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Unlocking Latent Profit in UK Banks: Decision Rules for Redeploying Structural Excess Liquidity Across UK Financial Services

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Abstract

The post-global-financial-crisis transformation of banking regulation has significantly strengthened the liquidity resilience of financial institutions. The Basel III framework introduced the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR), requiring banks to maintain sufficient liquid assets and stable funding to withstand periods of financial stress. While these reforms have reduced the risks associated with inadequate liquidity, they have also created an important management question concerning the economic consequences of maintaining liquidity beyond regulatory and prudent requirements. This research examines the phenomenon of structural excess liquidity in UK banks and investigates how such liquidity might be identified and redeployed without compromising regulatory compliance, financial resilience or risk appetite.

The research is grounded in Critical Realism, recognising that observable measures such as LCR, high-quality liquid assets (HQLA) and profitability represent only part of the phenomenon. Underlying mechanisms, including regulatory requirements, market constraints, organisational routines, risk appetite, uncertainty and managerial judgement, may influence observed liquidity outcomes. A stratified ontology therefore distinguishes between observable financial outcomes and deeper mechanisms that cannot be directly inferred from financial ratios. An abductive approach is adopted to move iteratively between empirical evidence and theoretical explanation, while a mixed-methods design combines quantitative financial analysis with qualitative investigation of treasury decision-making.

The literature indicates that liquidity has both protective and opportunity-cost dimensions. Earlier research generally associates adequate liquidity with reduced financial risk, while excessive liquidity may reduce profitability because liquid assets generally provide lower returns than alternative uses. More recent evidence, particularly Vu (2024), identifies an inverted U-shaped relationship between LCR and profitability, suggesting that liquidity can improve performance up to an optimal point but may reduce returns beyond that point. However, much of the literature remains concerned with liquidity shortages, regulatory compliance and crisis prevention rather than persistent structural excess liquidity.

The research further proposes that excess liquidity cannot be explained solely by regulation or financial optimisation. Behavioural decision-making may also be relevant. Bounded rationality, heuristics, intuition and precautionary behaviour may influence treasury decisions under uncertainty. At the same time, balance-sheet constraints and changes in financial-market infrastructure may restrict the practical redeployment of liquidity. The concept of a Digitalisation Paradox is therefore considered as a potential mechanism through which increased technological

efficiency may coexist with reduced flexibility in complex liquidity and foreign-exchange transactions.

The study contributes to banking and management research by integrating liquidity regulation, profitability, market constraints and managerial decision-making within a single framework. Its intended practical contribution is the development of evidence-based decision rules for risk-adjusted redeployment of structural excess liquidity, rather than indiscriminate liquidity reduction.

Keywords

Structural excess liquidity; Liquidity Coverage Ratio; HQLA; bank profitability; liquidity management; treasury management; Critical Realism; bounded rationality; heuristics; decision-making; FX markets; digitalisation; risk-adjusted redeployment; UK banking.

Chapter 1: Introduction

1.1 Background and Context

Liquidity is fundamental to the operation of banks because banks perform maturity transformation: they accept liabilities that may be withdrawn or require settlement at short notice while holding assets that are comparatively longer term and less immediately liquid. The global financial crisis of 2007–2009 demonstrated that even apparently well-capitalised institutions could experience severe liquidity problems when funding markets deteriorated and confidence weakened. The subsequent Basel III reforms therefore placed liquidity resilience at the centre of prudential banking regulation.

The Liquidity Coverage Ratio requires banks to hold sufficient high-quality liquid assets to withstand projected net cash outflows over a 30-day stress scenario, while the Net Stable Funding Ratio addresses longer-term funding stability (BCBS, 2013; BCBS, 2014). The Bank of England similarly describes the LCR as a mechanism intended to promote short-term liquidity resilience through the maintenance of an adequate stock of HQLA.

The regulatory objective is therefore clear: banks should not be exposed to unnecessary liquidity risk. However, the existence of a regulatory minimum raises a

second and less extensively examined question. What happens when liquidity is maintained persistently above the amount required for regulatory, operational and prudent risk-management purposes?

This question is particularly important in the UK. Post-crisis monetary policy, including large-scale asset purchases, contributed to a substantial expansion of central-bank reserves and liquidity within the banking system. The Bank of England has also recognised that the usability of HQLA is affected by a range of institutional and market considerations, including banks' willingness and ability to draw on liquidity during periods of stress.

The issue is therefore not simply whether banks possess liquidity. Rather, it concerns whether part of that liquidity represents structural excess liquidity that could potentially be deployed more productively while maintaining sufficient resilience.

1.2 From Excess Liquidity to Latent Profit

Traditional banking theory provides competing explanations for liquidity holdings. On one hand, liquidity provides protection against funding shocks, supports confidence and allows banks to meet obligations. On the other hand, highly liquid assets generally offer lower returns than loans, securities or other risk-adjusted investments. Consequently, liquidity has an opportunity cost (Bordeleau and Graham, 2010).

The literature therefore does not support a simple proposition that banks should minimise liquidity. Instead, the theoretical problem is one of optimisation. Berger (1995) suggests that stronger financial positions can produce positive performance effects through reduced risk and signalling. In contrast, the opportunity-cost perspective suggests that excessive liquid assets can reduce profitability. Bordeleau and Graham (2010) reconcile these arguments by proposing a nonlinear relationship in which liquidity initially creates benefits, but excessive liquidity eventually produces diminishing returns.

