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Shifting tides: The future of bank liquidity regulation

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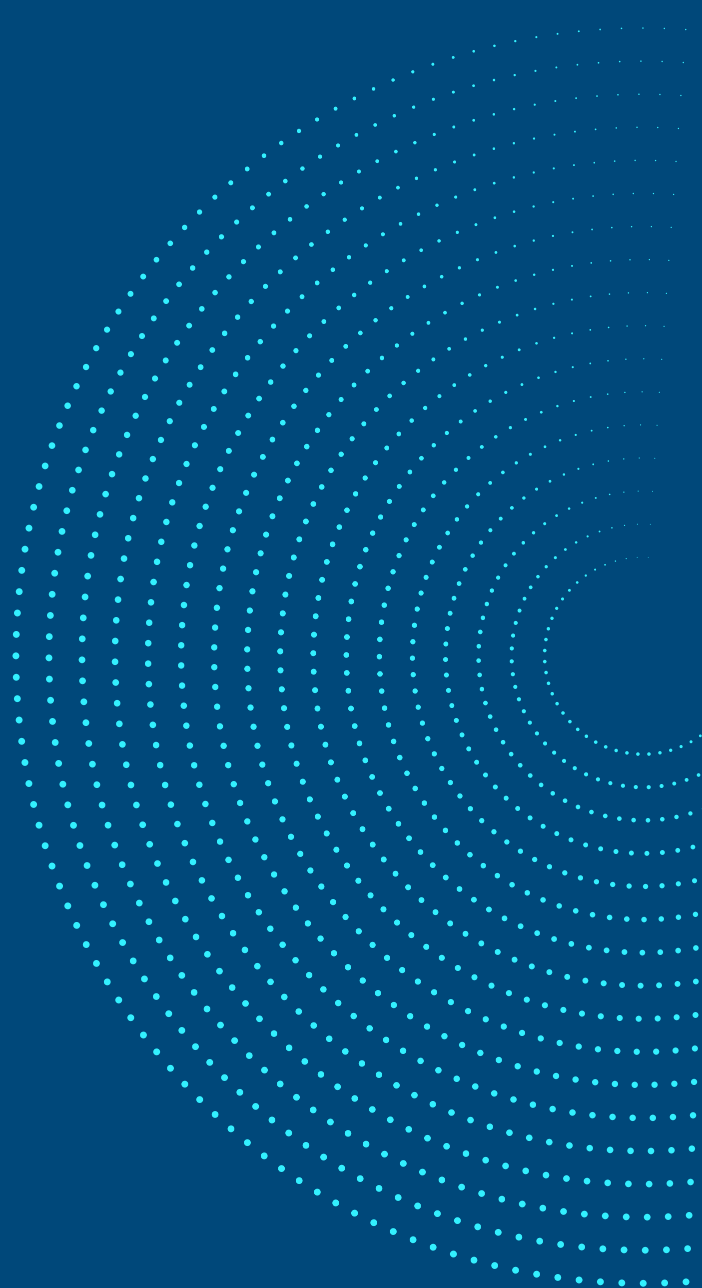
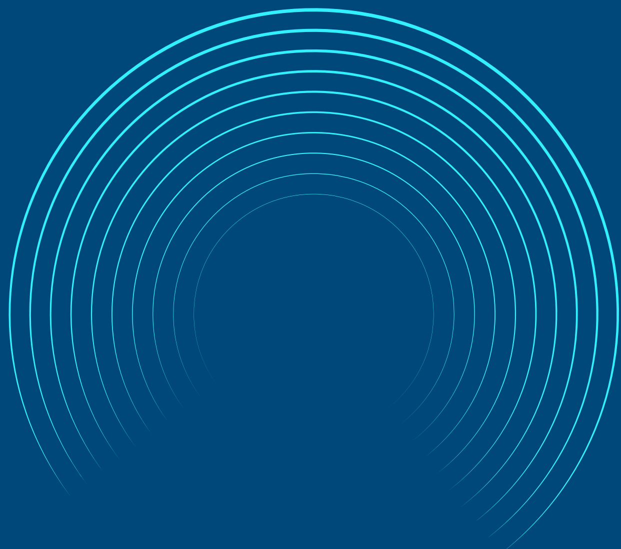
Center *for* Regulatory Strategy US

