Regulating Systemic Liquidity Risk

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Overview

- What is liquidity?
- Market liquidity and funding liquidity
- Micro vs. macro perspectives on liquidity risk
- Regulating liquidity risk
- Concluding remarks

Preliminary concepts (1)

- What is liquidity (for a financial institution)?

  → Ability to meet obligations when due

- What obligations?

  → Deposit withdrawals, debt repayments, asset purchases

- What are sources of liquidity?

  → Holdings of central bank reserves

  → Sale of assets: Market liquidity

  → Placement of debt: Funding liquidity

Preliminary concepts (2)

- Market liquidity

  → Ability to <u>sell</u> <u>assets</u> to meet obligations when due

  → Depends on the characteristics of the assets

- Funding liquidity

  → Ability to <u>borrow</u> to meet obligations when due

  → Secured borrowing: Depends on availability of collateral

  → Unsecured borrowing: Depends on solvency of borrower

- Both sources of liquidity depend on situation of markets

Micro vs. macro perspective

- Standard approach is micro: institution by institution

  → Inadequate from perspective of regulation

- Need a macro approach

  → Obligations to meet: idiosyncratic or systemic?

  → Ability to sell assets: to whom?

  → Ability to borrow: from whom?

Macro perspective (1)

Simplified aggregate balance sheet of financial system

Central bank reserves	Central bank borrowing
Bank loans	Bank debt
Government securities	Bank deposits
Private securities	Bank equity
	Mutual funds' shares

Macro perspective (2)

- Liquidity shocks involve shifts in liability side of balance sheet
  - → Deposits from one bank to deposits of another bank
  - → Mutual fund shares to (insured) deposits, etc.
- These shifts require adjustments in both sides of balance sheet
  - → Interbank lending
  - → Sterilized lending from central bank
  - → Acquisition of securitized loans by banks, etc.

Macro perspective (3)

- Adjustments may be difficult in case of systemic shocks
- Central bank should act as market maker of last resort

  → Replacing interbank flows

  → Funding (forced) asset acquisition by banks

  → Providing government securities (flight to quality)

Regulating liquidity risk (1)

- Adopt macro perspective
- Do proper analysis of regulatory trade-offs

  → Risk of inefficient (or even counterproductive) regulation
- Play down market liquidity

  → Avoid fire sale of assets

  → Preserve monitoring role of banks
- Focus on funding liquidity (ability to borrow)

  → Enhance banks’ solvency via higher capital

Regulating liquidity risk (2)

- Do <u>not</u> impose minimum liquidity requirements

  → Liquidity buffers must be usable (Goodhart's critique)

  → Avoid unnecessary distortions in asset markets

- Do <u>not</u> prevent banks from borrowing short

  → Disciplining role of wholesale short-term financing

Regulating liquidity risk (3)

- To the extent that liquidity risk generates externalities

  → Tax (net) short-term wholesale financing

  → Possible capital charge for liquidity risk

Concluding remarks

- Direct regulatory efforts toward fundamental issues

  → Do <u>not</u> follow the path of the FSA on liquidity regulation

- Enhance funding liquidity

  → Focus on (higher) bank capital

  → Do not throw the baby (Basel II) out with the bath water