Don't drain the river

Well-meaning initiatives to end the era of US bailouts have also dried-up market liquidity. That could be almost as dangerous

Banks perform critical functions in our economy, one of which is maturity transformation. They borrow in the short term, in the form of deposits, and invest in the long term, to a significant extent in the form of loans that are difficult for depositors to value. However, a loss in confidence in a bank can result in the withdrawal of deposits, creating a need for funds to be raised quickly by either borrowing replacement funds or liquidating assets. Since a loss in confidence generally makes additional borrowing unfeasible, the ability to liquidate assets is paramount.

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The price and speed at which assets can be liquidated depends on the liquidity of the market. Assets sold or pledged in highly liquid markets with narrow bid ask spreads will be converted into cash quickly with little or no loss in mark-to-market value; conversely, assets sold or pledged in illiquid markets will likely be sold at deeply discounted prices or pledged at high margins. As exhibited during the financial crisis, this process can generate losses, trigger the failure of otherwise solvent institutions and cause outright market panic. As market liquidity declines, the risks to overall financial and economic stability increase significantly.

The bank supervision and regulatory regimes in the US, including the National Bank Act in the 1860s, the Federal Reserve Act in 1913, the Federal Deposit Insurance Act in 1933 and, most recently, the Dodd-Frank Act in 2010, have attempted to reduce the likelihood and mitigate the consequences of bank runs and the ensuing disruptions to the economy. However, recent regulatory developments, largely under the dictate of ending too-big-to-fail, raise questions as to whether we are losing sight of the original overarching goal—to maintain macroeconomic stability—in the quest for lesser objectives.

For many, the phrase too-big-to-fail equates with bailouts and unfair treatment for a privileged few. These images evoke strong emotions which are conveyed in the provisions, and associated rules, of the Dodd-Frank Act, which was generally designed to extinguish banks' ability to shift the costs of their mistakes to taxpayers. Banks are now expected to weather financial crises entirely without any outside assistance, including credit from the Board of Governors of the Federal Reserve System which was originally viewed as a powerful tool to combat financial panic. In pursuit of this insular stability, banks must now increase their capital footings, limit perceived risky activities, hold reservoirs of liquidity and plan for their own insolvencies. However, the same process viewed as strengthening the resiliency of individual institutions may in fact be reducing the overall liquidity of financial markets and the stability of the financial system as a whole.

A lender of last resort

Since the passage of the Federal Reserve Act, US Federal Reserve Banks have functioned as a source of liquidity during financial stress, enabling depository institutions to meet liquidity demands by pledging assets to a US Federal Reserve Bank. This lender of last resort function can be traced to the works of Henry Thornton and Walter Bagehot, both of whom asserted that the Bank of England's role, as a central bank, should be to "pump liquidity into the market" to "insulate the economy from the impact of [financial shock]," preserving macroeconomic stability and free flow of credit. While Thornton did not believe that the Bank of England should "relieve every distress which . . . banks may bring upon [themselves]," he recognised the criticality of a "medium at which a public bank should aim in granting aid to inferior establishments . . . .".

The Federal Reserve Act was modeled after the Bank of England's role as a lender of last resort, but also enhanced that role by enabling the Federal Reserve to create money, effectively eliminating the need for the Federal Reserve to compete for market funds. In 1932, Section 13(3) was added to the Federal Reserve Act to authorise the Federal Reserve to open the discount window to nonbanks "in unusual and exigent circumstances." The Federal Reserve utilised this authority during the financial crisis to mitigate market panic; however, in doing so, the lender of last resort function became linked in the eyes of many with concerns over too-big-to-fail.

In response, the Dodd-Frank Act limits the Federal Reserve's lender of last resort function and seeks other means to preserve financial stability. For example, Section 1101 of the Dodd-Frank Act limits the Federal Reserve's ability to lend to non-depository institutions and numerous other sections have resulted in a cavalcade of regulations intended to ensure that financial institutions can prophylactically withstand financial shock on their own. However, as described below, these regulations have reduced overall market liquidity and left institutions and markets vulnerable to volatility during times of stress.

Dodd-Frank and diminished liquidity

The statutory authority provided under Sections 115, 165 and 619 of the Dodd-Frank Act has led to the implementation of a collage of capital requirements and other prohibitions in the name of macroeconomic stability and liquidity preservation. However, when viewed cumulatively, many of these requirements undermine market liquidity and the exact problem they intended to fix.

Under Section 115 of the Dodd-Frank Act, the Federal Reserve is directed to preserve US financial stability by establishing prudential standards applicable to systemically important financial institutions (Sifis) and large bank holding companies (BHCs). Moreover, under Section 165 of the Dodd-Frank Act, the Federal Reserve is directed to establish enhanced (ie more stringent) prudential standards for Sifis and BHCs with assets equal to or greater than $50 billion. Furthermore, Section 619 of the Dodd-Frank Act, or the Volcker Rule, prohibits covered banking entities from engaging in proprietary trading and acquiring or retaining any equity, partnership or other ownership interest in or sponsoring a hedge fund or a private equity fund.

