

Systemic Loops and Liquidity Regulation

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Discussion by

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Starting point of the paper

- Banks are exposed to spirals between **liquidity** scarcity and **solvency** risk
- Banks face various forms of contagion
 - **Liability side:** short run debt and runs
 - **Asset side:** Fire sales externalities and interconnected debt defaults in the interbank market
 - Problems are exacerbated by banks' tendency to **hoard liquidity** and induced liquidity freezes
- Does regulation help solving these problems?
 - Liquidity Coverage Ratio (LCR)

Main findings

- Model is calibrated with European data via simulated method of moments
- Systemic risk profile is not improved in the phase-in increases of LCR

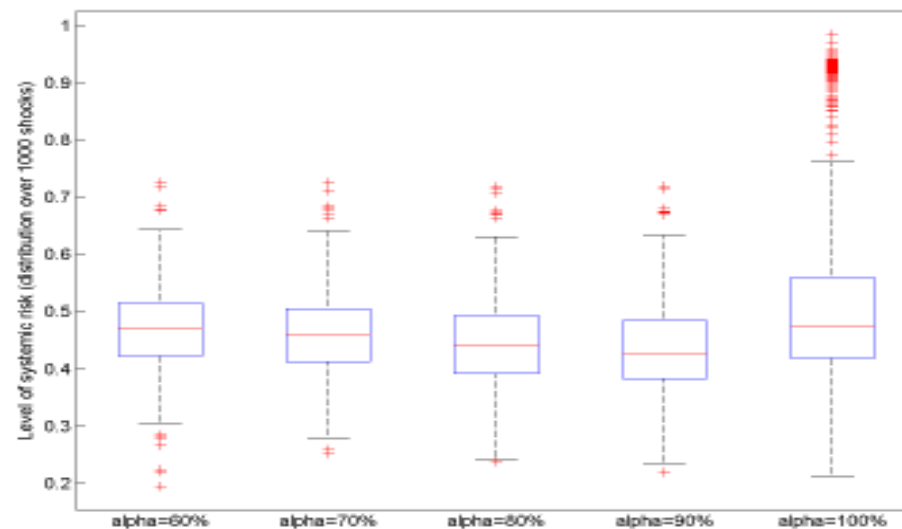


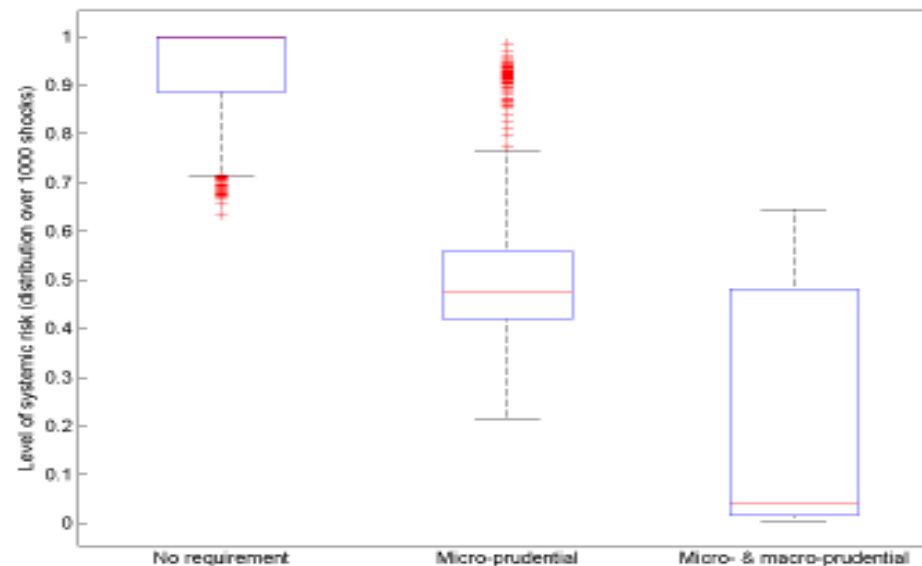
Figure 5: Systemic risk for different stages of the phase-in of LCR.

Main insights

- LCR leads to
 - Lower interbank leveraging and lower risk of debt defaults (+)
 - Higher liquidity buffers and thus lower fire-sales, in the case of investors' runs (+)
- but also to liquidity shortages (-)
 - Lower liquidity supply in the interbank market
 - Same application of the tool for banks with different liquidity needs and asset exposures
- The net effect of LCR is unclear
 - LCR increases systemic risk if reduction in liquidity supply dominates

