

Briefing Note

Systemic liquidity risk management: Inherent market and regulatory procyclicality and linkages with macroprudential policy

June 2026

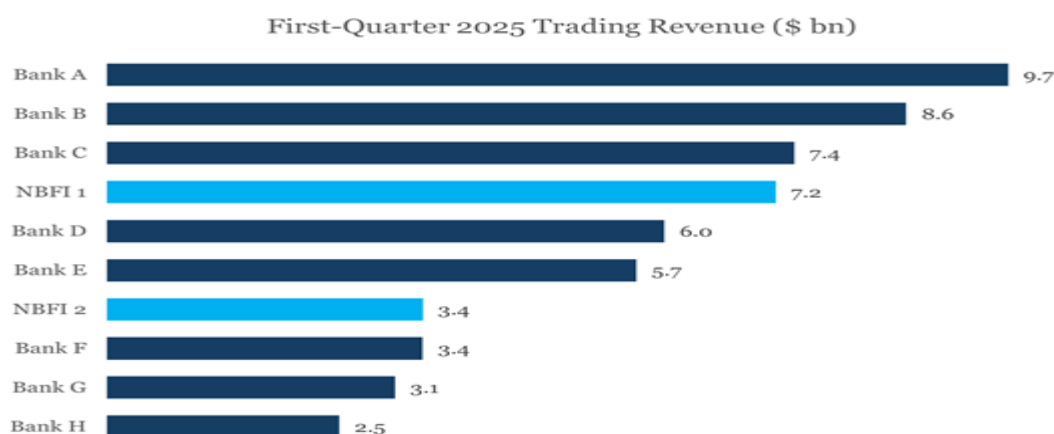
Introduction

AFME and its members are supportive of the principle of the on-going development and maintenance of a robust and proportionate framework for the effective management of liquidity risk with sufficient counter-cyclical flexibility to support lending and the financing of economic activity through the cycle.

Over the past decade, non-bank financial institutions (NBFIs)—including principal trading firms, hedge funds, asset managers, money market funds, and other non-bank liquidity providers—have increasingly complemented the role of banks as the primary providers of market liquidity. In benign market conditions, the growth of NBFIs has delivered tighter bid-offer spreads, deeper order books, and faster price discovery, particularly in liquid markets such as cash equities, ETFs, listed derivatives, and some government bond markets.

Figure 1: illustrative growth of NBFIs as providers of market liquidity

Newer trading firms now rival the banking giants



Source: Bloomberg

However, the transition has also altered the nature and resilience of market liquidity. Liquidity provided by NBFIs is generally less committed than bank-intermediated liquidity, more pro-cyclical, and highly sensitive to volatility, margin requirements,

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and funding conditions. During stress episodes (e.g. March 2020, the 2021 “memestock” episode, and UK gilt market stress in 2022), NBFIs have tended to withdraw liquidity abruptly, reflecting binding risk limits, margin calls, and operational constraints. This has resulted in sharp price moves, reduced depth, and impaired market functioning, even in otherwise liquid markets.

In addition therefore to possible liquidity and macroprudential measures to mitigate the risk from NBFIs that we summarise later in our paper, it is essential that banks also have the ability also to make effective use of liquid resources during times of stress to mitigate the risk to market liquidity and financial stability.

Liquidity and Bank Regulation

In the light of our introductory thoughts, we welcome one of the perspectives that the BCBS notes in its recent report on the 2023 banking turmoil that existing liquidity standards are adequate and that the focus should be on their effective implementation. We agree that operational requirements in relation to liquid assets are already in place together with a framework for the management of intraday liquidity risk and a range of additional monitoring metrics. We welcome the acknowledgement also that liquidity regulation cannot on its own prevent the risk of liquidity runs on banks which complements our long-held view that Level 1 measures and other common metrics serve only as broad indicators of liquidity risk and are not a substitute to the application of meaningful and bespoke stress and scenario testing coupled with adequate supervisory challenge and oversight.

Market Perceptions around the use of bank liquid asset buffers

Banks are likely to have significant concerns around market reactions to the use of their liquid asset buffers. The risk of negative market reaction and/or over-reaction from counterparties is often seen as very material and from a wider perspective has the potential to give rise to the possibility of contagion. Accordingly, if buffer usability is to be encouraged, there would it seem need to be very clear terms as to when regulators consider a period of stress to have been entered and where business as usual expectations no longer hold and banks are being expected to use their liquidity buffers. In particular, it could be useful to reduce HQLA requirements to a regulatory defined extent, upon which public disclosures would be based. This would necessitate a good level of international regulatory coordination.

