A Helpful Federal Reserve Board Statement on Bank Liquidity

By Bill Nelson and Brett Waxman | August 21, 2024

On Tuesday, Aug. 13, 2024, the Federal Reserve Board published a consequential FAQ on banks' internal liquidity stress tests. Large bank holding companies, those with over $100 billion in assets, are required by regulation to conduct internal liquidity stress tests, or ILSTs, over a variety of time horizons and report the results to their examiners at least monthly. The tests estimate each bank's liquidity needs under different scenarios at the overnight, 30-day, 90-day, and one-year horizons. Banks are required to 1) hold highly liquid assets such as reserve balances (deposits at a Federal Reserve Bank), Treasury securities or agency-guaranteed mortgage-backed securities sufficient to meet the projected net cash outflows during those stress scenarios, and 2) show that they can monetize their HLAs (convert the assets into cash). For many banks, ILSTs are their most binding liquidity requirement (i.e., more stringent than other regulatory requirements).

A longstanding issue with respect to the ILSTs is the extent to which borrowing from Federal Reserve Banks or Federal Home Loan Banks against HLA collateral can serve as the means by which a bank plans on monetizing its HLA. Of course, this question was brought sharply into focus by the failure of SVB, which held extremely large amounts of liquid assets but was unprepared to access the discount window or standing repo facility – in part because that access would not have satisfied the monetization requirement in the ILST.

The FAQ, which is reproduced below and linked here, states that a bank *can* point to its capacity to borrow against its HLA at the Fed's discount window, the Fed's standing repo facility or a Federal Home Loan Bank as the means by which it plans to monetize its assets under its ILST scenarios. The FAQ is consequential in part because banks will now be able to plan to meet a substantial portion of their projected immediate cash needs under stress by borrowing from the Federal Reserve rather than entirely by drawing on reserve balances maintained at the Fed. It will also increase the incentive of banks to be prepared to use the discount window or standing repo facility when needed.

Just as importantly, the FAQ makes these judgments by the Federal Reserve Board public, rather than communicating them as part of the examination process as confidential supervisory information. As a

result, bankers, academics, trade associations and government officials can engage in an open dialogue about these critical public policy issues. To start that ball rolling, some questions deserving of discussion include:

1. The FAQ states that a bank cannot anticipate borrowing against non-highly-liquid assets prepositioned at the discount window in its 30-day or overnight ILST – in other words, banks cannot receive credit for access collateralized by securities that do not count as HLA or by loans. What is the basis for this distinction, particularly when banks are allowed to assume borrowing from the discount window against non-HLA collateral at horizons beyond the 30-day scenario? Isn't the discount window intended to meet immediate but not longer-term funding needs? If so, the FAQ seems to have it backward.

2. The FAQ states that the discount window is a line of credit, but it is not. Regulation A is specific that Reserve Banks are under no obligation to extend a loan (link), and the OCC has discouraged counting on the discount window precisely because it judges the window to be unreliable. Does the Board endorse this characterization of the discount window as a line of credit? Moreover, if the discount window *is* a line of credit, wouldn't that make it a better, not worse, source of funding in a liquidity stress and thus a more, not less, appropriate component of liquidity stress testing?

3. The FAQ states that banks can point to the discount window, standing repo facility or FHLB advances as the means by which they would monetize their highly liquid assets under their ILST scenarios. Can banks point to these options as their planned means of monetization for high-quality liquid assets held to satisfy the regulatory liquidity coverage ratio (LCR)?

We commend the Fed's release of the FAQ as a constructive step towards greater transparency. It will make the financial system safer and more efficient, even though we believe further clarifications are warranted.

12 CFR 252.35 (BHC) and 252.157 (FBO) (Internal liquidity stress testing and buffer requirements)[1]

Q1: Can a covered firm incorporate non-private market sources such as the Federal Reserve's discount window, Standing Repurchase Facility (SRF), or Federal Home Loan Bank (FHLB) advances as monetization channels to demonstrate its capability to monetize a highly liquid asset (HLA) under each internal liquidity stress test (ILST) scenario, as required by Regulation YY?

A1: This Regulation YY requirement relates to a covered firm's ILST scenarios and its monetization capabilities.

With regard to ILST scenarios, yes. Regulation YY does not prescribe how a covered firm demonstrates that it can monetize the HLA in its liquidity buffer under each of its ILST scenarios required under Regulation YY. A covered firm can incorporate the discount window, SRF, and FHLB advances into its ILST scenario analysis, as a supplement to private market monetization channels, including for the 30-day planning horizon. The Federal Reserve encourages firms to assess the full range of liquidity sources. Covered firms should sufficiently support their assumptions and should not rely exclusively on non-private market sources for their assumed method of monetization of any major asset class.

With regard to monetization capabilities, the Federal Reserve expects a covered firm to demonstrate that it can monetize a *representative portion* of its HLA, by asset class, *in private markets* through periodically conducting either actual (versus assumed) sales or repo transactions.[2]

The response above is intended to provide clarity on this requirement and should not be viewed as an expansion of the assets that qualify for inclusion in a covered firm's liquidity buffer. For the avoidance of doubt, covered firms can only include assets that are HLA in their required liquidity buffer and cannot include assets that do not qualify as HLA even if they are prepositioned at the discount window or FHLB.[3] Covered firms cannot include a line of credit (including borrowing capacity at the discount window or FHLB) as a cash flow source that reduces the amount of their net stressed cash-flow need in their 30-day ILSTs.[4] Finally, an asset that qualifies as HLA that is pledged to a central bank or U.S. government-sponsored enterprise (such as the FHLB) but is not needed to secure an outstanding advance is considered unencumbered for the purposes of Regulation YY and could be included in the liquidity buffer, provided all other requirements are met.[5]

---

1. The same requirements apply to certain large savings and loan holding companies under section 238.124 of Regulation LL.

2. 12 CFR 252.35(b)(3)(iv)(B) and 12 CFR 252.157(c)(7)(iv)(B); 79 Fed. Reg. 17,240 (March 27, 2014), at 17,260–61.

3. 12 CFR 252.35(b)(3)(i) and 12 CFR 252.157(c)(7)(i).

4. 12 CFR 252.35(a)(5)(iii) and 12 CFR 252.157(a)(5)(iii); 79 Fed. Reg. at 17,257, 17,259.

5. 12 CFR 252.35(b)(3)(ii) and 12 CFR 252.157(c)(7)(ii).

Posted: 8/13/2024