RBA's Third Law of Finance

The Australian banks are being myopic in their negative reactions to APRA's proposals for strengthened liquidity requirements.

Those proposals involve a more restricted definition of liquid assets to those which can be used in normal repo transactions with the RBA (such as Government Debt) and increasing the length of the time period used in assessing whether a bank can cope with adverse circumstances leading to deposit outflows. Essentially, banks will have to hold more liquid assets such as Government debt.

At one level, social benefits from future crisis avoidance may outweigh any private costs argued to exist from such strengthened liquidity requirements. Banks have an important and privileged role in the economy, benefit (as we have recently seen) from government support, and can expect to bear some regulatory costs in exchange.

But more relevant, the individual micro perspective of the banks assumes *ceteris paribus*, and *ceteris* ain't *paribus*. It is true that if all that happens is that banks swap a given quantity of lower yielding liquid assets for higher yielding loans, bank profits drop.

But even in this simple case, the result is qualified by a possible increase in loan interest rates (due to the lower supply). Also possible, but highly unlikely given depositor and debt holder perceptions of implied (or currently actual) government guarantees over banks, would be a decline in interest rates paid due to perceptions of increased bank safety. A further factor to consider is a reduction in bank capital requirements if liquid assets have a lower regulatory risk weight.

A much more significant consideration though is the nature of the adjustments required for the banking and financial sector as a whole. Should we really expect that the authorities will leave the aggregate supply of outside liquid assets (cash, government securities etc) constant and accept a consequent reduction in bank lending?

More likely, arguably, would be an increase in aggregate liquidity allowing an increase in bank deposits with bank lending kept unchanged. Bank balance sheets would be larger in aggregate by the amount of additional liquid assets banks are required to hold. And to the extent that deposit interest rates are lower than the return received on liquid assets, banks may even have increased profits!

Wouldn't an increase in aggregate liquidity and bank deposits be inconsistent with the RBA achieving its target cash rate? No, in fact an increase in aggregate liquidity may be needed to keep the cash rate constant when regulatory requirements for increased bank liquidity holdings are introduced.

Tracing through the aggregate consequences of introducing the specific APRA proposals is not simple. But a general idea can be gained by considering what would happen if a hypothetical alternative were introduced which required banks to hold some minimum percentage of assets (say 5 per cent) as interest-bearing deposits with the RBA.

Generally (except during the depths of the Global Financial Crisis), the banks operate with deposits they hold in accounts at the RBA to settle interbank payments as close to zero as practicable, relying on interbank lending to get funds into their accounts when facing outflows. In the hypothetical situation, all that changes is the banks work with a target balance of just above 5 per cent of assets rather than zero.

As a very rough first approximation, when the hypothetical new requirement is introduced, the RBA would need to increase the supply of cash in the economy by the same amount as the increase in bank demand for it, in order to keep the cash rate constant. And to keep bank lending unchanged (since a reduced proportion of deposits is now available for loans) the increase in cash may need to be greater. That injection of cash would flow through into an increase in bank deposits.

APRA's specific proposals (quite different to the hypothetical example used above) may need some refining and certainly warrant extended discussion and evaluation. And it might even be asked whether use of a simple reserve ratio, as in the hypothetical example above, which could be varied as an additional instrument of monetary policy might not be worth considering.

Although compulsory liquid asset holdings are, paradoxically, illiquid (because they can't be drawn upon), a variable minimum requirement (like the Statutory Reserve Deposit ratio of long ago) may be a worthwhile macro-prudential alternative to countercyclical capital requirements for influencing credit creation.

Bank bleating about adverse profit consequences of APRA's liquidity proposals without recognizing and analyzing the consequences of aggregate effects is misplaced. In this regard, it would be valuable to have more information from the authorities about how they anticipate the aggregate financial system adjustment to the new regulations occurring.

Kevin Davis is Research Director of the Melbourne Centre for Financial Studies, Professor of Finance at The University of Melbourne (and a shareholder in a number of Australian Banks).
3-11-09