Recent empirical evidence strengthens this argument. Vu (2024) examines 20 Vietnamese banks over Q1 2015–Q4 2022 and uses a dynamic system-GMM approach to examine the quadratic relationship between LCR and profitability. The study finds an inverted U-shaped relationship, with increases in liquidity initially improving profitability but further increases eventually reducing profitability. This finding is particularly important for the present research because it shifts the question from: How much liquidity should a bank hold? towards: How can a bank determine when additional liquidity has ceased to provide sufficient marginal benefit and could potentially be redeployed?

1.3 The Decision-Making Problem

A purely financial interpretation would imply that banks should identify an optimal liquidity level and redeploy the remainder. However, actual treasury decision-making is more complex.

Treasury managers operate under uncertainty concerning:

- future funding requirements
- customer withdrawals
- market liquidity
- collateral requirements
- regulatory expectations
- counterparty risk
- interest-rate movements
- foreign-exchange markets
- internal risk appetite
- future stress scenarios

Consequently, a bank may rationally retain liquidity even where its expected financial return appears relatively low. The consequence is a tension between prudential rationality and economic optimisation.

This is where management theory becomes relevant. Simon's (1957) concept of bounded rationality recognises that decision-makers operate with limited information-processing capacity, time and cognitive resources. Kahneman and Tversky (1974) further demonstrate that people frequently use heuristics when making judgements under uncertainty. Such heuristics can be useful but may also produce systematic biases.

This research does not assume that treasury professionals are irrational. Instead, it proposes that managerial judgement, institutional experience, precautionary behaviour and cognitive shortcuts may form part of the mechanisms influencing liquidity retention decisions.

This represents an important research gap because most empirical liquidity studies examine observable financial variables, whereas relatively little attention is given to how treasury professionals actually make liquidity allocation decisions.

1.4 Market Constraints and the Digitalisation Paradox

Another dimension concerns the ability to redeploy liquidity once a bank decides that it is potentially available.

Financial-market literature demonstrates that profitable arbitrage opportunities cannot always be exploited freely. Du, Tepper and Verdelhan (2018) and Avdjiev et al. (2019) show that balance-sheet constraints, funding costs and regulatory considerations can contribute to persistent deviations from covered interest parity (CIP). This means that a bank can possess liquidity while simultaneously facing constraints on how effectively it can deploy that liquidity.

The development of electronic trading has further transformed financial markets. Digital platforms have increased transparency, speed and operational efficiency. However, a potential Digitalisation Paradox emerges when standardised electronic execution improves efficiency while reducing flexibility in complex, multi-leg or relationship-driven transactions.

The issue is relevant to treasury management because FX swaps, outright FX transactions and other instruments can involve multiple counterparties and transaction legs. The research therefore considers whether digitalisation changes not merely the speed of liquidity deployment but also the range of transactions through which liquidity can be strategically deployed.

1.5 Research Problem

The central research problem is therefore located at the intersection of four areas:

1. Liquidity regulation — banks must maintain sufficient liquidity.
2. Profitability — excessive liquidity may carry an opportunity cost.
3. Market constraints — available liquidity cannot necessarily be deployed without friction.
4. Managerial decision-making — treasury professionals must make decisions under uncertainty.

The research consequently focuses on structural excess liquidity, rather than treating every amount above the regulatory LCR threshold as economically redundant.

1.6 Research Aim

The aim of this research is:

To investigate how UK banks identify and manage structural excess liquidity and to develop decision rules for its risk-adjusted redeployment across UK financial services while maintaining regulatory and liquidity resilience.

1.7 Research Objectives

The research has six objectives:

1. To examine the extent and characteristics of structural excess liquidity within UK banking.
2. To critically evaluate the relationship between liquidity and profitability.
3. To examine regulatory, market and organisational mechanisms influencing liquidity retention.
4. To investigate how managerial judgement, uncertainty, heuristics and precautionary behaviour influence treasury decisions.
5. To examine how market constraints and digitalisation may affect liquidity redeployment.

6. To develop a conceptual basis for risk-adjusted decision rules for redeploying structural excess liquidity.

1.8 Research Questions

Main research question

How can UK banks develop decision rules for the risk-adjusted redeployment of structural excess liquidity while maintaining regulatory and liquidity resilience?

Sub-questions

1. What is the extent and nature of structural excess liquidity within UK banks?
2. What relationship exists between liquidity, structural excess liquidity and profitability?
3. What regulatory, market and organisational mechanisms influence liquidity-retention decisions?
4. How do uncertainty, managerial judgement, heuristics and precautionary behaviour influence treasury decisions?
5. How does digitalisation affect the flexibility and effectiveness of liquidity deployment?
6. What decision rules could support risk-adjusted redeployment of structural excess liquidity?

1.9 Philosophical Position

The research adopts Critical Realism rather than positivism.

A positivist approach could provide useful evidence about relationships between LCR, liquidity and profitability. However, financial ratios alone cannot explain why a bank maintains liquidity or why apparently profitable opportunities may not be pursued.

Critical Realism is therefore appropriate because it recognises that observable outcomes may be generated by deeper mechanisms. The research adopts a stratified ontology, distinguishing between observable empirical events and deeper structures and mechanisms that may not be directly observable.

Saunders, Lewis and Thornhill (2023) emphasise that research philosophy influences the way researchers understand knowledge and reality and consequently affects research design and methodological choices. The current research therefore treats philosophy not as an abstract methodological exercise but as an integral component of the research problem. The ninth edition of *Research Methods for Business Students* was published by Pearson in 2023.

