Easing Liquidity Regulations to Counter COVID-19

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Many countries are easing liquidity regulations to help banks get cash to their customers and to prevent liquidity shortages from spreading across financial markets. Countries are addressing liquidity shortages using two main tools: the liquidity coverage ratio (LCR), which most developed countries implemented in recent years as part of the Basel III agreements, and the more traditional reserve requirement ratio.

LCR rules require banks to hold high-quality liquid assets (HQLA) sufficient to meet their needs through a 30-day liquidity stress scenario. Most countries that have an LCR rule have now eased its enforcement, encouraged by the Basel Committee itself in March. Other countries have lowered their reserve requirements, the amount of cash relative to liabilities that banks must hold on reserve with their central bank. A few countries have taken other measures, such as easing rules on foreign exchange liquidity. All of these tools are countercyclical and macroprudential, in that regulators are now using them to spur broad-based lending during a difficult crisis.

This blog discusses options for easing liquidity regulations:

1. Which tool to use?
2. How long will the change last?
3. Will the government provide a backstop?
4. Are there targets or conditions for use?

Which tool to use?

Reserve requirements

Central banks have used reserve requirements to pursue monetary, macroprudential, and other policy goals for a very long time. Since central banks generally pay less than other cash-like instruments, reserves are costly for banks to hold. By raising the reserve ratio, a central bank can impose a tax on banks, tightening credit; by lowering it, the central bank can reduce that tax, incentivizing banks to lend. From the 1930s until the 1990s, the U.S. Federal Reserve used the reserve ratio frequently as a countercyclical tool, typically in conjunction with its monetary policy.

But reserve requirements lost favor in the U.S. and other developed countries amidst the deregulatory trend in the 1990s and 2000s. In recent years, it is primarily emerging economies that have used reserve requirements as a countercyclical policy tool. Since 2004, no advanced economy has actively managed its reserve ratio countercyclically; 90% of developing countries with reserve requirements have done so, including during the 2007-09 global financial crisis.

This trend has held in the current crisis. According to the YPFS Financial-Intervention Tracker, 22 countries, mostly developing countries, have lowered their reserve ratios or otherwise eased

their reserve policies this year. The Democratic Republic of the Congo and Iceland have cut their ratios to zero, from 2% and 1%, respectively. Others have made larger cuts. The United Arab Emirates (UAE) cut its reserve ratio from 14% to 7%; Croatia cut its reserve ratio from 12% to 9%.

Some countries made multiple cuts. Brazil cut its reserve ratio from 31% to 25% and later to 17%. The Philippines reduced reserve requirements from 14% to 12% and signaled up to another 2% of cuts. China cut its reserve ratios three times since the beginning of 2020.

Liquidity Coverage Ratio (LCR)

Global regulators developed the LCR after witnessing extraordinary, systemic wholesale funding runs in the global financial crisis. Its purpose is both microprudential and macroprudential, although some viewed it more as a microprudential tool before the current crisis. By requiring every bank to hold sufficient liquidity to make it through 30 days of stress, the LCR reduces the potential for asset fire sales and wholesale funding runs to spread across banks.

While the decision to ease the LCR is up to the discretion of supervisors or financial stability committees, the wording in the 2013 Basel agreement on the LCR strongly suggests supervisors should do so in a systemic crisis. The concern is that the actions banks may take to maintain their LCRs above 100% could lead to the very financial contagion supervisors seek to avoid. "[I]n a situation of sufficiently severe system-wide stress, effects on the entire financial system should be considered."

The members of the European Union and more than a dozen other countries have eased their LCR policies in response to the COVID-19 crisis. In explaining its policy easing on April 3, the European Central Bank (ECB) noted: "It is key that banks make use of the buffer under stress, even if that means falling substantially below the minimum 100% level, in order to ensure liquidity in the system and avoid contagion effects and chain reactions that might trigger liquidity problems in other institutions."

The UAE, South Africa, and Korea have set new targets of 70%, 80%, and 85%, respectively. The U.S., ECB, and most others that eased their LCRs did not specify a new target below 100%. Some experts have argued that this lack of specificity will limit the usefulness of easing the LCR in these countries.

A few countries with LCRs, including Australia and China, have not eased them during the COVID-19 crisis. China has aggressively eased its reserve requirements. Australia is unusual in that it allows banks to use a committed liquidity facility from the central bank to stand in for a substantial portion of high quality liquid assets in calculating their LCRs.

Net Stable Funding Ratio (NSFR)

Global regulators also included the net stable funding ratio (NFSR) in Basel III. The NFSR requires banks to maintain sufficient stable funding to meet maturing liabilities and other needs for one year. This helps to prevent banks relying on wholesale funding during booms and encourages them to better assess liquidity risk on and off their balance sheets.

