

## A response to the PRA's discussion paper on The prudential liquidity framework: Supporting liquid asset usability

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### Introduction

1. UK Finance<sup>1</sup> is the collective voice for the banking and finance industry. Representing more than 300 firms, we act to enhance competitiveness, support customers, and facilitate innovation.
2. We are pleased to respond to the Prudential Regulation Authority's (PRA) [Discussion paper 1/22](#) (DP) which explores why banks may be reluctant to draw on their high quality liquid assets (HQLA) in periods of market wide liquidity stress.

### The PRA's concern

3. Regulators require firms to hold liquidity buffers to ensure they can withstand potential market-wide and idiosyncratic stress scenarios. They are designed so that they can be utilised as the stressed outflows materialise. The Bank of England (BoE), the PRA and regulators in other countries have all reiterated that the intention of the LCR Framework is to allow firms to use buffers in stress. However, the impediments to firms' ability to use liquidity buffers in stress, described by the BoE in its DP, have resulted in the minimum 100% LCR requirement being a de-facto floor at all times. Firms are generally unwilling to allow their LCRs to fall below 100%, even in a very severe stress such as that experienced in the early stages of the Covid pandemic, despite statements by the PRA and other regulators that supported buffer usability at such times.
4. We strongly believe that the policy objectives of the LCR have significantly improved the resilience of banking institutions to withstand periods of persistent stress and to continue to support the economy across all market conditions. This was evidenced in March 2020 by strong liquidity positions held by firms at the onset of the Covid-19 crisis. However, regulatory liquidity buffers are held to ensure firms can pre-fund potential market-wide and idiosyncratic needs in a period of stress and should be used as these needs materialise. While global regulators have also acknowledged that the intention of the LCR framework is to allow firms to use buffers in stress, the impediments identified by the PRA are also identified internationally.
5. Inefficiencies in the existing regulatory liquidity framework to facilitate the utilisation of liquidity buffers can result in the need for government intervention to support the flow of credit and liquidity in a market-wide stress event. This was evidenced during the COVID-19 crisis,

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<sup>1</sup> Visit our website [here](#)

whereby swift government intervention was required through the establishment of government-sponsored funding facilities and interim capital and liquidity regulatory relief actions throughout March 2020 to May 2020 to alleviate liquidity and funding pressures across market participants and support the economy.

6. We therefore support this discussion about firms' reluctance to let LCRs fall below 100% in a time of stress in order that any impediments to their utilisation in the future can be identified and resolved. We also support the PRA's commitment to actively participating in the international debate on this topic. We believe there are sensible adjustments that can be made to the current LCR framework to alleviate these concerns and foster buffer usability. Given the international inter-connectedness of liquidity and funding markets any solutions must be internationally coordinated and consistently applied across the many different jurisdictions in which our members operate.

## Our recommendation – Stress LCR framework

7. We set out below our recommendation to address the liquidity buffer usability conundrum. In the sections that follow this recommendation section, we address each of the questions in the DP.
8. To facilitate the utilisation of HQLA in a stress, the PRA should provide greater clarity to firms and their boards by setting out a framework for using liquidity buffer assets in a stressed market condition. The key elements of this 'Stress LCR framework' are:
  - **Adjusting the LCR requirement in a time of stress:** Regulators should have explicit authority to lower regulatory liquidity requirements in stressed market conditions. The LCR framework should be adjusted to include a minimum stress requirement and an ongoing liquidity buffer requirement. In such stressed conditions regulators should focus on amending the factors in the LCR calculation, taking into account events that have occurred and other external sources of liquidity. This approach would effectively lower the minimum LCR requirement, allowing firms to deploy their available HQLA to support the economy and intermediate market activity, while still maintaining HQLA that exceeds their net cash outflows.
  - **Declaration of stress period and timelines to rebuild buffers:** There should be a clear and co-ordinated public regulatory announcement detailing the onset of a stress period. This should be internationally coordinated if necessary. Regulators should have the authority to declare a "stress period" based on an assessment of macroeconomic factors and ongoing monitoring of firms' liquidity positions through existing supervisory processes. Once regulators have determined that conditions have normalised and the economy is returning to business-as-usual environment, they can publicly provide a clearly defined time frame above a minimum period to allow firms to rebuild buffers to meet their LCR obligations. Regulators should consider, amongst other things, the difference between the stress LCR and the LCR and the prevailing market conditions at the time to ensure the time frame established to rebuild LCRs are both practical and achievable.
  - **Supervisory actions and disclosure requirements:** Any supervisory or regulatory consequences and relevant disclosure requirements would then be linked to the new stress LCR requirements.

