Q&A on the use of Liquidity and Capital Buffers

Overview

1. The Bank of England and its three policy committees have, in recent weeks, announced a number of measures to help UK businesses and households to bridge across the economic disruption resulting from Covid-19. These actions have sought to reduce pressure on banks, building societies and designated investment firms (hereafter ‘banks’) to restrict the provision of financial services, including the supply of credit and support for market functioning, and ensure that the financial system can be a source of strength for the real economy during this challenging period.

2. The Prudential Regulation Authority (PRA) and Financial Policy Committee (FPC) have previously, on several occasions, stated their expectation that all elements of the substantial capital and liquidity buffers that have been built up by banks exist to be used as necessary to support the economy.

3. The FPC noted in its Record of 24 March 2020 that “ensuring businesses and households could bridge the downturn would ultimately increase the resilience of the banking sector and it was therefore in the banking sector’s collective interest”. In addition, the Bank of England’s lending facilities provide banks with a range of options to obtain additional liquid assets to support lending, including via the Term Funding scheme with additional incentives for lending to Small and Medium-sized Enterprises (TFSME).

4. The FPC also noted that “banks should not face obstacles to supplying credit to the UK economy.” and that “given the resilience of the core banking system, businesses and households should be able to turn to it to meet their need for credit to bridge through a period of economic disruption”. Banks’ ability to use their buffers is key to ensuring banks can maintain and extend lending to households and businesses despite the uncertain economic conditions.

5. This document answers some commonly asked questions on the usability of liquidity and capital buffers and their operation as set out in PRA rules and guidelines. The document will be updated as the current situation evolves. New Q&As and updates to existing ones will appear in italics.

Scope

6. This document is aimed at all banks to which CRDIV applies.

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LIQUIDITY

Q1. What is a “liquidity buffer”?  

7. Liquidity buffers refer to banks’ stock of liquid assets, such as central bank reserves or high-quality government debt that can be easily used to repay obligations as they fall due. They are available to meet unexpected changes in cash flows.

8. These liquidity buffers include liquid assets used to satisfy the internationally agreed Liquidity Coverage Ratio (LCR) standard as well as additional bank-specific guidance (Pillar 2).

Q2. What does it mean that liquidity buffers can be used as necessary to support the economy?  

9. Banks hold substantial liquid assets in normal times so that they are better able to accommodate increased demands for liquidity from customers and clients and lower inflows of funds in times of stress. It is to be expected that the stock of these assets will decline during a stress, and that LCR ratios will fall far below their levels in normal times in a period of stress.²

10. During this time of Covid-19 related disruption to the economy, the PRA expects banks to focus on continuing to service and support their customers and clients. Banks are expected to use their liquidity buffers in doing so, even if it means LCR ratios go significantly below 100%.

11. The PRA recognises that the current conditions – with, for example, disruption to corporate customers’ cash flow and sharp moves in the prices of many financial assets – mean that bank customers will have extraordinary needs for funds. Banks should not hold back from supplying these funds because their LCR ratios decline as a consequence of assisting their customers.

12. The PRA expects that banks will continue to manage their liquidity risk in a prudent way. But the PRA recognises that this is not the same thing as maintaining the LCR ratio at a consistently high level.

13. The Bank of England has operations in place to lend in all major currencies on a weekly basis. Banks have pre-positioned collateral with the Bank of England to borrow through these regular facilities. These facilities allow banks to transform their assets so that more of them can be used to meet customers’ liquidity needs. During this period, we expect all Bank liquidity facilities, including the indexed long-term repo operations (ILTR), and the Discount Window Facility (DWF), to be used by market participants, as required. The Bank of England has also launched a Term Funding Scheme with additional incentives for lending to SMEs (TFSME), and has activated the contingent term repo facility (CTRF) offering additional

² The PRA recognises that during a stress such as the current one, mechanical increases in the measure of liquidity risk which feed into the calculation of the LCR ratio may also contribute to a fall in the ratio.
liquidity at 1 month and 3 month maturities. Banks are encouraged to consider the full range of these facilities in managing their liquidity risk.