A handful of countries have adjusted their NSFRs or related policies during the COVID-19 crisis. Singapore has lowered its NSFR for loans to households and businesses maturing in the next six months from 50% to 25% until September 2021. India has delayed implementation from April to October. Malaysia is sticking to its July implementation date, but will require an

NSFR of 80% rather than 100%. Australia has allowed banks to include their initial allowance under the central bank's Term Funding Facility in their calculation of the NSFR.

Foreign Exchange Measures

There is no lender of last resort to help borrowers whose debts are denominated in foreign currencies. During a crisis like the current one, liquidity shortages can propagate across borders, as happened in the Asian financial crisis of 1997-98. Since then, several emerging-market countries have foreign currency reserve requirements or liquidity coverage ratios to address currency mismatches. A few countries raised those requirements prior to the global financial crisis and later eased them. This year, some countries have eased these rules. South Korea lowered its foreign exchange LCR from 80% to 70% for banks until May. Indonesia expanded the range of transactions foreign investors could use to hedge their holdings of rupiah.

Measures changing the assets that can be counted for reserve ratios, LCRs, or NSFRs

A few countries changed their definitions of HQLA for the LCR calculation or of assets acceptable as reserves for determining reserve requirements. For example, Brazil's central bank increased the amount of central bank reserves that financial institutions can count in calculating their LCRs. This had a similar effect as lowering the LCR. Similarly, Iceland's 1% reserve ratio reduction effectively boosted the HQLAs, and thus the LCRs, for some banks.

The Dominican Republic revised the rules around its reserve ratio so that financial institutions could count central bank and finance ministry securities for up to 2% of their reserve ratios. This had a similar effect as a reduction in banks' reserve requirements.

In cases where an asset class has become or might become less liquid, governments might allow those previously liquid assets to count as HQLA for a longer period of time. Canada activated its hardship exemption for the LCR. This allows institutions to permit early outflows from retail and small business term deposits without imposing a penalty since they are not required to write down these withdrawals as LCR outflow.

How long will the change last?

Policymakers have to think about how long a liquidity easing tool will be in place, but how they choose to communicate the length of a program can be just as important. In 2012, the Bank for International Settlements (BIS) suggested that easing is more likely to be effective if authorities make a credible commitment to maintain loose policies for a "pre-specified period of time, or conditionally until the threat [...] has passed."

Some countries have been very specific about the duration of their reserve requirement changes. Chile said its change allowing banks to fulfill the foreign exchange reserve requirement using Chilean pesos, euros, and Japanese yen would end September 8. India lowered its cash reserve requirement for one year. The Philippines framed its easing as conditional on "the impact of COVID-19 on domestic liquidity." Others, like Turkey, Sri Lanka, and the UAE, did not say anything about how long they would maintain relaxed reserve requirements.

Most countries easing their LCRs were though not specific about the duration of the measure. The ECB only specified that it would "allow banks to operate temporarily below" the LCR. South Africa said its LCR cut would last "for the duration of the crisis." An exception was South Korea, which lowered its foreign exchange LCR only through May.

The 2013 Basel agreement said that supervisors should have a range of tools for dealing with a bank whose LCR drops below the target, depending on factors such as the severity and duration of the decline and whether the problem is idiosyncratic or systemic. At a minimum, a bank should report to the supervisors with an assessment of its liquidity position. "Potential measures to restore liquidity levels should be discussed, and should be executed over a period of time considered appropriate to prevent additional stress on the bank and on the financial system as a whole."

The U.S. took such a flexible approach. The central bank said that a bank that falls below the LCR "must submit a plan to its supervisor. But there is no requirement to rebuild high-quality liquid assets within a specific time period." The Bank of England made a similar statement.

Will the government provide a backstop?

The BIS said authorities should coordinate the easing of liquidity buffers with central bank liquidity support. The availability of central bank support can help reassure markets and make financial institutions more likely to actually use the liquidity buffers they have built above the required amounts. In describing first-quarter results to analysts, the CEO of JPMorganChase said the company's "liquidity position remains strong" even as it prepares to use internal buffers, reflecting that JPMC has "significant liquidity resources beyond HQLA including the discount window if need be."

Governments frequently coordinate reserve requirements changes with other liquidity-easing tools. Kenya cut its cash reserve ratio (CRR) from 5.25% to 4.25% in the same announcement in which it lowered its central bank rate from 8.25% to 7.25%. India coordinated a cut in its CRR with a targeted long term repo operations, an expanded marginal standing facility, and several regulatory changes. Governments might structure programs so that they support one-another. Australia allowed financial institutions to count some of their assistance from the central bank's Term Funding Facility toward their LCR.