Chapter 2: Method for Conducting the Literature Review

2.1 Purpose

The literature review seeks to critically evaluate research concerning bank liquidity, LCR, profitability, structural excess liquidity, treasury decision-making, market constraints and digitalisation.

The review is not intended to provide a simple catalogue of previous studies.

Following the principles of critical literature review advocated by Saunders, Lewis and Thornhill (2023), the literature is synthesised around competing arguments, methodological differences, theoretical assumptions and unresolved research gaps.

2.2 Search Strategy

The literature search was designed around the central concepts:

- liquidity coverage ratio
- excess liquidity
- structural excess liquidity
- bank profitability
- HQLA
- liquidity management
- treasury management
- liquidity hoarding
- bank decision-making
- behavioural finance
- heuristics
- bounded rationality
- FX liquidity
- covered interest parity
- balance-sheet constraints
- digitalisation
- financial intermediation

The principal academic databases considered include Scopus, Web of Science, Google Scholar and the UWTSD library resources. Regulatory and institutional evidence was obtained from the Basel Committee on Banking Supervision, Bank of England and Prudential Regulation Authority.

The principal review period is 2021–2025, consistent with the coursework requirement to examine research undertaken during the most recent five-year period. Older studies are retained where they provide foundational theories or concepts.

2.3 Inclusion and Exclusion Criteria

Included studies were:

- peer-reviewed academic research
- directly or indirectly relevant to bank liquidity, profitability or liquidity regulation
- studies addressing financial-market liquidity or balance-sheet constraints
- research addressing managerial decision-making where theoretically relevant
- major regulatory publications
- foundational theoretical contributions

Excluded were:

- publications without sufficient methodological information
- studies unrelated to banking or financial liquidity
- purely descriptive market commentary without analytical value
- duplicate publications
- sources where the relationship to the research problem could not be justified.

2.4 Analytical Procedure

The literature was analysed thematically rather than article by article.

Five major themes are:

1. Bank liquidity, intermediation and financial stability
2. Basel III, LCR and regulatory liquidity
3. Liquidity and profitability
4. Market constraints, arbitrage and liquidity deployment
5. Decision-making, behavioural mechanisms and digitalisation

The studies were also examined according to methodological and philosophical assumptions.

Most empirical banking studies adopt quantitative approaches and rely on observable financial variables. Such evidence is valuable for identifying statistical relationships but may provide limited insight into the organisational mechanisms underlying those relationships.

2.5 Philosophical Analysis of the Literature

A substantial proportion of banking research implicitly adopts assumptions compatible with positivism. Financial variables are operationalised, relationships are statistically estimated and hypotheses are evaluated through empirical evidence. However, this does not necessarily mean that such studies explicitly identify themselves as positivist. A Critical Realist analysis therefore avoids assigning

philosophical labels without evidence. Instead, it examines the assumptions embedded in the research design.

The present study accepts the value of quantitative evidence but argues that observable relationships require explanation. This provides the rationale for integrating quantitative and qualitative evidence.

2.6 Limitations

The literature review is subject to several limitations.

First, access to some specialist banking datasets is restricted. Second, empirical findings from emerging markets may not be directly transferable to the UK. Third, LCR measurement is not always consistent across studies. Vu (2024), for example, discusses the difficulty of estimating LCR from public financial statements in jurisdictions where detailed reporting is not mandatory. Fourth, the concept of “excess liquidity” lacks universal operationalisation. Regulatory surplus should not automatically be interpreted as economically redundant liquidity.

Chapter 3: Critical Literature Review

3.1 Theme 1: Banking Liquidity, Financial Intermediation and Stability

Banks perform a distinctive economic function by transforming deposits and other short-term liabilities into loans and longer-term assets. Kashyap, Rajan and Stein (2002) argue that banks' deposit-taking and lending functions are connected through liquidity creation. Berger and Udell (2009) further demonstrate the importance of liquidity creation for bank performance and financial stability.

This theoretical perspective implies that liquidity is not simply an idle asset. Liquidity supports the bank's ability to create credit and perform financial intermediation.

However, much of the literature concentrates on liquidity shortages. Cornett et al. (2011), for example, demonstrate that liquidity risk can influence credit supply, while Acharya and Mora (2015) examine how liquidity pressures influence banking behaviour during periods of stress.

The argument therefore has two sides.

One argument is that liquidity is productive because it enables banks to maintain confidence and continue intermediation.

The counterargument is that beyond an appropriate level, liquidity may become underutilised balance-sheet capacity.

The research gap is consequently not about whether liquidity is important. That is well established. The less developed question is:
When does necessary liquidity become structural excess liquidity?

3.2 Theme 2: Basel III and Liquidity Regulation

Basel III introduced two central liquidity standards.

The LCR seeks to ensure that banks possess enough HQLA to withstand a 30-day stress period, while the NSFR seeks to promote stable funding over a longer horizon (BCBS, 2013; BCBS, 2014).

The regulatory logic is principally prudential. It is designed to prevent liquidity shortages rather than maximise bank profitability.

This creates an important tension.

Regulatory argument:

Higher liquidity resilience reduces the probability and social cost of bank failure.

Profitability argument:

Liquidity assets can carry an opportunity cost because they may yield less than alternative investments.

The Bank of England's work on HQLA usability reinforces the point that the existence of liquid assets does not automatically mean that they are freely usable. Institutional behaviour, market conditions and perceptions of liquidity can affect their practical use.

Therefore, the LCR should not be interpreted as an optimisation ratio. It represents a prudential minimum and supervisory framework.

This distinction is central to the current research.