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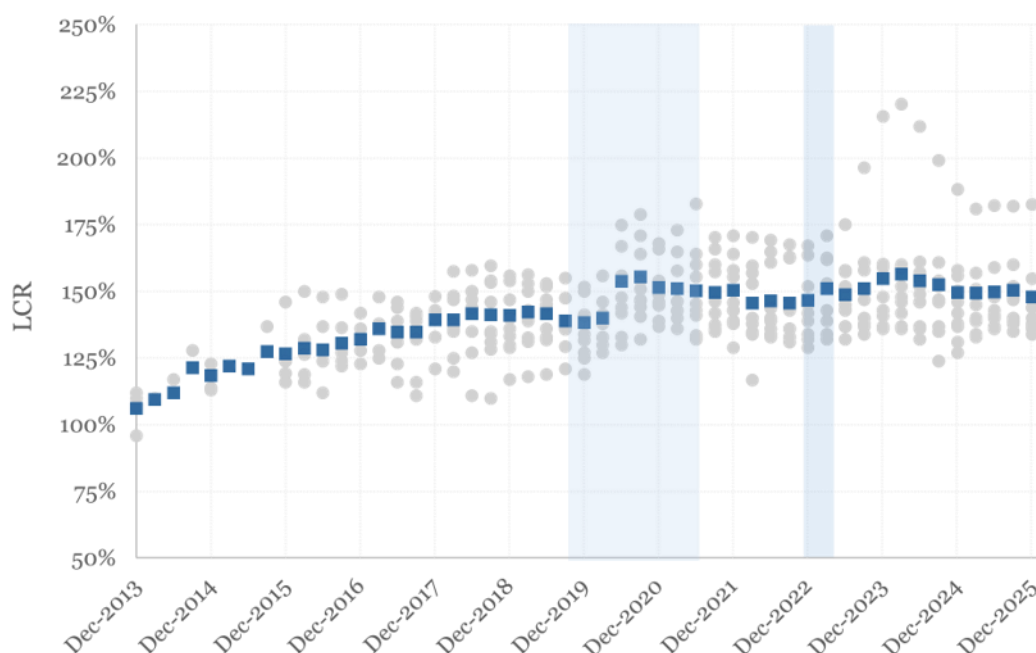
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Figure 2: Liquidity Coverage Ratio of EU G-SIBs highlighting periods of stress



Source: Pillar 3 disclosures of G-SIBs.

Note: Grey markers represent individual bank level observations, while blue marker denotes the average LCR across EU G-SIBs. Shaded areas highlight periods of market stress, including the COVID 19 pandemic and the collapse of SVB in early 2023

HQLA requirements could be reduced in a number of ways, including for example through applying a defined percentage scalar to outflows; through the removal or reduction of Pillar 2 requirements; or through the removal or delay of procyclical elements (explored in the separate section below).

The softening of regulatory guidance so that a temporary breach of liquid asset requirements is not considered a significant event would also mitigate the risk of banks holding ‘buffers on buffers’ and the holding of large excesses in the lead up to potential stress events.

Bank Regulatory Framework

There appears a current ambiguity in the regulatory framework whereby supervisors may publicly announce that liquid asset buffers may be used, while in practice regulatory drafting results in the LCR at 100% being a minimum requirement that

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banks are reluctant to go below owing to the increased reporting requirements and supervisory scrutiny which would follow.

We would note also that the LCR may not be the only binding constraint in a period of stress, and that banks may still be required to maintain similar level of HQLA to meet NSFR, internal stress testing, or other requirements. Clarity in regulatory guidance beyond the LCR is therefore necessary and firms would need clear guidance and essentially a playbook (globally consistent where possible) of what is expected during a period of stress.

Procyclicality inherent in the LCR framework

It appears to be widely recognised that the LCR metric can be volatile and behave procyclically during periods of financial and economic disruption. It is possible to note that the LCR continues to apply the same outflow rates as shocks crystallise, such that a given level of LCR generally implies resilience against an increasingly severe stress overall as risks crystallise. Some particular drivers of these characteristics include the Historical Look Back Approach and the haircuts applied to HQLA. One possible solution to these inherent levels of procyclicality might involve considering whether specific calculations might be 'frozen' during times of significant disruption (e.g. maintain HLBA or HQLA price decline at pre-stress values during the stress period). This would mitigate negative market reactions as firms could continue to disclose LCR ratios in excess of 100%, while holding less HQLAs in practice as requirements are effectively reduced. The relief in relation to procyclical elements would though need to be extended to Pillar 2 requirements to avoid these becoming a floor. Other temporary measures that might be considered could include adjustments to the inflow cap and easing of downgrade triggers.

It might also be possible to include a wider range of assets in the liquid assets buffer where a period of stress is entered and it is demonstrated that the underlying liquidity value of identified holdings of non-HQLA is significant. Assuming that the necessary consensus can be reached on the value of the relevant securities, this would lead to an improvement in liquidity measures and allow banks to use a source of liquidity that would otherwise not be available.

