

# CSFI

## CENTRE FOR THE STUDY OF FINANCIAL INNOVATION

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**Basel 2 and liquidity: A round-table with Diane Moore (FSA), Geoffrey Underhill (University of Amsterdam), David Rule (ISLA), John Tattersall (PwC) and Steven Hall (KPMG) held on Thursday, April 24, 2008, at Armourers' Hall, 81 Coleman Street, London, EC2R 5BJ, from 12:30-2:15pm.**

The financial turmoil has thrown Basel 2's purpose into doubt in many corners, particularly its focus, or lack of it, on liquidity. The first speaker said such discussion going into Basel, mainly through the Working Group on Liquidity chaired by the Bank of England's Nigel Jenkinson, will provide the Basel Committee with a stock-taking of existing regulatory and supervisory standards for liquidity risk management. It is likely to report in the summer.

Looking forward there are clearly key questions to be answered. What level of resilience do people want? Having decided that, how does one quantify it? The biggest challenge is to make it effective. Given that this is effectively a revisiting of these issues, it is obvious that this time it needs to be brought to life. However one member posed a counterview – given that only two banks have folded and that there has been no major global economic effect, surely the system worked well and the idea that one could do better is unproven.

The second speaker quoted Adam Smith's dictum that to "widen the market and narrow the competition is always the interest of the dealers". Basel 2 was the result of the industry lobbying to deal with the failures of Basel 1 and improve liberalisation, market access, use of models and innovations. Supervisors effectively adopted that agenda. What was the impact of Basel 2? Its QIS5 review found it was best for large banks that proposed it as it reduced their capital charges more. It also has a redistributive impact from developing to developed countries. Lastly ratings agencies benefited from the incentives to obtain ratings.

He said Basel 2's would fail to contribute to financial stability. Firstly private ratings agencies should be used as agents of public supervision as they are in the current system. Secondly Basel was supposed to deal with securitisation and yet actually contained incentives for banks to securitize. Thirdly the most systemically important banks were cut the most slack, creating risks that supervision would be pro-cyclical. Lastly research shows a negative impact on cost of capital and volatility to developing countries, making a crisis there more likely.

The speaker did not want Basel 2 scrapped but wanted less emphasis on market efficiency and more on stability and the precautionary principle. He urged greater stakeholder and public sector input while the onus should be on banks to explain what they are doing. Lastly there should be an effort to "join the dots" between financial supervision, credit and business cycles, pro-cyclicality, monetary policy and asset bubbles, which are currently dealt with in a compartmentalised way.

The third speaker drew two lessons. The first was there was a “hole” between overnight money and 12 month money. Secondly there are no reliable lenders in this world other than central banks. Central banks have lent term money on wide collateral. One implication is that regulation has to be diversified, as one never knows which market will dry up. Big banks should be in all major lending markets to avoid a Northern Rock situation.

The key is to tie liquidity regulation standards umbilically to central bank rules on lending. They should hold eligible assets in a quantity in accordance with their liquidity risk and in a way that consolidates different currency holdings. At its heart is a trade-off between central banks taking on more risk in exchange for banks obeying more onerous liquidity requirements. Another issue is how those assets should be held. In the UK, for example, they are held on repo for five days. The Northern Rock situation begs the question whether they should be held outright.

He said it was clear banks were undercapitalised. There had been no recession or corporate loss yet but already banks had run out of capital. Supervisors should ask for more capital: “Don’t move the deckchairs, we need more deckchairs.” But how much was a difficult issue. The first speaker said European banks had been told to hold an equivalent to what they had just lost, which seemed a good ready reckoner.

The fourth speaker denied banks were undercapitalised. The issue was market liquidity and the potential impact of falls in prices. Basel 2 was about capital not liquidity, which is seen as something that flows from capital. The problem was that risk management did not identify the risks, so if banks held paper that’s liquidity depended on being able to substitute it with loans through channels that become unavailable, then you had a problem – but not a Basel 2 problem, per se.

Looking forward risk management is vital and supervisors need to challenge banks’ boards about how much liquidity risk they are taking and what shocks they are stress-testing for. One challenge is to ensure greater consistency of collateral to enable cross-border rescues and similarly regulation generally should be internationally consistent so supervisors do not find other countries putting barriers up to liquidity transfers.

The final speaker said Basel 2, while not perfect, was valuable. It has been a driving force for improving risk management but its introduction turned out to be badly-timed. If Basel 2 had been fully in place, it might have softened the blow. He said he was glad there had been no knee-jerk reaction on the lines of Sarbox and believed Basel 2 was here to stay. There are still challenges: redundancy programmes may see the loss of the very people needed to run risk control; banks need to return to due diligence rather than relying on ratings agencies; there is a need for greater comparability across countries.

One member used a sporting analogy to highlight the need for this contract between authorities and banks. There should always be enough players on the field to keep the market open. When one player was injured they should be able to survive long enough to find a price for underlying collateral – five days was inadequate. Lastly they should make sure players were not operating to different rules off the field. The market will have to wait and see if the Basel process can produce that ideal outcome.