

BASEL III, BANK LIQUIDITY AND BUSINESS MODELS

Paper written by Bill Allen, Senior Associate Consultant Adsatis Ltd

EXECUTIVE SUMMARY

Basel III introduces for the first time internationally-agreed minimum liquidity requirements for commercial banks. They are likely to have profound implications for banks' business models. The changes in bank behaviour that have been enforced by the drying-up of market liquidity since the onset of the crisis are likely to be made permanent.

In our view, the new requirements are seriously flawed in one important respect (the proposal to weight the definition of liquid assets towards government debt and other public liabilities) and could aggravate rather than prevent financial instability in the future. In our view, this definition should be extended to include high quality private sector assets. Also, central banks should make contingency plans for managing future crises and publish the details, rather than continuing to practise 'constructive ambiguity'.

This paper is written to contribute to the debate on Basel III proposals and is primarily the work of the author, incorporating analysis and views from Adsatis consultants and feedback from senior bankers. Adsatis is happy to discuss any of the issues raised by respondents. The company is a specialist finance market consultancy and undertakes strategy and advisory consultancy for leading organisations in the industry.

BACKGROUND

The objectives of the Basel III liquidity proposals are clear:

1. to increase the amount of liquid assets held by banks and reduce their reliance on short-term wholesale funding
2. to limit the extent to which banks can perform maturity transformation.

In order to achieve these objectives, the proposals will force banks to retreat from the business model that was widely adopted in the UK and many developed economies in the 1970s and 1980s after various forms of credit rationing were abandoned. The abolition of credit controls in the 1970s enabled banks to decide for themselves what their total assets should be, and many of them adopted a 'liability management' model, in which marginal liabilities, to finance whatever assets the banks had chosen to acquire, were obtained from liquid wholesale markets.

The financial crisis has exposed the limits of liability management and the proposed regulation will make the retreat from liability management permanent. Banks will be forced back towards 'asset management', in other words towards a business model in which balance sheet size is determined from the liabilities side of the balance sheet, by the amount of funding which the bank can raise, and in which asset totals

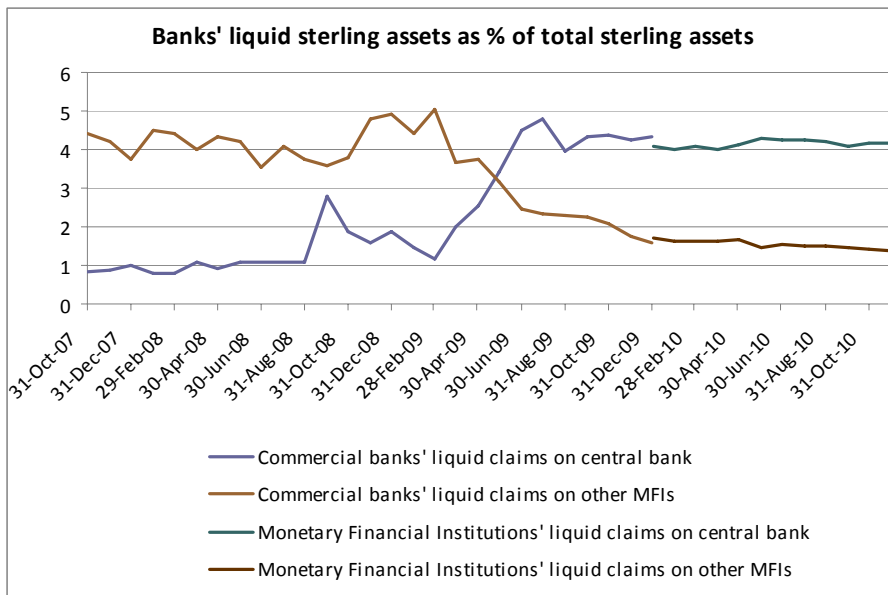
have to be adjusted to meet the available liabilities. This amounts to a ‘macro-prudential’ policy – that is, a policy designed to prevent credit creation from ‘getting out of hand’ as it did in the run-up to the recent crisis.

This report analyses the ways in which the funding and liquidity management, not only of banks but also of their customers, will be permanently affected by the Liquidity Coverage Ratio. It makes no comment on whether it is desirable to regulate bank liquidity by setting minimum liquid asset ratios, since such regulation seems inevitable.

THE LIQUIDITY PROPOSALS

Several particular aspects of the proposals are crucially important.

First, the Liquidity Coverage Ratio will require banks to hold 100% liquid asset coverage against net cash outflows over the next 30 days in a hypothetical stressed situation. In the hypothetical situation, it is assumed that no unsecured interbank deposits, and no repo financing, except of government securities, would be renewed. Therefore banks will have to hold 100% liquid assets against any unsecured interbank deposit liability. Unsecured inter-bank borrowing for maturities of less than a month will be uneconomic and the market is likely to atrophy (see graph below for evidence that this is already happening)



Even at longer maturities, borrowers will have to allow for the need to hold 100% liquid assets against the liability once its residual maturity falls to 30 days, and market activity at these maturities is likely to decrease greatly. The same applies to repo activity except in liquid assets.

