

The prudential liquidity framework - Supporting liquid asset usability

BSA response to Bank / PRA DP 1/22

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 Building Societies
Association

Introduction

As retail deposit takers, building societies are very aware of liquidity risk, as they perform a high degree of maturity transformation, and therefore maintain a good stock of high-quality liquid assets (HQLA). At the same time, their mission is to mobilise savings to finance housing, not to hold disproportionate amounts of wholesale liquid assets. So we welcome and support the Bank's engagement with this subject, with a view to enabling better use of HQLA in particular conditions. Before answering the individual questions in the DP, we set out several broad observations that we think are probably relevant in explaining the approaches taken by the majority of building societies.

General comments

First, memories of the previous financial crisis cast a long shadow, with the collapse of Northern Rock standing out as the first major run on a substantial retail bank in the UK in living memory. And the concern about contagion to otherwise solvent banks and building societies was sufficient to induce the Government to provide a sovereign guarantee of bank deposits for a couple of years through the worst of the crisis. So, understandably, societies remain relatively risk averse on the liquidity front.

Second, while the LCR remains a supremely important but relatively simple metric, it is far from the whole picture. Building societies also place great importance on meeting the **overall liquidity adequacy rule**¹ (the OLAR). And this frequently goes hand in hand with maintaining a total stock of HQLA that corresponds to an LCR substantially in excess of 100%. Indeed, SS 24/15 states quite clearly at paragraph 2.17

“ The LCR is distinct from and does not replace the concept of overall liquidity adequacy. The LCR is a set of rules applying to all firms and therefore could fail to capture firm-specific risks. The LCR also does not capture any of the qualitative arrangements that the PRA requires a firm to implement to ensure compliance with the OLAR. It follows that a firm cannot rely solely on meeting the LCR in order to satisfy the OLAR”

Moreover, since the OLAR is the product of the society's internal risk processes, and conservative outlook on risk management, it is unlikely to be weakened in a liquidity stress.

Third, there is the question of how to respond to liquidity stresses, and in particular, in which order to take mitigating actions. Put very simply, a society (perhaps facing a generalized market-wide increase in retail outflows) could either use a tool from its contingency funding plan, or similar, to counteract the outflow and restore the status quo, or simply allow the outflow to be met by monetising some HQLA and letting the LCR fall. Soundings among our

¹In ILAA Chapter 2 (PRA Rulebook)

membership suggest a society is more likely to reach for a mitigating tool and aim to maintain its LCR. (Nevertheless, it was recognized that where a society faces, for instance, a severe, idiosyncratic stress these mitigating tools may not help in time, and the immediate answer will be to sell or repo some HQLA to generate instant cash). So the question is not so much whether the HQLA is usable at all, but the preferences as to the order in which the various tools are resorted to. We note in passing that these may have different outcomes at individual and at market level. We return to this last observation later in this response.

The range of mitigating actions also varies between large and small societies, according to the scale of their access to, and presence in, wholesale markets, including regulated covered bond (RCB) and securitisation markets. Again, to oversimplify for emphasis, a large society with a sophisticated treasury operation will typically already have one or more credit ratings, have existing debt securities in issue, and therefore make regular disclosures to the market, and have capability and experience in issuing both full-recourse covered bonds and non-recourse residential mortgage-backed securities (RMBS). By contrast, a smaller society will be unrated, have no securities outstanding, be unable on size grounds to issue either RCBs or RMBS, and make fewer and less frequent disclosures. The smaller society will have a smaller range of contingency funding options, which may make it even more conservative on liquidity in the first place.

Finally, there is the question of individual actions vs. collective outcomes. The understandable concern behind DP 1/22 is that the banking industry should not be feeling constrained from using some of its aggregate liquidity, when appropriate, so as to maintain credit flows to the real economy. But at the individual firm level, the choice is whether to risk appearing temporarily weaker by dipping into HQLA, or use other tools first (as above). The paradox is that as each firm takes actions that they consider more prudent, the aggregate, macroprudential outcome may look undesirable – or at the least, sub-optimal.

