervision Michael Barr describe those priorities: a holistic review of the capital framework, implementation of the Basel finalization package, and several other priorities such as resolution, bank merger policy review, stablecoins, financial risks from climate change, innovation, access, and consumer protection and the Community Reinvestment Act.

Liquidity, however, has taken on new urgency among regulators and other stakeholders after liquidity risk contributed to recent bank failures. Potential changes to the liquidity framework have emerged in Congressional testimony, regulators' speeches and oversight reports. Below is a sampling of these suggestions:

- "The Federal Reserve generally does not require additional [capital or] liquidity beyond regulatory requirements for a firm with inadequate capital planning, liquidity risk management, or governance and controls. We need to change that in appropriate cases."[1]
- "We should re-evaluate the stability of uninsured deposits and the treatment of held to maturity securities in our standardized liquidity rules and in a firm's internal liquidity stress tests."[2]
- "We should also consider applying standardized liquidity requirements to a broader set of firms."[3]
- "The standard liquidity risk metrics in the RBO portfolio were likely not appropriate for a bank like SVB."[4]
- "Stronger resiliency requirements for large banks with regard to capital and liquidity would have reduced the probability of their failures."[5]
- "Legal documents and collateral arrangements for the discount window should be in place well before any funding need arises."[6]

Liquidity regulation is important because it comes with high benefits and high costs, and complex because there are no easy tradeoffs.  A fully liquid bank makes no loans and does not engage in the core function of banking –

[1] Testimony of Federal Reserve Board Vice Chair for Supervision Michael S. Barr Before the Financial Services Committee, U.S. House of Representatives (May 16, 2023), https://www.federalreserve.gov/newsevents/testimony/barr20230516a.htm.
[2] Letter of Federal Reserve Board Vice Chair for Supervision Michael S. Barr (Apr. 28, 2023), https://s.wsj.net/public/resources/documents/Fed-SVB-Barr.pdf.
[3] *Id.*
[4] Board of Governors of the Federal Reserve System, Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank at 7, https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf.
[5] Statement of Michael J. Hsu, Acting Comptroller of the Currency, before the Committee on Financial Services of the U.S. Representatives (May 16, 2023), https://docs.house.gov/meetings/BA/BA00/20230516/115922/HHRG-118-BA00-Wstate-HsuM-20230516.pdf.
[6] Speech by Lorie K. Logan, President of the Federal Reserve Bank of Dallas, before the Texas Bankers Association (May 18, 2023), https://www.dallasfed.org/news/speeches/logan/2023/lkl230518.

borrowing short-term and making long-term loans; a bank that holds no liquid assets and relies solely on government support in the face of a run creates significant moral hazard.

The wide range of liquidity changes under consideration, the high stakes involved, and the complexity of the task present a perfect case for the agencies to invite public input through an advance notice of proposed rulemaking or a request for information. ANPRs or RFIs are sometimes used at earlier stages of the rulemaking process as a necessary step to gather more information before determining an appropriate regulatory response. While they are two separate tools available to the agencies, the distinction between them is largely one of form over function, and using either to obtain public input would be a welcome alternative to reconsidering the liquidity framework behind closed doors and moving straight to a proposed rule to change it. A "holistic" review of the liquidity framework would serve the public well, so long as it reflects public input.

### *Broad Stakeholder Engagement is Particularly Valuable in the Context of Liquidity Policy*

Any changes to the liquidity framework must appropriately weigh the costs that any requirements will impose on both banks and their customers. One of the fundamental roles banks play in the economy is liquidity transformation: banks fund themselves with demandable deposits and invest in illiquid assets, like small business loans and mortgages, which fuel the American economy and help Americans build wealth. Reducing banks' liquidity risks through more stringent liquidity regulations would reduce banks' ability to perform this crucial role if such changes include expanding requirements to hold high amounts of high-quality liquid assets (as we have previously explained). The Bank for International Settlements estimates that compliance with the NSFR alone has reduced GDP permanently by 8 basis points[7], and that at current levels of capital, the social cost of the NSFR outweighs the social benefit.[8] A BIS review of the literature reported findings that compliance with the LCR reduces the supply of bank credit by 3 to 6 percent.[9] These findings do not mean that liquidity framework changes should be out of the question, but they provide a note of caution that such changes should be carefully crafted to avoid harming banks' ability to support the economy. Policymakers should strike a delicate balance between promoting financial stability and preserving banks' role as crucial intermediaries.

Regulators are understandably more focused on the financial stability side of this balancing act. As we've seen with recent bank failures, regulators receive blame when the risks that are inherent in banking lead some banks to fail. The public is never going to criticize bank regulators because their policies have caused U.S. GDP to grow by 1 percent rather than 1.08 percent in any given year. Thus, regulators are understandably biased toward ever more resilient banks. That is exactly why the perspectives of a diverse range of stakeholders – banks, academics, legislators, other market participants, and critically, bank customers – should be part of the discussion.

