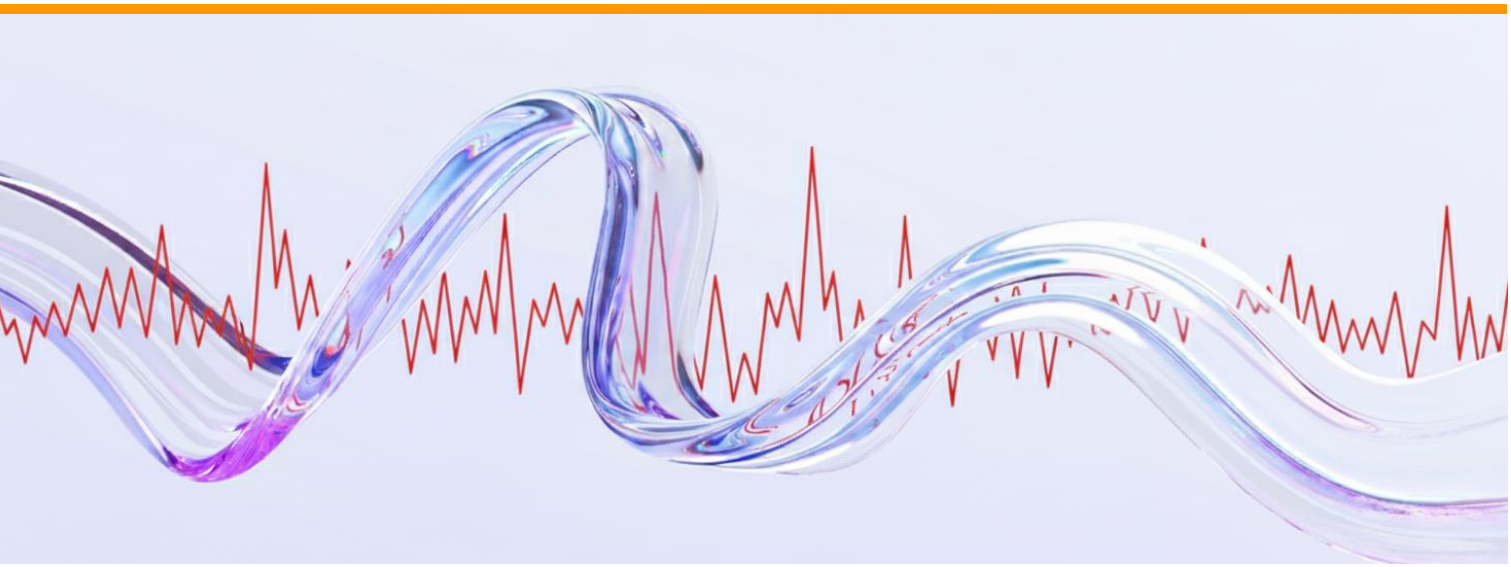

The Ongoing Distortion of the Internal Liquidity Stress Test

Brett Waxman | Sept. 26, 2025

Two post-crisis regulatory requirements, the liquidity coverage ratio and the Federal Reserve's internal liquidity stress testing requirement, were originally designed to work together and provide complementary assessments of large banks' liquidity risk. The LCR was designed and intended to provide a standardized view of liquidity risk using uniform run-off and outflow assumptions set by regulation, while the ILST requirement was intended to provide a firm-specific view by directing each bank to conduct an internal liquidity stress test that reflects its own unique and idiosyncratic risk profile and historical experience. While that conceptual approach was sound policy, the supervisory process has effectively converted the ILST requirement into a second standardized liquidity measure that is similar to the LCR but for one key difference – one-size-fits all assumptions are dictated to banks by examiners through confidential examination guidance, rather than by notice-and-comment regulation. The result is an ILST framework that no longer serves its stated purpose but instead functions as a powerful tool that permits examiners to impose binding liquidity requirements on banks in secret, tying up resources that could otherwise be used to support customers and the U.S. economy. This blog explores the origin of the ILST requirement, how the discretion that was supposed to reflect banks' unique risk profiles has been exploited by examiners to impose their own preferences and how the ILST can be returned to its original, appropriate intent: a complement to, and not an override of, the LCR rule.