We are also struck by some similarities between the problems addressed in DP 1/22, and those covered in the context of capital in Sam Woods' recent speech² on capital buffers. In that, he advances the thought that to ensure capital remains usable in a stress, capital requirements themselves might be varied somewhat in a countercyclical manner. We wondered whether a similar approach might bring benefits in the LCR / HQLA context: in the right circumstances, instead of the Bank / PRA offering guidance to encourage the use of HQLA, could the authorities temporarily reduce the effective Pillar 1 minimum by one of the following possible actions ?

- (i) Flex some of the inflow/ outflow weightings ;
- (ii) reduce the LCR minimum reduced from 100% to, say, 80% ; or
- (iii) allow a quantified benefit from a firm's access to the Bank's liquidity facilities where acceptable non-HQLA collateral has been prepositioned.

Measures like these could provide more effective cover against market reactions for banks otherwise disinclined to take the risk.

A potential alternative to provide flexibility during times of stress could also be to set individual liquidity guidance, i.e. the requirement for firms to maintain a liquidity surplus above Pillar 1 and Pillar 2 requirements, on an average basis over a rolling 12-month period. This aligns with the LCR disclosure requirement and enables firms to fall below 100% for a period of time. Obviously, this approach would require suitable guardrails to ensure liquidity is managed above minimum regulatory requirements in normal operating conditions.

² [Bufferati - speech by Sam Woods given at City Week April 2022](#)

Responses to specific questions

Q1: How do your perceptions of banks' willingness to draw on their stocks of HQLA compare with the evidence presented in this section?

Our members' perceptions of reluctance to run down HQLA stocks are generally consistent with the evidence presented, though the COVID experience may have proved less challenging for building societies as retail inflows remained fairly strong, so they were able to continue lending as well.

Q2: To what extent would market participants be comfortable with banks drawing on their stock of HQLA to meet unexpected liquidity demands, and with accompanying falls in LCR?

A substantial drop in LCR at an individual firm still risks being viewed negatively by counterparties as a sign of incipient distress (rather than, as the question suggests, an instance of resilience). So banks or building societies are unwilling to run this risk.

Q3: How do banks' internal LCR targets affect HQLA usability? To what extent would it be feasible and appropriate for banks to adjust or tailor internal targets for different scenarios?

As mentioned above, the key further element is the bank's internal assessment of what is needed to comply with the Overall Liquidity Adequacy Rule (OLAR), and it might be difficult to make this variable according to short-term circumstances if it is designed to establish resilience against a range of scenarios, not just the current conditions. Furthermore, it may be challenging for firms determine the points at which adjustments should be made to internal risk appetite given the unpredictable nature of a stress and a lack of foresight.

Q4: To what extent did authorities' communications around HQLA usability during the Covid-19 stress support banks in using their HQLA?

We think these were helpful as far as they went, but – as the evidence cited in the DP confirms – appeared unable to overcome reluctance to run down HQLA.

Q5: What forms of communication and guidance were, and would be, most effective?

The exact form is less important than whether the communication or guidance is clear, unambiguous, and published on the record – so that it is readily understood and can be easily transmitted or referenced in internal / external discussions. Societies feel a reduction of the effective regulatory requirement (i.e. one of the measures suggested above) in stress may be the only way to promote the behaviour desired.

Q6: How much are banks concerned about regulatory reactions to initial falls in LCR, and how much about potential regulatory views on the timeline for rebuilding HQLA stocks?

We think firms are probably more concerned about the initial fall – even against general encouragement from the Bank to use HQLA, a firm may believe that a drop in their individual LCR (which for all they know may make them an outlier) could put them under the regulatory spotlight. Societies may also seek to minimise additional regulatory scrutiny which would arise if a firm was below 100% LCR, to allow them to focus on management of the stress. Building societies are, we think, more relaxed about rebuilding HQLA stocks over a reasonable period by inter alia adjusting their retail savings product range and pricing.

