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Statement of the Shadow Financial Regulatory Committee on

The Basel Proposed Rules on Liquidity Regulation and a Suggestion for a Better Approach

September 12, 2011

The Basel Committee on Banking Supervision (Basel Committee) is proposing to regulate bank liquidity. This marks a major innovation in the Basel approach to international banking regulation. The Basel proposal envisions two sets of liquidity requirements: a short-term liquidity funding ratio and a long-term net stable funding ratio. Both are quite complex and may become still more complicated once the process of consultation is concluded. We believe both ratios, as currently conceived, are too complex and would result in an opaque application of the standard that would be subject to excessive supervisory discretion. Moreover, the liquidity requirements are not integrated with capital requirements or lender-of-last-resort arrangements.

One reason for this complexity and lack of integration is the failure to understand the interrelated problems of liquidity risk and solvency risk and the proper relationships among capital requirements, liquidity requirements and lender-of-last-resort facilities for addressing the risk of bank default. Once these relationships are clarified, a much simpler, less opaque, more effective and less distortionary combination of cash and capital ratio requirements may be designed.

The short-term liquidity funding requirement proposed by the Basel Committee aims to ensure that each bank has sufficient resources to survive an acute stress scenario lasting for one month. The degree of stress will depend on actual events during the recent crisis as modified by calibration simulations subject to supervisory discretion. The stock of "high quality liquid assets" must be greater than projected net cash outflows over the 30-day period. The Basel Committee will decide during the impact study and comment period whether to use a narrow definition of liquid assets (cash, central bank reserves, high quality sovereign paper) or a broader version (including, in addition, corporate and covered bonds, which would be subject to potentially substantial haircuts and size limits). In either case, the ratio places a premium on stable retail and small business deposits that reflect strong, persistent relationships with the bank and are believed to be less subject to large runoffs in the event of a loss of confidence, in part because these depositors are more securely wrapped in the safety net.

The long-term net stable funding ratio aims to address maturity mismatch issues and to guard against the effects of a significant decline in profitability or solvency arising from heightened risk aversion or a material event that affects firm reputation. The available amount of stable funding must cover the amount required by supervisors. The amount of stable funding available to address the mismatch will include Tier 1 and Tier 2 capital, other capital stock with maturity of one year or longer, liabilities with effective maturities of one year or greater, and long-term deposits subject to haircuts determined by supervisors' judgment about their stability. The required stable funding is the sum of the value of the assets held and funded by the institution, multiplied by a specific required stable funding factor assigned to each particular asset type, added to the amount of off-balance-sheet activity, or potential liquidity exposure, multiplied by an associated risk factor determined at the regulator's discretion.

The Committee believes that implementation of these rules will impose large and distortionary costs on the financial system. These costs take the form of acquisition and restructuring of liabilities, distortion of the market for core deposits, the costly addition of liquid assets and the capital required to support them, and the inevitable pressure to weaken those liquidity standards arising from these costs.

Because these liquidity standards favor funding through core deposits, the prospect of this rule has already led a number of large banks to acquire smaller banks with significant core deposits. This motivation is distorting the normal competition for retail deposits based on comparative advantage. Alternatively, banks can address both new requirements by increasing their cash assets, and balance sheet size, at the cost of raising additional capital (given the 5% leverage requirement on all asset classes). Industry estimates indicate substantial potential changes in bank balance sheets from these kinds of adjustments. The alternative to those adjustments would be substantial reductions in maturity transformation (e.g., disintermediation and credit contraction).

Given these potential costs, regulators are already facing pressures to bend the rules to reduce compliance costs, and further increase the potential for discretionary forebearance. For example, the Basel Committee is considering including covered bonds in the category of liquid assets despite the fact that covered bonds do not qualify under any reasonable definition of a liquid asset. The Europeans are pressing hard for the inclusion of covered bonds, which became illiquid during the recent crisis.

The proposed new liquidity regulation regime, therefore, will be a complex, costly, distortionary, opaque, and possibly ineffectual set of standards. That outcome, however, can be avoided by beginning with a better understanding of the proper role of liquidity regulation, which implies a simpler and better approach.

Rather than devising two new complex liquidity regulations to address short-term and long-term liquidity risk in isolation, as the Basel Committee seeks to do, the Shadow Financial Regulatory Committee suggests a simple cash asset ratio requirement that is part of an integrated prudential regulatory approach combining the three regulatory tools of capital standards, liquidity standards and lender-of-last-resort assistance to address the combined liquidity and solvency risks faced by banks.

Cash ratio requirements, of course, will not eliminate liquidity risk from the banking system, nor should they. Systemic liquidity risk during crises is associated with the drying up of interbank funding and thus the need to rely on the lender of last resort to provide liquidity to the banking system, and thereby (through the payment system and lines of bank credit) liquidity to the whole economy.

The proper role of liquidity requirements, like capital requirements, therefore, is not to serve as a substitute for the lender-of-last resort, but rather to improve the effectiveness of micro-prudential regulation. Cash assets, like capital, serve as a buffer to reduce default risk on bank debt. An integrative approach to prudential regulation would recognize that, since cash and capital are alternative means of reducing risks of default that arise from all types of risk, higher mandated cash holdings, all else equal, should reduce requisite capital holdings and vice versa.

The benefits of banks' cash holdings, therefore, are not limited to times of crisis. Not only does cash reduce the liquidity risk of an institution by helping to insure its ability to service maturity debts irrespective of market conditions, it also plays important roles during normal times. A micro-prudential regulatory regime based only on minimum capital requirements generally does not work as well as one that combines minimum capital ratios and minimum cash asset ratios. Unlike capital, which is prone to being overstated when asset loss recognition is delayed, cash assets (particularly, reserves at the central bank) are continuously observable to regulators, and therefore, serve as a more credible buffer against bank default.

Furthermore, the presence of significant cash in the balance sheet mitigates "risk-shifting" incentives that can arise in the wake of hard-to-observe losses from risky assets. Having more cash on their balance sheets reduces the payoff to banks from adopting high-risk strategies for risky assets. For both reasons, a minimum ratio of cash assets can be an effective complement to a minimum capital ratio requirement.

A minimum cash reserve requirement (a minimum required ratio of remunerated cash reserves relative to total assets of, say, 15 or 20 percent) would be simple, transparent, and easy to enforce, and thus would reduce problems associated with opacity, supervisory discretion, and potential forbearance. Unlike other assets, whose degree of liquidity varies and may be a matter of potential disagreement, cash assets are unambiguously liquid. In both normal and crisis times, cash can be transformed into purchasing power without the risk of losses attendant to asset sales, which might otherwise deplete an institution's capital cushion. A cash asset ratio requirement, if integrated with capital ratio requirements properly to provide adequate buffers against potential loss, would reduce both solvency and liquidity risk. It would not hobble banks, nor distort competition in the market for retail deposits.

Liquidity regulation should not and cannot be designed to attempt to eliminate all liquidity risk in the banking system. A proper banking system should employ effective prudential regulation (based on the credible measurement of the riskiness of bank activities, and the appropriate combination of capital and liquidity requirements commensurate with that risk) to address bank safety and soundness, and rely on the lender-of-last resort to address moments of systemic liquidity risk.