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Bank Liquidity Requirements

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Liquidity Matters for Banks

- Banks have always been vulnerable to runs, since they make multi-year loans using deposit funding
- The lender of last resort function is designed to help protect solvent banks from such runs
- But, we want banks to handle the vast majority of liquidity scenarios without invoking LOLR facilities
  - » Decreases frequency and size of LOLR demands
  - » Reduces problems caused by fire sales

Banks were too illiquid pre-crisis

- Liquidity regulation and supervision was fairly loose, without the equivalent of the Basel capital standards
- Liquidity seemed abundant and likely to remain so
- Banks therefore generally chose not to increase expenses
  - » Did not pay up for enough long-term funding
  - » Did not lose income by holding enough short-term, safe assets

New Liquidity Rules are Being Put in Place

- Liquidity Coverage Ratio (LCR) in Basel III (as of 2015)
- Net Stable Funding Ratio (NSFR) in Basel III (as of 2018)
- Liquidity stress tests
- More careful liquidity supervision

Liquidity Coverage Ratio (LCR)

- Essentially a stylized stress test to see if a bank could handle 30 days of a market liquidity crisis on its own
- Funding sources are assumed to dry up to varying extents
  - Runoff of deposits and wholesale funding
  - Haircuts on asset values
- Funding demands are assumed to rise
  - Drawdowns on credit facilities
- The minimum 100% level means there would be just enough funds available to cover all the outflows

Net Stable Funding Ratio (NSFR)

- LCR is intended to check ability to handle sudden crisis
- NSFR is intended to check underlying vulnerability to liquidity issues, to discourage dangerous business models
- Available Stable Funding (ASF)
  - » 95% of “stable” deposits
  - » 50% of funding from non-financial customers
- Required Stable Funding (RSF)
  - » Portions of credit lines are assumed to be drawn down
  - » Haircuts on securities