Regulating under Uncertainty: The Impact of Financial Reforms on Liquidity

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Liquidity Regulation

- In the aftermath of Lehman, Central Banks have had to play a decisive role in order to avoid the implosion of the financial system.
- Next to insufficient capital buffers, consensus that *liquidity* was insufficient too.
- Reason behind Liquidity Coverage Ratio (short-term) and Net Stable Funding Ratio (more structural).
- Idea: *self-insurance* will make financial markets work better, and reduce « free-riding on Central Banks » (should not become Lenders of First Resort).

Liquidity Regulation

- Over time, several worries (esp. over LCR):
  - (long-term) lending to the real economy;
  - lower-quality assets parked at the ECB;
  - lack of usability in crisis time, due to stig-ma effect.
- Worry about *long-term lending* at first paradox-ical: for example, LCR time horizon is one month … But argument could make sense as very long-term lending will require swaps to hedge interest rate risk, which then create counterparty risk and therefore collateral requirements. Not a reason to drop LCR, but do think about long-term lending.

Liquidity Regulation

- Essential of course to have *usability* of the buffer in crisis time, otherwise we will just have managed to have (highly) liquid assets illiquid (« Goodhart taxi problem »)! Some interesting avenues (e.g. Committed Liquidity Facilities), but this key area is still largely untested.
- Beyond this, LCR is about market liquidity: *Central Bank eligibility* is Central Bank's choice … This problem and that of usability are linked: when the Eurozone is in crisis, a 100% LCR does not make sense. Explains the Basel compromise: start in 2015 with 60% rather than 100%.

Liquidity Regulation

- One potential worry: objections to LCR, often valid, have however naturally led, given the dynamics of international regulatory negotiations (where the status quo is NO liquidity regulation) to a gradual softening of the standard.
- EBA sample: average LCR in June 2013 of 104% for larger banks (instead of 83% one year earlier). Aggregate gross shortfall relative to 100% now down to 262 billion (relative to assets of 31.7 trillion). Only one bank (out of 41) under 60%.
- Be careful therefore, especially given that liquidity concerns could be heightened by the current trend towards *bail-in*.

Bail-in

- Paradox of the crisis: (i) Basel III stresses quality of capital and micro/macroprudential distinction, while (ii) current « *bailout fatigue* » has now led to « *bail-in fashion* », with a desire to vastly enlarge set of bank claimholders meant to be « held respon-sible », and this even under systemic stress.
- Explanation: politicians and public at large do not feel that Basel III requires enough capital to protect taxpayers.
- Be careful however for cost of financial instability. Relevant in particular in the EU, with BRRD.

Banking Recovery & Resolution Directive

"Other tools (than bail-in) can be used to the extent that they conform to the principles and objectives of resolution set out under the BRRD. In circumstances of *very extraordinary systemic stress*, authorities may also provide *public support* instead of imposing losses in full on private creditors. The measures would nonetheless *only become available after the bank's shareholders and creditors bear losses equivalent to 8% of the bank's liabilities* and would be subject to the applicable rules on State Aid." (FAQs on BRRD)

Banking Recovery & Resolution Directive

"Bail-in will potentially apply to any liabilities of the institution not backed by assets or collateral. It will *not apply* to *deposits protected* by a deposit guarantee scheme, short-term inter-bank lending or claims of clearing houses and payment and settlement systems (that have a remaining maturity of *seven days*), client assets, or liabilities such as salaries, pensions, or taxes. In *exceptional circumstances*, authorities *can choose to exclude* other liabilities on a case-by-case basis, if strictly necessary to ensure the continuity of critical services or to prevent widespread and disruptive *contagion* to other parts of the financial system, or if they cannot be bailed in in a reasonable timeframe." (FAQs on BRRD)

Banking Recovery & Resolution Directive

"The write down will follow the *ordinary allocation of losses and ranking in insolvency*. Equity has to absorb losses in full before any debt claim is sub-ject to write-down. *After shares and other similar instruments, it will first, if necessary, impose losses evenly on holders of subordinated debt and then evenly on senior debt-holders.*"

"*Deposits from SMEs and natural persons*, includ-ing in excess of EUR 100,000, will be *preferred over senior creditors*."

(FAQs on BRRD)

Banking Recovery & Resolution Directive

"By definition, this will depend on the systemic footprint of different institutions. *Depending on their risk profile, complexity, size, interconnected-ness, etc., all banks should maintain (subject to on-going verification by authorities), a percentage of their liabilities in the form of shares, contingent capital and other unsecured liabilities not explicitly excluded from bail-in.* The Commission, upon a review by EBA, could specify further criteria to ensure similar banks are subject to the same standards." (FAQs on BRRD)

Comments

- BRRD insists on 8% bail-in even under systemic stress, as of January 1, 2016.
- Beyond secured liabilities, it exempts very short-term debt (up to 7 days).
- It gives priority to natural persons and SMEs.
- At this point, it does not impose hard targets for bail-inable securities (« GLAC », « MREL »).
- Suggestion: think of requiring a minimum of *8% of long-run junior liabilities* (equity, hybrids and *junior* debt, or an « *extended leverage ratio* ») in order to foster financial stability.

Example of bank liabilities

Secured + very short-term liabilities	25
Retail deposits	40
Bail-inable senior liabilities	30
Junior liabilities	1.5
Capital	3.5
Total liabilities	100

- Losses for senior liabilities before a bailout can be considered: (8 – 3.5 – 1.5)/30 = 3/30 = 10%.
- ***Conclusion***: to avoid bank runs (esp. with volatile wholesale deposits), better to increase junior liabi-lities to 4.5. Instead, *including senior claims in MREL /GLAC does NOT protect other claimholders* !

Conclusion

- Aversion to bailouts understandable: taxpayer money, moral hazard, …
- Remember however the cost of financial instability: the *costliest* bank failure for taxpayers in last 10 years was Lehman, *despite lack of bail-out*, while TARP bailout has *almost been fully repaid* (more than 400 Billion $ out of 428).
- Remember also that « orderly » resolution will not prevent depositors from running if they can and feel their money is at risk.
- This requires: (i) sufficient liquidity buffers, and (ii) sufficient long-term junior claims to absorb bail-in, reassure senior claimholders (and *limit need for LOLR*!)