Q7: What may be driving a potential stigma around banks allowing LCRs to fall? How much do

you think a potential stigma may be around falls in LCR in and of themselves, and how much around concerns around how quickly LCRs can be restored?

The discussion in the DP under “Concerns around market reactions” already identifies the basic problem: *“Liquidity crises can be fast-moving and self-fulfilling: concerns about an individual bank’s liquidity position may prompt a self-fulfilling liquidity crisis, which could result in a bank failing even if it is solvent. This could happen particularly when noisy disclosures provide misleading signals.”*

Again, there is the private/ public or individual / collective divergence pointed out by the BCBS and also mentioned in the DP – *“when the market becomes aware that a bank is in a weakened position it may react more harshly than is desirable from the point of view of the authorities.”*

We would hazard a guess that potential stigma derives more from the immediate impact of any initial fall in LCR than from concern over the ability to recover and subsequently restore normal liquidity levels. See also response to next question.

Q8: To what extent is it challenging for market participants to interpret the signals they receive from LCR-related disclosures when banks are facing liquidity pressures?

As the DP says, liquidity crises can be fast moving, so there may not be the leisure for more sophisticated analysis of a particular counterparty’s disclosures – rather, the incentive will be “safety first”, so other banks could react to an outlier’s falling LCR by curtailing exposures, or at least unsecured exposures.

Q9: What impact do regulatory liquidity disclosures have on HQLA usability? How might regulatory liquidity disclosures be improved?

Notwithstanding the points raised previously in respect of other factors which impact decisions as to whether not a society may allow HQLA to fall (e.g. market reactions), disclosing an *average* LCR is helpful and in theory provides firms with the ability to run an LCR below 100% for periods of time. However, information contained within financial statements (such as residual maturity of funding and liquid assets), as well as historic Pillar 3 LCR data (average LCR Pillar 1 requirements), means that it is possible to deduce whether a society has used significant HQLA.

Furthermore, if HQLA was used beyond the point at which a firm no longer met its minimum regulatory requirements, consideration would need to be given as to whether this was a disclosable event for the firm under the Market Abuse Regulation. If it was determined to be disclosable, this negates the benefit of disclosing an average LCR.

If, as suggested, spot (point in time) regulatory liquidity disclosures prompt a “safety first” response by market counterparties, there will be an incentive for each bank or building society to avoid sharp falls in their disclosed LCR by resorting to other tools first when managing liquidity stresses. Averaging disclosures may however help, subject to the caveats above.

Q10: How do factors that drive LCR volatility contribute to concerns around HQLA usability? Which factors are most important?

This boils down to the potential for customer behaviour (manifested through savings flows and mortgage completions) to differ from the average assumptions represented in the LCR. For instance, the LCR includes an outflow requirement determined by a proportion of post-offer mortgage pipeline held, but recently the market-wide conversion of post-offer pipeline to mortgage completions seems to have slowed, leading to recent underperformance compared to the percentage assumed in the LCR, but also increasing the chance of future over-performance if there is a sudden surge of market activity. On the savings side, the ‘BAU’

drivers of savings flows are often market pricing changes or individual circumstances, which do not necessarily correlate with the high/medium/low risk categories in the LCR. So in conclusion, the potential for LCR values to vary significantly from forecasts due to outturn customer behaviour limits the appetite for HQLA usability because of the potential for further adverse movements which societies have little immediate control over.

In addition to changes in retail customer behaviours and their interplay with the LCR, the procyclical nature of the Historic Look Back Approach (HLBA), which is used to determine LCR stressed derivative collateral requirements, is also a factor in managing LCR in a stress.

This could be alleviated if the requirement was fixed as part of setting individual liquidity guidance. This therefore provides time to respond to higher HLBA requirements over time rather than creating immediate additional pressure on the LCR. In addition, this may also provide flexibility for the regulator to reduce the requirement in times of stress if firms have “crystallised” the collateral risk, albeit conscious that actual collateral postings may continue.