Bank Disclosure requirements

We would note that firms may still wish to maintain liquidity ratios in excess of 100% owing to the level of detail required under the associated disclosure requirements and their potential signalling effects. Public disclosures could therefore be simplified as at present they include a lot of information which is not required by stakeholders and which could make reductions in HQLA more obvious during stress periods.

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NBFIs - Market Liquidity and Microprudential Supervision

In addition to the increased role of NBFIs in the provision of market liquidity, market liquidity provision has also become more concentrated, with a small number of large NBFIs accounting for a significant share of trading volume and quoted liquidity in certain asset classes (e.g. ETFs and electronic equities). This concentration increases single-firm dependency, reducing substitutability if a major liquidity provider experiences stress or outage. Unlike banks, many of these firms lack formal resolution frameworks or obligations to maintain liquidity through stress.

NBFIs are deeply interconnected with the financial system through CCPs and margining frameworks, prime brokerage and repo markets, Securities financing and collateral transformation chains. As a result, liquidity shocks can propagate rapidly across asset classes and institutions via margin spirals, fire sales, and correlated de-risking. Liquidity stress at one large NBFI can therefore translate quickly into broader market dislocation.

NBFIs have become essential to modern market liquidity, improving efficiency in calm conditions but increasing fragility under stress. The key challenge for policymakers is to preserve the benefits of NBFI-driven liquidity while ensuring that liquidity provision remains resilient, robust, and supportive of financial stability during periods of market stress.

AFME has previously made recommendations in relation to the supervision of NBFIs including:

- Regulation should be activity- and systemic-footprint-based, not entity-type-based.
- Systemically important NBFIs should face capital and liquidity standards aligned with the risks generated by market-making and liquidity provision, including stress-calibrated market risk requirements.
- Consolidated supervision and intraday risk visibility are increasingly necessary to assess true loss-absorption capacity and resilience.

Simpler, less risk-sensitive regimes remain appropriate for genuinely non-systemic firms, but should not be applied to entities whose stress behaviour could destabilise markets.

NBFI Macprudential Considerations

Liquidity stress at NBFIs can therefore transmit rapidly to banks and market infrastructure via higher margins, collateral calls, and correlated deleveraging. From a prudential policy perspective, solo, entity-level supervision is insufficient to capture

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these channels, particularly where risk resides in unregulated affiliates or cross-border group structures.

A number of possible macroprudential measures are available to mitigate possible system-wide risks posed by NBFIs and a recent ECB report considers:

- Swift implementation of international reforms - Europe should fully and consistently implement existing Financial Stability Board (FSB) recommendations, notably on money market fund resilience, open-ended fund liquidity management, non-bank leverage, and preparedness for margin and collateral calls.
- A new macroprudential liquidity instrument for investment funds - The report's central proposal is the introduction of an explicit macroprudential tool to address liquidity mismatch in open-ended funds, applied ex ante. This instrument—modelled on existing leverage powers under AIFMD and extended to UCITS—would allow authorities to impose measures such as notice periods, or complementary liquidity tools, on cohorts of funds whose redemption terms are misaligned with asset liquidity. The goal is to reduce first-mover advantages, fire-sale risks and systemic amplification.
- System-wide stress testing (SWST) - The Eurosystem recommends establishing a European system-wide stress testing framework that spans banks, NBFIs, key markets and infrastructures. Using a hybrid top-down/bottom-up approach, SWST would capture cross-sector interactions, liquidity spirals and endogenous behavioural responses, complementing existing sectoral stress tests.

Bringing it Together': Possible Longer-term Combined Banking Industry and NBFIs scenario and empirical analysis

Policymakers are in addition considering for the medium term, the development in Europe of a comprehensive NBFIs data strategy, and a consistent EU-wide systemic risk assessment framework.

We noted earlier in our paper that to ensure adequate market liquidity there is no substitute to the application of meaningful and bespoke stress and scenario testing coupled with adequate supervisory challenge and oversight. When considering the correct mix and calibration of micro and macroprudential measures for banks and NBFIs one approach for supervisors might be to assess the expected system wide supply and demand for liquidity across all types of institution and major products to ensure that increases in demand can be offset to the extent necessary by increases in supply thereby maintaining equilibrium and pricing stability.

Over the longer term, empirical analysis and projections across institutions and markets might therefore be modelled with a view to determining the type and level of regulation needed to maintain equilibrium for given supervisory risk appetites and

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tolerances. As part of this work, an understanding would need to be developed, together with possible associated macroprudential tools, of the mechanisms through which shocks are transmitted to and from the banking and NBFIs sectors. While these interactions and tools are currently underdeveloped and less developed than other vulnerability-reducing measures, they could be an important element of a flexible macroprudential policy framework to mitigate system wide liquidity risk and maintain optimal levels of market based and traditional bank funding.

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Published

June 2026

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