Navigating liquidity stress: operational readiness for central bank liquidity support[1]

Executive summary

The events of the 2023 banking turmoil demonstrated once again the potentially systemic consequences of liquidity stresses and the need for effective central bank lending operations to contain financial instability. During this episode, deposit outflows from the affected banks occurred at an unprecedented speed, enabled by increasingly digitalised finance, including faster payment and settlement services and 24/7 access to banking services through mobile apps, and accelerated by social media. These rapid depositor runs led to the banks' swift decline to non-viability, severely limiting the time available for authorities to prepare a failure management strategy.

A lack of operational readiness to access central bank facilities exacerbated the liquidity stress in 2023. Operational unpreparedness meant that some banks were unable to execute contingency funding plans. For instance, Silicon Valley Bank (SVB) had not recently tested its capacity to borrow at the Federal Reserve's discount window, could not mobilise eligible collateral quickly enough and lacked the necessary operational arrangements to obtain liquidity. While central bank lending would probably not have prevented SVB's failure given the flaws in its business model and governance, it might have allowed more time for authorities to prepare a resolution and may have limited broader system-wide stress.

Operational readiness of both central banks and institutions is key to ensuring that central bank facilities are a reliable source of contingency funding. Access to central bank liquidity requires a range of steps. First, banks and central banks need to have the necessary operational capacity. Second, banks need to post collateral, and the central bank, through a due diligence process, needs to be confident that it can take a legal claim over the collateral and manage all relevant risks associated with the lending operation. Last, the central bank needs to properly value the assets offered as collateral and set haircuts. The process for the second and third steps can be complex for non-traded assets. Hence, it requires time and ideally, will have been completed in advance of any borrowing need.

Banks must have the operational capacity to access central bank lending operations. This entails both the central bank and private sector counterparties having an appropriate IT and legal infrastructure in place and staff that are familiar with the operational process and requirements. Since large volumes of liquidity may be needed unexpectedly and at short notice, a failure on the part of banks to understand legal and operational requirements can unnecessarily delay or even prevent central banks from responding effectively to such requests. This can undermine financial stability. Appropriate preparation in advance of such liquidity needs is crucial to mitigate those risks.

Collateral due diligence is an essential element of central banks' risk management frameworks. The process enables central banks to ensure that the pledging institution can legally and operationally mobilise the collateral. It also allows the central bank to manage potential risks and consider how the collateral will be operationally handled and managed when presented. Early due diligence is particularly important when dealing with less liquid or non-traded collateral such as loan portfolios.

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Collateral due diligence is a resource-intensive process requiring specialised legal, operational and risk expertise, and it can take a substantial amount of time to complete.

Appropriately valuing collateral and setting haircuts is crucial for central banks to protect their balance sheets and mitigate potential risks. Central banks adopt various approaches to valuing assets, often relying on market input for marketable assets and using internal methodologies for less liquid collateral. Haircuts are applied to the collateral depending on their risks, with the aim of protecting the central bank from loss if a counterparty defaults. Haircuts are determined based on factors such as the liquidity of the collateral, credit assessments and concentration risk. Central banks may also adjust haircuts to account for idiosyncratic risks of the borrowing institution or the currency of the collateral presented.

The prepositioning of assets significantly expedites the provision of liquidity against non-traded collateral. The prepositioning process can take different forms across countries. Generally, it involves banks providing details of the possible collateral, the necessary documentation and confirmations. This gives the central bank sufficient information to conduct due diligence, value the asset and set haircuts. Once this process is complete, the assets are said to be "prepositioned". Typically, prepositioned collateral is not encumbered and the arrangements allow banks to use the underlying assets for other purposes. Prepositioned assets allow banks to better plan for contingencies as they can anticipate how much they are likely to be able to borrow from the central bank. Importantly, when collateral is prepositioned, banks can swiftly draw on central bank facilities if needed.

Central banks and supervisory authorities can take actions to improve banks' operational readiness for accessing their lending operations. Supervisory guidance on funding and liquidity risk management encourages banks to incorporate central bank lending operations into their contingency funding arrangements. Central banks may also improve operational readiness through regulatory requirements for testing and simulations across all eligible asset classes. Central banks may also encourage or even require banks to preposition assets at the central bank.

Actions to promote operational readiness are more effective when accompanied by initiatives to reduce the stigma associated with central bank borrowing. Such initiatives seek to minimise the deterrent effect of stigma and encourage greater willingness among institutions to seek liquidity support. This may be pursued, for example, through the provision of market-wide operations during times of crisis and by structuring lending operations in a way that is perceived positively, or at least neutrally, by the market. Additionally, to the extent that stigma persists, lending collateral rather than cash can help mitigate the risk that banks will be identified and stigmatised for accessing central bank facilities. Stigma may also be reduced through disclosure of central banks' lending operations in a way that protects the confidentiality of borrowing institutions and avoids the unintended consequence of stigmatising them. Disclosure may even help to increase confidence in the borrowing institution if it is part of a convincing package of stabilising measures. Finally, transparent communication by authorities regarding their expectations is crucial to ensure readiness and maintain confidence.