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Liquidity Resiliency, Financial Stability, and the Role of the Federal Reserve

Remarks by

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at

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sponsored by the Committee on Capital Markets Regulation

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Good morning. It's a pleasure to be with you this morning to open our discussion on the bank liquidity framework. Hal and his team have assembled a series of excellent panels that will further inform our approach as we consider adjusting this framework. The panelists' perspectives—including academics, market participants, and fellow policymakers—will enrich our understanding of these complex issues and, importantly, challenge us to think critically about whether the framework we have in place works as intended.

Bank liquidity ensures that the banking system remains resilient.¹ Regulatory requirements including the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR) were designed to ensure that potential cash withdrawal and repayment obligations could be met with on balance sheet holdings. Internal liquidity stress testing and resolution planning were also designed to require banks to assess liquidity positions, in preparation for monetizing assets under stressed conditions. In theory, these requirements should work together to mitigate the risk of a bank failure resulting from a lack of liquidity to meet its ongoing payment obligations and foreseeable cash outflows.

Fifteen years post-GFC, we need to know whether these tools deliver the promised resilience or whether we have created a framework that looks impressive on paper but fails to capture the vulnerabilities that emerge in times of stress. It is time to move beyond asking whether banks are compliant and ask whether compliance actually translates into resilience.²

¹ The views expressed here are my own and are not necessarily those of my colleagues on the Federal Reserve Board or the Federal Open Market Committee.

² Michelle W. Bowman (2024), "Bank Liquidity, Regulation, and the Fed's Role as Lender of Last Resort," remarks at The Roundtable on the Lender of Last Resort: The 2023 Banking Crisis and COVID, Washington, April 3, <https://www.federalreserve.gov/newsevents/speech/files/bowman20240403a.pdf>

Today I will review the current liquidity framework, then turn to the considerations relevant to reform—and the principles that should guide our work. I will conclude with brief discussion of the discount window and broader implications for the Fed’s balance sheet. Without question, these are challenging issues, but if we’re committed to building a more resilient banking system, we need to identify what is working and what could be improved in our current approach.

The Current Liquidity Framework

The prudential liquidity framework relies on three main components: 1) the LCR and NSFR set quantitative standards for liquid assets and stable funding; 2) internal liquidity stress testing (ILST) requires banks to assess liquidity needs under adverse scenarios; and 3) resolution planning governs how firms manage liquidity in distress or failure. These tools, developed largely in response to the 2008 financial crisis, were designed to work together to ensure that banks could withstand both sudden withdrawals and prolonged market disruptions.

The LCR is designed to promote short-term liquidity resilience by requiring banks to hold high-quality liquid assets (HQLAs) to meet presumed net cash outflows over a 30-day time horizon.³ These assets, subject to regulatory haircuts, are readily convertible into cash enabling banks to meet short-term liquidity needs without emergency borrowing.

The framework does not consider how banks actually perform during stress. Banks have strong incentives to convert less liquid assets, like loans, into cash to meet withdrawal and repayment demands. They routinely pledge collateral to secure liquidity through Federal Home

³ HQLAs are defined as reserve bank balances; foreign withdrawable reserves; securities unconditionally guaranteed by the U.S. Treasury, securities unconditionally guaranteed by certain foreign entities; GSE securities; other securities issued by sovereign governments and multilateral development banks; certain corporate debt securities; publicly traded common equity shares that meet various eligibility requirements; and investment-grade municipal obligations. See 12 CFR 240.20, which sets forth criteria for HQLAs.

Loan Bank (FHLB) advances. Yet, the LCR does not provide credit for this collateral for a number of reasons, including uncertainty around availability and valuation.

The Federal Reserve's discount window similarly allows banks to pledge illiquid assets for cash during market disruptions, accepting an even broader range of collateral than the FHLBs. However, whether the discount window is effective as a reliable liquidity backstop requires careful examination.

In practice, the liquidity framework creates two problems. During normal times, banks over-allocate to HQLAs because they must demonstrate that liquidity needs can be met with their own balance sheet resources. At the same time, traditional Federal Reserve sources of liquidity—like daylight overdrafts, the discount window, and standing repo facilities—are stigmatized. This reduces a bank's capacity to lend and support its communities.

During stress, the framework becomes pro-cyclical. Banks that maintain HQLAs at or above 100 percent of presumed outflows are often reluctant to use them out of concern they will fall below the minimum LCR. The LCR effectively becomes an isolated, unusable buffer. This reluctance exacerbates stress, forcing banks to convert less liquid assets into cash to meet obligations.

Liquidity Regulation Considerations

Liquidity requirements create incentives that affect bank behavior. In practice, the regulatory requirements understate the amount of liquid assets that banks are effectively required to maintain on an ongoing basis and limit optionality in stress conditions. In the aggregate, the liquidity framework produces strong incentives for banks to engage in "liquidity hoarding," where they maintain liquid assets well in excess of what may be necessary or prudent for ongoing business operations and possible stressed outflows over a 30-day window.

Maintaining liquidity resources in excessive amounts may impose unnecessary costs on the banking system and the broader U.S. economy.

As we consider changes, we must carefully consider the consequences—both intended and unintended.

Role of the Federal Reserve and the Impact on the Balance Sheet

The Federal Reserve plays a vital role in banking system liquidity. Since 2003, our discount window has operated through two facilities, primary credit for strong banks and secondary credit with more stringent terms.

As we have seen, banks avoid the discount window, even in times of stress, because of the stigma that disclosure and higher borrowing costs present. Weekly aggregate disclosure makes borrowing potentially detectable by markets. Above-market interest rates make borrowing costly, even for testing. Markets interpret any usage as a sign of fragility. These factors combine to discourage banks from using the facility precisely when they may need it most.

The Federal Reserve's discount window is a critical but underutilized tool, one that requires fundamental reform to fulfill its intended purpose. It should function as a liquidity backstop with consistent rules, processes, and procedures. Currently, each of the 12 Reserve Banks has their own rules and processes and an independent ability to make lending decisions—decisions that may vary across Reserve Banks for similarly situated borrowers and similar collateral. This fragmentation creates uncertainty for borrowers, but it can also serve to exacerbate fragilities in the banking system.

After years of recognized flaws, we have yet to address these known weaknesses. The consequences are clear. Banks create additional buffers by hoarding high-quality liquid assets

rather than lending. This liquidity hoarding reduces credit availability to the economy. In addition, by increasing the demand for reserves, it also requires the Fed to maintain a larger balance sheet to meet that demand.

Some see tension between monetary policy implementation tools and regulatory objectives. In my mind, these goals should be compatible if we are modernizing the discount window to serve as an effective liquidity backstop, instead of a theoretical option.

Closing Thoughts

I hope today's discussion provides an opportunity to explore these issues. Hal, I appreciate your invitation to begin a transparent and public discussion on this topic. I look forward to better understanding the considerations that could lead us to alternative approaches.