9. The Stress LCR framework would permit the LCR to be appropriately countercyclical by allowing firms to use liquidity buffers to meet liquidity needs that are pre-funded in the LCR as they materialise, without adverse supervisory consequences such as immediate notification or the filing of a remediation plan.
10. Below we have summarised various elements of the proposed framework that the BoE, and the PRA (and regulators in other jurisdictions) should consider implementing.

### **Adjust LCR requirements in a time of stress**

11. The first option promoting the usability of HQLA is to make the following changes, collectively referred to as LCR requirements, during the publicly declared stress period:

- increase the scope of HQLA;
- reduce net cash outflow (NCO) computations; and
- adjust Pillar 2 requirements

In this way, the minimum LCR requirement is also effectively lowered, and firms may consequently deploy now surplus HQLA to support the economy and intermediate market activity, while still maintaining HQLA in excess of the adjusted LCR requirements.

12. The “Stress LCR” would prescribe an adjustment to reduce LCR requirement for institutions subject to 100% LCR in ordinary times. This is a pivotal component of the proposed framework, as it would alleviate market perception concerns by allowing firms to maintain a reported LCR of >100%.
13. In our view reducing the LCR requirement during a stress is a conceptually sound approach. The LCR requirement is designed to model potential outflows in a short-term liquidity stress. During a “stress period” firms are actively experiencing stressed outflows. This means that their balance sheets already reflect some of the stressed outflows which the LCR stress scenario was designed to model. To apply an incremental stress to already stressed numbers is pro-cyclical. Therefore, we propose that, during a time of stress, the requirement for incremental outflows on already stressed flows should be lowered, reducing the inherent cyclicity in the existing LCR calculation during the stress period and encourage HQLA usability by creating LCR headroom.
14. The proposed adjustment would be applied for both the HQLA & NCOs as required by both Pillar 1 LCR and Pillar 2 requirements.
15. A similar approach could also be considered for more idiosyncratic stress scenarios.

### **Declaration of stress period timeline to rebuild buffers**

16. The PRA LCR framework does not define the time period firms’ LCR can remain below 100% in a stress.
17. BoE and the PRA (and other regulators) should have the authority to explicitly declare a “stress period” based on an assessment of macroeconomic factors, and ongoing monitoring of firms’

liquidity positions through existing supervisory processes. The declaration of the “stress period” should be publicly announced, universally applied and the effective LCR requirement immediately reduced, thus allowing firms to utilise their HQLA buffers straight away, avoiding possible temporary market disruption.

18. Once it is determined that conditions have normalised and the economy is returning to a business-as-usual environment, regulators can publicly provide a clearly defined time frame in which firms should rebuild liquidity buffers to meet a 100% LCR requirement without any stress adjustment. The timelines could be further extended based on an assessment of available actions that firms plan to execute to rebuild liquidity buffers.

## **Supervisory actions and disclosure requirements**

19. One of the factors which inhibited firms from using their HQLA during March 2020 was ambiguity about supervisory corrective actions that might occur were LCRs to drop below 100%. While regulators actively encouraged firms to use their LCR buffers, it was not clear what the supervisory reaction would be and whether it would be consistently applied if firms breached that level, and if they were still expected to trigger an action plan should LCR remained below 100%. Also, we understand that the PRA has previously penalised some firms with capital charges when the LCR fell below 100% under PRA’s ACS stress tests, adding to UK firms’ nervousness.
20. To facilitate firms’ use of their HQLA buffers during a stress period, supervisory expectations and responses should be aligned to the effective Stress LCR requirement. For example:
  - In ordinary times, firms should manage to a minimum 100% LCR requirement. If LCR drops below 100%, firms need to submit an action plan for remediation. However, consistent with some regulators, notification and an action plan, should only be necessary if firms drop below 100% for a period defined by the regulator. This approach in ordinary times would encourage firms to reduce any excess buffers and support the BoE objectives of encouraging buffer use in periods of stress.
  - Under the “Stress LCR” framework, during the stress period, firms should manage to an LCR above 100%, but based on a lower LCR requirement, for instance by adjusting the weightings on outflows in the denominator. If a firm’s LCR drops below 100% on consecutive days (see above) after adjusting the denominator to a lower requirement, they would need to submit an action plan for remediation. However, an action plan would not be required provided a firm maintains HQLA greater than the prescribed % of total NCOs + Pillar 2 requirement during the stress period.
  - As the “Stress LCR” becomes the legal requirement during the period of stress, directors’ duties are aligned i.e. when using buffers in stress, the firm does not breach any regulations and suffer potential impacts from meeting disclosure obligations, as importantly the disclosures support external issuance and related due diligence.
21. In addition, supervisors should clearly state that under the “Stress LCR” framework, the supervisory assessment of firms’ meeting the liquidity threshold conditions will not change solely on the basis of managing to the lower “Stress LCR” requirement.

