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Acting Comptroller Hsu recommends new liquidity requirements for large and midsize banks

Initial perspectives related to remarks by the Acting Comptroller of the Currency, Michael J. Hsu

Center for Regulatory Strategy US

On January 18, 2024, the Acting Comptroller of the Currency, Michael J. Hsu, delivered a speech at Columbia Law School where he outlined his perspective on how to enhance liquidity risk management for large and midsize banks.[1] Hsu recommended a new 5-day liquidity requirement to address short-term deposit outflows that the industry experience in spring 2023. The new initiative aims to enhance banks' operational readiness and reduce the stigma associated with the use of the Federal Reserve's discount window. Furthermore, Acting Comptroller Hsu expounded upon the ongoing efforts by the Office of the Comptroller (OCC) to standardize deposit classifications and develop robust risk management expectations for the emerging faster payments system and potential tokenization for real-world financial assets and liabilities.

5 insights you should know

Potential 5-day liquidity coverage ratio: Acting Comptroller Hsu recommended a new liquidity requirement for ultra short-term, acute outflows that would cover liquidity stress over a five-day period. As envisioned by Hsu, the new liquidity ratio would consist of potential uninsured deposit outflows in the denominator, and pre-positioned discount window collateral and reserves in the numerator.

Improving discount window usage: Banks' utilization of the Federal Reserve's discount window faces two primary challenges: (i) operational preparedness and (ii) stigma. An additional policy goal of the recommended 5-day liquidity requirement would be to improve banks' preparedness for accessing the discount window through pre-positioning collateral, as well as reducing the stigma by providing a safe space for appropriate discount window usage.

Standardizing deposit classification: The OCC is hosting a symposium in June 2024 on deposit gathering, franchises, and risk profiles, with the hope of contributing to efforts to credibly classify and differentiate deposit types. There is currently no standard classification system for deposits to distinguish between operational and non-operational deposits as banks define these differently, in part, because their customers and business models may vary considerably.

Faster payments risk management: Acting Comptroller Hsu encouraged banks and regulators to start working on building the right controls to meet the needs of a faster payment system and potential tokenization of real-world assets and liabilities. Faster payments can lead to faster fraud and limit the ability to remediate erroneous transactions. Therefore, the instantaneous nature of real-time payments will necessitate enhanced liquidity risk management, third-party risk management, and fraud and compliance risk management.

Fallout from 2023 banking crisis continues: Nearly a year after the spring 2023 banking crisis, regulators continue to closely scrutinize liquidity risk management and deposit runoff risks. Acting Comptroller Hsu's speech demonstrates policymakers are not finished evaluating regulatory enhancements to large and midsize banks.

5 considerations to evaluate

1. **Prepare to demonstrate short-term liquidity risk management:** Regardless of whether the 5-day liquidity recommendation become a final rule, Acting Comptroller Hsu's speech indicates regulators will continue to increase their scrutiny over banks' short-term liquidity risk management practices. Therefore, banks should prepare to demonstrate to supervisors that they hold sufficient liquid assets and have the operational capacity to monetize those assets quickly to meet any short-term outflows.

2. **Establish and maintain operational readiness to access discount window:** Operational readiness includes establishing borrowing arrangements and ensuring appropriate amount of collateral is available for borrowing based on the institution's potential contingency funding needs. Banks should ensure familiarity with the pledging process for different collateral types and regularly conduct small value transactions at regular intervals to ensure familiarity with discount window operations.

3. **Review deposit classification and runoff assumptions:** In the wake of the 2023 banking crisis, a key issue that emerged was the mischaracterization by some banks of high-risk deposits leading to a significant underestimation of risk. Banks should cultivate a detailed understanding of their deposit base. This includes implementing governance procedures that facilitate regular reviews of deposit assumptions, particularly in instances where shifts in deposit behavior have been detected. This should flow into modeling efforts.

4. **Evaluate increasing payment monitoring and control capabilities:** Real-time payments present unique fraud and other challenges to banks due to their speed and irrevocability. Banks should evaluate their existing monitoring and control capabilities and consider enhancing risk management tools, such as real-time fraud detection mechanisms, strong user authentication practices, and advanced monitoring system upgrades to review transaction data in real-time.

5. **Direct resources towards liquidity issue remediation:** Regulators continue to be focused on liquidity risk within the banking system. Banks should consider directing more resources towards issue remediation, particularly for any outstanding findings related to liquidity risk management. Additionally, banks should proactively engage with supervisors on their remediation efforts and evidence their progress through detailed documentation.

Connect with us

Richard Rosenthal

Principal
Risk & Financial Advisory
Deloitte & Touche LLP
rirosenthal@deloitte.com

John Corston

Independent senior advisor to
Deloitte & Touche LLP
jcorston@deloitte.com

Ryan McDevitt

Senior Manager
Risk & Financial Advisory
Deloitte & Touche LLP
rmcdevitt@deloitte.com

[1] Office of the Comptroller of the Currency, Remarks by Acting Comptroller of the Currency Michael J. Hsu "Building Better Brakes for a Faster Financial World," January 18, 2024.