Henk J. Brouwer

Henk J. Brouwer
Executive Director
De Nederlandsche Bank

Comments on Karel Lannoo, "Capital Adequacy versus Liquidity Requirements in Banking Supervision in the EU"

I believe the choice of topic for Karel Lannoo's presentation is excellent. The discussion of liquidity risk and liquidity requirements is not only highly relevant it is also timely. Liquidity is now at the forefront of the policy agenda. Liquidity is also a complex issue. Regarding my presentation, in light of the rather limited preparation time I was given, my comments today should be seen more as thoughts to provoke discussion than as balanced opinions. I have based my remarks on a draft paper provided to me by Karel Lannoo.

Let me start my comment with a definitional matter. What is liquidity? Four types of liquidity appear in the draft paper. It starts with discussing the liquidity of an institution, then moves on to the liquidity of a specific market and to the liquidity of an asset, and ends with the liquidity of the market as a whole, or "macro liquidity".

I believe it would be useful to find one single definition of liquidity. For my discussion today, I have thought of one such definition. It is by no means perfect but it more or less can be applied to all four types of liquidity. I will actually define *illiquidity* as being the degree to which the prices of financial instruments move in order to meet cash demands. That

means an institution is liquid if it can meet its cash demands without causing substantial price movements to the assets being sold to do so. A specific market or asset is liquid if the price moves little when cash is exchanged for the asset traded. And the market as a whole is liquid if this condition applies across markets.

I will now use this definition to raise some questions about the three main claims of Karel Lannoo's presentation. These are first that liquidity

requirements may be necessary, second that the increased liquidity of financial markets may have increased financial stability risks, and third that liquidity requirements need not necessarily be harmonised at the EU level.

Liquidity Requirements May Be Necessary

Let me start with liquidity requirements. The author claims that "the bottom line for policy is that there is no point in holding capital reserves if they cannot be liquidated in times of stress". This seems to make sense. After all, financial crises often are related to cash flow problems, not insolvencies. Reserves are meant to shield against bankruptcy, so surely then they should shield against a crippling liquidity shortage. This in turn, implies that one should be able to liquidate reserves.

Actually, I think the claim is too bold. First, capital reserves *are* useful, even if they themselves cannot be liquidated, for three reasons:

(a) they still reduce creditors' losses in case of a bankruptcy;
(b) capital reserves reduce moral hazard induced excessive risk taking; and
(c) even if the reserves themselves cannot be liquidated they could be used as collateral to obtain liquidity elsewhere.

Second, and this is a more fundamental question about liquidity requirements, I see banks as the main source of liquidity for the financial system. One of their principal roles is liquidity provision to the financial system and economy. They achieve this via maturity transformation. Does this not intrinsically limit the liquidity one should require of banks? To illustrate the point, imagine a 100% liquidity requirement on a bank. All recallable deposits should now be matched by immediately recallable loans. This would drastically reduce the liquidity of companies relying on bank credit and the liquidity in the financial system as a whole. That is, in a financial system comprised of creditors and debtors, in a way someone's liquidity is someone else's illiquidity.

Now, I think we also need a definition of financial stability. At De Nederlandsche Bank we speak of financial stability when a financial system is capable of efficiently allocating resources and absorbing shocks, preventing these from exercising a disruptive effect on the real economy or on other financial systems. I believe the banking system would not be performing this role very well if it were not engaging in liquidity provision through maturity transformation. In other words, whilst requiring banks to be more liquid can increase their own resilience to liquidity shocks, it might reduce the resilience of the rest of the financial system and the real

economy they service. This appears to undermine the very purpose for which banks exist.

Of course, I do not want to say that banks should be illiquid. In fact, at De Nederlandsche Bank we pay a lot of attention to liquidity levels at the banks we supervise, through our liquidity reports. We even require banks to stress test against liquidity shocks and to ensure that their liquidity management is resilient to them. The only question that I would like to raise is to what extent requirements on the *level* of liquidity of banks' assets actually increase financial stability?

Increased Market Liquidity Harms Financial Stability

Whereas I could imagine that increasing the liquidity of banks at some point would start to hurt financial stability, I believe the opposite is true of improvements in liquidity of financial markets. Here, I can combine my definitions of liquidity and financial stability to drive this point home. Markets that are liquid should quickly reflect fundamentals. This means there should be little over- or undershooting when shocks cause sudden sales and purchases, which are by definition matched by demands for cash. This means that liquid markets absorb shocks well and that they allocate resources efficiently. They do not experience excessive price fluctuations when subjected to shocks. This view is similar to that of Borio in a paper published by the BIS last year.[1] He thereby notes that an evaporation of liquidity in markets can act as an amplifying mechanism. In this regard, I therefore do not believe in the supposed tension between growing market liquidity and financial stability.

I can imagine, however, that the liquidity of the system as a whole can be increased by more than is necessary to facilitate the transactions in the real economy and the financial system. In such a situation of "excess liquidity", too much money might end up chasing too few goods leading either to CPI inflation or asset price inflation. As such, "excess liquidity" might be a risk to monetary and financial stability. I still, however, believe this is not the same as the increased liquidity of financial markets we have witnessed due to technical innovations etcetera. As I explained, I believe this type of liquidity actually helps financial stability.

Liquidity Requirements Need not Be Harmonised across the EU

Karel Lannoo suggests that liquidity requirements need not be harmonised across the EU because "the capital requirements directive already requires banks to implement a much more calibrated risk management framework". But did the author not suggest earlier that capital reserves are useless if illiquid at times of stress? Even if this claim is too bold, it still correctly implies that the capital reserves perspective is not enough. Then if we agree that liquidity requirements may be necessary, the capital accord cannot suffice.

Then there is the issue of the "level playing field". The draft paper cites a study claiming the current practice of

[1] *Borio, C. 2004. Market Distress and Vanishing Liquidity: Anatomy and Policy Options. BIS Working Paper 158.*

national liquidity requirements (or no requirements at all) harms the level playing field. I wonder whether a system with home country requirements monitored by hosts would do much to resolve this problem. The Joint Forum, in a report published last year, also highlighted the fact that inconsistent regulations, at least in theory, could actually hinder firms' liquidity management.[2] At De Nederlandsche Bank we believe that banks should manage liquidity at the group level. This can indeed be more difficult when regulations differ across the countries in which the bank is active. So on the question of whether there should be harmonisation, I believe that at the very least, there should be a step-by-step approach to convergence of requirements. And convergence of regulation, or harmonisation for that matter, I think should rather be dealt with by the Basel Committee than within the EU. Liquidity is, after all, a truly global affair.

So let me wrap up. I believe the discussion of this topic is well timed and the questions asked in the presentation are the right ones. I am however still unsure about the answers. Should there be requirements on the *level* of liquidity or only on the *management* of liquidity? If so, what sort of requirements should there be? Then, I do not believe in the tension between improved liquidity of markets and financial stability. There may be a relation between financial instability and "excess liquidity". But even if this is the case, what are the implications for liquidity requirements for banks? Finally, in my view, the claim that liquidity requirements need not be harmonised across the EU, or rather globally, has not been sufficiently argued for. ❧

[2] *The Joint Forum. 2004. Report of the Sub-Group on Liquidity Risk. Preliminary Findings on the Management of Liquidity Risk.*