3.3 Theme 3: Liquidity and Profitability

Research concerning the liquidity-profitability relationship produces mixed results. Ayoush, Toumeh and Shabaneh (2021), although examining industrial enterprises rather than banks, demonstrate the wider financial-management importance of liquidity, leverage and solvency for profitability. Their study examines 44 Jordanian industrial companies and uses ROA and ROE as profitability measures.

Within banking, the relationship is more complex.

Higher liquidity may:

- reduce funding risk
- improve confidence
- strengthen resilience
- reduce expected distress costs

However, excessive liquidity may:

- lower asset yields
- reduce balance-sheet efficiency
- create opportunity costs
- limit productive lending or investment

Bordeleau and Graham (2010) therefore provide an important theoretical foundation for a nonlinear relationship.

The evidence remains contradictory.

Some studies identify positive relationships between liquidity and profitability, while others report negative effects. Vu (2024) provides an important synthesis by explicitly testing a quadratic relationship and finding an inverted U-shape. The study identifies optimal points within its Vietnamese sample and argues that additional liquidity beyond those points produces diminishing returns.

Veeramoothoo and Hammoudeh (2022) provide a useful counterpoint. Their study of US banks uses simultaneous quantile regression with fixed effects and finds that LCR and NSFR have statistically significant but relatively small effects on profitability across much of the profitability distribution. They argue that quantile differences help explain conflicting findings in the literature.

This is important because it demonstrates that the relationship may depend upon:

- profitability level
- bank size
- institutional context
- regulatory environment
- model specification

Consequently, an optimal liquidity ratio identified in Vietnam cannot simply be transferred to the UK.

3.4 Critical Assessment of Vu (2024)

Vu (2024) is particularly valuable because it moves beyond a linear assumption.

The study uses 20 Vietnamese banks from Q1 2015 to Q4 2022 and applies system GMM to address dynamic-panel and endogeneity concerns.

Its central contribution is therefore methodological as well as substantive.

However, there are limitations.

First, the sample is relatively small.

Second, Vietnam represents a different institutional, regulatory and banking environment from the UK.

Third, the LCR-profitability relationship does not establish that excess liquidity is necessarily redeployable.

Fourth, the statistical relationship does not reveal how treasury managers make liquidity decisions.

Thus, Vu establishes an important financial relationship, but it does not explain the organisational decision mechanism behind liquidity retention.

That distinction is fundamental to the present DBA.

3.5 Theme 4: Liquidity Creation and Behaviour

Banking theory traditionally focuses on the role of banks in liquidity creation.

Kashyap, Rajan and Stein (2002) demonstrate that banks simultaneously provide liquidity through lending and deposit-taking. Berger and Bouwman (2009) extend this perspective by examining liquidity creation at bank level.

However, the literature largely concentrates on how banks respond when liquidity becomes scarce.

This creates an asymmetry:

There is extensive research on what banks do when liquidity is insufficient, but less research on what banks do when liquidity is persistently abundant.

This distinction motivates the concept of structural excess liquidity.

3.6 Theme 5: Global Liquidity, Market Constraints and Arbitrage

The ability to redeploy liquidity depends partly on financial-market conditions.

Brunnermeier and Pedersen (2009) show how funding liquidity and market liquidity interact. When funding conditions deteriorate, market participants may reduce positions, which further reduces market liquidity and creates reinforcing liquidity spirals.

Du, Tepper and Verdelhan (2018) demonstrate that deviations from covered interest parity can persist because of funding and balance-sheet costs. Avdjiev et al. (2019)

similarly show that intermediary constraints help explain persistent CIP deviations.

Cenedese, Della Corte and Wang (2021) further highlight the importance of dealer balance-sheet constraints for currency mispricing.

The implication is important:

Liquidity that appears economically available on a bank's balance sheet may not be economically deployable in every market.

This introduces the concept of redeployable liquidity.

The research therefore distinguishes between:

Structural excess liquidity

and economically redeployable structural excess liquidity.

The latter must consider:

- capital usage
- leverage
- counterparty risk
- funding costs
- transaction costs
- regulatory constraints
- market depth

This distinction is central to the proposed decision rules.

3.7 Theme 6: Digitalisation and the Digitalisation Paradox

Digitalisation has significantly improved banking operations.

Electronic platforms provide:

- faster execution
- improved transparency
- better data availability
- automated risk controls
- reduced operational errors

Boot et al. (2021) argue that FinTech is transforming financial intermediation, although some technological innovations replicate existing financial functions rather than completely replacing them.

However, efficiency does not necessarily equal flexibility.

The Digitalisation Paradox proposed in this research is that increased technological standardisation may improve routine execution while potentially limiting flexibility in complex, relationship-driven or multi-leg transactions.

This is particularly relevant in FX markets, where liquidity may sometimes be structured across multiple counterparties and instruments.

The proposition is not that voice brokerage is inherently superior to electronic trading. Rather, the research proposes that different transaction structures may create different opportunities for liquidity deployment, and that digitalisation may influence the range of structures that are practically accessible.

This is an area where empirical treasury interviews could be particularly valuable.

3.8 Theme 7: Behavioural Decision-Making and Bounded Rationality

A major gap identified in the literature is the relative absence of organisational decision-making.

Simon (1957) challenged the assumption that managers always possess complete information and unlimited analytical capacity. His concept of bounded rationality suggests that managers operate within cognitive and informational limitations.

Kahneman and Tversky (1974) demonstrate that decision-makers use heuristics when judging uncertain events. Availability, anchoring and representativeness can simplify complex decisions but may also generate systematic deviations from purely statistical judgement.

