Liquidity Risk and Contagion

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Key messages

Simulation exercise, showing that

- Contagion via effect on asset prices can be severe
- Interbank linkages *might amplify* contagion effects via asset prices when capital requirements are present (mark to market)
- This effect is possibly non-monotone in number of interbank linkages
- Liquidity and capital requirements should be set in relation to a bank's contribution to systemic risk

Truly important topic

- Understanding sources/determinants of systemic risk (contagion)
  - – liquidity risk focus
  - – contagion not only via interbank linkages
    - → insurance companies
    - → hedge funds (LTCM)
- Implications for regulatory policy
  - – focus on capital and liquidity reserve requirements

Related work

Bank panics are not sunspots:

- Gorton (1988): strong correlation between business cycles and banking panics in the US prior to the creation of the Federal Reserve
- Calomiris-Gorton (1991): American banking panics “ predictable”, i.e. follow stock price declines and business failure increases

Interbank market as source of contagion

We know that interbank market has two effects:

- Reduces the probability that an individual bank fails (Bhattacharya-Gale, 1987 → but further underinvestment in liquid asset)
- Increases the probability of a collapse of the entire banking system (Allen-Gale, 2000)
  - → paper shows that effect via asset prices amplifies this when there are few interconnections
  - → in the limit (many banks/interconnections) no effect

Ex ante versus ex post

Authors clearly spell-out limitations of the analysis

- Only ex post perspective; no tradeoff with ex ante incentives
- True tradeoff requires link with raison d'être of banks
  - banks play also a key role in providing liquidity
    - → in Holmstrom-Tirole (1998): access to credit lines prevents inefficient liquidations

Policy lessons complex

Authors claim that liquidity requirements might be more effective than capital requirements

But are we confusing buffers with requirements?

- selling liquid asset prevents contagion via asset prices, but liquidity requirement would then be violated…

Conclusions

- Paper makes us very aware of the potential importance of contagion via asset prices
- During rest of the workshop, we need to get a feeling for what it truly implies for regulatory policy