Regulation has to come to terms with the endogenous nature of liquidity

by Wolf Wagner

Liquidity has the unpleasant habit of vanishing when it is needed most. This column argues that liquidity requirements for banks have the potential to worsen this problem. The recent decision of the Basel committee to broaden the set of assets eligible for the liquidity coverage ratio (LCR) alleviates some of the issues – but more work is needed.

Capital and liquidity are two very different animals. Capital that has been put by shareholders into banks is readily available as a buffer against losses when a crisis hits. It is thus a foregone conclusion that requiring banks to hold minimum levels of capital increases their safety. By contrast, assets acquired by banks when fairly liquid are no longer necessarily so in times of stress. For example, during the crisis of 2007-2008, many assets become effectively untradeable. The reason behind the endogenous nature of liquidity is that in order to be able to sell an asset at a reasonable price, there has to be a sufficient number of *potential buyers relative to sellers* at the time of sale. This makes the case for liquidity requirements less straightforward. In particular, I argue that liquidity regulation tends, in crises, to affect both sellers and buyers of assets, with potentially unwelcome consequences.

First, there is the problem of correlated liquidations. If liquidity requirements demand that banks hold similar assets as liquidity buffers, a significant proportion of the stock of these assets would be liquidated in a systemic event, rendering them illiquid. The Basel committee's move to broaden the set of eligible assets (coupled with appropriate haircuts) is to be welcomed in this respect. When banks can hold a variety of liquid assets, this will result in a greater diversity in the type of assets being liquidated. This limits the "selling pressure" in each individual asset class.[1]

Liquidity requirements will also affect the potential buyers of eligible assets. Liquidity needs frequent trading of assets, such that information about them becomes widespread. However, when assets gather dust on the balance sheet of banks, fewer investors acquire information about these assets, making them less ready buyers. Liquidity requirements may thus ultimately

[1] The benefits of diversity in reducing systemic risk has been emphasized in Wagner (2011) and Goodhart and Wagner (2012).

reduce liquidity! Again, this issue can be alleviated by allowing banks to hold a range of assets as liquidity buffers, such that within each asset class the effect remains limited.

Liquidity regulation also runs up against the fact that the stock of potentially liquid assets is limited (several commentators have argued that there is currently a shortage of safe assets in the world financial system). If banks are forced to hold more of them, other players in the financial system will hold fewer. In the end, liquidity requirements only redistribute liquidity in the financial system! And if liquidity played a useful role for its previous holder, it is unclear whether this ultimately helps financial stability. In particular, liquidation regulation at banks will tend to make the unregulated part of the financial system more illiquid and hence more fragile. In addition, liquidity regulation will also reduce the pool of liquidity outside the banking system that can be used to acquire bank assets in a crisis. Thus, while increasing the share of liquid assets at banks, it may make other parts of banks' balance sheets less liquid by reducing the potential for investors to buy bank assets. This suggests that assets eligible for the liquidity coverage ratio should as much as possible come from agents that are unlikely providers of liquidity to banks in a crisis.[2] Broadening the set of eligible assets to include equity and corporate bonds is hence a good idea as it draws in liquidity from mutual funds and private investors -- who are significant holders of such assets.

Finally, liquidity regulation also affects the ultimate provider of liquidity: central banks. Many of the assets that can be counted as liquidity buffers are eligible as collateral at central banks. Central banks may hence still be the marginal source of liquidity in crisis times, an outcome the LCR was intended to avoid. This issue has been recognized by the Basel committee and more work is planned on this issue. It will be interesting to see how this dilemma is resolved.

In conclusion, the discussion on liquidity requirements largely ignores the endogenous nature of liquidity. This could prove costly if systemic liquidity problems materialize in the financial system. More thought needs to be given to the systemic implications of liquidity regulation in order to arrive at regulation that truly enhances financial stability.

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[2] In Kahn and Wagner (2012) we analyze the impact of liquidity regulation at banks on the provision of liquidity from outside the banking system in crisis. The analysis shows that the overall effect depends crucially on the type of institution (or investors) banks are raising liquidity from.

References.

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