The Origins of the LCR and ILST Requirements

To understand how the ILST and the LCR requirements are meant to fit together, it is necessary to outline how each requirement works. The LCR, which applies to large banks and their holding companies pursuant to uniform rules issued by the Federal Reserve, OCC and FDIC, is a standardized liquidity metric – it requires large banks to hold sufficient unencumbered high-quality liquid assets (HQLA) that can be converted into cash to meet projected net-cash outflows over a 30-day period of market and idiosyncratic stress. Put simply, it requires a bank's liquid assets to exceed its near-term runnable

liabilities. To determine the quantity of HQLA required, banks must apply outflow and inflow rates prescribed by regulation to their funding sources, obligations and assets over a 30-day period. The prescribed outflow and inflow rates are the same for all banks at all times, regardless of the bank's size, characteristics or situation.

The ILST requirement differs significantly because it is ostensibly firm-specific by nature – it requires that large banks hold a liquidity buffer sufficient to meet their projected net stressed cash-flow needs over a 30-day time horizon, as determined via an internal liquidity stress test. The largest banks are required to conduct these tests each month using liquidity stress scenarios that reflect (1) adverse market conditions, (2) an idiosyncratic stress event, (3) combined market and idiosyncratic stress and (4) any other appropriate scenario based on a bank's financial condition, size, complexity, risk profile, scope of operations or activities. In further contrast to the LCR, which assesses liquidity risk only over a 30-day horizon, the ILST regulations require the bank to conduct internal liquidity stress tests at a minimum of four distinct time horizons: overnight, 30 days, 90 days and one year, as well as any other horizon relevant to an institution's liquidity profile. Unlike the LCR, which applies to all large banks and bank holding companies under interagency rules, the ILST requirement is unique to the Federal Reserve, imposed on larger bank holding companies and supervised by Federal Reserve examiners alone.

In short, whereas the LCR is based on standardized metrics designed to be applied on a uniform basis and comparable across all institutions, the ILST requirement's assumptions were intended to be specifically tailored to an institution's idiosyncratic risk profile and historical experience. As the Federal Reserve clearly explained when it enacted the ILST requirement in 2014:

> The proposed U.S. LCR and the enhanced liquidity requirements included in this rule were designed to complement one another. Whereas the final rule's internal liquidity stress-test requirements provide a view of an individual firm under multiple scenarios, and include assumptions tailored to the specific products and risk profile of the company, the standardized measure of liquidity adequacy that would be provided by the proposed U.S. LCR would facilitate a transparent assessment of firms' liquidity positions under a standard stress scenario and facilitate comparison across firms.[1]

This conceptual approach has been reinforced as recently as last year, with then-Vice Chair for Supervision Barr noting that "[t]he LCR and ILST are two separate, but complementary, liquidity requirements. The LCR is a standardized liquidity measure across banks, meaning the outflow assumptions are the same for each bank. The ILST is a nonstandardized liquidity measure across banks, meaning each bank determines its own outflow assumptions, subject to supervisory input."[2]

When Supervisory Input Goes Awry

Conceptually, a framework that applies a well-calibrated standardized measure of liquidity as well as a complementary, firm-specific view of liquidity is sensible, mitigating the risks that can arise through reliance on a single view of an important risk to bank safety and soundness. Unfortunately, however, the ILST requirement has strayed significantly from that original intent, with discretion that was supposed to be left to banks to reflect their unique circumstances instead utilized by examiners to impose a second set of standardized assumptions by supervisors over and above those of the LCR.

[1] https://www.govinfo.gov/content/pkg/FR-2014-03-27/pdf/2014-05699.pdf
[2] https://www.bis.org/review/r241001b.pdf

Instead of permitting banks to reasonably incorporate their idiosyncratic risk profile and historical experience when determining the key parameters of their internal liquidity stress tests, supervisors have instead largely treated the LCR's assumptions as a "floor" to what the bank may assume, with any departures from the LCR assumptions allowed only – and sometimes effectively required – when they increase the stringency of the internal liquidity stress test. This practice, largely effected through supervisory feedback to individual banks after horizontal and other examination activity, has resulted in a convergence of the ILST and LCR requirements over time, with the ILST requirement ultimately becoming a more conservative measure, and thus more binding on banks in practice.

