Jean-Paul Redouin: Liquidity and transformation

Speech by Mr Jean-Paul Redouin, Deputy Governor of the Bank of France, at the General Meeting of the French Association of Bank Treasurers (AFTB), Paris, 30 May 2011.

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Ladies and gentlemen,

It is a great pleasure for me to speak at this General Meeting of the AFTB. I would like to take this opportunity to welcome the successful cooperation that has been established between your association and the Banque de France. It is extremely beneficial for us and I believe that you and your institutions also find it valuable.

In many respects, bank and market liquidity is a fascinating area because few phenomena have been perceived in such different ways over such a short period of time. Indeed, market liquidity became abundant and cheap in the 1980s: financial markets deepened and transaction costs fell. In the 1990s, the growth of derivatives products facilitated the management and transfer of risk. In the following decade and up to 2006, many studies had already focused on excess liquidity. Then, during the financial crisis of 2007–2008, sources of bank funding suddenly dried up. I would like to highlight some conclusions that can be drawn from this crisis:

– First, the crisis reminded us that not only does liquidity have a price and that this price could fluctuate greatly, but above all that liquidity cannot be taken for granted, irrespective of the price that some market participants are willing to pay;

– Second, central banks rapidly and efficiently adjusted their operational frameworks to provide liquidity to the financial system, re-establish the normal functioning of the money market and restore confidence. But such measures must naturally remain exceptional, and central banks must be vigilant about the signals and incentives they give to the financial system.

– Third, due to its magnitude, the crisis has highlighted the risks associated with excessive maturity transformation when long-term assets are funded by short-term liabilities, or even funded overnight. This raises questions regarding both interest rate risk management and liquidity risk management. While these are distinct areas, they have close linkages. It is important not to have a short memory and relegate all this to ancient history. Indeed, at present, in an environment of ongoing extremely low interest rates, it is still possible to fund long-term assets at very low cost, with the risk of creating further asset price bubbles. In this respect, the example of the real estate sector seems telling. Housing loans have become highly important commercial product and could prompt certain institutions to slash their profit margins in order to win customer loyalty. Yet, such practices contribute to rapidly pushing up property prices.

Thus, having observed that liquidity can disappear very rapidly, that central bank intervention must remain exceptional and that excessive maturity transformation increases systemic risk, a preventive approach is called for. Such an approach should take into account two aspects:

– I will start by discussing Basel III liquidity regulation, while stressing the fundamental goal: reducing liquidity risk and limiting maturity transformation.

– Nevertheless, whatever changes are made to the regulatory framework, this necessary but one-size-fits-all approach will still be inadequate if it is not accompanied, or even preceded, by new policies to manage maturity transformation by banks.

I. An overview of Basel III liquidity regulation

1. A fundamental goal: preventing excessive maturity transformation risks

Since banks are in the best position to reduce information asymmetries in credit markets, select and monitor loans and diversify their asset portfolios, they are at the heart of maturity transformation activities.

In traditional financial intermediation, banks collect savings and provide liquidity to the whole economy through transactions on their balance sheets. To do this, they transform liquid short-term liabilities into medium- to long-term assets with poor liquidity. This activity generates well-known risks, in particular in terms of interest rates and liquidity. Maturity transformation is therefore subject to prudential regulation to ensure that basic security rules are followed.

At the Seoul Summit in November 2010, the G20 leaders endorsed the Basel III framework that overhauls the current prudential regulatory regime. In particular, this is the role of the two new liquidity ratios:

– The one-month liquidity ratio or ***Liquidity Coverage Ratio (LCR)*** has the two-fold objective of preventing short-term liquidity shocks and requiring institutions to self-insure against liquidity shortages in order to limit refinancing exclusively via the central bank. Institutions should in no way consider that they have a guarantee of permanent access to such refinancing. In this respect, the use of foreign currency funding is not always justified by the need to fund assets denominated in these currencies in the absence of a sufficiently broad customer base in the countries concerned. Such strategies are also used for arbitrage purposes. They contribute to overall market liquidity but they must remain of a magnitude that allows institutions to unwind positions in stressed market conditions. However, during complete liquidity dry-ups some institutions became largely dependent on swap lines between central banks, as was the case from the end of 2007 to the start of 2010. It is also clear that the use of swap lines between central banks cannot be considered a natural market adjustment. In this respect, it is advisable for banking supervisors to have indicators that enable them to measure possible foreign currency mismatches, without necessarily imposing a specific currency matching requirement.

– The one-year liquidity ratio or ***Net Stable Funding Ratio (NSFR)***, for its part, aims to limit the risk of excessive maturity transformation such as illustrated by the failure of Northern Rock. In practice, it is defined as the "available amount of stable funding" over one year divided by the "required amount of stable funding" for one year. The standard requires that the ratio be no lower than 100%.

2. A observation period necessary to calibrate these ratios

While the implementation of quantitative and harmonised rules at the international level represents a major step forward, the calibration of these proposed ratios is not without shortcomings.

As regards the one-month ratio, the composition of its numerator must be reviewed, that is to say defining the high-quality liquid assets that are largely composed of government securities. The sovereign debt crisis has shown us that caution is required when assessing the degree of actual liquidity of certain debt instruments. Conversely, equities, which remain liquid even under stressed market conditions, are not eligible for the numerator. Furthermore, it is somewhat paradoxical that collateral eligible in normal times for central bank refinancing operations – i.e. excluding non-standard measures – is not considered to come within the Basel definition of liquid assets and is not fully eligible for the numerator of the ratio.

