ECB liquidity risk stress tests: a step forward but with two caveats

The introduction of sensitivity analysis of liquidity risk in the ECB's supervisory stress test for 2019 is a welcome step forward from the more traditional stress tests targeting capital levels in adverse scenarios (like the EBA-ECB exercises completed last year). As a reminder, the Global Financial Crisis started with banks running into severe liquidity and funding difficulties before additionally facing capital depletion.

Since the crisis, regulators have implemented several significant prudential steps to strengthen the level and mix of banks' liquidity and funding, such as the Liquidity Coverage Ratio (LCR), the Net Stable Funding Ratio (NSFR), and norms on minimum levels of High Quality Liquid Assets (HQLA). Gone are the days when risky structured products carrying fake top ratings counted as liquid assets, or when too many banks aimed to maximise profits by gleefully mis-matching assets and liabilities in both currency and maturity.

And yet over the post-crisis decade, stress-testing regulatory capital compliance has remained a lodestar for supervisors, mostly through worst-case scenarios replicating crisis millstones: a decline in GDP and in house prices, a surge in unemployment etc. This was despite the reality of new categories of risk emerging for banks, such as those related to cyber-attacks, misconduct, or ESG, which can harm a bank in a less predictable and gradual way and also with greater force.

This is why the ECB's liquidity-risk stress test, announced on 6 February, is a much-needed step forward. The four-month exercise kicking off this week is focusing on banks' expected short-term cash flows (six months from the end of 2018) to calculate a "survival period", which is the number of days a bank can continue its activities using the available cash and collateral without any additional funding. It is aimed solely at the potential impact of idiosyncratic liquidity shocks on each bank. It will not assess the potential causes of the shocks or the impact of wider market turbulence and should be carried out without reference to monetary policy decisions.

Tentatively the aggregate results of the exercise will be disclosed during the second half of this year, after the ECB supervisors have had the chance to discuss the individual results with each bank. Individual results will not be disclosed publicly, and rightly so: a bank with stress-test capital flagged as borderline would normally have the time to remedy it; a bank shown with borderline stress-test liquidity is likely to see investors and depositors racing for the hills as fast as they can.

Two caveats

But there are two caveats. The first refers to the idiosyncratic shocks to liquidity being stress-tested. According to the ECB, a moderate shock would see limited-scale deposit outflow, a freeze in wholesale funding, and a one-notch rating downgrade. A harsh shock would see severe deposit run-offs, plus a three-notch rating downgrade (plus access to wholesale funds remaining frozen).

However, rating downgrades are sometimes lagging indicators, and less quantifiable risk categories – cyber, misconduct, ESG – can hit with very little warning to investors or to rating agencies. Also, the shocks will be based on patterns identified by ECB supervisors in recent bank-specific liquidity crises. Again, in light of the potentially harmful impact of the new risk categories, this could in some instances be tantamount to fighting yesterday's battles.

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Second, the stress test focuses on idiosyncratic shocks only and makes no reference to systemic liquidity crises such as changes in risk premia or asset valuations, etc. The liquidity shocks will also not be based on macroeconomic or geopolitical scenarios. However, in today's highly interconnected world – for investors and also for depositors – one bank's idiosyncratic shock can quickly propagate to become a more general meltdown, especially in the specific banking sector of the bank in shock.

The weakest-link pattern of market behaviour is more evident for a shortage of liquidity than for a shortage of capital. Liquidity outliers are more threatening to a banking system than capital outliers. Supervisory reactions to the former also need to be much faster than to the latter.

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