New policy experiment

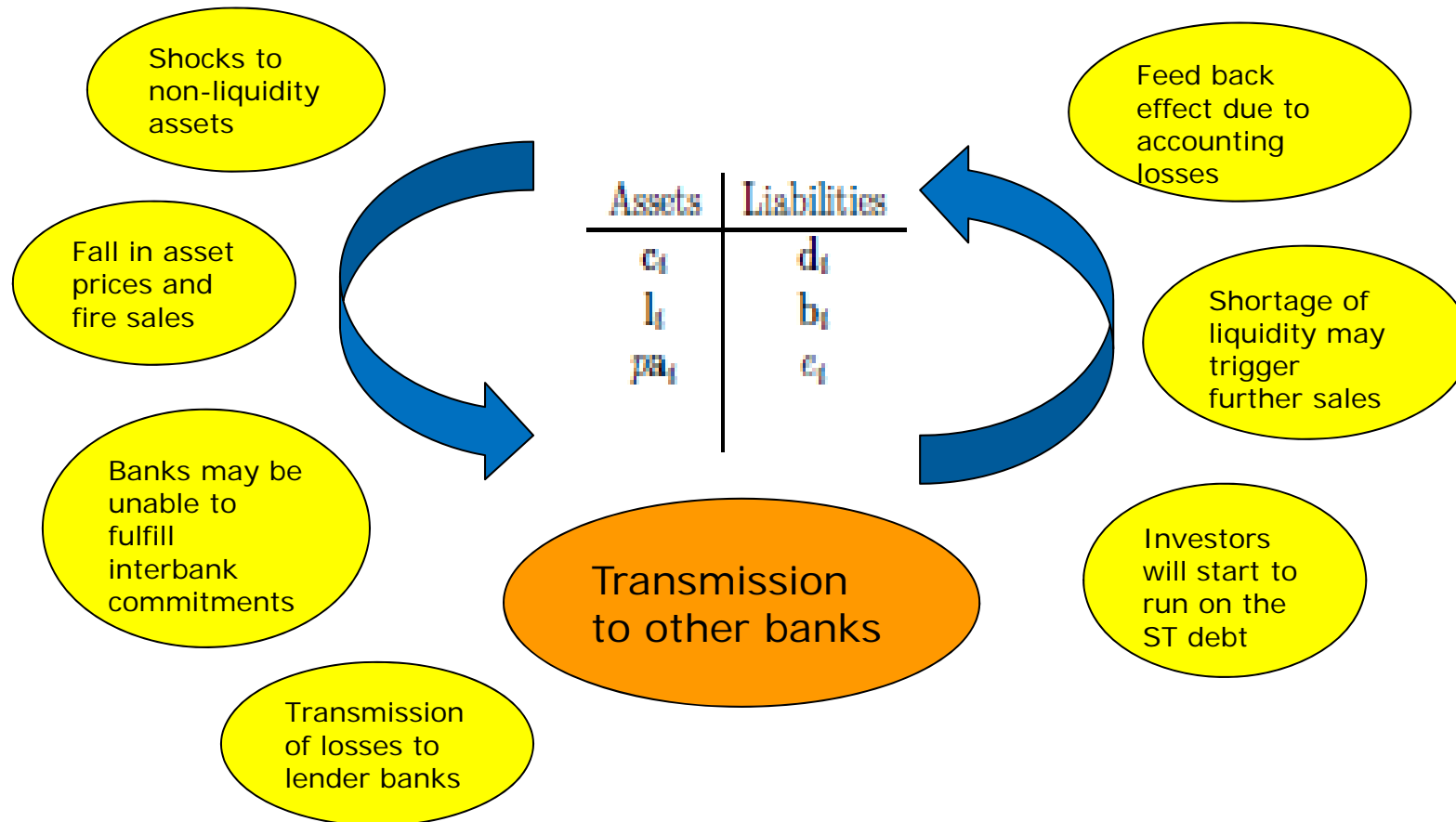
- LCR based upon banks' systemic importance
 - Stricter LCR for more systemic banks depending on their size, interconnectedness and complexity on the asset side
- Systemic risk decreases now monotonically



A few comments

- Very interesting paper, combining micro and macro
 - Very important to understand effects of new regulation
 - Important to build models that can be calibrated
 - Liquidity regulation is very much under-studied
- More specific comments
 1. Channels of contagion
 2. More on LCR
 3. Interaction with other regulatory tools

