Federal Reserve Staff Presentation
March 25-27, 2012

Participants: William R. Nelson (Federal Reserve Board)

Representatives from various regulatory authorities and financial institutions, including: Reserve Bank of Australia; Australian Prudential Regulation Authority; Commonwealth Bank; Bangladesh Bank; Office of the Superintendent of Financial Institutions Canada; People's Bank of China; China Banking Regulatory Commission; Hong Kong Monetary Authority; Standard Chartered Bank (Hong Kong) Limited; KPMG; Bank for International Settlements; PT. Bank CIMV Niaga Tbk; Bank of Japan; Financial Services Agency Japan; Sumitomo Mitsui Banking Corporation; Mitsubishi UFJ Financial Group, Inc.; Mizuho Corporate Bank, Ltd.; Bank of Korea; Financial Supervisory Service Korea; KB Kookmin Bank; Monetary Authority of Macao; Bank Negara Malaysia; RHB Bank Bhd; Nepal Rastra Bank; Reserve Bank of New Zealand; Bangko Sentral ng Pilipinas; Bank of the Philippine Islands; Monetary Authority of Singapore; Sveriges Riksbank; Bank of Thailand; Bangkok Bank PCL; Kasikorn Bank (Public) Co., Ltd.; UK Financial Services Authority; HSBC Holdings plc; Federal Deposit Insurance Corporation; University of Chicago; and the Federal Reserve Bank of New York.

Summary: Staff of the Federal Reserve Board participated in a conference organized jointly by the Executives' Meeting of East Asia-Pacific Central Banks, Working Group on Banking Supervision (EMEAP-WGBS), a cooperative group of central banks in the East Asia and Pacific region; and the Financial Stability Institute (FSI), a group created by the Bank for International Settlements and the Basel Committee on Banking Supervision. The conference was hosted by the Bank of Thailand. As part of a panel discussion, staff discussed the potential for increasing financial stability through liquidity regulation. Among the topics covered as part of this discussion were the liquidity requirements proposed under Basel III, which included a brief discussion of liquidity coverage and net stable funding ratios. A copy of the presentation is attached to this summary.

Remarks at "High-Level Meeting on Current Initiatives to Promote Financial Stability and Enhance Supervision"

William Nelson*
Federal Reserve Board
27 March 2012 – Bangkok, Thailand

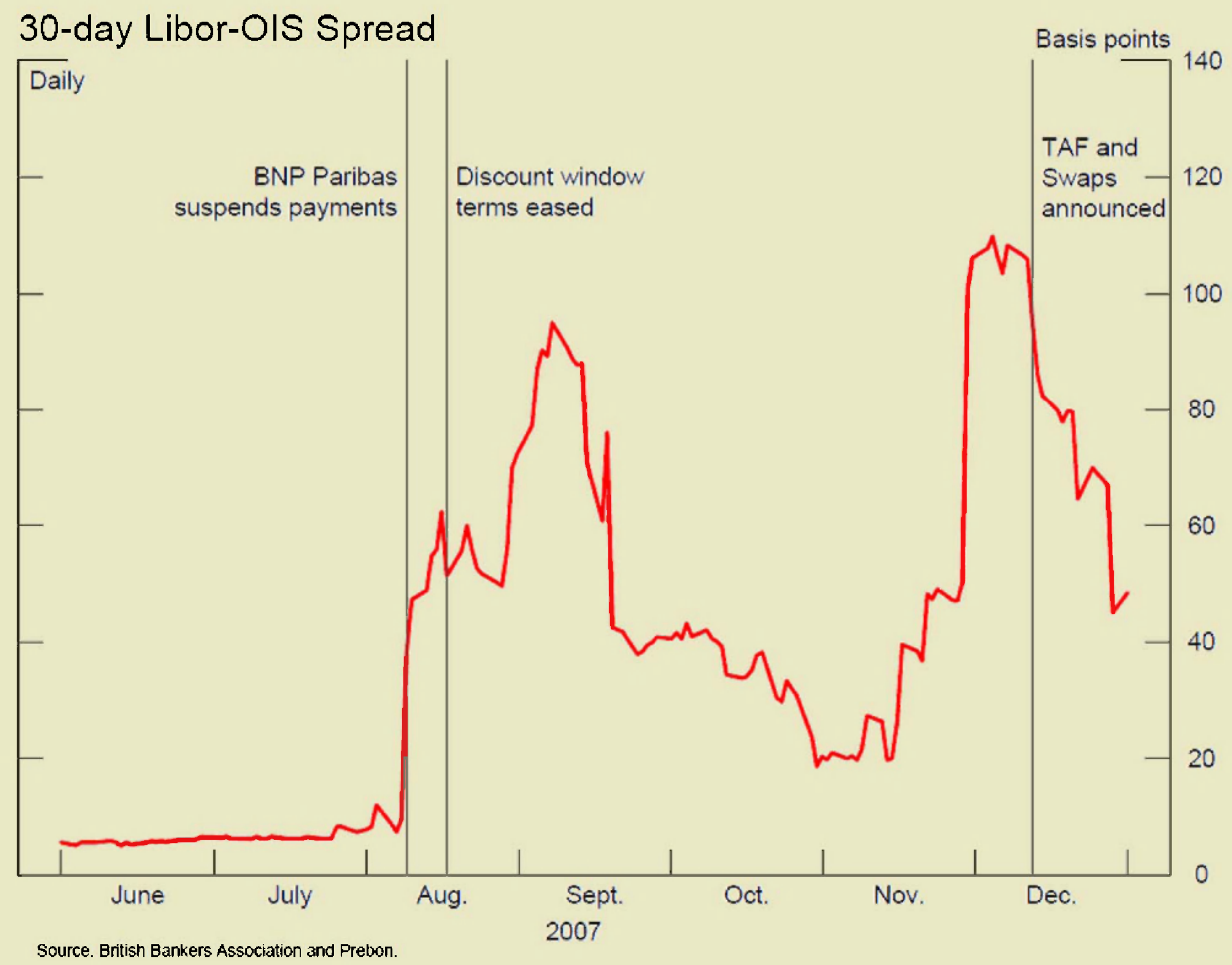
How can liquidity regulations increase financial stability?