Applied to treasury management, these concepts should be treated as possible mechanisms rather than predetermined explanations.

For example:

Availability

A previous liquidity crisis may make severe liquidity events highly salient, encouraging managers to maintain larger buffers.

Anchoring

Established internal liquidity thresholds may continue to influence decisions even when market conditions change.

Representativeness

Current market conditions may be interpreted through comparison with previous stress periods.

The critical question is therefore:

Does professional treasury judgement under uncertainty contribute to persistent liquidity retention beyond what would be predicted by regulatory and financial variables alone?

This cannot be answered adequately through LCR data alone.

3.9 Competing Explanations

A critical realist approach requires competing explanations.

Structural excess liquidity could result from:

Explanation 1 — Regulation

Banks retain liquidity because regulation requires resilience.

Explanation 2 — Precaution

Banks deliberately maintain buffers because future liquidity needs are uncertain.

Explanation 3 — Market constraints

Banks cannot deploy liquidity efficiently because balance-sheet and transaction constraints reduce opportunities.

Explanation 4 — Weak demand

There may simply be insufficient attractive lending or investment opportunities.

Explanation 5 — Behavioural mechanisms

Managerial judgement and heuristics may encourage excessive precaution.

Explanation 6 — Digitalisation

Technological infrastructure may influence the flexibility of liquidity deployment.

The purpose of the research is not to assume that one explanation is correct but to determine which mechanisms are supported by the evidence.

3.10 Research Gaps

Six principal gaps emerge.

Gap 1: Excess-liquidity bias

Most research focuses on shortages and crisis prevention.

Gap 2: LCR-profitability integration

LCR and profitability are often examined separately rather than as components of a structural liquidity-allocation problem.

Gap 3: UK-specific evidence

A significant proportion of empirical evidence comes from Vietnam, India, the US, Jordan and other markets. The institutional environment of the UK requires separate investigation.

Gap 4: Treasury decision-making

Quantitative studies rarely explain how internal treasury decisions determine liquidity buffers.

Gap 5: Behavioural mechanisms

Bounded rationality, heuristics, intuition and precautionary behaviour remain underexplored in explanations of structural liquidity retention.

Gap 6: Digitalisation and market structure

The relationship between digitalisation, market microstructure and strategic liquidity deployment remains insufficiently examined.

Chapter 4: Philosophical and Methodological Analysis of the Selected Study

4.1 Selected Study

The selected study is:

Vu, T.H. (2024), 'Liquidity coverage ratio and profitability: an inverted U-shaped pattern'.

The study investigates whether LCR affects profitability and whether an optimal liquidity level exists. It uses 20 Vietnamese banks covering Q1 2015–Q4 2022 and measures profitability through ROA and NIM. A quadratic system-GMM model is employed.

The selection of this study is justified because it is directly connected to the central financial relationship in the present research - liquidity and profitability.

4.2 Research Philosophy

Vu's research is strongly compatible with a post-positivist/empirical quantitative orientation, although the paper does not need to be reduced to a simple philosophical label.

The research assumes that:

- LCR can be measured

- profitability can be measured
- relationships between variables can be statistically estimated;
- statistical models can provide evidence concerning the relationship.

This is appropriate for its research question.

The system-GMM approach also demonstrates awareness that observed relationships may be affected by endogeneity and dynamic effects. The study therefore does not simply calculate correlations.

4.3 Ontology

The study implicitly adopts an ontology in which banking characteristics and profitability exist as measurable phenomena independent of the researcher.

This is appropriate for the quantitative question.

However, from a Critical Realist perspective, the limitation is that observable financial variables represent only one level of reality.

For example:

LCR = 150% is observable.

But the reasons for maintaining that level could include:

- internal risk appetite
- regulatory expectations
- stress-testing assumptions
- management preference
- market uncertainty

These mechanisms cannot be directly inferred from the ratio.

Therefore, the current research extends the approach by combining quantitative measurement with qualitative investigation.

4.4 Epistemology

Vu's epistemological approach is empirical and quantitative.

Knowledge is generated through:

1. operationalisation
2. data collection
3. statistical modelling
4. hypothesis testing
5. interpretation of coefficients

This produces valuable knowledge about relationships between variables.

However, the Critical Realist position adopted in the present study argues that statistical association should not be treated as a complete explanation of causality.

An inverted U-shape may demonstrate what relationship exists without necessarily explaining why banks behave in this way.

This is why the present research adopts abduction.

4.5 Axiology and Researcher Positionality

Quantitative research often seeks to minimise researcher influence.

Vu's methodology benefits from this orientation because the main variables are numerical and the econometric model can be replicated.

Nevertheless, research decisions involve values, including:

- which variables to select
- which profitability indicators to use
- which sample to study
- which econometric specification to apply
- how findings are interpreted

The current research therefore recognises that researcher judgement cannot be eliminated completely.

Critical Realism does not require the researcher to pretend to be entirely value-free.

Instead, reflexivity requires awareness of how theoretical assumptions and research decisions influence knowledge production.

4.6 Reliability

The use of clearly defined financial variables and a formal econometric methodology contribute to reliability.

The study covers a structured panel of banks and uses established profitability measures such as ROA and NIM.

The use of system GMM is also relevant because the study explicitly addresses endogeneity in dynamic panel relationships.

Nevertheless, reliability is affected by the quality of LCR measurement.

The article itself discusses the difficulty of calculating LCR accurately from financial reports and notes that estimated LCR values can differ from officially reported figures.

This is an important methodological lesson for the UK study:

If actual regulatory LCR data are available, they should be preferred to proxy measures.