Some banks think that the Basel III minimum liquidity requirements as set out by the Basel Committee could be less stringent than the current rules applied by the FSA.

Second, the Liquidity Coverage Ratio will also require banks to hold 100% liquid asset coverage against liquidity commitments (e.g. back-up lines) made to non-financial corporate and other customers. These include facilities granted to support financing vehicles such as asset-backed commercial paper and other security issues. As a result banks will no longer be able to provide such facilities and liability management for banks' customers will also become more difficult.

Third, the proposed definition of liquid assets is heavily weighted towards government securities and other liabilities of the public sector, such as deposits in the central bank (there are alternative arrangements for countries where government securities are scarce). Some claims on the private sector will be considered, such as corporate bonds and covered bonds, but subject to minimum haircuts of 15% and a number of other conditions such as 'proven record as a reliable source of liquidity in the markets (repo and sale) even during stressed market conditions'. The conditions are drawn so tightly that it seems unlikely that a large volume of claims on the private sector would be eligible, at least initially; more important, the supply of eligible claims on the private sector could not be expanded quickly at a time of liquidity pressure because of the need for a 'proven record', which would necessarily take time to establish and because it might also take time to meet some of the other conditions.

With the proposed definition of eligible liquid assets, bank liquidity will be heavily concentrated in government securities. This is likely to have the following consequences, all of them undesirable.

1. Banks will be practically obliged to maintain large-scale credit exposures to governments. Governments will therefore be partly exempted from normal market tests of creditworthiness. This is a privilege which governments in many countries have abused in the past, when they have possessed it. There are also associated risks given the current extremely high levels of government debt and ongoing concern about the creditworthiness of a growing list of countries.
2. The market for government securities, particularly at the short end, will be distorted by inelastic demand from banks. Liquidity in the market will deteriorate, because large amounts will be locked up in the banks' liquidity portfolios.
3. If a government lost creditworthiness and its debt lost its 0% weighting for Basel II purposes, then its securities would suddenly become ineligible to be counted as liquid assets. Banks holding them would find that they had both lost both market value and liquidity at the same time. Such an event would seriously aggravate the risk of financial instability that the deterioration of government credit would have caused in any case.
4. The pressures on central banks to monetise the debts of governments which get into financial difficulty will be much more intense than they would have been if commercial banks were not obliged to hold government securities to meet liquid asset requirements.

MARKET IMPACT

The concentration of commercial banks' liquid assets on government securities, which the proposed liquidity regulation mandates, is therefore destabilising and extremely dangerous. The only way to overcome this serious defect in the proposal is to enlarge greatly the opportunities for liquid assets to be created out of the banks' claims on the private sector. The admission as acceptable liquid assets of short-term trade-related commercial loans, such as commercial bills of exchange (see appendix) is one promising way forward, and other corporate debt instruments could also be considered.

Banks need sources of liquidity to enable them to accommodate fluctuations in their cash flow, in addition to meeting whatever liquidity requirements are imposed on them by regulators. Until the financial crisis, much of the required liquidity came from the unsecured inter-bank deposit market, but the interbank market is now heavily tiered, and, as explained above, it is unlikely to be able to provide much liquidity in the future. Instead, liquidity will have to come from the assets side of the balance sheet. Since the financial crisis, deposits at the Bank of England (for example) have become UK banks' main source of liquidity, but the Bank of England's balance sheet is abnormally large at present. This situation appears to have been replicated in other countries. If the Bank's balance sheet is to shrink, commercial banks will need other kinds of assets which they can trade with each other so as to provide liquidity.

A POTENTIAL SOLUTION

The need for liquid assets has existed for many decades. Short-term bills of exchange representing self-liquidating transactions, whose conclusion will generate the funds necessary to redeem the bill, represent precisely the kind of instrument that banks will need in the world of Basel III. Moreover, they represent a form of liquid asset that banks can generate from their own operations with their commercial customers and that does not indirectly subsidise government borrowing. Additionally, they provide a flexible source of financing for bank customers. The Bank of England has recently been unwilling to contemplate accepting commercial bills as collateral for loans, though it routinely accepted them until 2006. Nevertheless, there is no reason why commercial banks should not trade commercial bills as liquid assets among themselves, so as to economise on short-term gilts and balances with the central bank, which will have relatively low yields.

MANAGING FUTURE CRISES

What will be the function of the liquidity regulators in the world of Basel III? In normal times, their functions would include ensuring that the commercial assets which the banks were using to satisfy their liquidity requirements met required minimum standards of liquidity. In addition, the financial stability authorities would also need to develop a contingency plan for dealing with a liquidity crisis, which would necessarily involve:

1. the regulators being ready to reduce minimum liquid asset ratios promptly to enable liquidity to be used when it was needed.
2. the central bank being ready to purchase eligible liquid assets without stigmatising the seller as a weak bank.

