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Systemic liquidity risk: An European approach

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Introduction

The repeated burst of financial distress in Europe in 2010-11 reflect vulnerabilities built up in the previous decade, and germane to the roots of the credit crisis. Abundant global liquidity relaxed funding constraints for banks and their borrowers, whether governments, firms or consumers. It enabled private and public debt to grow faster than domestic savings, and in fact too fast for its risk to be properly assessed. Wholesale funding was temptingly cheap. Yet because it was so short term, uninsured and uninformed, it was very prone to runs.

Credit grew fastest at the EU periphery, where the stability induced by the euro eased historical concerns on private productivity or fiscal laxitude. But overall, European banks abandoned organic growth built on local retail and business clients, globalizing lending by lending into real estate booms and excess public consumption anywhere. As this credit expansion was built on large scale wholesale funding, EU banks are now over-exposed to a very unstable funding structure, as the last couple of months showed.

The ratification of the Basel III norms need to be a chance for a new funding architecture, to restore proper credit incentives and strengthen resilience, moving banks away from a failed business model. Central to this transformation is to nudge banks towards a more stable structure of funding. A banking system based on more retail deposits and informed, long term investors would not only be more resilient, but would also promote a focus on local business credit opportunities, moving away from oversized carry trades in risky global assets, funded with unstable global liquidity.

Prudential control of liquidity risk under Basel III

In the ongoing regulatory reform, attention has focused on raising capital ratios. Understanding bank equity is, unfortunately, much easier than understanding liquidity risk. Yet even a bank with a 10 % adjusted capital ratio usually has a 95/96% debt to assets, thanks to risk weights. So the key question is: how to control refinancing risk for 95 % of bank funding, since banks tend to raise cheap, short term funding, in the knowledge that they can rely on central bank rescues in a run?

Unstable funding imposes a negative risk externality, since runs force fire sales which propagated shocks across markets and banks. On this conclusion there is by now complete academic and general consensus, which lead to a shared urgency to establish macroprudential tools to act preventively. To contain liquidity risk build up, academics have advocated using both ratios and risk charges (Perotti and Suarez, 2009; Stein, 2010; Acharya, Khrishnamurti and Perotti, 2011).

The Basel process focuses on fixed standards, so the Basel III liquidity proposals are cast in terms of ratios. Two standards have been introduced:

Liquidity coverage ratios: minimal buffers of liquid assets as a fraction of estimated outflows in a 30 days stress period.
Net stable funding ratios: quantitative ceilings to less stable funding, related to average asset liquidity risk.

There is a key distinction between LCRs and NSFRs. Liquidity buffers are microprudential tools modeled on traditional reserve requirements. The NSFR are a novel structural measure with aggregate effects.

These standards reflect a traditional central bank orientation to strengthen individual resilience at times of stress. But a policy based on individual ratios alone has clear limits, as it does not enables a preventive approach on a timely base to contain aggregate risk creation.

Specifically:
- Ratios are too rigid. As they are fixed, they need to be set tight enough to be adequate all the time. So they are easily characterised as very expensive, and arise massive resistance. They have accordingly been seriously delayed (the key ones till 2018 !) and are likely to be diluted.
- Ratios are not countercyclical, and in fact buffers (LCR) are pro cyclical (Perotti Suarez, 2011). Buffers do not discourage aggregate liquidity risk build up in good time, when the wholesale funding spread for banks is minimal (it was zero in 2004-07), while it jumps in a crisis. So incentives to rely on unstable funding are unchanged in a boom. Ex post, buffers are useful in small shocks, but clearly insufficient to contain systemic runs.
- NSFR ratios may constrain the stock of unstable funding, though in a more distortionary form than charges. Quantity limits penalise more efficient lenders, which get rigidly constrained. This is analogous to the reason why quotas are usually less efficient than tariffs.

To be effective, fixed liquidity ratios need to be very constraining. The risk is that in the end they will not be used precisely because they are constraining.

Consider the following analogy. Let the financial crisis be the Great Fire of London, and the Basel liquidity measures the equivalent of new prudential rules to prevent fires starting and spreading. LCRs are equivalent to demand each household to keep an bucket of water in the house. NSFRs demand that houses be built predominantly in stone, a much greater cost. It is clear which measures bind most, and which is more expensive to implement. It is not surprising, though worrisome, that NSFR are been postponed till 2018, and their definition so far remain incomplete.

