

## Press Points for Chapter Two:

### *Systemic Liquidity Risk: Improving the Resilience of Institutions and Markets*

Prepared by Jeanne Gobat, Alexandre Chailloux, Simon Gray, Andy Jobst, Kazuhiro Masaki, Hiroko Oura and Mark Stone.

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#### *Key points*

- Financial institutions and regulators failed to account for rising liquidity risks during the global crisis that were caused by increased reliance on short-term wholesale funding.
- Collateral valuation practices in the repurchase markets need to be improved. Greater use of central counterparties for repurchase transactions should also be encouraged.
- The recent proposals by the Basel Committee on Banking Supervision will help enhance liquidity cushions and lower banks' exposures to maturity mismatch risk.
- The liquidity guidelines should, in some form, include non-bank financial institutions that contribute to maturity transformation.
- Cross-border, cross-currency dimension of funding risks should be accounted for in the new liquidity regulations.

The inability of multiple financial institutions to roll over or obtain new short-term funding was one of the defining hallmarks of the crisis. Banks and non-banks financial institutions, in particular in advanced countries, increased their reliance on short-term markets for funding, exposing them to significant risks when these markets dried up. Secured lending through repurchase operations grew immensely, greasing the funding markets. Perhaps insufficiently recognized was that the wholesale providers of funds had changed—instead of banks playing a central role in intermediating unsecured funds where needed, others, such as money market mutual funds, were growing suppliers of funds while traditional more stable depositors were not. Underestimated were also the risks associated with the greater use of low quality securities as collateral for secured funding. Moreover, the crisis demonstrated that regulators, and banks themselves, had underestimated the risks emanating from the reliance on cross-border funding. This chapter outlines a comprehensive approach for dealing with systemic liquidity risk.

***Policy proposals:***

A number of policy proposals arise from the chapter, including the following:

- Policymakers should strengthen collateral valuation and margin practices in the secured funding markets. Important would be to have more realistic assumptions about how long it might take to sell the collateral, more frequent adjustments to collateral to avoid the problem of abrupt shortfalls in cash. Supervisors should also encourage markets to value collateral through a full credit cycle so to discourage excessive funding when values are high. Moreover, financial supervisors should periodically validate the models banks use to price collateral used to secure funding.
- Market regulators should advocate greater use of central counterparties to lower operational and counterparty risk associated with repo transactions. Central counterparties serving repo markets should be subject to minimum regulatory requirements to ensure safety and soundness. Central bank emergency liquidity should be made available to well-run central counterparties in times of systemic liquidity crisis.
- Over time, money market mutual funds should have to choose to either become mutual funds whose net asset value fluctuates, or be regulated as banks. Ensuring that investments in such funds are regularly valued at market prices would enhance investors' awareness that they bear investment risks and that their funds are different from a bank deposit in that the principal is not guaranteed and not backed by a public deposit insurance scheme.
- The agreement reached to implement the quantitative liquidity requirements as proposed by the Basel Committee on Banking Supervision in September 2010 is a significant step towards lowering liquidity risk. The rules will encourage banks to hold higher liquidity buffers and reduce the mismatch between the cash flows of their assets and payment obligations of their liabilities.
- Policymakers should also consider extending the Basel quantitative rules, in some form, to other financial institutions that, as the crisis demonstrated, can contribute to maturity transformation and a buildup of systemic risk. This would help mitigate the buildup of liquidity risks in the less-regulated "shadow banking" system.
- Policymakers should consider ensuring that foreign exchange swap facilities of central banks are readily available in the future in times of stress. This should be complemented by placing greater emphasis on the cross-border, cross-currency dimension in the new liquidity regulations.

- Finally, closer international coordination is called for to improve the collection of financial information on relevant funding markets and institutions to allow for an adequate assessment of buildup of liquidity risks in the financial system.