Policymakers modifying their LCR or NSFR in response to COVID-19 have nearly always chosen to announce the measures at the same time as other policy initiatives. Singapore announced its NSFR changes and its policy relaxing capital buffers at the same time. The UK said banks could use their countercyclical capital buffers and liquidity buffers in the same announcement, which also included monetary policy easing and a funding scheme for small businesses.

Are there targets or conditions for use?

Several countries have sought to tie liquidity easing with lending goals during the COVID-19 crisis. The U.S. said it encouraged banks "to use their capital and liquidity buffers to lend and undertake other supportive actions in a safe and sound manner." Other countries made similar statements.

Reserve requirements are easier to use for such targeted policies. Authorities can set higher or lower requirements on various types of liability for policy reasons. They can also guide banks to a particular type of lending by lowering the reserve "tax" if banks meet lending targets.

China is a good example. On March 13 (following up with more information on March 17), China said it would cut its required reserve ratios by 50-100 basis points for large and medium-sized banks that met government criteria for financing small companies. It cut the separate reserve ratio for larger joint-stock banks by 100 basis points, noting: "The funds released are required to

be used to issue inclusive finance loans, and the interest rates of these loans would drop significantly, thereby increasing credit support for the inclusive financial areas, such as MSEs and private enterprises." On April 3, the central bank cut the reserve ratio for the country's 4,000 small and medium-sized banks from 7% to 6%. It also reduced the interest it paid on excess reserves from 72 to 35 bps to further incentivize lending.

Indonesia aimed to help its export-import sector by cutting rupiah reserve requirements (local currency reserve requirements) by 0.50% "for banks financing export-import activity in coordination with the Government."

COVID-19 Liquidity Measures

Reserve Requirements (RR)

Lowered: Algeria (10% to 8%), Aruba (12% to 11%), Brazil (31% to 25% to 17%), China (1.0% cut and then a 0.5% cut) Croatia (12% to 9%), Democratic Republic of the Congo (2% to 0%), Iceland (average RR lowered from 1% to 0%) India (4% to 3%), Kenya (5.25% to 4.25%), Malaysia (3% to 2%), Moldova (41% to 38.5% for Moldovan lei and other nonconvertible currencies), Philippines (14% to 12% and authorized to lower to 10%), Peru (5% to 4%), Poland (3.5% to 0.5%) Sri Lanka (5% to 4%), United Arab Emirates (14% to 7%), United States (eliminated reserve requirements)

Lowered but with no new target specified: Belize

Change to Policy: Argentina (lowered for bank-loans to households and SMEs), Chile (FX reserve requirements can now be fulfilled by euros, Japanese yen, and Chilean pesos, in addition to US dollars) Indonesia (lowered RR 50bp for firms financing import-export) Hungary (exempted credit institutions subject to reserve requirements from their domestic counterparties), Moldova (increased 20% to 21% for freely convertible currencies), Dominican Republic (Central Bank and Finance Ministry securities can count for up to 2% of the reserve ratio; a portion of this figure must be used to finance MSMEs and households in strategic sectors)

Foreign Exchange: Indonesia (8% to 4%), Peru (50% to 9% for instruments with terms of two years or less; additional FX reserve requirements suspended), Turkey (lowered by 500bp)

Liquidity Coverage Ratio (LCR)

Lowered: Korea (100% to 85%), South Africa (100% to 80%), United Arab Emirates (100% to 70%)

Allowed banks to fall below LCR, but with no new target specified: Basel Committee, Canada, Croatia, Denmark, European Union, Finland, Germany, Italy, Japan, Lithuania, Malaysia, Malta, Netherlands, Norway, Poland, Portugal, Romania, Russia, Spain, Sweden, United Kingdom, United States

Changes to Policy: Australia (portion of aid from the Term Funding Facility in the calculation of the LCR), Brazil (a larger portion of reserves now count as HQLA when calculating the LCR), Canada (withdrawals by depositors related to a new hardship exemption will not change the treatment of deposits when calculating the LCR), Chile (decided not to modify the regulatory limit applicable to the LCR), Denmark (institutions can count the ability to roll-over short term borrowing from the Danish Central Bank in the LCR), Mexico (any asset that counted as liquid asset for the LCR as of February 28, can be counted toward the LCR for a period of six months and may be extended for a maximum period up to six additional months), Russia (eased requirements for one method used to calculate an alternative to the LCR, the irrevocable credit line)

Foreign Exchange: Republic of Korea (80% to 70%)

Other Liquidity Ratios

Lowered: Aruba (18% to 15%)

Net Stable Funding Ratio (NSFR)

Lowered: Singapore (for loans to individuals and businesses 50% to 25%)

Policy Change: Australia (included the benefit of the Initial Allowance from the Term Funding Facility in the calculation of the Net Stable Funding Ratio)