** The views expressed are my own and not necessarily those of the officials or staff of the Board of Governors of the Federal Reserve System.*

Outline

- What are the characteristics of an aggregate liquidity shock?
- How can liquidity regulations make the financial system more resilient to a liquidity shock?
- Can liquidity regulations replace a lender of last resort?
- Update on current evaluation of the LCR's treatment of central bank lending.

Characteristics of a liquidity shock



Characteristics of a liquidity shock

- Banks became more uncertain about their funding needs and their ability to meet such needs at reasonable costs.
- As a result, they became exceptionally cautious in their liquidity management.
- Term spreads widened sharply, term money-market lending dried up, borrowing became concentrated at the overnight maturity.
- Banks became less willing to provide credit, downward spiral ensued.

How can liquidity regulation make a financial system more resilient?

- Liquidity regulation can increase banks' confidence in their own and their counterparties' liquidity situation.
- By…
  - Ensuring banks have robust stockpiles of reliably liquid assets.
- But…
  - Banks need to be able to use the liquid asset stockpile.

Ensuring banks have robust stockpiles of liquid assets

- Basel III includes two new liquidity requirements
  - Liquidity coverage ratio (LCR) (beginning 2015)
  - Net stable funding ratio (NSFR) (beginning 2018)
- Liquidity Coverage Ratio (LCR)
  - Banks must hold liquid assets to cover 30 day net outflow under stress conditions.
  - LCR = liquid assets/net outflow ≥ 1
- Net Stable Funding Ratio
  - Banks have sources of funding that will cover funding needs after one year of stress.

Making liquid asset stockpiles usable

- The regulations currently state that the LCR should be kept at or above 1 continuously.
- More robust stockpiles of liquid assets can only prevent fire sales and liquidity hoarding in a stress event if those stockpiles can be used.
- Regulation is being revised to indicate buffers are intended to be used in stress situations.