The one-year ratio raises many questions, including in terms of principles, in that it places major constraints on certain maturity transformation activities. Also, can a one-size-fits-all

approach be applied to institutions worldwide even though their business models vary from universal banking to specialised banking models (investment banks, custodians, etc.)? The greatest attention will be therefore required when assessing the impact of this standard on the financing of the economy.

To back up this somewhat critical observation, I would like to stress three points:

- First, I wish to recall that central banks and supervisors are aware of the demands made on banks to implement the new regulations and we are regularly assessing with them the technical details of these standards.
- Second, a distinction must be made between the different measures set out in Basel III:
  - those that are absolutely necessary, such as the increase of capital charges for market activities, securitisation and counterparty credit risk exposures, and,
  - those, such as liquidity ratios, whose impact on the real economy must be assessed ex ante. As regards the latter, a real observation period has been scheduled to allow for any necessary changes. The current arrangements should not be regarded as set in stone.
- Third, while the proposed rules may appear harsh, we will ensure that a level playing field is achieved for their implementation. However, French institutions are well-equipped to comply with them. The major French banks have no difficulties raising funds in capital markets: to date, thanks to their size, ratings and reputation they have maintained their funding capacity.

II. What are the avenues for improving the management of maturity transformation risk?

The progress made in the reform of the prudential regulation of banks needs to be accompanied by further reflection about the functioning of the financial system as a whole and the different ways of improving the management of liquidity risks. That is why, as a complement to the regulatory responses, banks need to take immediate action straightaway regarding their internal risk management policies, which play a crucial role both in terms of liabilities and assets. I would like to say a few words about this.

1. On the liabilities side

- First of all, it seems to me important to not wait for the final calibration of the new rules to gradually increase the duration of bank liabilities. The management of maturity gaps, which is the primary responsibility of treasurers and ALM managers, cannot only be dictated by regulation; it also needs to be adapted to the risk profile of each institution. In the current context, we can only encourage banks to increase the proportion of medium- and long-term liabilities issued on the markets, so as to be less dependent on more volatile sources of funding. They should also reduce as far as possible their short-term vulnerability vis-à-vis unsecured market funding, notably in foreign currencies.
- Second, the treatment given to customer deposits in the one-month liquidity ratio could justify a form of reintermediation of money market funds and increased competition in banks' deposit-taking. We are monitoring these developments very closely. The asset management industry is indeed a sector where there is robust activity that should not be destabilised. Moreover, the reintermediation of the deposits of institutional clients and companies cannot be justified on the basis of regulatory ratios (in view of the strict treatment of these deposits in the draft

regulations/reforms). Furthermore, the broadening of the deposit base of banks should not happen at any price: we are monitoring developments in the remuneration of deposits very closely.

- Lastly, securing maturity transformation activities can be achieved by encouraging the use of stable sources of financing. I have just talked about deposit-taking, but I should also mention the role played by the issuance of covered bonds. Backed by a dedicated portfolio of underlying assets, these securities proved to be resilient during the crisis and have since played an important role in the funding of European banks.

2. On the assets side

The rebalancing of banks' liabilities structure is not sufficient on its own. In a general way, banks would also benefit from systematically making sure that their maturity transformation activities are profitable, by ensuring that the return provided by assets is proportional to the risks incurred. I would like to stress here that the greatest vigilance is required when the loans extended do not generate sufficient margins. This is the worrying trend that we are seeing at the moment with respect to housing loans: margins on housing loans – veritable loss leaders – are being compressed in order to attract customers who become captive due to their borrowing. In these circumstances, the level of margins may not be sufficient to cover the cost of the risk, or even the cost of the funding.

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I would like, finally, to underline the need for accurate traceability of funding flows. From this perspective, improving the management of liquidity risk linked to OTC-traded derivatives requires stronger supervision of markets and market participants. That is why the Banque de France supports all of the initiatives taken to this end:

– the clearing through central counterparties (CCP) of all products deemed sufficiently standardised. The management of margin calls and collateral is more robust here than in OTC-trades;

– the recording of trades by dedicated infrastructures (trade repositories) in order to identify all of the systemic players;

– extending the scope of regulation to include players that are part of the unregulated or "shadow banking" sector.

Several reforms are already well under way as they correspond to G20 guidelines. The United States adopted the Dodd-Frank Act in July 2010. At the European level, the draft EMIR regulation should be adopted in summer 2011.

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By way of conclusion, I would like to stress the persistence of a number of warning signals that are still present. For instance, leverage levels in the financial sector remain very high. The current low interest rate environment is encouraging risky high-yield strategies; activity on these high-yield markets is sustained; innovations on the ETF market are raising questions and the commodity market is being financialised. The active management of these new complex instruments is thus likely to reach its limits, as happened with CDOs.

The current challenge for central banks is two-fold: we need to improve our ability to monitor risks at a system-wide level; we also need to re-establish the moral hazard that the management of the crisis suspended. On their side, banks and market participants need to ensure that they improve their risk management autonomously in order to reduce this

hazard, in the interests of their shareholders and depositors, but also of economic development as a whole.

Thank you for your attention.