Exploring UK Regulatory Reform Amid Global Bank Failures

By **Alix Prentice and Carl Hey** (May 24, 2023)

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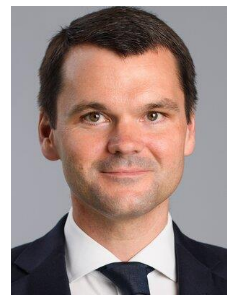

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Given recent stresses in the global financial system and the associated high-profile bank failures, there has understandably been much attention focused on bank liquidity.

While this attention is clearly justified, the significant work to address issues surrounding prudential liquidity provisioning on foot since the global financial crisis of 2007/2008 should not be overlooked.

In this article, we will examine some of the prudential liquidity reforms implemented following the global financial crisis and the current status of the ongoing regulatory review in the U.K.

We will also look at how, while the purpose of these measures is to ensure that banks create a "rainy day" fund to tap into in times of emergency, deploying these funds in times of stress is possibly easier said than done.

Background

Before the global financial crisis, banks operated in an environment with high cash inflows, low interest rates and low net cash outflows.

The global financial crisis was the biggest shock to the banking system since the 1930s and raised fundamental questions about liquidity risk. Banks were under severe pressure to maintain adequate liquidity as there was urgent demand for cash from various sources, including counterparties, short-term creditors and existing borrowers. The supply of credit dried up and central banks were required to mitigate this decline by supplying emergency credit programs.

Basel III Liquidity Standards

This shock exposed a number of significant cases in which banks did not hold an adequate quantity of sufficiently liquid assets. Following the failure of many to adequately measure, manage and control their liquidity risk in 2007 and in subsequent years, in 2010 the Basel Committee on Banking Supervision introduced a number of reforms to improve the quality and quantity of bank capital, known as Basel III.[1]

Basel III sets out two liquidity standards:

Liquidity Coverage Ratio

The liquidity coverage ratio was introduced to ensure that banks hold sufficient reserves of high-quality liquid assets to allow them to survive a period of significant liquidity stress lasting 30 calendar days.

This is the minimum stress period deemed necessary for corrective action to be taken by the bank's management or by supervisors. To qualify as high-quality liquid assets, assets must be liquid in markets in times of stress and, ideally, be central bank eligible.

The liquidity coverage ratio requires internationally active banks to hold a stock of high-quality liquid assets at least as large as expected net cash outflows over the stress period.

However, the floor for high-quality liquid assets can be breached during periods of significant stress and supervisors are expected to provide guidance on the usability of high-quality liquid assets according to circumstances. The Bank of England may also use its balance sheet to provide liquidity insurance as appropriate.

Net Stable Funding Ratio

The net stable funding ratio was also introduced to ensure that banks maintain a stable funding profile over a longer horizon in relation to the composition of their assets and off-balance sheet activities. The net stable funding ratio is expressed as a ratio that must equal or exceed 100% and relates the bank's available stable funding to its required stable funding.

The net stable funding ratio aims to address the issue that arises when banks are incentivized in a favorable economic climate to rely excessively on unstable funding of core — often illiquid — assets. During such periods, banks may expand their balance sheets quickly by relying on cheap and abundant short-term wholesale funding.

The Problem of "Too Big to Fail"

As part of the post-global financial crisis regulatory reforms, many countries have undertaken programs of change, focused on ensuring that regulators have the legal powers, outside the ordinary corporate insolvency framework, for dealing with systemically important financial institutions.

Regulators have also tried to address issues associated with the levels of loss absorbency, above those required under Basel III, that a systemically important financial institution would need in order to contain the potential systemic impact of its failure by using existing liabilities to absorb losses and recapitalize the systemically important financial institutions.

The total loss-absorbing capacity standard requires global systemically important banks to have financial instruments available during resolution to absorb losses and enable them to be recapitalized to continue performing their critical functions while the resolution process is ongoing.

The objective is to have an orderly resolution by making debt or equity holders absorb losses, enabling a so-called bail-in, instead of using public funds, conducting a "bailout." Thus, holding high-quality liquid assets is of fundamental importance in stemming the risk of contagion within the financial system.

The Bank of England, as the U.K.'s resolution authority, requires banks, building societies and investment firms to maintain a minimum requirement for their own funds and eligible liabilities for loss absorption and recapitalization.