## Calculation options for liquidity metrics

22. Regulators should focus on amending the factors in the LCR calculation taking into account events occurred and other sources of liquidity. These changes should be set out in advance in the legal text and the reversal of the changes should happen over an extended period of time after the end of the stress period. This would address the issue of falling below 100% LCR but a similar approach would be needed for NSFR and other regulatory metrics. Some considerations are:

- **Historical Look Back Approach (HLBA)** –regulators announce market stress and HLBA data used is prior to stress period.
- **Haircuts** - adjust haircuts used in LCR to generally reflect changes in market prices –. regulators announce market stress and haircuts to be reduced by X%.
- **Collateral extension** - treat unencumbered non-HQLA, both Treasury-controlled and non-Treasury-controlled, as HQLA and they become central bank eligible i.e. regulators announce market stress and allow additional collateral within the LCR metric. Where previously non-HQLA is allowed to be treated as HQLA, firms would need to be able to demonstrate monetisation of such collateral with trial runs to the PRA during BAU.
- **Financial institution outflows** - behavioural outflows that have been dictated within the template, such as financial institution on demand outflows, which may actually not be reducing as quickly as projected could be updated to prevent firms holding surplus liquidity that could be deployed to support customers.

## Public disclosure requirements

23. By adjusting the LCR requirements, the potential impact of market disclosures on investor appetite are alleviated or at least reduced. To the extent the "Stress LCR" concept is adopted we think the current PRA requirement to disclose regulatory LCR as an average over a 12 month average period is appropriate.

## Concerns around regulatory and supervisory reactions

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

*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?*

*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?*

24. Firms have board and market (investor, rating analyst) reactions to consider. The LCR, with its high degree of visibility, is regarded as a key indicator of financial stability. There still continues to be a stigma around liquidity issues, which has morphed from not approaching central banks during the 2007/2008 global financial crisis (GFC) to now not falling below 100%, as this could be taken as a signal of weakness.

25. We largely agree with the PRA's analysis but note that as firms redeploy assets from HQLAs to 'real economy' assets there may be a consequential impact on capital requirements, depending on which customer segments are supported, which may moderate the appetite to redeploy liquidity reserves.
26. Liquidity stress tests whilst useful are theoretical as the stress scenarios work to a given playbook whereas in reality, there is significant uncertainty over the evolutionary pathway of a stress, including its likely impact and duration.
27. International firms must also factor in different guidance, interpretations and supervision by regulators in various jurisdictions in which they operate.
28. Taking the Covid scenario in the first half of 2020 as an example, members saw a period of stress and uncertainty forthcoming and hence instead of letting LCR drop, actions were generally taken to bolster LCR, as identified in the DP. There were a series of unknowns beyond liquidity, such as impact on credit losses, market risk, and cross-overs into broader prudential risk management, recovery and resolution planning (RRP) and capital management as well as government reaction. Boards focus on this broader risk management nexus and its impact on their internal targets rather than on liquidity, LCR and liquidity buffers in isolation.
29. LCR is a very visible metric and boards and investors have come to expect strong LCRs with elements of firms' risk appetite aligned to maintaining a 100% LCR. To the extent the "Stress LCR" is adopted the risk appetite can be appropriately maintained and also allow liquidity to be utilised. We generally do not believe it is appropriate for firms to lower their risk appetites during a stress as this would not align with individual responsibilities under the senior management regime.
30. Separately, if a significant number of firms took similar actions to enhance liquidity a market stress could be precipitated. Therefore, regulators would need to have some mechanism to monitor and moderate as appropriate during the market-wide stress period, perhaps by leveraging off information in the recently introduced PRA 110 returns.
31. There are also other liquidity metrics - NSFR, survival horizon, internal stress testing management buffers - which matter equally to LCR – and would need to be considered as part of the stress LCR framework.

