NARROW ROAD CAPITAL

Bank capital matters more than liquidity

The announcement on Friday that APRA is winding down the ability of banks to rely on the RBA's Committed Liquidity Facility (CLF) to meet their Liquidity Coverage Ratio (LCR) requirements might be the end of a debate that at times lost sight of the forest for the trees. Bank capital and liquidity ratios are an arcane speciality. They typically don't matter for a long time but when a crisis hits, they are vital. APRA has rightly focussed predominantly on capital ratios since the Financial Crisis, as bank capital ratios are the main event. Liquidity ratios are a sideshow with recent history showing them to be ineffective when it mattered most.

The old debate – capital versus liquidity

For decades, academics and investors have argued whether it is a lack of capital or a lack of liquidity that brings down a bank. The business of banking creates much of its value by maturity transformation, that is borrowing short and lending long. Banks make home loans for 30 years, but depositors want to access their funds at call. This mismatch creates the possibility of a bank run, where depositors withdraw funds faster than a bank can sell its assets or wind down its loans.

Many observers fall into the trap of believing that banks fail because of a lack of liquidity when this is a consequence of a perceived (and often actual) lack of capital that precedes a bank run. Bank runs typically occur on banks that have riskier assets and lower levels of capital, problems that are visible years before the bank run occurs. Conversely, banks in developed economies with healthy capital levels and reasonable risk tolerances are unlikely to face a bank run and can withstand one if they do. (Note that temporary government liquidity assistance may be needed to allow a bank to trade through a bank run – more on that later.)

Changes since the Financial Crisis

The bankruptcies and bailouts of banks and brokers during the Financial Crisis rightly resulted in prudential regulators adopting stricter standards that reduce the risk of future failures. Banks now must hold more equity and subordinated capital relative to their asset base. This ensures that if a small portion of their assets lose value, the bank is sufficiently capitalised to retain an obviously positive equity position. This has been largely implemented with bank failures now rare and limited to those that were weakest on the new standards.

The second major change is the requirement for banks to hold more liquid assets. Whilst this too has been largely implemented, the requirement for governments to intervene and provide liquidity to banks after the onset of the Covid downturn showed the significant limitations of liquidity ratios. These limitations include:

- the regulatory formulas for liquid assets can underestimate what is required when a substantial economic downturn creates a widespread fear of bank failures
- supposedly highly liquid assets can become difficult to trade (even government bonds) and can see significant volatility in their prices
- doom loop risks, where weak banks and weak governments can be brought down by the other

Just as occurred after the onset of the Financial Crisis, governments again stepped in during 2020 to provide liquidity support to banks. This is an inevitable consequence of maturity transformation and political reality colliding. Unless governments instruct their prudential regulators to force banks to hold balanced asset and liability maturities, liquidity risks will remain. This is the accepted cost of having a banking system that provides both liquidity to depositors and long term loans to borrowers.

Why liquidity measures still matter

Given governments keep having to provide liquidity support to banks, some could conclude that liquidity requirements could be ditched altogether. However, the best mechanism for governments (typically via central banks) to provide liquidity support is via repurchase arrangements. This requires banks to have a stock of reasonably generic and low risk assets to provide as collateral. These can be securities such as government bonds, senior bank bonds, highly rated corporate bonds or AAA rated securitisation tranches.

How banks "game" the system

Prudential regulators (like APRA) set the rules on what counts as a liquid asset and how much of these banks must hold. They also have a hand in influencing what assets a central bank may accept as collateral as part of repurchase arrangements. Naturally banks will look at the list of acceptable securities and think "what are the highest yielding assets I can hold?" To paraphrase Taylor Swift, players gonna play, haters gonna hate, and bankers gonna optimise.

Some argue that this sort of activity is gaming the rules and banks should only hold government bonds, as they have historically been the most liquid securities. However, even by APRA's own rules government bonds arguably failed the test during March 2020 to have a "proven record as a reliable source of liquidity in the markets (repo or sale) even during stressed market conditions." On a strict interpretation, only cash assets (mostly balances held with a central bank) are truly liquid throughout the market cycle and won't see volatility in their prices during a severe downturn.

APRA's wind down of the credit given to CLFs effectively forces banks to increase their holdings of government bonds and decrease their use of other securities. This will improve the liquidity profile of banks, but it is unlikely to remove the need for government liquidity support in future downturns. We could see the RBA's term funding facility (TFF) resurrected every significant downturn, or it could become a semi-permanent feature like the ECB's facilities.

One possible negative consequence of the change is that banks will replace floating rate bank bonds and securitisation tranches with the highest yielding remaining assets, long duration fixed rate government bonds. Credit risk may be reduced but it is replaced with duration risk. It is often assumed that government bonds will increase in price during a downturn (lower interest rates create higher prices on fixed rate bonds) but what if the next crisis occurs when central banks choose to normalise/raise interest rates?

The liquidity versus capital trade-off

A final point on this issue is the reduced revenue banks will receive from holding more government bonds and less securitisation tranches. Whilst the impact is likely to be a very small percentage of a bank's current profit, it is worth considering how much additional subordinated capital could be added with that lost revenue? This is near impossible to know as banks don't disclose that level of detail on their assets. However, as a rough estimate, I suspect tier 2 capital could increase by more than 1%. If it was my choice, I'd choose more capital over more liquidity every day of the week given bank capital matters more than liquidity.

Written by Jonathan Rochford for Narrow Road Capital on 11 September 2021. Comments and criticisms are welcomed and can be sent to info@narrowroadcapital.com

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