The minimum requirement for own funds and eligible liabilities was originally introduced through the U.K.'s implementation of the Bank Recovery and Resolution Directive[2] and in December 2021 the Bank of England published a revised minimum requirement for own funds and eligible liabilities statement of policy, which sets out its minimum requirement for own funds and eligible liabilities framework and has applied since Jan. 1, 2022.

The Bank of England has adapted the U.K. minimum requirement for own funds and eligible liabilities framework to implement the total loss absorption capacity standard for global systemically important banks set by the Financial Stability Board in 2015.

Feedback Statement on High-Quality Liquid Assets Usage

In March 2022, the Bank of England and the U.K. Prudential Regulation Authority published Discussion Paper 1/22, "The prudential liquidity framework: Supporting liquid asset usability."

DP1/22 solicited views in order to help the bank regulators improve their understanding of a number of issues, including:

- The extent to which banks feel constrained in their ability to draw on their stock of high-quality liquid assets to meet unusual liquidity demands and the factors that affect this; and
- The extent to which it is desirable that banks feel more able to draw on their high-quality liquid assets and how improvement in this area could be achieved.

On April 3 this year, the two regulators published a joint feedback statement on the discussion paper FS1/23.[3] While the statement contains no policy proposals or indications on how the PRA "is considering to support banks in prudently using their [liquid assets] when facing liquidity pressures in the future," it does discuss their concern that banks are "overly reluctant" to use their stock.

A sufficient reserve of high-quality liquid assets available to meet payment obligations in situations of severe short-term stress is a requirement of the post-global financial crisis implementation of a liquidity coverage ratio to help build up banks' resilience in such circumstances.

The feedback statement highlights a number of themes from the responses received:

- Most respondents agreed that banks are reluctant to draw on their stock of high-quality liquid assets in periods of unusual liquidity pressures.
- Many respondents mentioned concerns about regulatory views on the amount of time that is appropriate to rebuild high-quality liquid assets buffers following a drawdown.
- The majority of respondents suggested that future regulatory communications in a period of liquidity stress should clarify the extent to which liquidity coverage ratios can fall, and the time banks have to rebuild their stocks.

- Many respondents suggested simplifications to liquidity-related disclosures in a liquidity stress period, as well as recalibrations of the liquidity coverage ratio to account for procyclicality in the metric.

- The majority of respondents advocated greater international coordination to avoid conflicting regulatory guidance in different jurisdictions.

Unsurprisingly, the feedback statement noted respondents concerns about how markets would react to a deployment of high-quality liquid assets and a consequent fall in liquidity coverage ratio below 100%.

Suggestions for improving high-quality liquid assets usability include improving communication and guidance from authorities, particularly on the extent to which banks' liquidity coverage ratios can fall without regulatory consequences.

Conclusion

When looking for practical examples of the actual deployment of high-quality liquid assets, in the case of recent high-profile failures, regulators involved generally look to have taken the opportunity to avoid the bank collapsing in on its capital in the first instance and have instead pursued, successfully, the bank sale route.

While in the case of the recent failure of Silicon Valley U.K. the Bank of England was clear that the sale was a bank resolution tool, but not a bail-in, in that of Credit Suisse, the Swiss regulator has not pursued bank resolution at all but has effected a merger. We are still waiting, then, for examples of globally significant banks using their high-quality liquid assets as a first line of defense in extraordinary circumstances.

This does beg the question whether regulators now need to go back and rethink the operation of the liquidity coverage ratio. While this ratio is designed to ensure that banks can keep functioning for at least 30 days by ring-fencing a large amount of expensive capital, what in practice appears to be happening is that events are quickly overtaking the utility of this cooling-off period.

The speed with which we are seeing negative investor sentiment grow and translate into significant outflows that would be difficult for any bank, or regulator, to stem, coupled with the role of perception in those events, challenges a bank capital model that requires a bank to publicly dip into its reserves in times of stress.

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[1] https://www.bis.org/bcbs/basel3.htm.

[2] Bank Recovery and Resolution Directive 2014/59/EU.

[3] https://www.bankofengland.co.uk/prudential-regulation/publication/2023/april/prudential-liquidity-framework-supporting-liquid-asset-usability