# Guy Debelle: Remarks on liquidity

Address by Mr Guy Debelle, Assistant Governor (Financial Markets) of the Reserve Bank of Australia, to the Australasian Finance and Banking Conference, Sydney, 17 December 2013.

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Thank you to Fari for again organising a good conference.

Today I will make a few points about liquidity. I have spoken about this on a number of other occasions, but one year out from the Basel III liquidity regime becoming fully operational, it is timely to do so again.[1]

Why do we have liquidity regulation?

The fundamental answer is that banks engage in maturity transformation. They borrow short and lend long. This is a service which society values.

There is a demand for banks to provide liquidity services. Depositors place their savings with a bank but want to be able to withdraw some part of their funds at short notice. A corporate treasurer wants to have the company's funds in an account where they can be accessed quickly to meet the needs of the firm.

At the same time, we prefer to have our loans for substantially longer periods of time. It would be particularly inefficient and bothersome if we had to renegotiate our home loan on a monthly basis. More importantly, it would be very difficult to make any sort of long-term planning or investment decision if there were no long-term loans available.

This desire for liquidity on the one hand and long-term lending on the other is intermediated by the financial sector and the banking sector in particular. But the maturity transformation this entails exposes the banking sector to liquidity risk. If all the depositors wanted their money back in a hurry, the bank would not be able to meet that obligation without either calling in their loans, which may be contractually impossible, or trying to sell them. The latter is often practically impossible to do at short notice, or even if it is possible, may only be able to be carried out by selling the assets (such as loan portfolios) at fire-sale prices. Neither of those outcomes is socially desirable.

Fire sales run the risk of generating contagion to other financial institutions as the price of the asset falls, as they may well hold that same asset too, and/or may use it as collateral in transactions themselves. Fire sales also limit the ability of the institution making the sale to make good on its obligations. So there are externalities to the asset that is being sold, as well as to the financial system as a whole.

Liquidity regulation addresses this issue by ensuring that the banking system has some level of liquidity at hand to meet predictable liquidity demands. In the case of Basel III, banks need to have available sufficient liquidity to meet a 30-day stress scenario. In simple terms, a bank must have enough liquid assets that can be easily liquefied (not at fire-sale prices) to meet any of its liabilities that fall due within that 30-day period. In Basel III, these assets are labelled high-quality liquid assets (HQLA).

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[1] See Debelle G (2013), "The Impact of Payments System and Prudential Reforms on the RBA's Provision of Liquidity", Address to the Australian Financial Markets Association and Reserve Bank of Australia Briefing, Sydney, 16 August. Also see Stein J (2013), "Liquidity Regulation and Central Banking", Speech at the "Finding the Right Balance" 2013 Credit Markets Symposium sponsored by the Federal Reserve Bank of Richmond, Charlotte, North Carolina, 19 April. Available at <http://www.federalreserve.gov/newsevents/speech/stein20130419a.htm>; Coeuré B (2013), "Liquidity Regulation and Monetary Policy Implementation – From Theory to Practice", Speech at the Toulouse School of Economics, Toulouse, 3 October. Available at <http://www.ecb.europa.eu/press/key/date/2013/html/sp131003.en.html>.

This implies that more liquid liabilities, those with less than 30 days to maturity, will be more costly for the bank to provide. Hence, one would expect to see an increase in the cost to the customer of obtaining that liquidity service. We have seen this start to occur in Australia as the implementation date of Basel III, 1 January 2015, comes into sight. But my sense is that there is more of this repricing still to come. As I have said before, the rate of return available on at-call accounts does not seem to sufficiently reflect the cost to the bank of providing such liquidity. Maybe we will have to wait for 31 December 2014 for this to occur, as there is potentially a large first-mover disadvantage from being the first to reprice the product. The lower interest rate is likely to see customers move rapidly to a competitor who has yet to reprice. In the online account world, the transactions costs of switching are very low, and the evidence is that the response rate to small interest rate differentials is rapid.

While there may be more repricing to come, it is worth mentioning that as part of the Basel III liquidity standards, banks are required to demonstrate to APRA that they have an appropriate liquidity transfer pricing model. APRA is conducting a trial run of the new liquidity regime over the coming year and one might expect these new liquidity pricing models to come into effect as part of that. This will affect not just deposit pricing but pricing on the other side of the balance sheet, namely loans, as well. It will have a particular impact on contingent facilities such as lines of credit.

To return to the issue of HQLA for a minute. As most of you are aware, there is a shortage of HQLA in Australia. The stock of government debt on issue, both Commonwealth and state, is well short of the liquidity needs of the banking system. Hence, as part of the liquidity regime, the Reserve Bank will be offering banks access to a Committed Liquidity Facility (CLF). For a fee, the Reserve Bank will make available sufficient liquidity (against eligible collateral) to address the shortfall of HQLA beyond the banking system's holdings of Commonwealth and state government debt. The motivation for doing so reflects the societal gains that I talked about earlier from the banking system engaging in an appropriate amount of maturity transformation. The pricing of the CLF is aimed at replicating the cost of holding HQLA in the form of government debt. That is, it is designed to be the same as the liquidity premium embedded in government paper.

The fact that there is a cost to the banking system of holding HQLA, either in the form of government debt or in the fee paid to have access to the CLF, is in keeping with one of the main motivations of the Basel III liquidity regime, namely that banks engage in the appropriate amount of maturity transformation. Generally speaking, liquidity was underpriced prior to 2007 with the result that excessive maturity transformation was undertaken, manifest in some cases in highly unstable short-term funding structures. The new liquidity regulation increases the cost of liquidity, but it is not designed to increase the cost so much that insufficient maturity transformation is undertaken from society's point of view.

Having talked about liquidity from the banking system's point of view, I will finish with a few thoughts on liquidity in the superannuation (pension) system. In many ways, liquidity issues in the super sector are very similar to those in the banking sector. While the super sector generally thinks of itself as being in the asset management business, it is obviously very much in the intermediation business. It takes in savings and then invests them in a wide array of assets.

Because of the portability of super accounts as well as the ability of superannuants to change their asset allocation at relatively short notice, the super sector is also in the business of maturity transformation. Some, potentially unknown, share of its liabilities may be called on at short notice. But some of its assets are long-dated and not easily liquefied at short notice, or if they can be, only at fire-sale prices.

As with banks, society values the maturity transformation that the super sector undertakes, particularly in terms of the funds it provides for longer-lived projects. But as with the banking system, there is an optimal degree of maturity transformation and an optimal amount of liquidity to be held. It is desirable that super funds don't hold all their assets in highly liquid

form for the fear that all of its members may withdraw their funds all at once, just as banks don't put all their assets in liquid form for the fear that a bank run might occur. But at the same time, it is not desirable for all of a super fund's assets to be invested in highly illiquid assets.

To some extent, the super sector's relatively large allocation to equities, which are, in principle, easily liquefied, but relatively small allocation to fixed income, which is not easily liquefied, may reflect some of these liquidity considerations.

But at the heart of it, these liquidity management issues are very similar to those facing a bank. I think many of the principles of liquidity management translate from the banking sector to the super sector, although I have the sense that this is not yet fully appreciated.