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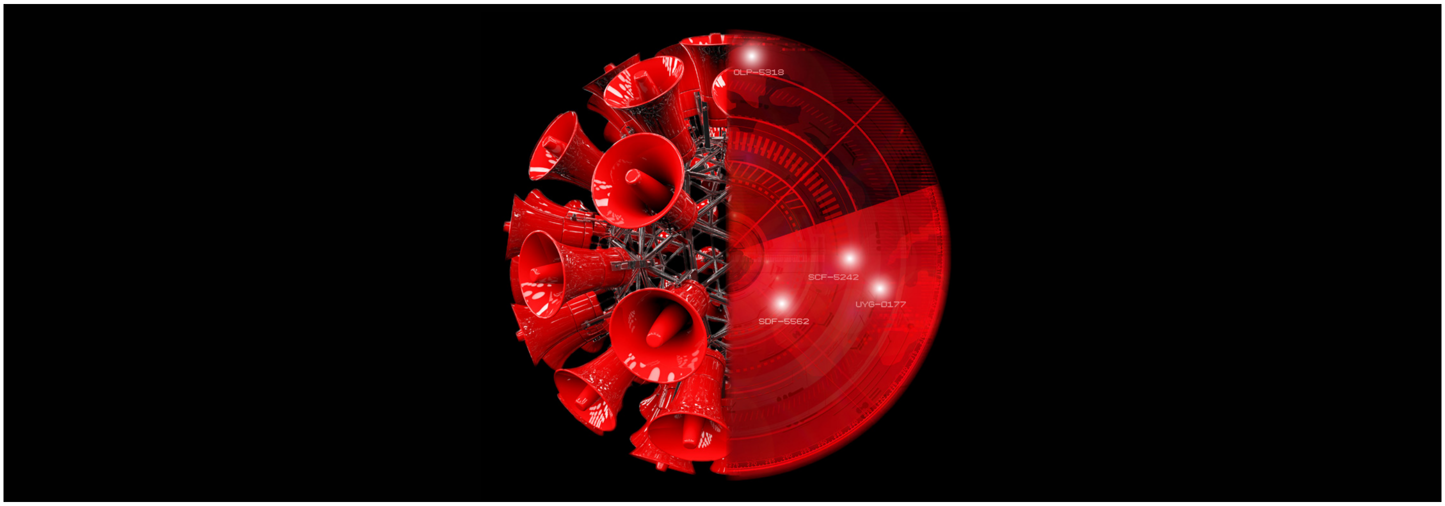

COVID-19 impact on bank liquidity risk management and response

Overview

As a result of COVID-19 and the actions taken by governments and businesses to help mitigate the impact, financial institutions have been challenged in their ability to manage and report on their liquidity positions and funding capabilities. Regulatory requirements put in place after 2008 were designed to improve banks' ability to meet funding obligations by establishing liquidity buffers, and to implement contingency funding plans (CFPs) to guide banks during times of crisis. However, recent equity market volatility, liquidity tightening, widening funding spreads, operational fails, and other challenges have put significant pressure on **bank liquidity risk management**.

In response to the recent adverse market activity, the Federal Reserve Board (the Fed) has taken steps to stabilize the financial markets through the purchase of Treasuries and government guaranteed mortgage-backed securities, reviving the Primary Dealer Credit Facility to offer loans to securities firms, reestablishing the Money Market Mutual Fund Facility, and substantially expanding its repo operations[1] The Fed has also encouraged banks to start borrowing from its discount window and regulators have extended the timeline for certain regulatory requirements (e.g. the Current Expected Credit Losses implementation) in an effort to reduce some pressure on bank resources. The capital and liquidity buffers that banks now have in place were designed to be available sources of capital and liquidity to support the economy during adverse situations such as the impacts of COVID-19 and to enable banks to continue lending. The Fed is encouraging banks to use their capital and liquidity buffers as they make loans available to households and businesses affected by the COVID-19 restrictions, assuming this lending is done in a safe and sound manner[2].

Industry challenges in liquidity and funding risk management

Although the Fed has taken steps to stabilize the market and make funding available, many banks have already activated their CFPs and are actively managing and reporting on their liquidity positions, often to the C-suite and executive committees. As a result, banks are facing a number

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Liquidity stress management reporting
A number of requirements put in place after the financial market crisis required that banks establish processes for the production of near real-time liquidity management reporting during periods of stress that may likely provide a full view of a bank's liquidity position across various entities and regions, and holistically across the organization. Intraday liquidity reporting requirements should also have incentivized banks to develop intraday liquidity monitoring and management capabilities. However, some institutions are still finding themselves without sufficient reporting capabilities, and therefore management may have reduced visibility of liquidity availability and shortfalls across the organization. Even those banks that have developed this reporting may have missed the importance of reporting on the impact of market fails that have been a result of the increase in trading volume and volatility.

Liquidity preservation and contingency funding
In the current market, banks have most likely reduced liquidity buffers and have already considered implementing actions documented in their CFPs to preserve liquidity. Banks should consider a number of factors as they begin to take action, starting with obtaining an accurate view of projected cashflow and liquidity shortfall across entities and businesses. The size, location, and expected duration of these shortfalls will impact decisions on liquidity preservation actions in the short term and banks will need to decide whether to seek alternative sources of funding in the longer term.

