Summary

The inability of multiple financial institutions to roll over or obtain new short-term funding was one of the defining characteristics of the crisis. Systemic liquidity risks were underrecognized by both the private and public sectors and required unprecedented intervention by governments and central banks during the crisis. This chapter aims to better understand the vulnerabilities that led to the systemic liquidity crunch and, in doing so, begin to provide a holistic framework for dealing with them, with central banks expected to step in only in dire emergencies.

A key aspect of the crisis was the increased use by banks of short-term wholesale funding and the risks that it posed when these short-term markets dried up. Perhaps insufficiently recognized was that the wholesale providers of funds had also changed—instead of interbank markets acting to move unsecured funds where needed, other intermediaries, such as money market mutual funds, were growing suppliers of funds while traditional, more stable depositors were not. Secured lending through repurchase operations also grew immensely, greasing the funding markets.

The chapter shows that going forward a comprehensive approach is needed to better mitigate systemic liquidity risks. Higher liquidity buffers and lower asset/liability maturity mismatches in banks will help to reduce the chance that an individual institution will run into liquidity difficulties. The proposals from the Basel Committee on Banking Supervision in this direction are likely to be a good starting point if designed and calibrated appropriately. To address the externality that some firms impose on the system as a whole, a measure of systemic liquidity risks attributable to them needs to be devised and perhaps a surcharge or insurance premia imposed. The chapter outlines some early proposals; a chapter in a subsequent GFSR will take up this topic more concretely.

The approach must also address how funding markets and nonbank institutions interact and, more specifically, how to correct infrastructure and practices that generate simultaneous and widespread dislocation in the funding markets. A well-functioning repurchase market is now a cornerstone of the wholesale funding market. In the run-up to the crisis, however, the market—in particular the triparty repo market—had features that increased systemic risks: poor collateral valuation and margining policies, a lack of due diligence about the counterparties’ credit risk, and fragmented or nontransparent methods of clearing and settlement. Hence part of the solution will be requiring better internal controls on collateral valuation and margining policies, more transparency about counterparties, including through triparty relationships, and greater use of central counterparties for clearing and collateral management.

While still of less significance in Europe, U.S. money market mutual funds as a means of channeling institutional and retail funds to banks (both in the United States and abroad) are also now a systemically important component of funding markets. Ensuring that investments in such funds are regularly valued at market prices, and clearly differentiated from bank deposits, is another important method of mitigating systemic liquidity risk.