Financial Risk&Regulation

Basel Committee's G20 Report on 2023 Banking Turmoil and Liquidity Risk

Newsletter - November 2024

Between March and May 2023, significant bank failures affected global markets, marking the largest banking stress since 2008. This led governments and central banks to offer support measures, including FX swap lines and guarantees. As a reflection to these events, the Basel Committee on Banking Supervision (BCBS) presented a report to the G20 assessing lessons from the 2023 banking turmoil, focusing on liquidity risk. Key vulnerabilities included high uninsured deposit concentrations, interest rate exposure, and insufficient stress-testing practices. To improve financial stability, regulators are urging enhanced liquidity resilience and risk management. This newsletter summarizes the main points, that also provide hints about the directions, the central bank, regulators, supervisors may take. For additional information on the topic, we also recommend our previous newsletters on liquidity management:

- 2024 October on Treatment of financial time series with seasonality,
- 2024 February on Changes in MNB ICAAP-ILAAP-BMA methodology manuals,
- 2023 March on Changes in MNB ICAAP-ILAAP-BMA methodology manuals,
- 2021 September on ICLAAP – Understanding supervisory expectations and how banks can improve ICLAAP performance, and
- 2020 August on Changing supervisory expectations: modified impairment calculations, liquidity stress tests for investment funds, and Pillar II capital requirement.

Key Findings on Liquidity Risk

Roughly a year ago, the October 2023 BCBS report recommended updating traditional liquidity practices in light of digital and social media's impact on deposit outflows. Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) standards were deemed essential but need adjustments to handle real-time challenges.

Recommendations to Mitigate Liquidity Risk:

- Increase the frequency of liquidity monitoring to daily or intra-day.
- Use high-frequency data from multiple sources.
- Enhance supervision of concentration risks and strengthen stress tests.
- Address liquidity transfer issues in multinational banks.

The 2023 banking turmoil exposed significant gaps in Basel III liquidity standards, highlighting the limitations of the LCR in addressing stress beyond the 30-day horizon and the NSFR's effectiveness in slow-burn crises. Key concerns include the operationalization of HQLA buffers, with supervisory scrutiny discouraging their use, and the LCR's inability to account for intraday and operational liquidity needs or to align assumed outflow rates with actual ones. The Figure 1 visually shows that the experienced outflows were faster and larger than the LCR outflow parameters. Additionally, the BCBS is reevaluating the eligibility of held-tomaturity (HTM) assets as HQLA and considering whether current stress metrics adequately reflect banks' liquidity vulnerabilities in rapidly evolving crises. These findings call for recalibration of standards and enhanced tools to address these challenges effectively.

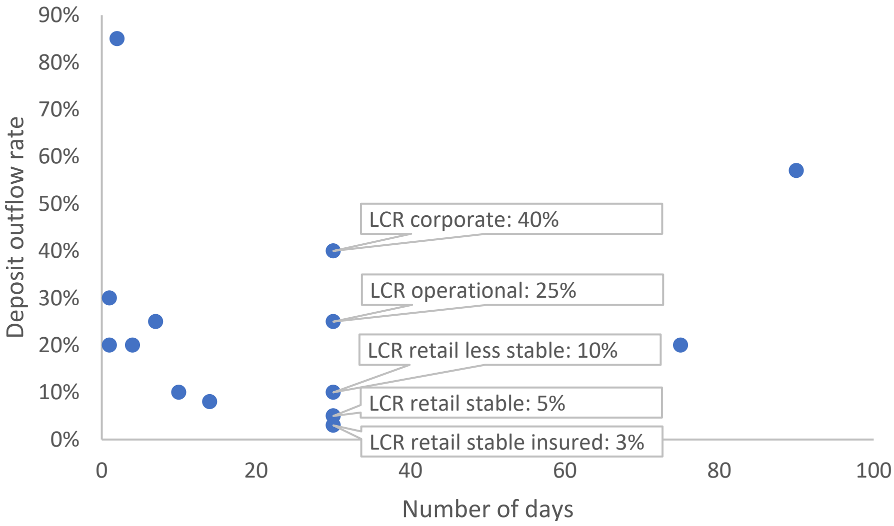

Figure 1.

Liquidity outflows of distressed banks – a historical comparison against the LCR outflow parameters

Comparing outflow rates of distressed banks is challenging due to variations in individual circumstances, such as differences in timeframes, funding sources, and the absence of some banks from LCR requirements. Additionally, public data on deposit outflows often lack consistency and comparability, making a direct assessment against LCR outflow rates difficult without a counterfactual analysis.

Committee's follow-up analysis on liquidity risk

As part of its follow-up analytical work this year, the Committee assessed whether specific features of the Basel liquidity standards performed as intended during the turmoil. The following sections provide details on the key takeaways and observed issues.

