Bank Liquidity and Funding: Reform and Regulation

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15 March 2010

Australian banks have expressed disquiet about new liquidity requirements proposed by the Australian Prudential Regulation Authority (APRA) and by the Basel Committee. APRA had released a consultation paper about its proposals in September 2009 with an expected implementation date of around mid 2010, but announced in December that the implementation date would now be mid 2011 to better match that contained in the Basel Committee's new proposal.

The proposals involve two key requirements. The first is that, essentially, banks will have to hold more liquid assets such as Government debt. APRA proposed a more restricted definition of liquid assets to those which can be used in normal repo transactions with the RBA (such as Government Debt) and increasing the length of the time period used in assessing whether a bank can cope with adverse circumstances leading to deposit outflows. In the Basel consultation document this is referred to as a *liquidity coverage (LC)* ratio.

The second requirement proposed by the Basel Committee involves a *net stable funding (NSF)* ratio. The standard will require banks to have some minimum proportion of long term stable funding over a one year horizon, based on an assessment of the liquidity of assets and contingent liabilities.

These proposals address the failings in bank liquidity management which became apparent in the Global Financial Crisis. Modern bank liquidity management had moved away from holdings of central bank deposits (cash) and government securities. Instead, banks (both commercial and investment) held marketable private sector securities which they assumed could be sold into deep and liquid markets to raise cash if needed. They also relied extensively on short-term capital markets funding (liability management) to be able to raise new funds to meet outflows of deposits or other funds.

These practices were particularly apparent for the off-balance-sheet activities of banks involving Structured Investment Vehicles (SIVs) and conduits, and in Investment Bank funding. The SIVs held medium-long term assets such as CDOs and other asset backed paper which was funded by rolling over short-term commercial paper. In the crisis, the markets for the assets froze (preventing their sale) and funding from commercial paper markets dried up. The bank sponsors of these vehicles were thus required to provide liquidity, stressing their own balance sheets.

The investment banks took these practices to the limit, relying on short term funding through activities such as repurchase agreements (repos). Securities would be bought and financed by a repo involving sale and agreed future repurchase of those securities to a third party – effectively a short term loan secured by the securities involved. In the crisis, the repo counterparties (lenders) were unwilling to continue to extend credit, and made margin calls, forcing the investment banks to try and sell securities into a falling market.

These examples illustrate the dual liquidity problems facing banks of “funding” risk and “asset price” risk – risks which are highly intertwined. By requiring banks to meet an NSF ratio requirement, the Basel proposals are designed to limit the funding risk element. The LC ratio requirement should mean that asset price risk is reduced because the markets for the high quality government securities which banks will hold are less subject to the disruption experienced by the markets for private sector securities.

The disquiet expressed by the Australian banks in response to such proposals is based on a number of factors.

First, it is argued that the Australian banking sector did not experience the same liquidity crisis experienced elsewhere. And while that is true, it is also true that inter-bank liquidity tightened significantly, with all banks increasing their holdings of Exchange Settlement Accounts at the Reserve Bank very significantly. And while banks continued to lend to each other overnight at the target cash rate set by the RBA, spreads for longer term loans increased significantly. And finally, the RBA acted pro-actively and speedily to widen the range of private sector securities which it would accept in its repo transactions – thus increasing the secondary market liquidity of such assets and providing a liquidity safety valve. One consequence of that change was to encourage the major Australian banks to convert on-balance sheet loans into mortgage backed securities which were held on-balance sheet to make them eligible for use in repo transactions with the RBA.

A second response has been to claim that a requirement that forces banks to hold a larger proportion of their assets in government securities will increase the cost of banking – because the returns on such assets are lower than those available on private sector lending. Banks would thus need to charge higher loan interest rates to customers to restore profitability. This argument is based on a blinkered perspective which assumes that the scale of bank balance sheets does not change when the requirement is introduced. It is a myopic view which ignores the system wide effects.

To illustrate, consider the case where a bank buys government securities from a superannuation fund to bolster its liquidity holdings. Because bank deposits are the means of payment for society, the net outcome is that banks, in aggregate, have an increase in deposit liabilities (to the superannuation fund seller of securities) and an increase in government security asset holdings. Only if the cost of those additional deposit liabilities exceed the return on government securities does this involve a net cost to the banks.

A third response has been that there are not enough government securities available to meet the liquidity requirements which the banks would face. There is some merit in that claim, with the Australian government bond market being very small due to years of government budget surpluses prior to the GFC. And even though the Federal Government budget has moved into deficit (due to the GFC effects on the real economy and the fiscal stimulus applied by the Government), there does not appear to be significant expansion of the available stock of government debt in prospect.

But there are many other possible securities available – although the *LC* requirement might need adapting to include them. Australian banks, for example, have issued very substantial amounts of bonds into domestic and international markets using the government guarantee facility. Such bonds, being government guaranteed, should be acceptable as liquid asset holdings (whereby one bank holds as an asset the government guaranteed bonds issued by another bank). Over, at least, the next few years this provides an additional source of liquid asset holdings. Longer term, the Kangaroo Bond market provides another possible source of high quality liquid assets, with overseas governments and multinational agencies issuing AUD bonds in Australia.

The other area where the liquidity requirements will have significant impact for Australian banks is in the *NSF* requirement. Australian banks rely extensively on offshore capital markets funding - although much of this is for longer term funds. Given the disruptions in international capital markets experienced in the GFC, there are concerns about the financial stability implications of this, and the banks themselves have attempted to reorient their funding more to domestic retail deposit markets. But the scope for much success there is limited.

What may happen (and the future is always hazardous to predict) is that the Australian banks might move someway towards a different intermediation model. Currently, the major banks effectively fund Australia's large and longstanding balance of payments current account deficit by borrowing offshore – and then lending on-balance sheet to Australian companies. Very few of those companies issue debt themselves in the international market – and much less so than in comparable countries internationally. For the large banks with significant securities origination, distribution and underwriting capacity, the option of generating fee income by taking Australian companies to the international debt markets to issue their own paper (rather than the current practice of the banks borrowing to on-lend) is one way of changing their funding mix. And if the credit rating or investor recognition of the Australian companies is inadequate, bank guarantees could be provided (for a fee) to make the securities more attractive to international investors.

There are other risks in such a scenario – but the GFC has provided such a shock to the global financial system that the financing mechanisms of the recent decades warrant re-examination and new scenarios careful consideration.