Chapter 13
Liquidity Risk Challenges to Regulators in Prudential Supervision

ABSTRACT

Basel regulations have evolved a long way – since their initial introduction under the 1988 Basel Capital Accord. With liquidity risks and leverage ratios now constituting additional focal points for regulators, issues relating to calibration need to be addressed. This section elaborates on the factors and rationale behind liquidity measures, present initiatives being undertaken to address such measures - as well recommendations aimed at enhancing such liquidity measures.

INTRODUCTION

Two vital prudential regulatory tools which Basel III addresses, namely capital and liquidity requirements, are considered to be instrumental in triggering the first of two types of crises (banking crises). These crises, as identified by Lastra and Wood (2010), are banking crises¹ and financial crises². Even though various factors have been put forward as constituting principal contributory factors to the recent Crisis (Lastra & Wood, 2010)³ the need to address liquidity requirements and particularly liquidity risks, – along with the role which market based regulation can assume to achieve this aim, will constitute the recurring theme of this chapter.

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The definition of liquidity, as provided by the Bank of International Settlements (BIS), is “the ability of a bank to fund increases in assets and meet obligations as they come due, without incurring unacceptable losses. The fundamental role of banks in the maturity transformation of short-term deposits into long-term loans makes banks inherently vulnerable to liquidity risk, both of an institution-specific nature and that which affects markets as a whole” (BIS, 2008).

A liquidity crisis is considered to be “the classic type of banking crisis whereby a bank for some reason, cannot meet all its payment obligations” (Lastra & Wood, 2010). The role played by imperfect knowledge in triggering such a crisis is further elaborated. In this sense, bank runs are triggered as a result of such “imperfect knowledge which customers have of their banks, and the links through the interbank market and payment system” (Lastra & Wood, 2010).

The ECB’s Financial Stability Review (2009), identifies the fact that “the specific knowledge that banks possess about their borrowers make bank loans particularly illiquid.” The connection between liquidity and systemic risks is further highlighted in the Review where it elaborates on possible consequences resulting from a bank’s failure, namely (ECB, 2009): The “destruction” of such specific knowledge which banks have about their borrowers and the reduction of “the common pool of liquidity.” Such reduction in the common pool of liquidity may also trigger the failure of other banks – with the result that i) the value of such illiquid bank assets diminishes and ii) further problems within the banking systems are aggravated (ECB, 2009).

In their report on “Addressing Pro cyclicality in the Financial System: Measuring and Funding Liquidity Risk”, the Financial Stability Forum (FSF) noted that at the onset of the recent financial crises, the complex response of financial institutions to deteriorating market conditions, was to a large extent, attributed to liquidity shortfalls which reflected “on and off balance sheet maturity mismatches and excessive levels of leverage” (FSF, 2009).

For these reasons, even though it has been concluded that “the first crisis of the century was a capital crisis – not a liquidity crisis” (Lastra & Wood, 2010), this chapter advocates for greater attention to be accorded to the topic “liquidity”, as well as measures aimed at addressing liquidity shortfalls - such importance being attributed to their contributory roles in triggering systemic and resulting banking crises. Furthermore the chapter highlights why greater focus on insurance and securities regulation is required since the most effective tools in addressing systemic risk, to a greater extent, will require the
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