

Liquidity insurance for systemic crises

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By Enrico Perotti and Javier Suarez

Securitisation was meant to reduce risk by spreading it, but in practice it created risk via regulatory arbitrage.

Banks placed long-term assets in boxes sustained by short-term wholesale funding, but with the backup of their credit lines in case of trouble. They kept a significant amount of risk, while reducing their own capital. When subprime mortgages were repriced, the house of cards fell apart.

Why did panic spread financial losses beyond subprime positions? Because short-term wholesale lenders refused to roll over funding. The extreme maturity mismatch was instrumental to spreading panic. It forced rapid firesales across markets, which caused sudden margin calls and more panic.

Which reforms can prevent this from happening again?

The leading argument proposes higher capital requirements indexed to asset growth, total leverage and maturity mismatch. Yet capital requirements are designed to cope with asset risk, not liquidity risk. When wholesale funding fails, no reasonable capital reserve can cope with massive withdrawals.

We propose a related approach, a liquidity and capital insurance arrangement, which offers better incentives and is likely to receive stronger political support.

We suggest a mandatory liquidity charge, to be paid continuously during good times to a supervisor who, in exchange, will provide emergency liquidity (and perhaps capital) during systemic crisis.

The charge would follow the principle that future regulation should work like pollution taxes, discouraging bank strategies that create systemic risk for everyone. Hence, it should be increasing in the maturity mismatch between assets and liabilities, and should be levied on all institutions with access to safety net guarantees. Its purpose should be to make short and medium term (up to one year) bank funding more comparable in cost. Retail deposits would be exempted, as they are more stable, thanks to their own insurance.

Revenues accruing from the charge would go into an Emergency Liquidity Insurance Fund, with legal autonomy and access to central bank liquidity and government funds backing. Upon significant aggregate liquidity runs (critically, not concerning isolated runs at individual banks), the insurance payment would be triggered by the relevant supervisor. This would result in immediate liquidity support, guarantees on uninsured wholesale funding, and some automatic capital injections. Conditions may be attached, such as restrictions on executive compensation and dividends.

The goal is to realign funding incentives among beneficiaries of the safety net. Reducing reliance on short-term market funding would reduce the spreading of panic in a confidence crisis, and ultimately systemic risk. Yet the insurance charges can also be seen as prepayment for future rescue costs. As such, it can make emergency intervention politically more acceptable, especially after the concern raised by bail-outs.

Why are higher bank capital ratios alone not a solution to bank liquidity risk? First, banks' own capital would need to be very large during normal times. This has disadvantages. Shareholders may be tempted to see bank capital as an asset to which they are entitled. Banks with plenty of capital on their books may try to "lever it up" through risky investment strategies.

In contrast, our insurance scheme arranges for a contingent injection of capital and liquidity in systemic crises only, and may trigger clauses which force prudential actions, such as dividend suspensions.

Liquidity charges should be proportional to short-term wholesale liabilities, weighted by the bank's maturity mismatch, which is easy to compute. They might be increasing in the slope of the short end of the yield curve (up to one year), so as to eliminate the incentives to excessively rely on short-term maturity funding.

The scheme we propose avoids imposing rigid restrictions on banks' funding strategies and leaves to capital requirements the traditional task of protecting against asset risk. It is likely to make it more expensive for banks to rapidly expand their lending above their deposit base, but it will certainly not block it. A greater fraction of long-term funding will go together with greater monitoring from the corresponding creditors. Residual short-term creditors will be less prone to panic in a systemic crisis.

Skeptics may fear that the liquidity charges will encourage the system to shift short-term funding to a shadow banking sector. This is unlikely to occur if unregulated intermediaries enjoy limited recourse to regulated banks.

The international implementation of our liquidity insurance arrangement is complex but desirable. Ideally, an international ELIF should be created. Countries should choose to participate by requiring either all their regulated institutions, or at least the largest ones, to join an international ELIF, pay its liquidity charges, accept its supervision, and count on its support in a systemic crisis. Countries that do not join, should not benefit ex post.

The scheme would constitute an explicit coordination device for the rescue of large international banks. The liquidity charges, as insurance premia, provide a mutually agreed metric for systemic risk and would offer a basis for burden sharing. In case of need, countries might contribute to funding the ELIF in proportion to the share of each national banking sector in liquidity charges paid during the pre-crisis period, rather than some politically debatable country quotas.

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