Effect of Banks' Current Ratio Requirements on Capital Market

Regulations on banks' current ratios require them to ensure the maintenance of liquidity apart from those reserves deposited at the central bank. Korea and other major countries require banks to ensure maintain liquidity in terms of a certain minimum percentage of deposits taken or specific liabilities. Although contributing to the strengthening of banking system stability, this system may also have side effects on the operation of the capital market in the form of bond price distortions when regulations are too severe given the maturity of the bond market. These side effects arise because, under these regulations, banks are inclined to hold bonds that are classified as current assets.

In accordance with the growing importance of banks' current asset management since the financial crisis, the Korean government bolsterd regulations on banks' current ratio in 1999 and, as a result, their bond holdings increased significantly. However, given the degree of maturity of the bond market and the structural changes taking place in the capital market under stricter regulations, it can be said that stricter regulations may serve as a factor distorting bond prices. In this respect, with the use of an econometric model developed on the basis of the Fisher equation, an empirical analysis was undertaken as to whether stricter current ratio requirements distort bond prices. The results show that changes in banks' bond holding patterns following the strengthening of current ratio requirements in 1999 brought down long-term interest rates and thereby distorted bond prices. This view is supported by the substantial difference between movements of real long-term interest rates and those of estimates calculated under a simulation assuming no change in banks' bond holding patterns.

Furthermore, under stricter regulations, various problems seem to arise in the capital market, including the reduced usefulness of the benchmark rate in response to a sharp fall in government bond yields, and the inversion of interest rates on interest rate swaps and those on government bonds. In addition, resource allocation may become less

effective owing to the combined effect of downward distortion of long-term interest rates and poor asset management by domestic banks. In other words, attention needs to be paid to the following problems; ① the phenomenon where by long-term bond market interest rates have remained at a lower level for a long period of time than those determined as a result of real economic activities, ② increased demand for the purchase of assets, including houses, by way of bank loans, ③ rising prices of assets including stocks and real estate, ④ increased issuance of financial debentures by domestic banks for the purpose of raising financial resources for lending, and ⑤ a possible chain reaction running from a widening spread between bond rates to a rise in market rates other than government bond yields.

As discussed above, the existing current ratio requirements for banks may have negative effects on the capital market and therefore efforts need to be made to make improvements to the system. First, the existing system, which requires banks to maintain the ratio of liquid liabilities/assets with a maturity of less than three months at at least 100% should be gradually adjusted to reach the level of major countries (ratio of liquid liabilities/assets with a maturity of less than a month of at least 100%), and won- and foreign currency-denominated liquidities/assets of both domestic and foreign bank branches should be governed by the same regulations. In addition, if adjustments are made only in quantitative terms, domestic banks may be complacent about meeting these standards and still stick to their previous pattern of liquidity management. In this respect, the introduction of qualitative, as well as quantitative, regulations should be positively considered in order to allow banks greater flexibly in developing their own liquidity risk management systems. Particularly, the introduction of qualitative regulations is even more important in order to cope effectively with the changing financial environment, such as maintaining banks' capital adequacy ratios in accordance with the implementation of Basel II starting from 2008, and external shocks such as subprime mortgage problems. In this way it is possible to strengthen the soundness and stability of the banking industry.