Distressed Bank Outflows

Recent turmoil revealed specific dynamics, including the fast-paced outflows of uninsured deposits. Failed banks in the US saw rapid withdrawals, fueled by concentrated deposit bases and access to digital platforms and social media. Some banks faced severe outflows due to trust erosion among clients and stakeholders, leading to challenges in both domestic and international business.

Outflows at some banks surpassed the assumptions of the Basel LCR and NSFR, revealing an amplified outflow risk when customers are concentrated within specific sectors. In particular, digital access accelerated withdrawals, highlighting limitations in the LCR's assumptions on deposit outflow speeds.

Challenges Beyond the LCR

During the 2023 turmoil, some banks faced additional liquidity demands outside LCR-covered risks. Prepositioning and collateral requirements added pressures that LCR liquidity buffers couldn't cover. This need for intraday liquidity further strained some bank's resources, with difficulties aggravated by delays in incoming payments and the bank's attempts to maintain regular outgoing payments.

Bank crisis revealed the challenge of "trapped liquidity," where HQLA held by specific entities couldn't be transferred within the group, underscoring the need to assess true HQLA transferability under stress.

Accounting Treatment and Monetization Issues

Assets held at amortized cost (AC) presented monetization challenges during the stress. The LCR treats HQLA at market value, but banks may avoid selling AC assets during liquidity stress to avoid realizing losses. Repo markets, though typically a liquidity source, became unreliable for distressed US banks. The experience suggests a need to re-evaluate whether AC HQLA should be repo-eligible in private markets.

Impediments in Liquidity Buffers Use

Certain banks lacked preparedness to mobilize liquidity efficiently via secured financing channels, contributing to the challenges of responding to the crisis. Furthermore, ad-hoc disclosures in stressed situations, such as emergency liquidity assistance (ELA) usage, raised market concerns and worsened liquidity challenges for some banks.

Supervisory Monitoring Tools

Supervisory tools, such as Basel monitoring, proved effective yet could benefit from higher granularity and tailored reporting frequencies. Non-Basel tools, designed for specific banking models, provided valuable data, helping supervisors preemptively assess banks' liquidity.

Roadmap for Liquidity Supervision

Based on BCBS communication, the following initiatives will be pursued:

- prioritising work to strengthen supervisory effectiveness and identify issues that could merit additional guidance at a global level; and
- pursuing additional follow-up analytical work based on empirical evidence to assess whether specific features of the Basel Framework performed as intended during the turmoil, such as liquidity risk and interest rate risk in the banking book and assessing the need to explore policy options over the medium-term.

KPMG's Role in Enhancing Client Resilience

As global financial markets continue to evolve, KPMG's team is dedicated to helping clients navigate these complex liquidity risk management challenges. KPMG offers a comprehensive suite of services to assist banks in strengthening their liquidity risk management practices and aligning with Basel III and other regulatory standards. Here are a few ways KPMG supports clients in light of these developments:

- **Customized Stress Testing and Scenario Analysis:** KPMG works closely with clients to design and implement robust stress-testing frameworks tailored to their specific risk profiles. Our team uses advanced modelling techniques to help financial institutions better assess and mitigate liquidity and interest rate risks.
- **Regulatory Compliance and Basel III Optimization:** KPMG assists banks in refining their LCR and NSFR metrics, ensuring alignment with BCBS's recommendations. Our specialists provide detailed assessments and practical solutions to improve compliance, optimize capital, and maintain regulatory readiness.
- **Risk and Governance Consulting:** We offer guidance on developing governance structures and risk frameworks that enhance transparency, foster resilience, and support robust reporting practices. KPMG's approach emphasizes sustainable, proactive risk management strategies that anticipate regulatory changes and reduce systemic risk exposure.

Building a Resilient Future in Financial Services

KPMG remains committed to helping clients understand and respond to the latest regulatory developments, providing actionable insights and tailored solutions to strengthen financial resilience. In collaboration with our global network, we work with clients to develop adaptive strategies that address both current challenges and future regulatory expectations.

For further insights on managing liquidity risk or to learn more about our financial services solutions, please contact us.

The newsletter was prepared by: Judit K. Nagy

Contacts:

Ágnes Rakó
Partner
M: +36 70 370 1792
E: agnes.rako@kpmg.hu
KPMG.hu

Péter Szalai
Associate Partner
M: +36 70 370 1739
E: peter.szalai@kpmg.hu

Gergő Wieder
Director
M: +36 70 333 1471
E: gergo.wieder@kpmg.hu

József Soltész
Senior Manager
M: +36 70 370 1766
E: jozsef.soltesz@kpmg.hu

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