While the rules barring banks from disclosing confidential supervisory information largely cloak these type of examiner actions in secrecy, by anecdotal accounts, it would not be uncommon for a bank to: (1) be considered an "outlier" if their internal liquidity stress tests don't at least replicate the LCR's treatment; (2) receive encouragement to have their ILSTs largely correspond to the LCR's assumptions, regardless of the bank's views on the accuracy of those assumptions or whether they are even subject to the LCR or (3) abandon attempts to independently determine outflow and run-off rates due to this same encouragement. This type of feedback pushes banks towards a model monoculture, in which the LCR's assumptions are sacrosanct and a bank has reduced incentives to independently analyze its own liquidity risk.

Similarly, by all accounts, supervisors have also used ILST feedback to force adoption of other liquidity risk management practices that have the impact of trapping more liquidity at banks. For example, at the end of the 2023 horizontal liquidity review, it appears that banks were told that they could not assume they would be able to use the discount window as the means of converting HQLA into cash in their internal liquidity stress tests under Reg YY. Examiners similarly disallowed use of the standing repo facility to monetize HQLA, notwithstanding that Reg YY would not prohibit these practices. This caused widespread confusion among banks; it was especially hard to understand why examiners were using the ILST requirement to further stigmatize discount window borrowing in the aftermath of market events that reminded everyone of the systemic risks associated with that stigma. That confusion around use of the discount window and standing repo facility was ultimately somewhat resolved when the Federal Reserve issued an FAQ in August of 2024 stating that banks *could*, in fact, incorporate the discount window or standing repo facility as part of their monetization capabilities in their ILSTs as a supplement to private market monetization channels (see here) for the 30-day planning horizon.[3] While that regulatory intervention was certainly welcome, it also reinforced how far supervisory overreach had gone.

The imposition of supervisory preferences via the ILST requirement has real-world consequences; in particular, it has altered the mix of assets that banks hold to satisfy their liquidity requirements. While banks are permitted to use a range of different liquid assets to satisfy ILST and resolution liquidity requirements, bank examiners have expressed a preference for central bank reserves over other forms of liquid assets, including Treasury securities. The extent to which examiner preference in this regard has influenced bank balance sheet and market liquidity was expressly recognized by then-Vice Chair Quarles in 2022:

> I do think that one of the drivers of that [treasury market] disruption in 2019 was our, not so much liquidity regulation, but liquidity supervisory policy, which put a pretty heavy

[3] https://www.federalreserve.gov/supervisionreg/legalinterpretations/reg-yy-frequently-asked-questions.htm#64

> thumb on the side of the scale of preferring reserves over Treasury securities in satisfying your liquidity obligations. And with that heavy of a demand for reserves, it meant that people weren't going to jump into the Treasury repo market in the way that we expected that they would in order to kind of equalize that quickly, because they valued reserves much more heavily than they valued Treasuries….[4]

While this type of supervisory approach to administering the ILST requirement has resulted in unnecessarily trapping liquidity, it has also served as a kind of end run around the administrative law requirements that apply to rulemaking. While supervisory feedback on ILST practices is largely uniform across banks, it is almost always provided outside the public view and therefore is not subject to a notice and comment process nor any type of public disclosure. As a result, and especially when issued on an industry-wide basis, supervisory expectations for bank ILST practices effectively function as generally applicable and binding rules that are imposed without the transparency and other protections of the Administrative Procedures Act.

Wrong on the Merits

The ILST requirement's descent into regulation by supervision is troubling on its own; even worse, many of the supervisory mandates that have resulted from this opaque process have made for poor policy, as they're incorrect on the merits. Banks should not be required to conform their ILST assumptions to the LCR standard because the two requirements serve different purposes. The LCR's standardized metrics are designed to be applicable and comparable across all institutions, while the ILST's assumptions were intended to be tailored to an institution's idiosyncratic risk profile and historical experience, not serve as a liquidity metric that is more severe in all cases.

For example, if a bank's own experience and data indicates that certain of its deposits are "stickier" than the underlying LCR standardized assumptions, the bank should be permitted to reflect its own experience for purposes of its internal liquidity stress testing. Forcing all firms to migrate towards the LCR assumptions removes the diversity of perspective and diminishes the usefulness of the exercise.