### *Stakeholder Input is Most Meaningful at the Early Stages of Policy Development*

Policymakers should begin considering broad stakeholder input from the earliest stage. Soliciting feedback from all relevant parties at the earliest stage of any holistic review will best position regulators to avoid unintended consequences that might result from changes to liquidity regulations. For example, a natural and intuitive initial reaction to the SVB failure was to call for increased LCR requirements, i.e., additional HQLA requirements, particularly for banks over $100 billion in assets. But this would not have solved the problem and could even have exacerbated the challenges on SVB's balance sheet. As we have previously explained, increasing SVB's HQLA requirement would simply have led it to shift its investments slightly toward longer-term Treasuries and Ginnie Maes and slightly away from Fannies and Freddies, leaving its total holdings of these securities unchanged and doing nothing about the interest rate risk that led to its failure. Collecting thoughts and ideas from a broad set of

[7] https://www.bis.org/publ/bcbs173.pdf.
[8] https://bpi.com/foundational-basel-committee-study-estimates-the-costs-of-nsfr-exceed-its-benefits-by-nearly-1-trillion/.
[9] https://www.bis.org/bcbs/publ/wp30.pdf.

stakeholders will best position regulators to craft revisions that appropriately mitigate liquidity risk while fostering economic activity and avoiding unintended consequences.

Therefore, the public interest would be well served by regulators issuing a formal request for information or an advance noticed of proposed rulemaking as part of any holistic liquidity review. This type of comment process would enable the public to provide the information that would be most helpful to the agencies as they begin to consider revisions, spark interesting and productive public discourse, and create the broadest opportunity for stakeholder engagement at the point in the rulemaking process at which various thoughts and ideas could meaningfully inform the ultimate proposal.[10]

An RFI or ANPR with respect to liquidity policy changes would likewise enable all stakeholders to improve the agencies' understanding of the relative costs and benefits of different alternatives under consideration.

Once a proposed rule has been issued, it is rare that the agencies make significant changes to the structure or framework of the regulation prior to its finalization. Given the scope of potential changes being considered, as well as the relative speed with which proposed changes may be issued in response to recent bank failures, limiting time for public input and discussion in advance of a proposed rule, it is imperative that the agencies issue an ANPR or RFI to allow for a more comprehensive public discussion. In fact, the agencies could go further than an ANPR or RFI given liquidity's importance, and host a public conference and series of stakeholder meetings to get feedback from those that would be most affected by changes to the liquidity framework. Importantly, soliciting a broad range of perspectives would also ensure that a holistic review is in fact holistic.

### *Questions the Agencies Should Ask in any ANPR or RFI*

There are several important questions that should be considered with respect to any proposals. The questions below would be relevant to include in any ANPR or RFI.

- Liquidity Regulations and Supervision
  - LCR and NSFR
    - What are the strengths and weaknesses of the current focus on liquidity positions through the use of the LCR and the NSFR as the primary liquidity regulations?
    - Have the outflow and stable funding assumptions underlying the LCR and the NSFR proven realistic? Are there particular aspects that should be recalibrated?
    - Does the LCR appropriately account for all potential sources of bank liquidity in a stress event?
    - Does the NSFR's methodology appropriately encourage banks to develop a variety of funding sources?
  - Internal Liquidity Stress Tests
    - Does the public have the information necessary to provide comments on supervisory expectations on bank assumptions utilized in ILSTs?
    - Do banks feel sufficient freedom to determine their own stress scenarios and related run-off rates under ILSTs such that the binding constraints and incentives generated from ILSTs differ meaningfully from those generated by LCR requirements?

[10] The Fed and FDIC took the approach of issuing an ANPR last fall, with respect to Resolution-Related Resource Requirements for Large Banking Organizations. In a statement accompanying the ANPR, FDIC Chair Gruenberg noted:

> "In this ANPR, the agencies will explore the effectiveness of a long-term debt requirement in promoting optionality in orderly resolution. The agencies are seeking input on questions such as: how the debt, which could be held at the bank, should be structured and issued; what is the right approach to determining the institutions in scope for such a requirement; what is the right calibration of the amount of any such requirement; and what other requirements should be considered. The agencies also seek to gain a better understanding of how the different alternatives being considered might impact the cost or burden of such requirements."

        - For banks subject to both LCR and ILST requirements, what are the unique benefits of the two?
        - Do ILSTs appropriately require firms to assess liquidity requirements and funding sources over a range of scenarios?
        - Do ILSTs appropriately account for all potential sources of bank liquidity in a stress event?
    - Are there alternative frameworks or requirements, whether quantitative or qualitative, that could better assess firms' liquidity positions and preparedness for a variety of liquidity scenarios?
    - Should liquidity requirements account for depositor concentration risk?
        - If so, what is the best way for liquidity requirements to account for depositor concentration risk? What types of concentration should be considered?
    - Do current liquidity requirements appropriately incentivize operational preparedness and contingency planning? How could this be improved?
- Liquidity Sources and Usability
    - What actions can regulators, industry, or other stakeholders take to destigmatize the use of central bank lending programs?
    - How well do the various Federal Reserve balance sheet programs function? What improvements could be made to:
        - Encourage banks to preposition collateral and establish borrowing capacity appropriate to their contingency funding needs in advance of any liquidity event; and
        - Reduce the cost and complexity of pledging collateral?
    - Are banks appropriately able to use securities in their HTM portfolios to obtain liquidity when needed? Why or why not?

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