Banks are bracing for a series of anticipated changes aimed at enhancing liquidity management and ensuring greater financial stability. These changes, catalyzed by banking failures in spring 2023,[1] underscore the importance of employing appropriate liquidity frameworks to withstand financial stresses. Although timing of these shifts may still be uncertain, recent public statements by leaders of the Board of Governors of the Federal Reserve System (FRB), Office of the Comptroller of the Currency (OCC), and Federal Deposit Insurance Corporation (FDIC) have provided a view into what the regulators are thinking and have foreshadowed adjustments across key liquidity risk management areas.[2]

The bank failures of 2023 highlighted significant vulnerabilities within the banking sector. These events were precipitated by a convergence of factors, including a swift rise in interest rates, which, in turn, led to a devaluation of bond portfolios, a surge in withdrawal demands from depositors, and the emergence of rapid money transfer technology. All combined to spur a crisis of confidence in the market.[3]

These failures have prompted a reassessment of regulatory frameworks governing banks' liquidity.[4] Policymakers and regulators are now keenly focused on enhancing the resilience of financial institutions to withstand similar shocks in the future. Upcoming regulatory changes are expected to emphasize more stringent liquidity requirements, enhanced stress testing, and improved risk management practices.[5] These reforms aim to bolster both individual banks' stability and provide for adequate liquidity buffers to better manage sudden and large-scale withdrawal demands. As a result, the reforms are intended to safeguard the broader financial system and public confidence.





Foreshadowing regulatory reform

Regulatory leaders across the federal banking agencies have expressed the need to reevaluate the current liquidity risk frameworks, which have helped to shed light on potential future regulatory changes related to liquidity risk management in the banking system.[6] Most recently, FRB Vice Chair for Supervision Michael S. Barr made remarks on improvements to liquidity regulations on September 26, 2024, stating that the modifications will "complement the other components of our supervisory and regulatory regime by improving banks' ability to respond to funding shocks."[7] These public remarks have highlighted regulators' evolving views toward new liquidity requirements, noting vulnerabilities across liquidity risk management highlighted by recent bank failures.

Discount window preparedness and eliminating the stigma

The Federal Reserve System's lending to depository institutions through its discount window is an integral part of maintaining the stability of the banking industry because it provides a source of funding that can assist banks with managing their liquidity position during stress events. The industry sees the discount window as a "lender of last resort" because of better options in the repurchase agreement (repo) markets and with Federal Home Loan Bank System (FHLB) advances. While the discount window was created to strengthen financial institutions, it is often avoided by financial institutions due to the stigmas associated with it, which include:

Reputational risk: When a bank borrows from the discount window, it can be perceived as a sign that the bank is experiencing financial difficulties and cannot obtain funding from other sources, potentially leading to a loss in confidence among customers, counterparties, and investors. While there has been proposed legislation for improved collateral movement,[8] the Dodd-Frank Act requires the Federal Reserve disclose information about discount window borrowers two years after a discount window loan is extended,[9] which may damage a bank's reputation of safety and soundness. Additionally, there are more prompt disclosures on schedule 6 in the H.4.1 report that breaks out FRB assets by branch, which market participants can use to help identify borrowing activities sooner.

Market reaction: News that the bank has used the discount window may lead to negative market reaction and potentially lead to a decline in the bank's stock price and an increase in borrowing costs.

Alternative funding sources: Banks will typically prefer to borrow from the interbank market or other private sources of funding, which are seen as an ability to manage liquidity needs without central bank assistance.

Cost-benefit considerations: While the cost of using the discount window is fairly low, the long-term costs of perceived instability and financial weaknesses associated with it may compound over time.

The Federal Reserve has been exploring ways in which it can improve the discount window to make it more accessible and reduce the stigma associated with it.[10] The FRB has been working on operational modernization, including a new online portal that allows banks to request and prepay discount window loans, rather than doing so by phone.[11] Previously, loans were only able to be requested through telephone calls, which increased inherent risk compared to an electronic solution.

With the financial stress events of 2023, this emphasized the frictions between the discount window and limits on the availability of payments services, such as Fedwire. The FRB recently published a proposal to expand Fedwire and National Settlement Service (NSS) operating hours to 22 hours a day, 7 days a week, all year.[12] Since the proposal only calls for cash movement in the expanded operating hours, there are currently no proposed changes to collateral movement. FRB leaders are discussing ways of improving collateral movement from the bank or FHLB to the central reserve bank in a timely manner, as needed.[13] This may be supported by regular operational testing to establish that access to the discount window remains available and ready to access.

