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Containing System-Wide Liquidity Risks: Some Issues and Challenges - Speech by Nigel Jenkinson

This afternoon, Nigel Jenkinson - an Adviser to the Governor - sets out a number of high-level objectives that should help guide future research and analysis on the development and design of a framework to strengthen the regulation of system-wide liquidity risks.

He begins by briefly reviewing the origins of the present financial crisis, noting that "defences against a rise in system-wide liquidity pressure were clearly inadequate" and that "attempts by banks to use defences designed to address idiosyncratic liquidity problems.severely compounded system-wide stress". As such he notes that, "reducing the likelihood and impact of future episodes of system-wide liquidity risk is high on the policy agenda". He welcomes the initiatives being taken by the Basel Committee and Committee of European Banking Supervisors to strengthen the management and supervision of liquidity risk by individual firms, but believes future financial regulation needs to take stronger account of system-wide implications.

He goes on to provide a preliminary assessment of some of the issues and challenges in meeting five high-level objectives that he believes should influence the future design of a new framework:

Objective 1: Liquidity regulation should encourage prudent liquidity risk management by individual banks. Defences should be robust to both the crystallisation of firm-specific and market-wide stress.

Objective 2: Liquidity regulation should provide a disincentive for banks to increase liquidity risk. The disincentive should take into account the impact of liquidity risk distress at the bank on the overall financial system.

Objective 3: Liquidity regulation should guard against the crystallisation of system-wide liquidity risk. Disincentives to contain liquidity risk should increase as system-wide liquidity risk rises.

Objective 4: Regulatory standards should be applied consistently internationally, to prevent regulatory arbitrage and leakage.

Objective 5: The design and operation of central bank facilities should underpin incentives for banks to manage liquidity risk prudently, in the long-run interests not only of the banking system but of the wider economy.

He believes that good progress has already been made in some of the areas discussed, but in others research is only just beginning. In conclusion, he argues that any new framework "must balance the containment of system-wide liquidity risks.against the benefits the financial system provides through maturity transformation and the taking of liquidity risk".

http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2009/speech388.pdf