4.7 Validity

Internal validity

The use of system GMM strengthens internal validity because the method addresses some endogeneity and dynamic-panel concerns.

However, econometric identification cannot eliminate every possible source of omitted-variable bias.

Construct validity

The study uses LCR as a measure of liquidity and ROA/NIM as measures of profitability.

These are established indicators, but:

LCR is not synonymous with structural excess liquidity.

This is one of the most important limitations for the present research.

A bank may have an LCR above 100% because it needs a prudent buffer. Therefore, the difference between LCR and the regulatory minimum cannot automatically be interpreted as idle or economically redundant liquidity.

External validity

The Vietnamese banking context limits direct generalisation to UK banks.

Differences include:

- regulatory environment
- financial-market development
- banking structure
- monetary policy
- reporting practices
- market depth

The study should therefore be regarded as theoretically informative rather than directly transferable to the UK.

4.8 Ethical Considerations

The study primarily uses secondary quantitative data, meaning that risks relating to participant confidentiality and informed consent are relatively limited.

Nevertheless, ethical research requires:

- accurate reporting
- transparent methodology
- avoidance of selective reporting
- appropriate treatment of statistical limitations
- correct citation of sources

The current research will similarly use secondary financial data but introduces a qualitative component. This creates additional ethical responsibilities.

Interview participants must be provided with:

- informed consent
- confidentiality
- anonymity where appropriate
- the right to withdraw
- information about data storage
- explanation of the research purpose

Particular care is necessary because treasury professionals may discuss commercially sensitive information.

Interview questions should therefore focus on decision processes rather than confidential transaction details.

4.9 Critical Appraisal

Vu's study is strong because it:

- addresses a clear research question
- uses a longitudinal bank sample
- examines nonlinearity
- addresses dynamic relationships
- provides an important theoretical implication concerning optimal liquidity.

Its limitations include:

- relatively small sample
- Vietnamese institutional context
- limited ability to explain managerial behaviour
- distinction between LCR and structural excess liquidity
- inability to identify the organisational mechanisms underlying liquidity retention

The present research therefore does not reject Vu's findings.

Instead, it extends the problem.

Vu asks:

What is the relationship between LCR and profitability?

The present research asks:

What mechanisms determine whether liquidity beyond prudent requirements is retained or redeployed, and how can those decisions be improved?

Chapter 5: Discussion and Contribution

5.1 Integrating the Evidence

The literature demonstrates that liquidity is simultaneously:

- a source of resilience
- a component of banking intermediation
- a regulatory requirement
- a potential opportunity cost
- a managerial decision problem

These dimensions should not be treated as mutually exclusive.

The central theoretical proposition of this research is therefore: Structural excess liquidity exists at the intersection of prudential necessity and economic opportunity cost.

The research does not assume that all liquidity above the regulatory minimum is unnecessary.

Instead: Regulatory surplus $\neq$ structural excess liquidity $\neq$ redeployable liquidity.
This conceptual distinction is an important contribution for this research.

5.2 Conceptual Framework

The proposed framework can be represented as,

Regulatory environment



LCR / NSFR / supervisory expectations

Market environment



Funding conditions / interest rates / FX opportunities / market liquidity

Bank characteristics



Size / capital / risk appetite / balance-sheet structure



Liquidity decision environment



Uncertainty



Treasury governance



Managerial judgement



Bounded rationality



Heuristics / Intuition



Precautionary behaviour



Decision

RETAIN LIQUIDITY $\leftrightarrow$ REDEPLOY LIQUIDITY



Market and technological constraints

- capital usage
- leverage
- counterparty limits
- transaction costs
- digital platforms
- market microstructure



Outcome

Liquidity resilience vs. Risk-adjusted profitability



Decision-rule development

Risk-adjusted redeployment of structural excess liquidity

5.3 What Philosophy Contributes

The philosophical contribution is significant.

A positivist analysis might conclude:

“Higher LCR is associated with lower profitability beyond a certain level.”

Critical Realism asks:

“What mechanisms produce the observed relationship?”

The mechanisms may include:

- regulatory structures;
- precautionary behaviour;
- organisational routines;
- risk appetite;
- market constraints;
- behavioural judgement.

Thus, Critical Realism changes the research from measurement alone to explanation.

5.4 Why Mixed Methods Are Necessary

The quantitative component establishes whether patterns exist.

For example, is liquidity significantly associated with profitability? Is the relationship nonlinear? Does the relationship vary by bank size?

The qualitative component investigates:

Why do treasury managers retain liquidity? How do they define an acceptable liquidity buffer? How do they evaluate deployment opportunities? How does uncertainty affect decisions? Do internal thresholds become organisational anchors? The two forms of evidence are therefore complementary rather than competing.

5.5 Abduction and the Search for Mechanisms

Abduction is particularly suitable because the research does not begin with the assumption that one mechanism explains excess liquidity.

The research may initially observe persistently high liquidity

Possible explanations are then generated and compared,

- regulatory explanation
- precautionary explanation
- market explanation
- behavioural explanation
- organisational explanation
- technological explanation

The strongest explanation is developed through iterative comparison between empirical evidence and theory.

This is consistent with Critical Realism because causal mechanisms may not be directly observable.

5.6 Behavioural Contribution

The integration of bounded rationality into liquidity research represents an important management dimension.

The research does not claim that treasury dealers are biased.

Instead, it asks whether decision-making under uncertainty systematically encourages liquidity retention and distinction is crucial.