In our view, the contingency plan should be published. Central banks have traditionally followed a policy of 'constructive ambiguity' in public statements about emergency liquidity provision, for fear of creating moral hazard by offering reassurance that liquidity would be provided in case of need. However it has been obvious during the crisis that central banks have no option in situations of financial instability but to provide liquidity where it is needed, willingly or unwillingly. So there is no ambiguity left. At the same time, if one of the purposes of the central bank is to provide liquidity insurance, it is surely reasonable for the public to know what the terms of the insurance are. To be more specific, a commercial bank which wanted to reduce to zero the risk that it would at some point become illiquid would need to hold 100% of its assets in currency, and charge customers heavily for the services it provided in taking deposits, unless it knew the circumstances in which emergency liquidity would be provided. Any more adventurous investment policy would involve liquidity risk. It has long been thought desirable for banks to accept some liquidity risk, even if the risks taken have been excessive in recent years. Coherent risk management on the part of commercial banks is impossible if the intentions of the provider of emergency liquidity are undisclosed.

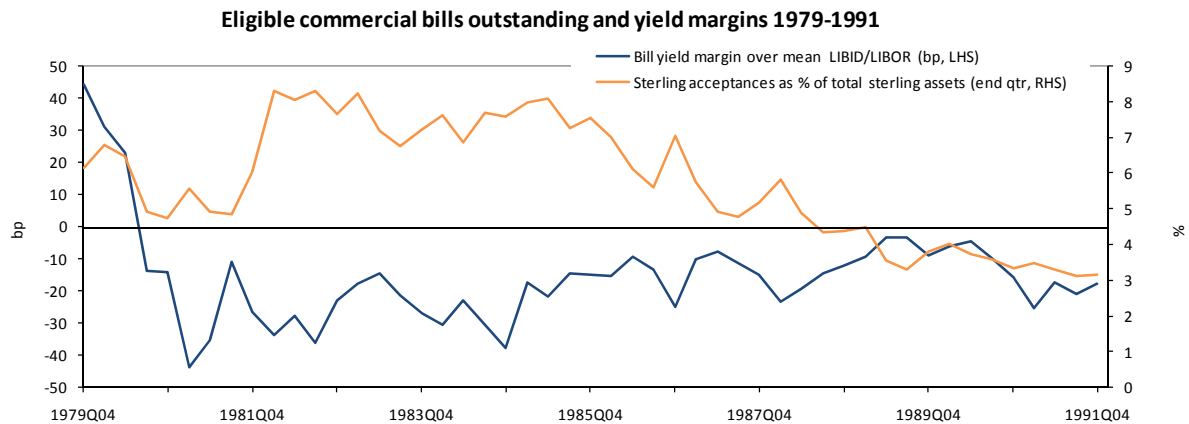
APPENDIX COMMERCIAL BILLS OF EXCHANGE

According to section 3 of the Bills of Exchange Act 1882,

A bill of exchange is an unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand or at a fixed or determinable future time a sum certain in money to or to the order of a specified person, or to bearer.

The person who gives the order is called the drawer. The person thereby required to pay is called the drawee. If he assents to the order, he is then called the acceptor. An acceptance must be in writing and must be signed by the drawee. The mere signature of the drawee is sufficient (section 17). The person to whom the money is payable is called the payee.

Bills of exchange have been used to finance commercial transactions since the middle ages. Some kinds of bills of exchange have inherent liquidity, in that they are financing vehicles for transactions that will be completed by the time that the bill matures, and which, when completed, will generate the funds needed to redeem the bill.



Source: Bank of England Quarterly Bulletin, various issues, table 3.1 (quantities), Bank of England Statistical Interactive Database and authors' calculations

For example, bills of exchange have been used to finance the transport of goods from the place where they were produced to the place where they are sold. The producer gets value for the goods (from the buyer of the bill) when he parts with them, while the buyer pays for them when he gets them. The sale proceeds finance the redemption of the bill. Bills can be accepted by bankers to enhance their credit quality. By accepting a bill, the banker takes on the liability for payment if the drawee fails.

It would be a mistake to think of commercial bills as a historical curiosity of no modern practical importance. In the early 1980s, the volume of commercial bills increased massively, stimulated by purchases by the Bank of England which were a consequence of the policy of overfunding the government budget deficit which it was then pursuing. This is illustrated in the graph, which shows the volume of eligible commercial bills outstanding as a percentage of the Banks' total sterling assets and the average differential between commercial bill yields and the LIMEAN.

The quantity of eligible commercial bills outstanding increased from 4.6% of commercial banks' total sterling assets in 1981 Q3 to 8.2% in 1982 Q2. The yield differential required to generate this additional volume of commercial bills was fairly modest, as the graph shows. This episode demonstrates the banks' ability to generate large quantities of high-quality liquid assets from their loan portfolios.