

Why we should worry about liquidity

By Andrew Large

Published: November 11 2004 02:00 | Last updated: November 11 2004 02:00

Significant progress has been made in recent years in addressing key potential threats to financial stability. This has been timely, given the dramatic increase in financial transactions and activity.

In credit risk, attention has focused on Basel II, the new international capital standard. Capital requirements play an important part in encouraging banks to maintain adequate financial resources to avoid a life-threatening erosion of confidence or outright insolvency. Efforts to manage these risks more effectively are an important underpinning to financial stability.

Likewise, there has been growing recognition that failure of key infrastructure - particularly payment, clearing and settlement systems - can prevent trades from being completed and increase the vulnerability of the financial system. Greater focus on this area, for example by the European Commission, is timely and welcome.

But there is another critical aspect of financial resilience where progress has been less marked - liquidity. Liquidity problems, which may be triggered by insufficient capital or insufficient liquid assets can also lead to insolvency and can be an immediate threat to financial stability.

I use the word "liquidity" in two senses. First, institutional. The essence of banking is the ability to provide payment - whether routinely from management of cashflows and access to money markets or, in times of pressure, from a cushion of liquid assets, or access to central bank facilities - when contracts are due. Second, "liquidity" relates to the depth of markets - the ability to transform assets into cash without a significant price discount or "one-way" markets developing.

Banks themselves have changed dramatically as the structure and diversity of financial markets and products have broadened. Concentration within the financial sector has increased with the evolution of a relatively small number of very large institutions, each undertaking a wide variety of financial business. Typically, the resulting "mega-institutions" operate globally. This can also increase the risks of contagion.

The complexity and characteristics of markets have also changed, raising questions about the robustness of liquidity in the face of shocks. New products and globalisation have linked markets that used to be less connected and led to correlations between previously independent asset classes.

A macro-environment of sustained low nominal interest rates and accommodatory fiscal policy in big economies has also encouraged financial institutions and investors generally to increase their holdings of less liquid assets, in an effort to sustain nominal returns by taking on higher risks. This "search for yield" - whether through direct holdings of assets or, indirectly, via alternative investment vehicles such as hedge funds - has encompassed a whole variety of asset classes, from mortgage-backed securities to high yield debt, from oil to real estate.

It seems likely that trading strategies based on a similar rationale will lead both to concentrations and interdependencies between asset holdings. This could increase the prospect of one-way markets developing and market liquidity evaporating in response to a shock. The fact that many banks adopt similar modeling techniques, assumptions, and risk management standards, and place a greater reliance on dynamic hedging might also exacerbate such market movements. Common sense suggests it would be prudent to hold liquidity cushions against such a possible outcome, particularly given the opacity of the concentrations.

The counterweight to such concerns is that market liberalisation and more advanced derivative techniques have dispersed risks and helped to reduce the threat to financial stability. Indeed, the evidence suggests that markets have continued to operate smoothly despite recent significant disturbances, including sovereign debt defaults and burst equity bubbles.

What is clear is that the greatly expanded size of and activity in today's financial markets make it particularly important to ensure confidence in both institutional and market liquidity. The private sector and public authorities would be unwise to draw undue comfort even from today's outwardly quite benign market environment.

The private sector has a crucial role in addressing institutional liquidity issues, through its own liquidity management. Added focus on the degree, nature and location of the liquidity cushions appropriate for today's demanding environment would appear timely. While regulators are often addressing this in a domestic context, there are currently no internationally agreed guidelines. It seems to me that public authorities and market participants should direct more attention to the concept of international prudential standards for liquidity management.

Public authorities also have a role in making clearer the international operational framework within which emergency liquidity may be made available - though, for moral hazard reasons, not the precise criteria. For countries like the UK, with global financial centres, deciding whether and in which country to provide liquidity support for a so-called "large complex financial institution" has become more difficult, and the mechanics of providing such support more complicated.

Useful work is being done in many of these areas but there would be real merit in encouraging a broader focus on liquidity issues. This would help to underpin confidence in markets, at a time when monetary policy internationally has become less accommodating and geopolitical shocks cannot be ruled out.

Sir Andrew Large is deputy governor of the Bank of England

"Why we should worry about liquidity", written by Sir Andrew Large, published by FinancialTimes <http://news.ft.com/home/uk> November 11, 2004. Reproduced with permission. Sir Andrew Large's article was written for the Financial Times and is reproduced for Vanguard investors.