Liquidity Contingency Plans (LCPs) Fire Drills

Regular testing and refining of LCPs ensures continued resilience in the face of potential liquidity crises and contributes to the overall stability of the banking sector.

What is a Liquidity Contingency Plan?

In the face of ever more dynamic and unpredictable risks, banks' ability to effectively manage liquidity shocks is of paramount importance.

In recent years, banks have experienced sudden and unexpected liquidity crises, and failures have been accelerated by unprecedentedly rapid bank runs around the world.

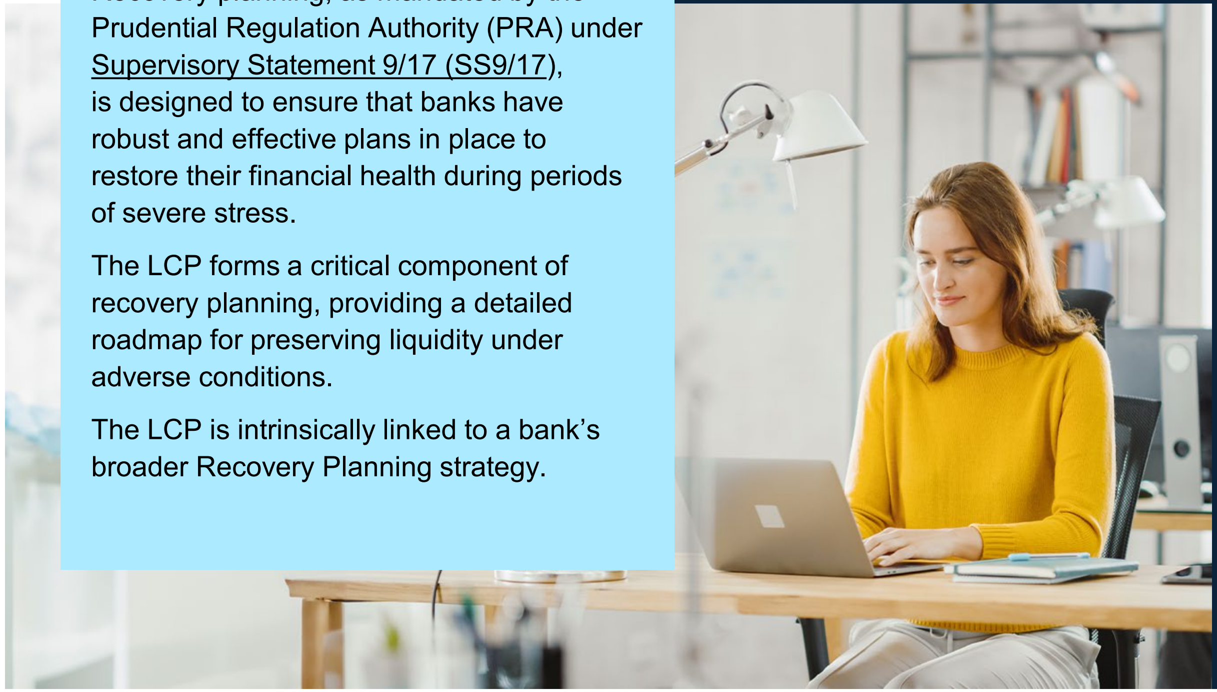
One of the key tools that banks can employ to manage their liquidity and funding exposures is a Liquidity Contingency Plan (LCP).

An LCP is a comprehensive strategy that outlines how a bank will maintain sufficient liquidity during periods of financial stress.

Recovery planning, as mandated by the Prudential Regulation Authority (PRA) under Supervisory Statement 9/17 (SS9/17), is designed to ensure that banks have robust and effective plans in place to restore their financial health during periods of severe stress.

The LCP forms a critical component of recovery planning, providing a detailed roadmap for preserving liquidity under adverse conditions.

The LCP is intrinsically linked to a bank's broader Recovery Planning strategy.



Testing the LCP through fire drills

The PRA places significant emphasis on the practical testing of LCPs through **fire drill exercises.** These exercises are **'live' simulations** where firms act out key parts of a response to a designed scenario.

Benefits of a liquidity fire drill

- **Assesses banks' preparedness for a liquidity crisis** and the robustness of their contingency plans.
- **Provides an opportunity to identify potential weaknesses** in liquidity risk management and rectify them proactively.
- **Fosters a culture of risk awareness and preparedness** within the bank, which is crucial for maintaining liquidity adequacy and overall financial stability.
- **Demonstrates to regulators** that the bank is actively managing its liquidity risk exposures effectively and is prepared for potential crises.

Conducting a liquidity fire drill exercise

The key stages in a liquidity fire drill are:

01

Design liquidity scenario

The fire drill begins with the design of hypothetical stress scenarios that could potentially impact the bank's liquidity position. These scenarios could involve a sudden market downturn, a significant operational loss or a combination of various factors.

02

Conduct the fire drill

The bank then runs a stress test and assesses the impacts on its liquidity position, including the liquidity coverage ratio and other related liquidity metrics.

03

Respond to the liquidity scenario

Where the impact of the liquidity shocks could cause a catastrophic situation for the bank if no actions were taken, the LCP is activated. This involves mobilising resources, implementing measures to mitigate the liquidity risk, and communicating effectively with all relevant stakeholders.

04

Review and analyse

The bank conducts a thorough review and analysis of the results. This includes evaluating the effectiveness of the LCP, identifying any weaknesses or areas for improvement, and assessing the bank's overall readiness for a liquidity crisis.

05

Monitor and evaluate

Post the fire drill exercise, the bank continuously monitors its liquidity position and the effectiveness of its responses designed to mitigate such periods of stress.

Some of the challenges we have seen with banks in conducting a liquidity fire drill include:

- Designing liquidity scenarios that are **not connected to the bank's business model.**
- **Easily getting distracted** during the fire drill exercise due to lack of clear guidance or insufficient understanding of the process.
- Relevant stakeholders **unsure of their roles and responsibilities** in a liquidity stressed event
- Selecting **recovery options that are not feasible** to implement in a short period of time.

How KPMG can help

KPMG is uniquely positioned to assist banks in designing and executing their liquidity fire drills.

Our team of experts can support you by:

- **Designing realistic and relevant stress scenarios.** Drawing on our deep industry knowledge and understanding of market trends, we can help identify potential risk factors that could impact a bank's liquidity, and help you to create scenarios that accurately reflect these risks.
- **Providing insights** on best practices for roles and responsibilities, decision making processes and communication strategies during a liquidity crisis.
- **Evaluating the effectiveness of the bank's responses** to the designed test, providing objective feedback and recommendations for improvement.
- **Providing recommendations** for enhancing the LCP and the bank's liquidity risk management based on the insights gained from the fire drill.

We are able to leverage KPMG in the UK's extensive experience of helping banks to carry out recovery or resolution fire drills to support your liquidity fire drill planning and execution. Contact us to discuss your requirements.

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