A treasury manager may deliberately maintain excess liquidity because the potential cost of a liquidity shortage is perceived as much greater than the opportunity cost of holding additional HQLA. That may be economically rational precaution, even if it produces lower short-term profitability.

Alternatively, internal thresholds may persist because they have become institutional norms. The empirical research can therefore distinguish rational precaution from potentially excessive precaution.

5.7 Digitalisation Contribution

Digitalisation introduces another possible mechanism.

Electronic systems may,

- increase information availability
- reduce execution time
- improve pricing
- automate compliance
- reduce operational risk

But the research proposes that digitalisation may also influence the structure of opportunities available to treasury professionals.

Therefore, the question is not “Is digitalisation good or bad?”

It is, Under what conditions does digitalisation improve or constrain strategic liquidity deployment? This is a more defensible proposition.

5.8 Practical Contribution

The practical contribution is the development of decision rules rather than a recommendation to simply reduce liquidity.

A potential decision-rule architecture could include,

Rule 1 — Regulatory floor

Never redeploy liquidity required to meet regulatory obligations.

Rule 2 — Internal resilience buffer

Identify the liquidity necessary for stress-testing and internal risk appetite.

Rule 3 — Structural excess test

Determine whether remaining liquidity is persistently above regulatory, operational and prudent requirements.

Rule 4 — Redeployment opportunity test

Evaluate whether an alternative use produces sufficient risk-adjusted return.

Rule 5 — Market constraint test

Consider:

- capital consumption
- counterparty exposure
- funding cost
- leverage
- transaction cost
- market liquidity

Rule 6 — Behavioural challenge

Require treasury teams to review whether decisions are based on current evidence or historical assumptions and institutional anchors.

Rule 7 — Dynamic review

Decision rules should be reviewed as,

- interest rates
- market conditions
- regulation
- bank risk appetite
- technology change

The final research would empirically refine these rules rather than assuming them to be correct in advance.

Chapter 6: Conclusion

6.1 Summary

This research examines structural excess liquidity in UK banks from a perspective that integrates banking regulation, profitability, financial-market constraints and managerial decision-making.

The literature demonstrates that liquidity is essential for bank resilience. Basel III therefore appropriately requires banks to maintain sufficient liquidity through the LCR and NSFR. However, the existence of regulatory liquidity requirements does not establish what constitutes an economically optimal liquidity position.

The literature on liquidity and profitability provides competing arguments. Adequate liquidity can reduce risk and improve confidence, while excessive liquidity can generate opportunity costs. Vu (2024) provides important recent evidence of an inverted U-shaped relationship between LCR and profitability.

However, the literature remains limited in several respects. It is heavily concentrated on liquidity shortages, regulatory compliance and crisis prevention. It also tends to rely on quantitative financial data, providing limited insight into internal treasury decision-making.

This research addresses that limitation through a Critical Realist perspective.

6.2 Philosophical Conclusion

Critical Realism is appropriate because the phenomenon of structural excess liquidity contains multiple layers.

At the empirical level: LCR, HQLA and profitability can be measured.

At the actual level: liquidity is retained, transferred and deployed through organisational and market processes.

At the deeper level: regulation, uncertainty, risk appetite, organisational routines, market constraints and behavioural mechanisms influence decisions.

The research therefore does not treat financial ratios as complete explanations.

6.3 Methodological Conclusion

The mixed-methods approach follows from the philosophical position.

Quantitative analysis can establish: What is happening.

Qualitative investigation can examine: Why it is happening.

Abductive reasoning then allows the researcher to identify the most plausible mechanisms connecting the two. This provides methodological coherence between:

Critical Realism → stratified ontology → abduction → mixed methods.

6.4 Theoretical Contribution

The proposed contribution is an integrated framework connecting liquidity regulations.

- Structural excess liquidity
- Managerial decision-making
- Market constraints
- Redeployment
- Risk-adjusted profitability

The addition of bounded rationality and heuristic decision-making introduces a management dimension that is relatively underdeveloped in liquidity research. The Digitalisation Paradox provides an additional market-structure dimension by considering how technological change may influence the flexibility of liquidity deployment.

6.5 Practical Contribution

The practical objective is not to encourage banks to reduce liquidity indiscriminately. Instead, the research aims to identify circumstances under which liquidity may,

1. Regulatory required liquidity
2. Prudentially necessities
3. Reduce structural excess and economically redeployable Liquidity
4. Graduated Redeployment and Potential Stimulation Effect

6.5.1 Regulatory required liquidity

This is the liquidity that banks need to maintain because of formal regulatory requirements. The clearest example is the Liquidity Coverage Ratio (LCR) under Basel III, which requires banks to hold sufficient high-quality liquid assets to withstand a defined short-term liquidity stress scenario. The important point for your research is that Regulatory requirement is a floor, not necessarily an economically optimal liquidity level. Therefore, if a bank has an LCR substantially above the regulatory minimum, the entire amount above the minimum should not automatically be classified as excess liquidity available for redeployment. Some of that additional liquidity may be necessary for other regulatory, operational or risk-management reasons.

6.5.2 Prudentially necessary liquidity

A bank may hold liquidity above the formal regulatory minimum because it considers the additional buffer necessary to protect itself against uncertainty. for example, a treasury department may retain additional liquidity because of,

- potential deposit withdrawals
- volatile wholesale funding
- unexpected market disruption
- collateral requirements
- stress scenarios
- uncertainty about future funding conditions
- institution-specific risk appetite
- management's preference for maintaining a safety buffer.