14. The existence of these central bank liquidity facilities should provide banks with the confidence needed to operate for a period below the level of liquidity that we expect them to maintain in normal times.

Q3. What are the implications for a bank of using its liquidity buffers?

15. When assessing a bank’s liquidity position, supervisors will take the individual circumstances of the bank and the disruption which results from the current exceptional situation into account.

16. The LCR ratio is only one measure of a bank’s ability to manage its liquidity to meet its customers’ needs. The PRA will continue to consider a wider range of factors in determining its supervisory response. These, include:
   - a bank’s broader ability to generate liquidity - including through access to central bank facilities;
   - the stability of its funding profile;
   - the particular drivers of changes in its LCR ratio; and
   - other measures of liquidity adequacy a bank may use.

17. A bank should notify the PRA if its liquidity buffer is, or is forecast to be, below the level of liquidity we ask it to maintain in normal times, as part of its usual supervisory communication. Supervisors are likely to request more frequent updates on the bank’s liquidity position, but this is not generally indicative of any further supervisory action by the PRA. A reduction in the LCR ratio, including below 100%, in and of itself will not trigger any automatic restrictions. This is consistent with EU law.

Q4. What is the expected period banks will have to restore buffers?

18. There is no requirement to rebuild liquidity buffers within a specific time period. Once this current period of stress is over, where banks have made use of their liquidity buffers, the PRA will give banks a sufficient period of time for these to be restored. In doing so, the PRA will consider the individual circumstances of each bank. These will include the particular drivers of the bank’s liquidity position and the need for banks to be able to support their customers and clients as they bridge the economic disruption related to Covid-19.

CAPITAL

Q1. What is a “capital buffer”?

19. Capital is a part of banks’ funding that can be written down if the value of bank assets declines in unexpected ways. Banks need to maintain capital that is proportionate to the size of their balance sheet and the risks they take, so they can dampen rather than amplify shocks. The UK capital regime includes risk-weighted capital requirements and, for the
largest banks, a leverage ratio requirement, each of which distinguish between minimum requirements and buffers.

20. Capital buffers are the capital that banks hold in excess of regulatory minimum requirements. In stress, some loans will go bad and some securities banks own may lose value. Buffers exist so that such losses can be absorbed by the banks without restricting the provision of financial services, including the supply of credit and support for market functioning. And buffers can be drawn down to support new lending to businesses and households which should be able to turn to the banking system to meet their need for credit to bridge through this period of economic disruption. The FPC and PRA have repeatedly stated that all buffers are usable for these purposes.

21. Minimum capital requirements are capital ratios set to ensure that banks can continue to operate, even after having exhausted their buffers, with an adequate layer of capital to protect depositors, maintain the confidence of markets and enable an orderly failure without losses to the taxpayer.

22. As of 31 December 2019, major UK banks’ capital ratios were over three times higher than at the start of the global financial crisis.3

Figure 1 shows the individual elements of banks’ capital buffers:

23. Banks can be subject to four types of buffers.
   - Systemic buffers which are set for banks judged to be systemically important for either the global or domestic economy.
   - The Capital Conservation Buffer which applies to all banks. This is set as 2.5% of RWAs and establishes a base level of capacity across the system to absorb losses while continuing to provide services to the real economy.
   - The Countercyclical Capital Buffer (CCyB) that applies to all banks and can be varied over time. It is increased as risks build, and can be released in a stress. This ensures that capital levels respond to the risk environment.
   - The PRA buffer. This is set on a bank-specific basis to ensure that banks that are more at risk of loss than the system in aggregate have additional capital buffers to reflect these idiosyncratic risks.

