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BANKING ON KNOWLEDGE

Banker's Take

Re-regulation will change the dynamics of liquidity management

By Dr R Seetharaman

The Financial Stability Board (FSB) is concerned recently as to whether exchange traded funds (ETFs) based on assets that trade in less-liquid markets would be able to sell their holdings and honour all their obligations during a large withdrawal. The FSB is examining whether ETFs pose a risk to market stability when interest rates start to rise.

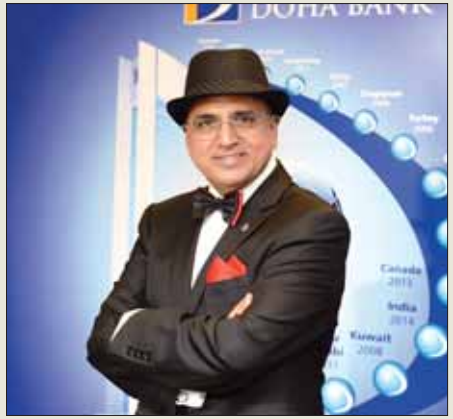
The global market for ETFs had grown to $2.7tn in the last decade. The underlying assets of ETFs may be liquid only in respect of the equity, but they are diversified with other assets which could be illiquid.

The US Federal Reserve is forecast to start raising its benchmark rate by the middle of next year. The value of fixed-income products, and the ETFs tied to them, would generally decline as rates rise. Bond liquidity had dried up for corporate issues after new regulations and capital requirements forced Wall Street banks to slash their inventories of fixed-income products following the financial crisis.

GCC (Gulf Co-operation Council) regulators are expected to follow the new Basel III liquidity requirements, but may face challenges in relation to liquid assets and in developing market liquidity as domestic debt market is still under development. Qatar has made some efforts in this direction. The Basel III liquidity requirements should give an impetus to domestic debt market development in the GCC.

In relation to net stable funding requirement, banks need to match the maturity of their funding more closely with the maturity of their assets. In relation to GCC, this could mean more retail deposits, issuing long-term liabilities, or reducing on long-duration assets.

There is also a need to limit the build-up of liquidity risk that can occur when short-term foreign borrowings are channelled into funding medium- and long-term domestic lending. The measures to limit foreign funding risks may include higher reserves required for short-term foreign liabilities and limits on foreign currency lending. Liquidity



requirements aimed at more closely matching the maturity of liabilities with the maturity of their assets can be calibrated specifically to target foreign liabilities.

The FSB has also highlighted that there are increasing signs of complacency about risks in financial markets, in part reflecting a search for yield amidst exceptionally accommodative monetary policies. Volatility in asset prices has become compressed and asset valuations stretched across a growing number of markets, increasing the risk of a sharp reversal. While market forces and regulatory reforms since the crisis have reduced leverage in the banking system, leverage has picked up in other parts of the financial system, including in corporate debt markets.

There are also concerns about the mispricing of liquidity risks. Authorities are stepping up their monitoring of the migration of risks to less regulated parts of the financial system.

A number of emerging market countries have taken policy measures to reduce risks that could arise from volatile capital flows and market dislocations. The FSB has also made further progress in defining the terms and conditions of total loss absorbing capacity for global systemically important banks (G-SIBs) and in finding solutions to remaining obstacles to cross-border resolution.

The FSB plans to present an updated roadmap for "shadow banking" in the Brisbane Summit. The FSB has conducted a feasibility study on approaches to global aggregation of OTC (over the counter) derivatives data and will publish the report and recommendations.

The FSB discussed this month with the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) on new standards for the financial sector that take account of the lessons of the crisis and introduce forward-looking expected loss provisions for loan losses. The FSB has also approved the recommendations for reforms to foreign exchange benchmark practices. The global regulatory reforms have made progress and re-regulation developments will change the dynamics of liquidity management.

Dr R Seetharaman is Group CEO of Doha Bank. The views expressed are his own.