Capital requirements

In July 2013, the US federal banking agencies issued rules to implement the Basel III capital standards (the US Basel III Capital Rule), which includes a revised definition of regulatory capital, a new common equity tier 1 minimum capital requirement and, for advanced approaches banks, a supplementary leverage ratio. US banks and BHCs must maintain minimum regulatory capital, including: a common equity tier 1 capital ratio of 4.5%, a tier 1 capital ratio of 4.5%, a total cap ratio of 8% of total risk-weighted assets, a tier 1 leverage ratio of 4% and, for advanced approaches institutions, an additional leverage ratio of Tier 1 capital.

Although not its primary intent, the US Basel III Capital Rule has had a notable impact on liquidity because banks are unable to effectively "deploy capital in trading markets," according to CFTC Commissioner J Christopher Giancarlo. He believes the necessitating of greater capital has "prioritis[ed] capital reserves over investment capital, balance sheet surplus over market-making and system safety over investment opportunity." Banks have had to reduce inventories of certain securities or leave industries all together. In passing the US Basel III Capital Rule, the US federal banking agencies have seemingly overlooked whether these capital constraints are "properly calibrated to the amount of capital that institutions need to deploy to support market health and vibrancy."

Single-counterparty credit limits

In March 2016, the Federal Reserve proposed rules to limit the aggregate net credit exposure of covered companies to a single counterparty to one of three categories of credit exposure limits, each with increasing stringency. At its most stringent level, globally systemically important banks (G-Sibs) would be prohibited from maintaining credit exposures that exceed (i) 15% of the G-Sib's tier 1 capital to any other G-Sib and (ii) 25% of the G-Sib's tier 1 capital to any other counterparty. The proposal seeks to limit risk to individual counterparties and exposures amongst G-Sibs; however, the proposal also reduces market liquidity — banks would be forced to "substantially reduce their credit intermediation and market making activities in order to reduce their exposure within limits," resulting in "lower liquidity in the derivatives and securities lending markets." This sentiment was acknowledged by Federal Reserve Chair Janet Yellen, recognising the market's concern regarding "possible deterioration in market liquidity" as a result of the credit limits.

The liquidity coverage ratio

In September 2014, the Federal Reserve issued the Liquidity Coverage Ratio (LCR) Rule to establish, consistent with Basel III, a minimum LCR requirement for certain US banking organisations. Under the LCR Rule, banking organisations must maintain an amount of high-quality liquid assets (HQLAs) that is no less than 100% of its total net cash outflows over a prospective 30 calendar-day period. To qualify as an eligible HQLA, the asset must be unencumbered and, therefore, able to be converted into cash quickly during a stress period. The LCR Rule divides HQLAs into three categories: Level 1 (considered the most liquid), Level 2A and Level 2B liquid assets (considered the least liquid).

Accordingly, the market for and hence the liquidity of securities that do not qualify as HQLAs under the LCR Rule is discouraged. For example, the decision to exclude municipal securities from the definition of HQLAs has diminished the demand for such securities by large financial institutions, ultimately harming overall liquidity. By year-end 2014, municipal bonds in the US had declined by 3.2% from 2010. In March 2016, the Federal Reserve issued a final rule that will enable some municipal bonds to count towards a bank's total HQLAs; however, the final rule is limited because it applies solely to Federal Reserve-regulated institutions subject to the LCR Rule and contains a number of restrictions unique to municipal securities. It remains to be seen whether overall market liquidity for municipal securities will improve.

The Volcker Rule

The Volcker Rule prohibits covered banking entities from engaging in proprietary trading and maintaining interests in, or relationships with, hedge funds or private equity funds, subject to certain exceptions.

The prohibition on propriety trading has had the most significant impact on market liquidity—underwriters must maintain limited inventories of securities designed not to exceed the reasonably expected near term demands of clients, customers or counterparties. However, the liquidity of markets hinges largely on the ability of specialised dealers (ie market makers) to respond to temporary imbalances in supply and demand . . . as buyers (or sellers) against trades sought by other market participants.

A reduction in proprietary trading has meant the limiting of market-makers' ability to redistribute risky positions, which has reduced their willingness to build up large inventories of less liquid assets. In 2014, the Securities and Exchange Commission division of investment management noted that, partly due to fewer proprietary trading desks, dealer inventories of certain securities, such as corporate bonds, "appear to be at an all-time low, relative to the market size . . . before the crisis." Accordingly, the division asserted that such a "reduction in market-making capacity . . . has the potential to decrease liquidity and increase volatility in the fixed income markets." In 2015, the Financial Stability Oversight Council explained, "broker-dealers have significantly reduced their inventories of fixed income securities, such as Treasury securities, agency and corporate debt . . . and relative derivative instruments."

To qualify as an eligible HQLA, the asset must be unencumbered

No safety net

The post-Dodd-Frank world has ultimately left financial institutions to fend for themselves in times of crisis. Financial institutions that have the ability to meet liquidity needs in a future crisis will certainly benefit taxpayers and promote financial stability. However, should liquidity demand exceed individual institutions' capacity to meet their liquidity needs from their own resources, the ability to turn to the markets or alternative sources for assistance will be significantly hampered. While requiring that banks save themselves fits neatly within the too-big-to-fail narrative, it remains to be seen whether the current regulatory regime has left the economy in a sounder state.

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