In 2023, a number of banks repositioned their balance sheets so that total cash plus borrowing capacity at the FRB and FHLB exceeded total uninsured deposits.[14] This removed the "first mover advantage" that can start a bank run. However, this greater-than-100% ratio can be costly to maintain in the long term. A policy option under consideration would require banks to maintain a minimum ratio of cash and discount window borrowing capacity as a share of uninsured deposits—reportedly around 40%.[15] In his September speech, FRB Vice Chair for Supervision Barr suggested that this would apply to "larger banks" (likely those above the $100 billion in total assets threshold) and would take a tiered approach.[16]

However, such an option may face challenge from within the agencies themselves. For example, FDIC Vice Chairman Travis Hill has expressed reservations about the policy, believing it may amplify the "first mover advantage" by "shining a magnifying glass on the fact that a bank cannot cover every depositor."[17] Part of the motivation behind this option is likely to destigmatize the discount window by requiring banks to pre-position collateral at their local Federal Reserve Bank.

For a long time, discount window capacity was not considered in the computations of minimum liquidity buffers, including the Liquidity Coverage Ratio (LCR) and the first 30 days of the Internal Liquidity Stress Test (ILST). FDIC Vice Chairman Hill suggested including the discount window in the LCR and ILST to entice banks to preposition collateral and maintain ongoing operations with the discount window.[18] In response to this gap, on August 13, 2024, the FRB issued clarifying details that encourage firms to assess the full range of liquidity sources in a stress scenario, including high-quality liquid assets (HQLA) at the discount window, standing repo facility (SRF) and FHLB. However, banks "should not rely exclusively on these non-private market sources."[19]

Other considerations include allowing banks to count loans that are monetizable through the discount window in the LCR.[20] Former Governor of the Bank of England, Mervyn King, has suggested central banks require banks' cash and central bank borrowing capacity to exceed all runnable liabilities—a playbook that would turn central banks into a "pawnbroker for all seasons."[21]

In July 2024, Senator Mark Warner introduced the Discount Window Enhancement Act of 2024, which would, among other things, mandate testing of banks' operational readiness to access the discount window and require regulators to reflect discount window borrowing capacity in liquidity evaluations.[22] The idea behind this is that by forcing banks to pre-position collateral, banks will have an available pool of liquidity to draw during times of stress. This may also mitigate some of the stigma associated with the discount window, given collateral is already pre-positioned there and may be the most cost-effective option; however, it would not address any changes to FRB reporting of discount window usage, which still represents a potential barrier to banks.

These proposals and considerations may prompt banks to reevaluate their liquidity risk management strategies across the industry. Reducing the stigma associated with the discount window can provide advantages to both individual banks and the financial system overall by encouraging banks to tap additional liquidity in times of stress. Enhancing operational processes and integrating discount window capacity into regulatory liquidity metrics could bolster contingency funding planning, mitigate reputational risks, and enable more effective cost management, aligning with robust liquidity risk management frameworks. Banks should also consider the implications for their collateral management and related procedures. Incorporating the discount window into liquidity buffers and internal liquidity stress-testing frameworks, as proposed, will aid banks in better complying with regulatory requirements. Utilizing the discount window as part of the overall liquidity management strategy will better enable banks to not only meet regulatory standards but also proactively manage liquidity risk and maintain financial stability in accordance with governance and regulatory expectations.

Real intraday liquidity: Faster payment services and real-time data

Our experience shows intraday liquidity risk has been a focal point of supervisory attention. Regulators have high standards, and increasing expectations, when it comes to whether banks can meet their payment and settlement obligations on time, which assists with maintaining the stability of the interconnected overall financial system. As the global financial infrastructure moves toward faster payment systems and real-time monitoring, intraday liquidity management is ever more a focal point across the financial industry. However, like discount window usage, some banks may be reluctant to access FRB intraday credit due to concerns regarding stigma. Faster payment systems create emerging risks related to risk types such as operational, fraud, compliance, Bank Secrecy Act (BSA)/anti-money laundering (AML), and third-party risk management (TPRM). As payment speeds increase, the innovation and enhancement of risk and control frameworks should match its pace.