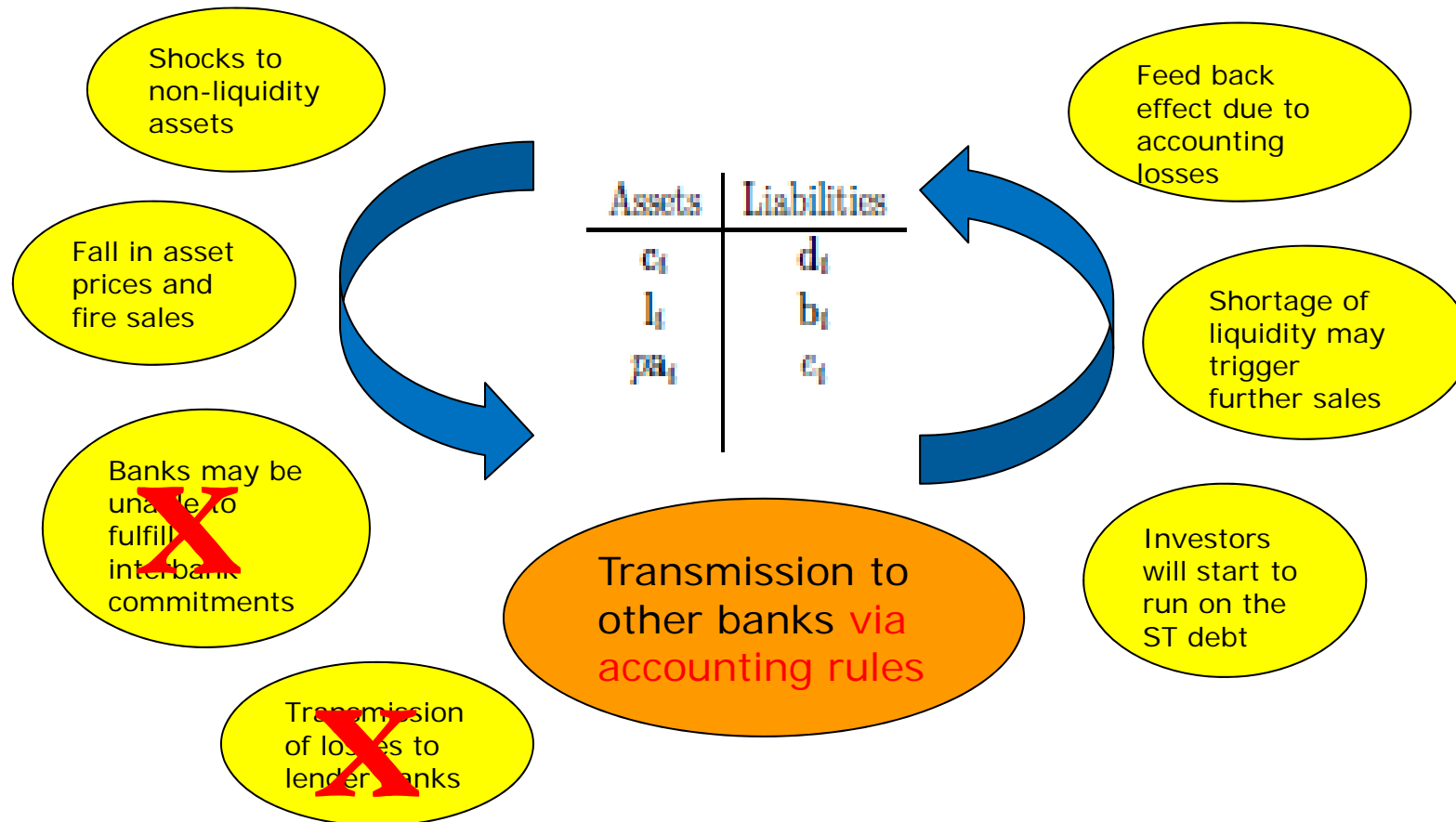
1. Channels of contagion



1. Channels of contagion (cont.)

- Very rich model of contagion – all “necessary”?
- How about to focus on one channel only?
 - E.g., shocks to non-liquid assets and fire sales
 - Transmission of losses through accounting rules
 - Reaction of investors’ at other banks
- Advantages
 - Interbank market is typically considered to deal with liquidity shocks (e.g., Bhattacharya and Gale, 2007; Allen and Gale, 2000)
 - More micro-foundation?
 - E.g., Internalization of effects of shocks on banks’ behavior, investors’ reaction and probability of runs and contagion?

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2. More on LCR

- LCR reduces interbank liquidity – novel effect
- Other contributions:
 - Diamond and Kashyap (2016): Basel liquidity regulation are not optimal because regulators have **imperfect information** about banks' liquidity risk
 - Carletti, Goldstein, Leonello (2016): Liquidity regulation may **increase** probability of runs because it lowers banks' profitability
- Problem with LCR:
 - Uniform application or inability to deploy liquidity in crisis times?
 - Goodhart (2008): Weary traveler arriving late at night sees there is one taxi standing....but **cannot** take it because of local bylaws...

3. Interactions with other regulatory tools

- The paper considers LCR
 - Can the model say something on Net Stable Funding Ratio?
 - Or do we need a model of maturity mismatch?

- More research is needed on the interaction of different regulatory tools
 - E.g., how about capital regulation?
 - Can it help solve some of the negative consequences of LCR?

Conclusions

- Very interesting paper trying to
 - build a macro model with micro features,
 - and to calibrate impact (and optimality) of policy tools on systemic risk

- Suggestions to push the paper further
 - Streamline the contagion channels or justify why they are needed?
 - Discuss other LCR shortcomings – deploy liquidity in crisis time?
 - More on interactions with other regulatory tools?