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

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

32. In our experience market wide communications relating to liquidity did not have the expected or intended impact. There was more effective communication from the authorities to support continued capital adequacy e.g. releasing countercyclical capital buffers, treatment of software and infrastructure supporting factors, which helped to increase capital capacity in times of stress. Firms were able to take advantage of the measures as these were explicitly incorporated into minimum capital requirements.
33. Different jurisdictions have also provided conflicting guidance so any solution would need to be internationally coordinated and supervisory colleges used to iron out differences.

34. The PRA should consider amending the text of Art 414 in the PRA Rulebook (Liquidity (CRR) Part). As currently drafted, we think it is difficult to view [Article 414](#) as providing for a liquidity buffer, rather than a liquidity floor. Article 414 is compliance-focussed and not supportive of the concept of a buffer, using words such as such as “compliance”, “shall”, “without delay”, “without undue delay”, “restoration of compliance”, and “must be capable at all times”. The ordinary meaning of these words sends a message to firms that Article 414 must be complied with at all times (for example, firms cannot allow LCR to fall below 100%), otherwise they will be in breach of compliance requirements. As a result, firms have accordingly adjusted their behaviour and decisions to avoid falling below the floors set by Articles 414 in combination with Articles 412, 413 and 428b, in almost every scenario. So, firms are unlikely to change their behaviour in response to informal regulatory messages such as “buffers are there to be used”, in light of the clearly ‘compliance-requiring’ regulatory text.
35. Furthermore, the practical consequences for firms falling below the floors set by these Articles are significant. The development of a “restoration plan” under Article 414(1)(b) is a significant undertaking, as is the ongoing updating and assessment of progress against the plan. The requirements for daily reporting of the various templates and data item PRA 110, under Article 414(3)(a) (or weekly reporting of data item PRA 110 under Article 414(3)(b)) is also a significant undertaking for firms.
36. Similarly, the UK bank recovery and resolution framework also discourages liquid asset usability. Paragraph 31 in the Liquidity Indicators section of the EBA Guidelines for Recovery Plan Indicators (EBA/GL/2015/02) specifically refers to “minimum regulatory requirements applicable to the institution”. EBA/GL/2015/02 remains applicable in the UK today. In 2021, the EBA updated these guidelines (EBA/GL/2021/11). Although the updated guidelines do not apply in the UK, having been adopted after the end of the Brexit transition period, the updated guidelines are even clearer that the LCR and NSFR at 100% are minimum regulatory requirements. Paragraph 54 of the updated guidelines states “the thresholds for indicators based on regulatory liquidity requirements (LCR and NSFR indicators) should therefore be calibrated above the minimum requirements of 100%.” Accordingly, institutions subject to the EBA guidelines will view the 100% level as a floor, rather than a buffer, and institutions that are part of groups that also operate in the UK are likely to take a similar approach in the UK context.
37. Some regulators went beyond general communications and adjusted the regulatory standard. For example, the Reserve Bank of India (RBI) took a specific action requiring banks to reduce their LCR from 100% to 80% effective immediately from a high point during the peak of the Covid crisis. At the same time, they defined the recovery period, such as improving to 90% in six months and reverting to 100% after 12 months. Members generally feel that it would be more prudentially sound to adopt the “Stress LCR” approach suggested above. Additionally, as suggested in paragraph 20 above, alignment with other regulators, such as in the US, in requiring notification and an action plan only in the event of a firm’s LCR dropping below a 100% requirement on prescribed number of consecutive days would encourage firms to both reduce excess buffers and use them in a stress.
38. Firms rely on communications from the regulator to set expectations in times of stress, such as using targeted communications directed at CEO and / or Boards, similar to “Dear CEO”

letters to align management expectations in times of stress. To the extent the “Stress LCR” concept is adopted these communications should be clear around why the “Stress LCR” is now the appropriate and legal risk and regulatory measure.

