Paper Session #3: Liquidity Regulation

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The better the question. The better the answer.
The better the world works.

Building a better working world

A brief history of Basel liquidity requirements

"We also are developing benchmarks, tools and metrics that supervisors can use to promote more consistent liquidity standards for cross-border banks."

– **Dr Nout Wellink,** President of the Netherlands Bank and Chairman of the Basel Committee on Banking Supervision (March 2009)

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A brief history of Basel liquidity requirements

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“Two regulatory standards for liquidity risk which have been developed to achieve two separate but complementary objectives.”

“The first objective is to promote the short-term resiliency of the liquidity risk profile of institutions by ensuring that they have sufficient high quality liquid resources to survive an acute stress scenario lasting for one month.” ➔ **Liquidity Coverage Ratio**

“The second objective is to promote resiliency over longer-term time horizons by creating additional incentives for banks to fund their activities with more stable sources of funding on an ongoing structural basis.” ➔ **Net Stable Funding Ratio**

— **Basel Committee on Banking Supervision**: “Consultative Document International framework for liquidity risk measurement, standards and monitoring (December 2009)

Key design considerations

"The first objective is to promote the short-term resiliency of the liquidity risk profile of institutions by ensuring that they have sufficient high quality liquid resources to survive an acute stress scenario lasting for one month." ➔ **Liquidity Coverage Ratio**

Key design considerations / attributes:

- Ex ante self insurance
- Harmonized
- Firm-specific distress during period of market disruption
- Calibrated to periods of stress
- Risk sensitive
- Contractual and contingent funding sources and needs
- 'Fire sale' contagion
- Transparent
- Time consistent
- Robust to uncertainty

"Arbitrage Capital of Global Banks"
Anderson, Du and Schlusche

- ✓ Primary response of global banks to a large negative wholesale funding shock for global banks (as a result of the U.S. money market mutual fund reform implemented in 2016) was a cutback in arbitrage positions that relied on unsecured funding, rather than a reduction in loan provision
- ✓ Decline in unsecured funding directly translated into declines in excess reserve balances
- ✓ Do not find any significant evidence of a decline in banks' loan positions following large negative funding supply shock

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“Capital and Liquidity Interaction in Banking” Acosta-Smith, Arnould, Milonas and Vo

- ✓ Capital and liquidity requirements are to some extent substitutes over the period studied
- ✓ Find banks engage in less liquidity transformation when their bank-specific capital requirements increase
- ✓ If better-capitalized banks engage in less liquidity transformation, relaxing liquidity requirements could be warranted given the stricter capital requirements in Basel III
- ✓ “In a period of high liquidity stress, when uncertainty is high and the value of assets is particularly uncertain, a bank's level of capital matters less as liquidity risk increases sharply. In this case, capital and liquidity requirements should act in a more complementary fashion.”

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