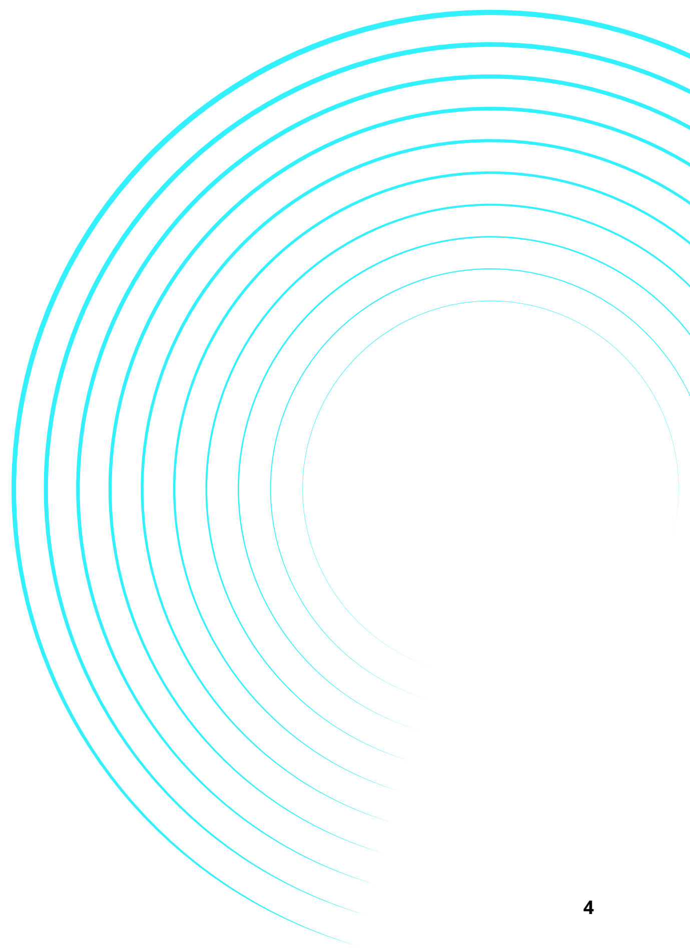
OCC Acting Comptroller Michael Hsu recently noted how a wide range of nonbanks have been able to innovate and use technology to compete in the payments space, which has been fueling growth for both banks and nonbanks.[23] According to Acting Comptroller Hsu, this technology will likely continue to drive the digitalization of banking, with open banking and real-time payments further accelerating this payments trend in the industry. While there has been a sharp increase in operational efficiencies, the availability of real-time data in the financial industry is lagging and may jeopardize the safety and soundness of financial institutions.

The digitalization of banking has created opportunities for customers to have easier access to products and funds; however, the vulnerability of bank runs increases as customers can move money with the accessibility through smartphones and other technology solutions. As a result of this emerging risk, banks and regulators may seek greater visibility into the real-time data, specifically real-time deposit flow data.

Banks should be focused on their intraday liquidity capabilities (including establishing a liquidity buffer rightsized to the size, scale, and complexity of the bank and its associated business activities) and having a formal payment throttling and prioritization framework to mitigate risks during a potential bank run. This strategy involves establishing key risk indicators (KRIs) and early warning indicators (EWIs) that are tied to real-time intraday data to manage outgoing payments during a time of high or volatile activity to allow adequate time to put compensating measures and controls in place. These controls should have clearly defined escalation paths and communication channels. Banks must have the ability to analyze and assess their intraday liquidity needs in both a business-as-usual and stress environment to establish a liquidity buffer demonstrating their ability to monitor and manage intraday needs.

Banks may wish to consider integrating their intraday liquidity requirements across their liquidity risk management processes, including collateral management, internal liquidity stress testing, cash flow forecasting, and their contingency funding plan (CFP). This could be complemented by the bank's limit framework and risk appetite with relevant thresholds well defined and established to monitor and proactively mitigate key risk drivers.

The shift toward digital banking is increasing the risk of bank runs, prompting a need for enhanced visibility into real-time deposit flows. In order to bolster their intraday liquidity capabilities, banks should consider establishing appropriate liquidity buffers, implementing payment throttling and prioritization frameworks, and integrating these requirements into their broader liquidity risk management strategies including the setting of the risk appetite and limits. This holistic approach will help enable banks to proactively address key risk drivers and maintain financial stability.