Q11: Why do some banks disclose spot LCR? How does the practice of spot LCR disclosures affect HQLA usability in times of liquidity pressure?

Spot LCR disclosures were originally used in the lead up to full implementation of the LCR to enable societies to demonstrate that they were in a position to meet future regulatory requirements, with this practice remaining in place even once the 12-month average approach was adopted.

A spot disclosure may result in societies needing to act faster, particularly if a stress coincided with an upcoming external financial reporting date. However, as described in the response to question 9, signs of a stress and use of HQLA may be inferred regardless of whether a spot LCR disclosure is made or not.

As noted previously, some societies believe that letting LCR drop below 100% may be disclosable under MAR, and therefore routine disclosure of the actual LCR adds transparency against the regulatory requirement and lessens the surprise if the metric ever needs to be disclosed.

Q12: What would the potential costs and benefits be of changing prudential regulatory LCR disclosures to be more in line with the Basel (typically 90-day) averaging approach?

Whilst a 90-day average may provide a more up-to-date view of liquidity positions relative to the 12-month average, it would restrict the time which a firm could operate below 100% LCR before it significantly reduces the disclosed average LCR and therefore highlight that a firm has fallen below 100% LCR (assuming that the magnitude of HQLA use led to that). Whereas, under the 12-month average, a firm could run an 80% LCR for three months for example, but still disclose an LCR of 100% if it had at least an average LCR of c. 110% for the other nine months.

Benefits – some smoothing of the short-term LCR volatility might be helpful. Costs – variable (depends on each firm’s systems). More granular information can be provided direct by firms.

Q13: How and to what extent may a collective action problem be a factor in limiting HQLA usability?

The individual / collective action problem may show up in two ways. When a particular bank faces a liquidity stress and, if it uses its HQLA, risks being seen as an outlier on disclosed LCR, (i) the incentives are for that bank to use other liquidity tools first; and (ii) for counterparties to react to a drop in the bank’s LCR by curtailing exposures. In both cases, the bank and the

counterparty have limited information about what others might do, and have to make individual decisions accordingly. In theory, if the authorities were able to coordinate market reactions, a self-fulfilling crisis could be avoided, and the outcomes would be better all round. But it is difficult to see how this could be arranged in today's world even if similar exercises may have been possible in the past (e.g. the 1970s Lifeboat).

Q14: What other factors may impact on HQLA usability?

As described in the response to question 9, Market Abuse Regulation requirements could be a factor in whether a society was willing to let LCR fall below 100%. Societies may be impacted through their own approach to encumbrance and the use of liquid assets in stress, that combined with the lower pricing of assets that may occur in a market wide stress.

Running down HQLA to service real economy flows would likely have an impact on other prudential risk measures that all need to be considered prior to taking any action. Each society's risk appetite for each of these measures (e.g. leverage) would need to be considered prior to allowing the LCR to deteriorate. Furthermore, societies would also need explicit comfort from regulators that this result would not create concern from supervisory teams !

Q15: What other approaches could enhance banks' use of HQLA in times of unexpected liquidity needs?

If there is an expectation of a general liquidity stress, then one possibility might be (as the DP indicates has already been tried in some other jurisdictions) to temporarily reduce the Pillar 1 requirement – either flexing some outflow / inflow weightings, giving quantitative recognition for access to liquidity facilities using prepositioned collateral, or even dropping the LCR minimum to below 100% - say, for instance, to 80% for a period of three or six months. See paragraph 165 of the [BCBS paper](#) for relevant instances during the early pandemic.

Also as described in the opening part of this response, setting Individual Liquidity Guidance on a 12-month average basis may also enable firms to use HQLA during a stress with sufficient time during that 12-month period to respond and ensure the average remains above 100%.

Conclusion

We have tried in the foregoing response to draw together varied and different insights from our individual members into a reasonably coherent whole. We also welcome any individual responses our members may submit direct. We would be happy to facilitate further contact between the Bank's liquidity policy team and the expert practitioners in our members' treasury functions, if this would be helpful.

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