The LCRs are to be introduced earlier (though not before 2015). Initially there was much confidence in an early adjustment. The funding crisis for EU banks has quickly reversed this impression, as buffers clearly need to be run down in a stress situation. This suggests that a weakening of the LCR standards is likely, e.g. via changes in the eligibility criteria for refinancing by central banks.

The NSFR ratios, which hold the most promise for macroprudential purposes, are under even greater pressure. They have been portrayed as very tight, and their introduction has been very delayed. This undermines their credibility. Collective resistance to a progressive adjustment will enable banks to argue by 2018 that implementation is unaffordable, undermining current incentives to adjust.

Regulators are already under heavy pressure. The EC in its CRD4 report has avoided any reference to the critical NSFR ratios, on the argument that their introduction is far in the future. This has caused serious concerns, leading the ECB board to demand recognition of the need to introduce the standard in the EU ratification process.
In order to be credible, the introduction of these standards needs a credible transition path, guided by a preventive approach where regulators use flexible tools to nudge adjustment.

Possible amendments to CRD4: A key choice for implementation

How to introduce prudential measures on liquidity risk which may be effective but not too onerous? and which may be introduced earlier than 2018 without disruption, and thus politically feasible?

A concrete solution would be as follows. The Basel III process has defined the required standards, which should be ratified as commonly agreed long term targets. Banks will be allowed (until some deadline) not to comply with these standards, reflecting individual or national circumstances, or business model choices. Any delayed adjustment, however, contribute to the stock of aggregate systemic liquidity risk. So banks would be charged ‘prudential risk surcharges’ on the difference between the desirable and actual ratios.

These charges would be set by national central banks. Ideally, such a step should be co-ordinated at the level of the European Union. This would justify their framing within the EU directive proposal, ensuring a critical role for the Europarliament to reshape the CRD4 proposal.

Risk charges would start quite low, certainly in the current state of confidence. They can be raised in more stable times to “nudge” banks towards the standards. This is clearly superior to allowing a full delay with no incentive to timely adjustment. Had EU central banks had such a tool in 2009-2010, they could have used it to initiate a funding shift away from vulnerable sources.

The banks which would be more affected are those with the least retail deposits, money center banks which in 2003-2007 expanded credit by relying on international wholesale funding. Besides reducing vulnerability, this change would rebalance the current bias where nonretail funding is de facto insured, but evades insurance charges.

The critical feature of ratios is that they may be adjusted counter cyclically, to stem excess growth in unstable funding. Raising charges would be much easier than adjusting ratios, as they have lower adjustment and disruption costs than quantity adjustments. They would enable individual banks to optimise over their adjustment over time. In line with Basel III, public disclosure would be delayed and limited to aggregate volumes.

The presence of the charges would ensure that

- The process of adopting the liquidity standards woul dbe moved earlier in time, strengthening supervisors ability to monitor on a constant basis the liquidity risk build up at the individual and system level.

- All banks will be induced to monitor the difference between the desired and current liquidity standing. Up to 2008, most large banks did not have a central tracking of their liquidity exposure.
- Risky strategies could be discouraged in good times without raising interest rates.
- All EU countries would subscribe to an unified convergence process, avoiding a differentiated transition regime at the national level.
- International coordination of such charges would be desirable, but uniformity is by no mean indispensable. There is no violation of the principle of level playing field, of course, if banks with different risk contributions were charged different amounts. An analogy would be with insurance premia, which differ across risk profiles.

To illustrate further this point, it is clear that it have been desirable in 2005-2007 for Spain and Ireland to have higher charges on wholesale bank borrowings than, say, Germany, where there was no credit-fuelled real estate boom. This flexibility would actually reinforce the cohesion of the Euro area, reducing the rigidity imposed by a single monetary area.

• The natural locus of coordination to set rates would be the ESRB. It would be called to comment on an (indirect) macro prudential tool, and would then gain a concrete role. This is consistent with the EuroParliament's stated preferences for a more concrete empowerment of the ESRB as a macro prudential regulator.

• Charges would accumulate in reserve funds for general financial stability purposes.