Therefore, not all liquidity above the regulatory minimum is necessarily economically redundant. Critical Realist approach particularly the observable LCR may show, for example, 150%, but the underlying reason for maintaining that level may involve mechanisms that cannot be identified simply from the ratio itself.

Therefore, have Potential structural excess
Regulatory minimum → Prudential buffer → Potential structural excess
rather than ,150% LCR → 50% excess → redeploy all 50%.

6.5.3 Structural excess / economically redeployable liquidity

After identifying ,6.5.1 what is regulatory required + 6.5.2 what is prudentially necessary, the remaining liquidity may potentially represent structural excess liquidity.

However, even this amount should not automatically be regarded as immediately deployable. Then research can therefore distinguish between Structural excess liquidity — liquidity held beyond regulatory and prudential requirements and economically redeployable liquidity — the portion of structural excess liquidity that can actually be redeployed without creating unacceptable liquidity, regulatory, market or operational risk.

For example:

Observed LCR = 150%

↓

Regulatory requirement = 100%

↓

Additional prudential buffer = perhaps 20–30%

↓

Potential structural excess = remaining portion

↓

Economically redeployable portion = determined through decision rules

(The actual percentages should be empirically established here only an assumption)

6.5.4 Graduated Redeployment and Potential Stimulation Effect

The study proposes that structural excess liquidity need not be viewed as a binary choice between complete retention and aggressive deployment. A graduated redeployment framework could allow banks to test whether small incremental reductions in excess liquidity such as 5%, 10% ,15% or 20% and generate additional returns while maintaining adequate liquidity resilience. The potential cumulative effect of such incremental redeployment could stimulate productive financial activity by increasing the capacity available for lending, investment, market-making or other income-generating activities. However, the study does not assume that every institution should reduce liquidity by a predetermined percentage. Rather, the

appropriate level would depend upon institution-specific conditions and the underlying mechanisms identified through the research.

6.6 Future Research

Future research could extend the study through:

- larger UK bank panels
- cross-country comparisons
- transaction-level FX data
- further treasury-dealer interviews
- experimental research on liquidity decision-making
- investigation of digital versus voice-mediated transactions
- machine-learning approaches to liquidity forecasting
- Treasury based performance KPIs

The most important future direction is to move beyond asking whether excess liquidity affects profitability and instead investigate how banks can systematically distinguish necessary resilience from potentially inefficient liquidity retention.

Overall, the study proposes a decision-oriented approach to distinguishing regulatory-required, prudentially necessary and economically redeployable liquidity. Rather than seeking an immediate reduction to regulatory minimums, it considers gradual redeployment of identified excess liquidity, potentially in incremental steps such as 5%, 10% or 15%, subject to risk and liquidity conditions. This provides a practical basis for treasury decision-making while recognising that the appropriate level of redeployment depends on institution-specific circumstances and underlying market mechanisms. Future research could develop treasury performance-based KPIs to assess the effectiveness of such liquidity redeployment.

The ultimate DBA contribution is therefore the development of risk-adjusted decision rules for structural excess liquidity, grounded in empirical evidence and informed by the realities of treasury decision-making.

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Appendix

Table 1: Key Concepts and Definitions

Concept	Definition used in this research	Role in research
Liquidity	Ability to meet financial obligations when due	Fundamental risk-management concept
LCR	HQLA relative to net cash outflows over a 30-day stress period	Principal regulatory indicator
HQLA	Assets capable of being converted into cash rapidly with limited loss	Core component of LCR
Excess liquidity	Liquidity above a specified requirement	Starting point for analysis
Structural excess liquidity	Liquidity remaining after regulatory, internal, operational and prudent stress requirements	Central research construct
Latent profit	Potential economic value from underutilised resources	Opportunity dimension
Risk-adjusted return	Return after accounting for relevant risks and costs	Basis for deployment decisions
Liquidity redeployment	Allocation of surplus liquidity to alternative uses	Practical issue
Decision rules	Criteria governing retention or redeployment	Proposed contribution
Treasury management	Management of liquidity, funding and financial-market exposures	Organisational context
Balance-sheet constraints	Capital, leverage, funding and regulatory restrictions	Limits deplorability
CIP	Relationship between interest-rate differentials and forward FX pricing	Relevant to FX opportunities
FX swap	Exchange of currencies with a subsequent reverse transaction	Potential deployment instrument
Digitalisation	Use of digital systems and platforms in financial activities	Contextual factor
Digitalisation Paradox	Possible reduction in flexibility resulting from increased digital standardisation	Exploratory proposition
Critical Realism	Recognition that observable events may arise from deeper mechanisms	Research philosophy
Abduction	Movement between empirical evidence and theoretical explanation	Research approach
Mixed Methods	Integration of quantitative and qualitative evidence	Methodological design

Table 2: Excess LCR UK Banks

Bank	2018	2019	2020	2021	2022	2023	Average
HSBC	154%	150%	139%	138%	132%	136%	141.50%
Barclays	169%	160%	162%	168%	165%	161%	164.17%
Lloyds Banking Group	130%	137%	136%	135%	144%	142%	137.33%
NatWest Group	158%	152%	165%	172%	145%	144%	156.00%
Standard Chartered	154%	144%	143%	143%	147%	145%	146.00%
Average	153.00%	148.60%	149.00%	151.20%	146.60%	145.60%	149.00%

LCR % (*Basel III Minimum Requirement = 100%*)

Source: Author's compilation from HSBC Holdings plc, Barclays plc, Lloyds Banking Group plc, NatWest Group plc and Standard Chartered plc annual reports/financial results, 2018–2023.