Similarly, supervisory determinations that prevent banks from incorporating access to the discount window and standing repo facility into their own internal liquidity stress test may also change bank behavior in ways that are counterproductive. For example, as was common among regional banks, Silicon Valley Bank had not signed up to participate in the Federal Reserve's standing repo facility, notwithstanding that it could have served as an important source of contingent funding when SVB underwent liquidity stress in 2023. That was by inadvertent supervisory design; because examiners would not have provided SVB or similarly situated banks with any credit under the ILST requirement (or the LCR) for being prepared to use the facility, these banks had little incentive to undertake the process.

Beyond the lack of credit, the "rules" for including these monetization sources (and associated inflows) are anything but clear. To start, although a discount window loan is not considered to be a "line of credit," it appears that banks were told they could not include them in their ILSTs due to Reg YY's prohibitions on utilizing lines of credit as a source of liquidity for purposes of any internal liquidity stress test over a stress period of 30 days or less. However, since many of these stipulations arise from supervisory feedback and not regulation, banks are often uncertain regarding what is and is not permitted, leading to differing practices at institutions based on the feedback they have received.

[4] https://www.mercatus.org/macro-musings/randal-quarles-inflation-balance-sheet-reduction-financial-stability-and-future-fed

Indeed, as noted above, it was this type of confusion that caused the Federal Reserve to finally clarify in an August 2024 FAQ that banks could in fact incorporate discount window or standing repo facility borrowing into their internal liquidity stress tests. However, even after that FAQ was released, a BPI survey of bank treasurers found that banks had different interpretations of the ILST rules, presumably because they were still receiving different instructions from their examiners. Our survey showed that 40 percent of banks believed they are not allowed to project inflows from the discount window at any horizon, while one quarter concluded that they are allowed to project such inflows at any time horizon. Two-fifths of banks interpreted the FAQ as stating that they are allowed to project inflows from the discount window for ILSTs of greater than 30 days.[5]

This confusion is particularly problematic because the right policy answer here is so clear: examiners should absolutely recognize the liquidity risk management benefits that come with discount window borrowing capacity. Consider two identical banks with one key distinction – one has pre-pledged collateral at the discount window, permitting it to monetize that collateral quickly and easily, but the second has not. Clearly, the bank that is operationally prepared to use the discount window has greater liquidity than the bank that is not so prepared.

Bringing ILSTs Back to the Original Intent

The result of the supervisory overreach described above is an ILST requirement that no longer serves the purpose for which it was intended. Instead, it now operates as a de facto second, and secret, LCR that further embeds conservatism, leaving significant liquidity trapped at banks instead of supporting the economy. But the ILST can be restored to its original purpose and more accurately ascertain a firm's liquidity position with a few changes.

First, with respect to discount window matters in particular, the Federal Reserve could either amend its regulations or update its existing FAQs to make clear that the discount window (and standing repo facility) is not considered as a "line of credit" for purposes of Reg YY, and thus can be treated as potential liquidity source in any internal liquidity stress test with a planning horizon of 30 days or less.

Second, the Federal Reserve could revise its regulation to reaffirm that banks retain appropriate flexibility to determine the assumptions on which their internal liquidity stress test is based. Those revisions should make expressly clear that, for purposes of the ILST requirement, a bank may use any assumption, methodology, estimate or projection that is reasonable in light of that bank's balance sheet exposures, off-balance-sheet exposures, size, risk profile, complexity, business lines, organizational structure and other characteristics of the bank holding company and the relevant stress scenario, including reliance (whether exclusive or not) on non-market sources of funding as a means of meeting its liquidity needs under the test. Those revisions should also affirm that the bank is *not* required to adopt any specific assumption, methodology, estimate or projection with respect to the elements of any internal liquidity stress test except as expressly provided in the Federal Reserve's regulations.

Enacting these changes would return the ILST requirement to its original stated intent, ensuring that each bank's internal liquidity stress tests are "tailored to … reflect [that bank's] capital structure, risk profile, complexity, activities, size, and other appropriate risk-related factors" as opposed to the status quo, where they are governed by increasingly imposed uniform "examiner expectations" as to specific assumptions and practices that have turned the ILST exercise into a binding quantitative liquidity

[5] https://bpi.com/bpi-survey-of-bank-treasurers-on-willingness-and-perceived-ability-to-borrow-from-fed-lending-facilities/

requirement. And, in the process, these changes would begin to correct one of the more pronounced and consequential instances of supervisory overreach that has occurred in recent years.

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