Desperately seeking a line in safe assets
By Ralph Atkins in London

As if the world’s central bankers did not have enough to do already.

With the global economy still badly scarred by successive financial crises, another job is falling to today’s masters of the universe: ensuring there are sufficient “safe assets” to keep the financial system functioning.

Overseeing the supply of assets that can be used as collateral or to provide cash quickly may not fit obviously with central banks’ post-crisis responsibilities for supporting economic growth and helping banks in emergencies – while watching out for inflation. But the task is rapidly gaining importance. Investor nervousness is discouraging unsecured lending. More crucially, regulators are demanding stronger cushions of safe assets built into the banking system.

The risk is of a sudden shortage of sufficiently high-quality assets triggering a “collateral crunch” and paralysing credit flows into the real economy. The danger may not be immediate; there are still plenty of high-quality government bonds around, for example. But it is a legitimate concern, for example, in the eurozone, where perceptions about the safety of sovereign debt have been undermined.

Official acknowledgment that this has become a real issue came this week when central bankers and regulators, meeting in Basel, Switzerland, agreed how first-ever global liquidity standards should be applied to banks.

The original plan was to keep the definition of “high quality liquid assets” relatively tight, focused on government bonds, cash and central bank reserves. But on Sunday, Sir Mervyn King, the Bank of England governor who oversees the Basel oversight group, announced a much broader than expected definition, which also included corporate bonds rated as low as triple B minus and even some residential mortgage-backed securities.

This was great advertising for the securitisation industry, still tainted by its role in triggering the global financial crisis in 2007. But with all due respect for mortgage-backed securities – no doubt much improved – their official designation among assets deemed of the highest quality pointed to some devaluation in the meaning of “safe”. The term has become a relative, rather than absolute, measure.
For some critics, regulators have caved into the power of the banking lobby, rendering the new rules ineffective as safeguards for future financial stability. Sir Mervyn put it differently: the changes were not about making the rules stronger or weaker but “more realistic”.

For now, the liquidity coverage rules will not make much difference.

Most large banks meet the requirements comfortably already – not because their books are full of wholesome mortgage-backed securities or corporate bonds but because central banks have flooded the financial system with liquidity through their crisis-fighting monetary policy operations.

Indeed, a simpler approach to liquidity rules would have been to include anything that can be used as collateral to borrow from central banks. Sir Mervyn, however, is looking to the day when central banks can wind down their own balance sheets and return to more normal operations. As he put it on Sunday, central banks should act as lender of last resort – not first resort.

The snag is that the private sector cannot substitute for central banks as anchors of financial stability. Intriguingly, exactly this point was emphasised in research published in Basel just as details of this week’s liquidity rules were being finalised.

In a paper on “global safe assets,” Pierre-Olivier Gourinchas of the University of California at Berkeley and Olivier Jeanne of Johns Hopkins University argue claims on the private sector are “inherently risky and should stay so to limit moral hazard.” Their conclusion is that “besides money, government debt remains the best candidate for the status of safe asset” with central banks having “a role to play in making government debts safe”.

The warning is salutary for the European Central Bank, which last year engaged in a high-stakes battle of will with governments over the region’s debt crisis, even as it took ever bolder measures to stop the continent’s monetary union disintegrating. Greek bonds, for example, were for times banned as collateral to obtain ECB liquidity.

But in other ways the ECB has been exemplary. Generally, its rules have been loosened considerably so banks can now offer a wide range of lower quality assets as collateral to obtain essential liquidity – freeing up higher quality assets for use elsewhere. Europe’s economy would be in peril again if the ECB neglected the supply of safe assets.

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