Panelist Comments:
Basel III: Liquidity Rules and Regulations

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Where We Stand

- Basel III’s “deliberate but cautious approach” to liquidity regulation:
  - Liquidity coverage ratio to be introduced in 2015.
  - Net stable funding ratio in 2018.

- Big open questions:
  - How to calibrate: what is the right value of the ratio?
  - Coverage: just banks, or beyond?
  - How to deal with regulatory arbitrage?
What Problem Are We Trying to Solve?

- **Microprudential:** fortifying individual institutions.
  - Holding fixed its capital ratio, a bank is more fragile if it has more short-term debt (STD), and/or fewer liquid assets.

- **Macroprudential/systemic.**
  - The financial system as a whole is more fragile when there is a lot of STD.
A Theory of the Case

- Intermediaries like to fund with STD because it is “money-like”, and hence a cheap source of financing.
  - Money-like: short maturity plus collateral makes it near riskless, and hence useful in a variety of transactions.
  - Think of ABCP, and repo—and the fact that these are ultimately held by money market funds.
- But key tension: short maturity plus collateral also creates vulnerability to fire sales.
- And fire-sales effects are not internalized by individual intermediaries.
  - Bank A issues money-like claims, does not account for the fact that this degrades collateral value of Bank B’s assets in a crisis.
These externalities come from any issuer whose combination of short-term funding and asset holdings feeds the fire sale.

- ABS conduit funded with ABCP.
- Hedge fund that repo finances its ABS holdings.

Not just banks!

Magnitude of non-bank money creation is huge: think of $3 trillion of MMF assets.

- And $1.2 trillion of ABCP alone at the peak in 2007.
Weaknesses in Basel III Approach

- Coverage is too narrow: need to deal with maturity transformation in shadow-banking sector.

- Danger that pure quantity regulation with no market feedback will be too tight or too loose.
  - How much of a tax is implicit in the quantity constraint?
  - This depends crucially on market-equilibrium considerations.

- And if it’s too tight, even more activity will flow to shadow-banking world.
An Alternative Approach

- Impose reserve requirements symmetrically on all forms of private money creation.
  - E.g., on money-market funds that hold non-Treasury assets.
  - Not just bank deposits.

- Difference between funds rate and interest on reserves (IOR) acts as a tax.
  - Example: funds rate = 5%, IOR = 3%, reserve requirement = 10%.
  - Reserves tax is approximately 20 basis points.

- Can adjust quantity of reserves in the system to vary the tax, while getting market feedback.
  - If funds rate spikes up relative to IOR, a clue that demand for maturity transformation is rising.
  - Can then decide if you want to inject more reserves to accommodate this demand.
A New Twist on an Old Theme

- Old-school quantity-theoretic view of monetary policy: central bank needs to control “money supply” to rein in inflation.
  - Displaced by more recent view that funds rate is summary statistic for stance of policy; no need to worry about quantity of money.

- But from a financial-stability perspective, should care about total amount of private money creation.
  - To the extent that this money is used to fund illiquid, fire-sale-prone assets.
  - Want to regulate this process in addition to using funds rate to deal with inflation.