Regulators' high-wire act

The recent easing of the Basel III liquidity coverage ratio is welcome, but highlights the difficult – perhaps impossible – regulatory challenge of striking the right balance in a world of too-big-to-fail banks, writes ***David Rowe***

The difficulty regulators face in balancing bank safety and soundness against credit supply and economic growth first became a practical reality for me in 1987. The first Basel capital accord was coming into effect in January 1988 and banks were busily trying to comply. Many of their customers, meanwhile, were complaining about a credit squeeze in which even good, established borrowers were having problems. A colleague pointed out that these two developments were directly related, and the arithmetic is obvious when you think about it. A bank can raise capital-to-asset ratios in two ways – it can increase capital or reduce assets. At the time, many banks were clearly finding it necessary to restrict lending and reduce their total loan assets as part of their strategy to bring themselves into compliance.

In the aftermath of the searing crisis of September 2008, many politicians and casual observers seemed to have lost sight of this inherent conflict. When Basel III appeared in December 2010, it included proposals that would sharply increase holdings of liquid assets to cover stress-level net outflows from banks – the liquidity coverage ratio (LCR). These proposals came in addition to significant increases in the amount and quality of bank capital. At the same time, politicians were screaming about the failure of the banking industry to lend enough to support economic recovery.

Something had to give and, in January, it did. After two years of pressure from the banks and other critics, the Basel Committee on Banking Supervision considerably eased the terms of the LCR and gave banks a phased-in implementation timeline.

The basic idea behind the LCR is to ensure banks hold enough high-quality liquid assets to meet potential net cash outflows over a 30-day period even in a crisis. The original proposal allowed little more than central bank reserves and government bonds to be counted as liquid assets. The new rule expands the range of eligible assets while, not surprisingly, introducing yet another layer of complexity. It defines three categories of assets: level 1, level 2A and level 2B.

Level 1 assets are essentially cash and official obligations assigned a zero risk weight in the Basel II standardised approach.

David Rowe is president of David M Rowe Risk Advisory, a risk management consulting firm. Email: davidmrowe@dmrra.com

Level 2A and 2B assets may include lower-grade official obligations, corporate bonds rated as low as BBB– subject to different haircuts depending on their credit ratings, simple residential mortgage-backed securities rated AA or better (excluding structured products) and even certain equities subject to a 50% haircut.

Other provisions deal with the added risk of exchange rate fluctuations for liquid assets that are not denominated in the bank's home currency.

The terms for calculating the potential net cash outflow were also eased. For so-called stable deposits, specific jurisdictions can lower the 30-day run-off assumption from 5% to 3%, provided that the national deposit insurance programme meets certain requirements and historical evidence can demonstrate a 30-day run-off of less than 3% under past periods consistent with the conditions specified in the LCR. Less stable deposits are subject to 30-day run-off assumptions of 10% or higher as determined by national supervisors.

Finally, implementation is to be phased in, starting with 60% of the full requirement in 2015, rising to 100% in 2019.

Needless to say, all these provisions will be subject to endless wrangling between banks and their national supervisors. How does an instrument qualify as being "traded in large, deep and active repo or cash markets"? What makes a deposit stable or less stable?

More to the point, how can we be sure that supervisors will consistently strike the right balance between bank safety versus the socially essential functions of intermediation and maturity transformation? The simple answer is we cannot be certain of this. In fact, the very complexity of the regulations within which this balance must be struck virtually ensures that institutional momentum – both in the banks and the supervisory authorities – will be the dominant force.

As long as we continue to act as if bank failure is not an option, we cannot rely on the fear of failure as a disciplining force. Furthermore, the attempt to eliminate the risk of failure by uniform and highly complex regulatory requirements actually promotes a degree of institutional homogeneity that is conducive to systemic crises.

I am pleased that the Basel Committee has eased the terms of the LCR. The original proposal would very likely have prolonged the already painfully slow process of economic recovery. I remain completely unconvinced, however, that this continuing exercise in financial casuistry will do much, if anything, to prevent a future systemic crisis. ■