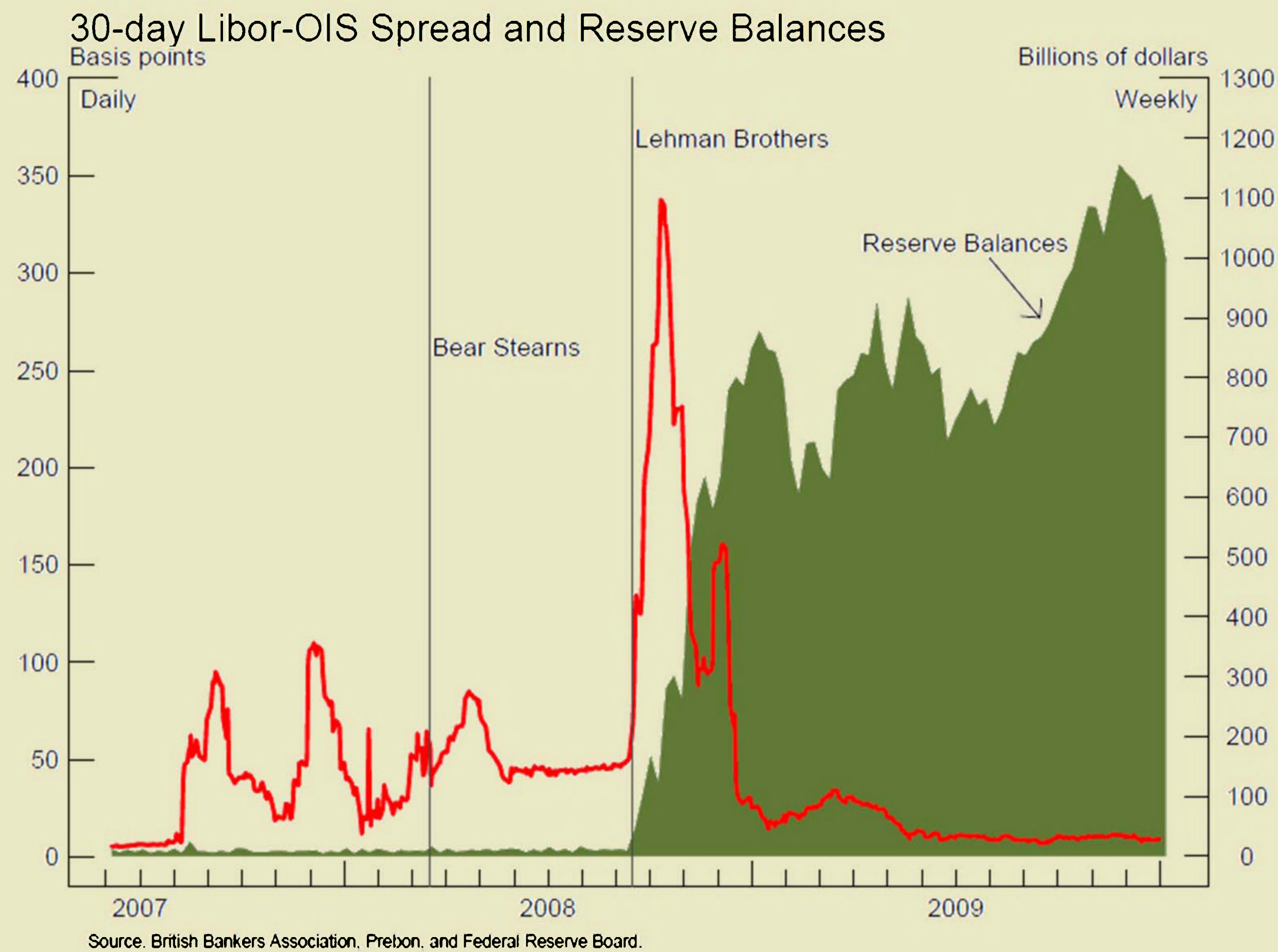
Challenges for making pools of liquid assets usable

1. It is difficult to allow liquid asset stockpiles to be used and also increase confidence by ensuring the stockpiles are robust.
2. Banks may not be willing to draw down stockpiles at a time of heightened liquidity concerns.
3. Selling liquid assets to pay off short-term uninsured creditors can raise government resolution costs if the bank fails.

Can liquidity regulations replace a lender of last resort?

- The Federal Reserve was created in part because reserve requirements did not prevent financial panics.
- In a financial crisis, the demand for liquid assets goes up sharply.
- By buying, or lending against, illiquid assets, the central bank increases the supply of liquid assets.

Central banks increase the supply of liquid assets in a crisis



Central banks ease terms on standing loan facilities in a crisis

- By easing terms, central banks make backup funding more reliable and less costly.
  - Reducing banks' liquidity concerns.
- Eased terms on back up funding would support banks' making use of their liquid asset stockpiles.
- But…banks have to be willing to borrow!
- Important supervisory message: being prepared to borrow from, and *appropriate* borrowing from, the central bank is desirable.

LCR's treatment of central bank lending (1)

- LCR applies 75 percent rollover rate on maturing central bank loans made against illiquid collateral.
  - Generating a cash outflow equal to 25 percent of the loan.
- No credit is given for unused borrowing capacity.
- Central bank eligibility is a desirable but not a sufficient nor necessary criteria for liquid assets.

LCR's treatment of central bank lending (2)

- Establishes level playing field and limits moral hazard.
- But…
  - May not accurately measure liquidity situation of banks.
  - Could hamper ability of central bank to provide liquidity effectively in a crisis.

Should LCR's treatment of central bank lending be changed?

- Issue considered by Committee on the Global Financial System (CGFS) and the Basel Committee on Banking Supervision (BCBS).
  - But there are still a range of views.
- The Economic Consultative Committee (ECC) formed a work group in January to consider possible adjustments.
  - The group has agreed on principles to guide appropriate treatment.
  - The group is currently discussing whether to recommend any specific changes.

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