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Administrative Office
c/o Professor George Kaufman
Loyola University Chicago
820 North Michigan Avenue
Chicago, Illinois 60611
Tel: (312) 915-7075
Fax: (312) 915-8508
E-mail: gkaufma@luc.edu

Statement No. 336

Robert Eisenbeis
(770) 416-0047

Richard Herring
(215) 898-5613

Statement of the Shadow Financial Regulatory Committee on

How can we do better than the Basel liquidity coverage ratio?

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In response to the financial crisis, the Basel Committee proposed to reduce the vulnerability of the banking system to a liquidity shock by introducing a regulatory Liquidity Coverage Ratio. In January the Basel Committee issued a final standard for this ratio.

The Liquidity Coverage Ratio standard was intended to ensure that banks have unencumbered, high-quality liquid assets sufficient to deal with a thirty day period of stress. It is defined as "The Stock of High Quality Liquid Assets" divided by the "Total Net Cash Outflows that Could Be Expected Under a Stress Scenario over 30 days".

While the concept was broadly endorsed by the Basel Committee, problems arose in negotiating the details as each country sought to diminish the burden on its banks. Several countries were concerned that their banks lacked sufficient High Quality Liquid Assets to be included in the numerator of the ratio to meet the new standard. Thus, a flurry of proposals was made to expand the definition to include many more assets than the cash and government securities that were originally contemplated. For example, the most recent round of revisions includes corporate debt securities rated A+ to BBB- (subject to a 15% cap) and unencumbered equities (both subject to 50% haircuts). In addition, the revised ratio includes Residential Mortgage Backed Securities rated AA or higher (subject to a 25% haircut) and the possibility to include required reserves, as well as interbank deposits, at the discretion of the central bank. Thus, the notion of High Quality Liquid Assets is expanded well beyond any

intuitive definition of immediately available funds.

The issue of how to reflect stress in the denominator of the ratio was also contentious. The Basel Committee defined the degree of stress in terms of assumed liability run-off rates that did not reflect the experience during the crisis. Negotiations have softened these assumptions. Originally demand deposits were assumed to run-off at a 50% rate. In the latest revision the assumed outflow for insured retail deposits has been reduced to 3% and for other insured deposits to 20%. The assumption regarding outflows of corporate deposits was reduced from 75% to 40%. The assumption regarding the drawdown of committed liquidity facilities was reduced from 100% to 30%. The outflow rate on maturing discount window borrowing fell from 25% to 0%. In the Shadow Financial Regulatory Committee's view, the degree of stress embodied in the assumed run offs fell from severe to negligible. The implementation period also was extended so that the initial ratio will be only 60% with a 10% increase each year until the 100% target is finally reached in 2019.

The result is that what began as a relatively simple concept has become a very complicated standard with a variety of unexplained differences in haircuts on many different instruments. The changes impair the ability to measure, verify, and monitor an institution's liquidity positions and invites arbitrage of the regulatory definitions. More fundamentally, the approach ignores the fact that asset and liability liquidity characteristics vary across banks, over the cycle, and particularly within periods of financial stress. Finally, it ignores the complementary relationship among capital adequacy standards, liquidity standards and the role of the lender of last resort in mitigating safety and soundness concerns.

The Shadow Financial Regulatory Committee believes that a better regulatory liquidity standard would focus exclusively on cash, defined as currency and deposits at the central bank. Only cash, so defined, would be unambiguously available under all possible circumstance to meet an emergency demand for funds. It is also instantly verifiable at any point in time and acceptable at par value even during a financial crisis.

Now is a particularly suitable time for the U.S. to adopt a cash-only definition of high-quality liquid assets. Institutions already hold substantial excess reserves at the Fed. The interest these reserves earn helps to offset the opportunity costs of holding cash assets. The Committee would envision that unlike ordinary reserve requirements, the required liquidity standards would be relaxed during times of stress to make the needed funds available. Finally, if interest were also paid upon required reserves, this new liquidity requirement would blunt arguments that the standards would be costly or damaging to the availability of credit.

Given this refined definition of high quality liquid assets the final issue is how to determine how much liquidity is enough? The Committee favors a stringent and objectively verifiable degree of stress based upon regulatory-determined run off scenarios in which the bank would be assumed to be unable to roll-over any of its maturing liabilities. This gives rise to a natural measure of the adequacy of liquidity. How many days could a bank withstand this degree of stress? Estimates of these time variables should be made publicly

available, and regulators may at some point want to set a minimum number of days in the context of the ability of the institution to absorb losses.