*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?*

39. The primary concern for firms’ board and senior managers is to manage the business within the risk appetite of the firm. The uncertainty that accompanies breaching a regulatory limit, the enhanced reporting and the more intensive regulatory engagement that inevitably follow at a time when boards and senior management at firms are dealing with lots of matters, may drive the firm to execute actions which are detrimental to it, to generate liquidity e.g. by selling assets at a discount. There is also a perception that regulatory supervisory engagement would be extensive - this acts as another potential deterrent.
40. Although firms have credible recovery plans, board members would likely remain concerned about the path back to recovery given the inherent uncertainty in periods of stress and concerns around both regulatory and market reactions even if there is communication from regulators to lower liquidity ratios.
41. It should be acknowledged that the LCR is a relatively new regulatory ratio and less understood by many compared with capital ratios. To some extent, the banking industry and the regulators still have work to do to improve the understanding of liquidity metrics, including HQLA and LCR, LCR’s limitations as an appropriate measure of liquidity risk once a firm starts to experience stress outflows and articulating tolerances in stress. There are also inter-plays with the RRP. Most firms have an invocation trigger point above 100% LCR under a severe resolution planning scenario.
42. It may also not be appropriate for a firm to change its risk appetite in a stress, as firms should be managed prudentially at all times. Regulators should not direct them to reduce risk appetite as the responsibility of the risk management sits with their boards. This, and the concern above, however, can be mitigated by the “Stress LCR” recommendation that regulators reduce LCR requirements during stress enabling firms to hold lower HQLA but still maintain an LCR of at least 100%.
43. Utilising liquidity for certain actions may have additional costs for firms and have unintended consequences such as changing the liquidity nature of products:
  - Actions to provide non-contractual liquidity in stress may increase Pillar 2 requirements e.g. for franchise protection.
  - Increase debt buy-backs may create expectations with counterparties that this is an overnight product instead of a term product and change its nature creating additional liquidity risk.
  - Any actions taken by the firm would need to be taken in the context of the future potential cost which could be mitigated by removing the action from Pillar 2 calculations e.g. the regulator could confirm that Pillar 2 will not be calculated for franchise related to retail or corporate loan rollover.

## Concerns around market reactions

*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?*

44. LCR, NSFR and other metrics are designed to provide regulators with comparable data across the industry, to identify outliers. The market – analysts and rating agencies – also view these metrics in the same way. But the crucial difference is that the regulator sees the underlying details in the context of a firm's peer group which can show whether certain movements in components are concerning or not whereas the market focuses on the headline ratio meaning that firms will be reluctant to disclose lower than expected ratios. However, we do not suggest that the level of public regulatory disclosure should be increased as that would be counter-productive.
45. External disclosures are frequent, e.g. quarterly already for larger firms – and will be equally frequent for others under CRR2. They are also more granular, for example in a firm's Pillar 3 disclosures.
46. Rating agencies' views and actions have a direct consequence on firms' wholesale funding costs.
47. The suggested "Stress LCR" approach allows firms to meet their disclosure requirements without causing financial stability concerns.

*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?*

48. Whilst the LCR is a visible metric and has been widely accepted across the industry, it can decrease without any deterioration in the underlying liquidity risk profile due to the inherent nature of the metric. For example, the metric applies standardised assumptions based on client / product groupings irrespective of idiosyncratic characteristics of the firm i.e. seasonality. More importantly, the metric applies constant stress assumptions with no regard to prevailing market conditions – which means LCR leads to a downward spiral, requiring firms to hold extra liquidity despite changes in outflows. The LCR could benefit from more supervisory discretion allowing firms to apply adjustments based on changes in market conditions.
49. By adopting the stress LCR approach the LCR number will become more meaningful in a stress.

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

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

50. The pro-cyclicality of HLBA contributes to volatility – see Our recommendation section for suggestions.

51. The collective action problem can be solved by adopting the “Stress LCR” as it will apply across the industry.

## Disclosure and reporting

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

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

*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?*

52. Our members generally consider that longer term averages give a more representative view of a firms’ liquidity profile, though this needs to be balanced with the requirement to offer sufficient insights on the ‘instantaneous’ liquidity risk profile of the firm. The current 12-month average disclosure approach can help in any lead up to market-wide stress period in somewhat ‘sheltering’ the usability of liquidity buffers in stress because it could mask temporary dips in the LCR that would become more evident if the disclosure was in line with the much shorter-tenor Basel averaging approach. Therefore, most firms prefer the 12-month average as the basis for disclosure.

53. Most of our members have indicated that there are significant operational complexities over any move to a daily average for public disclosure purposes

## Other thoughts

*Q14: What other factors may impact on HQLA usability?*

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

54. We encourage the use of the PRA 110 return which provides transparency on liquidity, both contractually and under stress, and can therefore provide useful insight into various factors that may impact the LCR output which may not actually be materialising at the onset of a stress. Using this return will provide consistency and comparison across firms and could also inform updates to outflow factors that would generate an ability to deploy liquidity if directed by the regulator.

## Future engagement

In conclusion, we welcome the PRA’s engagement on this important topic and we would be happy to work with the PRA on refining our recommendation and other suggestions to create a pragmatic and workable approach.

### *Responsible Executive*

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