The European Central Bank (ECB), concerned about European banks' liquidity risks, will conduct a dedicated stress test of liquidity in 2019. Most banks should have little to fear. Even so, failing to prepare for what will be an onerous process could be a costly error. Banks should initiate their planning immediately, with a particular emphasis on having sufficient resources in place to meet the ECB's demands.

One of the most important changes in banking supervision since the crisis of 2008 has been the shift from a singular focus on regulatory capital - and Tier 1 ratios in particular - to a more balanced view of solvency and liquidity.

Globally, the incorporation of the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR) into Basel III has been the most obvious response to the liquidity crises that many well capitalised banks experienced during the market dislocations of 2008. In Europe, liquidity has also become an integral aspect of banking supervision and this focus is increasingly gaining momentum. There have been numerous initiatives from European supervisory authorities, such as the recently published guide on the Internal Liquidity Adequacy Assessment Process (PDF 510 KB) (ILAAP) by the ECB. ILAAP plays a vital role in the risk control assessments of risks to liquidity and Pillar II liquidity determination process.

Today Europe's banks may be far better capitalised than they were ten years ago, but liquidity remains on top of the ECB's agenda. October 2018 saw notable public statements on the topic from Danièle Nouy, Chair of the Supervisory Board and Sabine Lautenshläger, Member of the ECB’s Executive Board. These pointed to concerns about possible weaknesses among Single Supervisory Mechanism (SSM) banks, and set out the ECB's intention to conduct a dedicated liquidity stress test ("LiST 19") in 2019. This was confirmed at the end of October with the ECB's publication of the SSM Supervisory Priorities for 2019 (PDF 48KB) which included liquidity stress test as one of its priorities for the year. Through this exercise the ECB endeavours to assess banks' resilience against liquidity shocks. The results of LiST 19 will inform the Supervisory Review and Evaluation Process (SREP) assessments.

This could be a timely decision, given the growing volatility of capital markets. For now, the methodology and timing of LiST 19 remain to be confirmed. However, previous dedicated stress tests such as the ECB sensitivity analysis of Interest Rate Risk in the Banking Book
(IRRBB) stress test exercise of 2017 suggests that banks should expect to be tested against a number of scenarios. Some parameters will be set by supervisors, but others will be derived from internal models - a process that is also likely to be assessed.

Banks' experience of measuring themselves against the LCR and NSFR requirements, and of conducting ILAAP, should mean that most have well established procedures for reporting liquidity metrics. We would expect supervisors' requests to cover liquidity metrics in multiple scenarios, including:

- Maturity ladders and cash flow profiles;
- Time to wall' and survival horizons;
- Currency or counterparty concentrations; and
- The composition of liquidity reserves.

In addition to quantitative testing, banks should expect a qualitative examination of their liquidity risk management. This is likely to cover aspects including governance and oversight, risk reporting and reconciliations between different liquidity requirements.

When it comes to timing, we would expect guidelines and templates on LiST 19 to be published during the first quarter of 2019, and for testing to take place during the spring and early summer. The process is likely to be complete by the second quarter of 2019, with the results feeding into the annual SREP process later in the year.

Even if the precise impact of LiST 19 is still unclear, banks hoping to demonstrate a good grasp of liquidity risk management should start preparing now. Past experience of similar stress tests tells us that it's essential to allocate adequate resources, responsibilities and management time to the greatest areas of priority as early as possible.

In particular, banks should ensure that they have adequate human resources available to meet the requirements of LiST 19. As a rough guide, we might expect a large Significant Institution to require between 400 and 700 person days. Banks can also start preparing for likely data requests, as well as taking any quick and easy steps they can to enhance liquidity risk management frameworks.

Most banks should have little to fear from LiST 19. But a failure to start early, to allocate enough resources, to work across the whole group or to win support from senior managers could lead to some institutions being found wanting. Preparation will be key to success.