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3 This Q&A focuses on risk-weighted capital requirements. UK banks are also subject to minimum requirements on own funds and eligible liabilities (MREL) that support an effective resolution, and major UK banks are subject to a leverage ratio framework that sits alongside the framework of risk-weighted requirements.
24. The CCyB was designed so that it could be released as a stress emerged. Consistent with this, reflecting the disruption associated with Covid-19, on 11 March the FPC decided to reduce the UK CCyB rate to zero. The rate had been 1% and had been due to reach 2% by December 2020. This released £23 billion of capital compared to continuing with the planned rise, which can support up to £190bn of bank lending to businesses.  

25. That is equivalent to 13 times banks’ net lending to businesses in 2019. This means that losses on any bank assets that emerge, including from new loans, can be absorbed with this capital. This will allow the banks to continue to lend and engage in market making even if conditions remain turbulent.

**Q2. What are the implications for a bank of using its capital buffers?**

26. The Bank, the FPC and PRA have reiterated that all elements of the substantial capital and liquidity buffers that have been built up by banks exist to be used as necessary to support the economy, during this period of Covid-19 related stress. Banks’ supervisors consider it appropriate that banks draw down on their capital buffers for this purpose.

27. Banks can draw down on all available capital buffers starting with any additional capital buffer held above their regulatory buffers. Whilst a bank should notify the PRA if its capital level is, or is forecast to be, below the level of capital we ask it to maintain, this should just be viewed as part of its usual supervisory communication. This communication would include a discussion about a bank’s plan to restore its buffers (see Q3 below).

28. As shown in Figure 1 the top part of the regulatory buffer is the PRA buffer. The PRA buffer is not disclosed publicly and using the PRA buffer does not trigger any automatic restrictions.

29. If a bank has used its PRA buffer, it will then start drawing down on its publicly disclosed regulatory buffers. These comprise any remaining CCyB, the capital conservation buffer, and any systemic buffers. As banks start drawing down on these buffers they will face restrictions on distributions, such as dividends, coupon payments on additional Tier 1 (AT1) instruments, and discretionary bonus payments, as required by European legislation (CRDIV) which continues to apply in the UK.

30. These restrictions exist so that the money that would otherwise have been paid out remains with the banks. Retaining this money provides a further cushion of capital that can be drawn down if there are declines in bank asset values.

The largest UK lenders have already implemented restrictions on distributions. Their boards have recently decided to suspend dividends and buybacks on ordinary shares until the end of 2020, and to cancel payments of any outstanding 2019 dividends. This will

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4 In its statement on 11 March the Prudential Regulation Authority (PRA) has explained that is expects banks not to increase dividends and other distributions in response to this policy action.

5 While the FPC has set the UK CCyB rate at 0%, internationally active banks may still be subject to positive foreign CCyB rates that apply to their non-UK exposures.

6 For further information on the calculation of automatic restrictions please see https://www.bankofengland.co.uk/prudential-regulation/publication/2014/implementing-crdiv-capital-buffers-ss

reduce the impact of the automatic restrictions on distributions that come into place as banks begin to draw down on buffers.

**Q3. If banks use their buffers, what is the expected period they will have to restore these buffers?**

31. There is no pre-specified time period during which banks must rebuild their capital buffers. Once this current period of stress is over, where banks have drawn down their capital buffers, the PRA will give banks a sufficient period of time for these to be restored. In doing so the PRA will consider the individual circumstances of each bank, taking into account its capital restoration plan. These will include the bank’s capital position and the need for banks to be able to support their customers and clients as they bridge the economic disruption related to Covid-19. Where capital buffers need to be restored this will be a gradual process and the PRA will not, in general, expect banks to restore their capital buffers in full until a significant time after the end of the current stress.

32. The FPC has also made clear in its statement of 11 March 2020 that it expects to maintain the 0% rate for the CCyB for at least 12 months. Furthermore, due to the usual 12 month implementation lag, any subsequent increase would not be expected to take effect until March 2022 at the earliest. In addition, the pace of return to a standard-times rate of in the region of 2% will take into account how far banks' capital has been depleted through this period and thus the task to rebuild capital.