Treatment of deposits

Bank deposits are a critical source of funding for banking institutions and continue to be an ongoing key liquidity risk driver in the financial industry. Massive deposit outflows can occur within days or hours, and the need to adapt to the faster pace of bank deposit runs has been emphasized across the regulatory agencies.[24] These agencies continue to stress the importance of carefully categorizing and segmenting deposits and applying appropriate high-stress outflow rates to high-risk deposits to ultimately improve the accuracy of liquidity risk management.[25] The need for standardizing how tranches of deposits are treated within the LCR framework and potentially adjusting the assumptions for deposit runoff rates have been echoed by Acting Comptroller Hsu and FDIC Vice Chairman Hill.[26] These assumptions may include standardizing the definitions of stable versus non-stable and operational versus non-operational deposits as these are defined differently based on the business profile of each institution.

Acting Comptroller Hsu has stressed the importance of financial institutions having the ability to identify and forecast where deposit "herd" behavior may occur (e.g., relying on heavily concentrated sectors, companies, or specific investor deposits for bank funding).[27] Banks should be able to segment these types of deposits and apply appropriately higher outflow rates to better capture the heightened risk of herding and better manage liquidity risk.

On July 30, 2024, the FDIC Board of Directors, by a vote of 3-2, approved a notice of proposed rulemaking that would make several key revisions to the agency's rules on brokered deposits.[28] These key revisions include:

Broadening the definition of deposit broker: Replacing the term "matchmaking activities" with a wider set of deposit allocation services, as well as adding a new factor related to fees.

Eliminating exclusive placement carve-out: The FDIC would eliminate the exclusive placement carve-out and restore the rule to any third party that meets the definition of deposit broker, including those involved in placing deposits at only one insured depository institution (IDI).

Narrowing primary purpose exception: The proposal would provide additional factors to consider (e.g., fees, level of discretion, or other remuneration provided to the third party) in determining whether the intent of the third party in placing deposits at an IDI is for a substantial purpose other than to provide deposit-placement services.

Lowering the 25% test and narrowing permitted agents/nominees: Under the proposal, this 25% test would be replaced with a new "Broker-Dealer Sweep Exception" available only to registered broker-dealers or investment advisers and provided that less than 10% of total assets under management, as agent/nominee, in a particular business line, is placed into non-maturity accounts at IDIs.

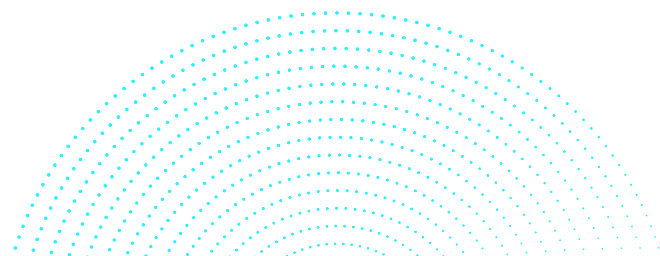
Eliminating the enabling transaction exception: The FDIC would eliminate this enabling transaction test from Primary Purpose Exception (PPE) analysis. As such, PPE applications previously approved under the enabling transaction exception would be rescinded, and IDIs currently relying on such exceptions would need to file an application under the revised general PPE.

Banks are being encouraged to foster a detailed understanding of their deposit portfolio and create a sustainable process to review deposit classification and runoff assumptions to avoid the misclassification of high-risk deposits leading to an understatement of risk.

Recent remarks by FDIC Vice Chairman Hill stressed what he viewed as the flaws of the FDIC's brokered deposits framework.[29] Specifically, he pointed out that the main criterion to assess the risk posed by a deposit does not consider if the deposit was received through an intermediary. He also highlighted that the current scope of what constitutes brokered deposits is broad and includes a variety of classified brokered deposit agreements that are quite different from the ones historically handled by deposit brokers.

In his September speech, FRB Vice Chair for Supervision Barr confirmed that the Federal Reserve will review the treatment and outflow rates associated with various deposit types within the current liquidity framework. This review comes in response to shifts in market dynamics and behaviors observed during the events of 2023. The need to recalibrate depositor assumptions has been a significant topic among regulators worldwide, and the FRB is now taking a leading role in this initiative.

Additionally, the FDIC's proposed revisions to brokered deposits rules aim to broaden definitions, eliminate certain carve-outs, and refine exceptions, thereby encouraging banks to develop a detailed understanding of their deposit portfolios and maintain robust processes for deposit classification and runoff assumptions that should be incorporated as part of the ILST to mitigate risks.