Liquidity stress testing assumptions
In compliance with Regulation YY, banks have implemented liquidity stress testing models using assumptions for inflows and outflows related to existing sources of funding that may likely be impacted during periods of market and firm-specific (idiosyncratic) liquidity stress. Models were primarily based on data taken from idiosyncratic and market events during the financial market crisis and in some cases updated for more recent liquidity events and market dislocations. However, many of the disruptions in the liquidity markets that the banks are seeing today were not captured in these model assumptions. In addition, declines in price visibility may lead to increased liquidity risk via changes to haircut assumptions. This and the market impacts may result in inaccuracies and large daily movements in liquidity positions and stress testing results.

Transition from monthly to more frequent FR 2052a reporting
As per the FR 2052a guidelines, the Fed has already requested that monthly filers submit FR 2052a data on a more frequent basis. The reality is that not all banks are well positioned to support more frequent reporting and these banks may face constraints on data availability and resourcing to support process cycle times. Submission procedures that rely on manual processes, observed more frequently in monthly than daily filers, may be overwhelmed, resulting in a deterioration of controls and quality. Institutions subject to this transition may also be faced with responding to the Federal Reserve while also managing crisis-related resource constraints and dislocation challenges.

Collateral management
The potential for disorderly markets increases the challenges in determining the value, availability, and eligibility of collateral. A continuation of the volatility seen in recent weeks may result in extreme swings in value, increasing the financial and operational pressures in monitoring collateralization of asset/liability values and in managing and controlling calls for collateral delivery and receipt.

Collateral availability monitoring may become more complicated due to increased needs for secured funding combined with increased levels of collateral substitution as firms call back high-quality collateral. Availability monitoring will likely be further complicated by the need to monitor rehypothecation rights against counterparty credit ratings and events (e.g., downgrades).

Regarding eligibility, the Fed's expansion of its practice of securing lending facilities is creating new options for utilizing collateral. These new options may require firms to modify and enhance collateral databases to support eligibility determination.

Actions banks should consider

Given the challenges that banks are likely experiencing, organizations should take certain steps to address these challenges promptly to effectively manage current liquidity risk and better prepare for longer-term actions.

Rapidly assess and take action on liquidity challenges and management requests
As during the financial market crisis, preserving cash and access to liquidity is the overarching goal for banking organizations. Understanding the size, timing, and funding of cash requirements will likely be the highest priority request from senior management. Quick and effective responses may require a focused, dedicated team (e.g., a task force) that can react quickly to offer innovative approaches and adjust processes.

Cross-functional teams comprised of first and second lines of defense, operational and technical resources should be sponsored by executive management. Careful consideration should be given to ensuring that ongoing and business-as-usual operational needs continue to be met, while dealing with crisis-related issues. Supplementary skilled and experienced resources may be required to provide additional capacity.

Strengthen liquidity monitoring and reporting capabilities
It's critical that banks utilize accurate and updated information to manage liquidity during a crisis. Tactical solutions leveraging existing reporting, data, processes, and resources implemented after 2008 can be leveraged to enhance the scope, depth, and timeliness of liquidity and funding reporting. Bespoke tactical approaches can be used to overcome liquidity monitoring challenges arising from segregated data, incompatible data structures, and fragmented monitoring and reporting capabilities.

Monitoring improvements should focus on currently available liquidity management tools, forecasts on expected and potential inflows and outflows, early warning indicators and risk limits. Liquidity monitoring should also cover collateral, specifically availability (encumbrance and rehypothecation rights), haircut behavior, credit quality, calls for delivery, calls for receipt, substitution capacity and risk and eligibility for the Fed's lending programs.

Establish processes for coordinating regulatory responses

Banks should implement processes to respond efficiently to regulatory inquiries and changes in reporting requirements. Using the financial market crisis as a precedent, banks should expect inquiries based on existing reporting regimes as well as inquiries that extend or build upon those regimes. These inquiries are likely to compete with internal requests for information. Liquidity task force teams should assess whether existing regulatory reporting teams are capable of supporting regulatory responses and internal needs concurrently, and whether supplemental resources should be brought in to enhance existing capabilities.

Revise cash flow forecasts and liquidity model assumptions

Liquidity model and cash flow forecast modifications will likely need to be made to more accurately reflect current and projected conditions given the COVID-19 crisis (and in the aftermath, as the economy adjusts and recovers). Modeling assumptions including asset haircuts and cash flow timing (e.g., roll-off, drawdown assumptions) should be assessed in the context of the current environment. As market pricing observability declines, haircuts and related assumptions should be updated. Consulting subject matter resources on assumption reasonableness is encouraged. In addition, banks should consider whether in-house modeling teams have the capacity to keep pace with necessary revisions and consider whether supplemental resources may be needed to overcome constraints or skill gaps, and address the most impactful changes as efficiently as possible.

Conclusion

The market turbulence and economic impacts resulting from the COVID-19 crisis are ongoing and continually evolving. Bank liquidity teams will need to ensure that they understand the current and continuing effects, and put in place tactical solutions that can be supported for a potentially extended duration. Impacts to liquidity and funding availability, risk management, reporting and management, and regulator requests should be prioritized to enable resources to quickly and effectively a ddress challenges and requests on an ongoing basis.

As the crisis resolves, lessons will be learned. Tactical fixes that are put in place today could lay the foundation for more robust and innovative solutions in the future.

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Endnotes

1. https://www.federalreserve.gov/newsevents/pressreleases/monetary20200323b.htm; also "What's the Fed doing in response to the COVID-19 crisis? What more could it do?", Brookings, Jeffrey Cheng, Dave Skidmore, and David Wessel, March 23, 2020, https://www.brookings.edu/research/fed-response-to-covid19/.
2. https://www.federalreserve.gov/newsevents/pressreleases/monetary20200315b.htm.