Treatment of held-to-maturity assets

Currently, banks have the option to classify certain securities as held-to-maturity (HTM), which exempts these assets from mark-to-market (MTM) accounting, and instead report these on the balance sheet at their amortized cost.[30] This accounting approach has its pros and cons and has been a topic of discussion for quite some time, with proponents stating that classifying as HTM and amortizing on the balance sheet focuses on the long-term earning effects, while contrasting opinions believe MTM provides transparency to investors, creditors, and others who use the financial statements to evaluate the investment strategies. Unrealized losses on HTM securities portfolios played a significant role in the spring 2023 bank failures and have brought this accounting practice back into the spotlight.[31]

A research note produced by the Federal Reserve Bank of Boston postulated three options to address concerns with HTM accounting:[32]

1. **Eliminate HTM classification:** Fair value accounting would provide a preferable measurement of a bank's regulatory capital; however, this would result in increased capital volatility resulting in a higher cost of capital and increased likelihood of bank failure as well as skewing the balance sheet while most liabilities continue to be amortized.
2. **Further restrict use of HTM classification:** Potentially introduce regulatory guidance that restricts a HTM portfolio to a certain percentage of total securities to substantiate a firm's intent and ability to hold a security to maturity.
3. **Require banks to include unrealized gains/losses on HTM debt securities in Common Equity Tier 1 (CET1) capital:** This would reduce the incentives for certain firms to classify disproportionate amounts of securities as HTM; however, it may penalize banks with predominantly buy-and-hold strategies.

Banks are actively increasing their HTM portfolio in the current environment of rising rates, despite the shortcomings identified in this strategy through the spring 2023 crisis.[33] Forthcoming regulatory changes are expected to address the liquidity risk associated with HTM securities, particularly in a stress scenario in which monetizing these assets might be necessary.[34] In particular, the FRB is considering a partial limit on the extent of reliance on HTM assets in larger banks' liquidity buffers, such as those held under the LCR and ILST requirements.[35]

Anticipated regulatory changes aim to address the liquidity risks associated with HTM securities, especially in stress scenarios where liquidating these assets may become crucial. The evolving regulatory landscape underscores the need for banks to balance long-term investment strategies with the transparency and risk management required by regulators and stakeholders.

Heightened expectations on contingency funding plans

Banking supervisors have recently placed an emphasis on the ongoing management and operational readiness of banks' contingency funding plans.[36] While this has always been a focal point of liquidity and funding risk management, with the bank failures of 2023, this topic has been at the forefront of banks' strategic priorities and heightened regulatory expectations, which was evidenced in a July 2023 addendum to SR 10-6, "Interagency Policy Statement on Funding and Liquidity Risk Management."[37]

Our experience advising clients shows banks have been focusing their internal reviews on the adequacy of their CFP on the following topics:

- Assessing the stability of funding and accessibility to a broad range of funding sources
- Documenting the operational steps to obtain funding, including potential counterparties, contact details, and availability of collateral
- Regular testing of any borrowing lines for operational readiness, training staff on how to act swiftly
- Recognizing within the CFP that in times of stress, contingency lines may become unavailable
- Reviewing and revising the CFP periodically, including triggers for market conditions and strategic initiatives to evaluate emerging risks
- Incorporating the discount window into contingent funding actions

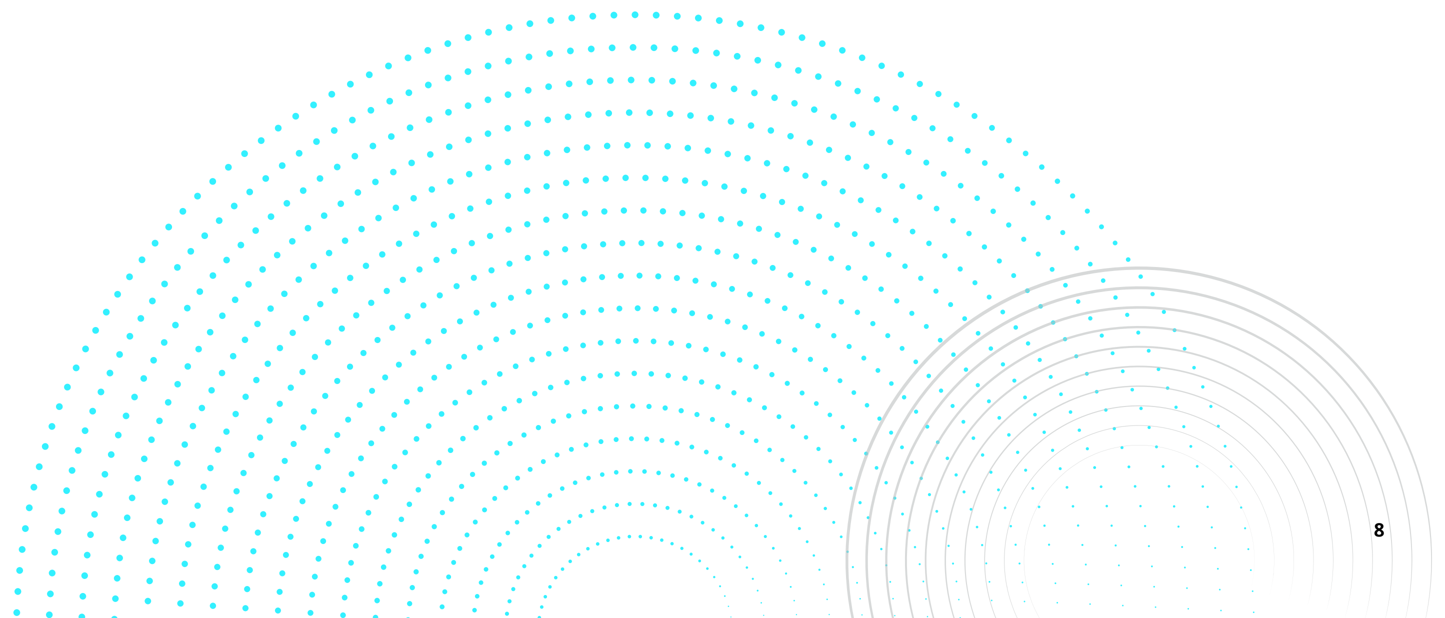
Banks are being encouraged to recognize a wide and diverse set of funding strategies to meet liquidity needs in a rapidly changing macroeconomic environment. Enhancements should consider the integration of banks' capabilities over key risk management processes such as risk appetite, EWIs, and recovery and resolution planning.

How banks can prepare

As we look to the future, banks should consider investing in enhancing their existing capabilities in alignment with upcoming regulatory changes and what leading peers are doing around the marketplace. In our experience working with clients , supervisors have been pointing out deficiencies in bank liquidity risk management processes, for which ILST, CFP, intraday liquidity management, and data and reporting should be prioritized. Considerations for improvement may include:

- Increasing the frequency and granularity of product data as they review and enhance ILST assumptions and perform regular back testing. Stress scenario narratives need to have detailed rationale that provide a transparent view into the impact of adverse events and tie back to the risk taxonomies tailored to specific institutions.
- Establishing CFP linkage across EWIs, limits, and resolution planning with comprehensive contingent and recovery actions, including increased discount window usage. Limits and EWIs should be constantly evaluated to provide that thresholds are fit for purpose and provide actionable insights into the bank's health.
- Maintaining a live inventory of assets that can be monetized in the event that the CFP is invoked, which would be constantly evaluated and updated as part of the bank's testing routines for asset monetization.
- Establishing real-time monitoring of banking cash flows and a formal framework for payment throttling and prioritization tied to key risk indicators will assist with avoiding some of the shortfalls we saw in 2023.
- Building data controls across the end-to-end processes from data source to reporting; providing transparency to regulatory processes, such as 2052a reporting; and improving the bank's ability to provide timely management reporting.

Banks investing in their risk programs, technology, and strategic planning will, in addition to improving their regulatory compliance, gain operational efficiencies and increased reputational trust to give them a competitive advantage and sustainability in their risk programs.



The road ahead

Recent bank failures have elevated the necessity for widespread regulatory changes to promote greater financial stability in the marketplace. These anticipated changes aim to improve liquidity risk management practices, and banks should be preparing to invest in improving their internal processes and capabilities. The regulatory, technology, and liquidity risk reforms should bolster the banking sector's stability and improve the ability to withstand sudden and large-scale risk events. In addition, with the rapid change and growth across the industry, banks must strive to continually enhance their framework for safety, soundness, and sustainability.

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Endnotes

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