Discussion of:

Mobile vs. Immobile Collateral

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There is a lot going on in this paper

- Aim: to evaluate new regulations using historical evidence

I will focus here

- Along the way:
  - discusses changes in the financial systems from 1970-present
    - follows Gorton, Lewellen and Metrick (2012)
  - uses repo fails data as evidence on the scarcity value of Treasury securities 1990-present
    - complements Krishnamurthy & Vissing-Jorgensen (2012, 2015)
  - proposes a resolution of the bank note issue puzzle from the National Banking Era (1863-1914)
    - discussed by Friedman & Schwartz (1963), many others
- From the introduction:
  - “Combining [these steps] in one paper is somewhat unusual …”

Liquidity regulation

- Basel III introduced the Liquidity Coverage Ratio (LCR)
- Idea: require banks to hold assets that can be converted "easily and immediately" into cash during a crisis
  - includes Treasury securities and others (subject to haircuts, limits)
- Goal: prevent a problem at one or more banks …
  - from leading to a fire sale of illiquid assets …
  - that spreads the problem to other banks holding similar assets
- Seems like a reasonable idea (on the surface), but …

The idea here

- Safe assets (like all good things) are scarce
  - perhaps increasingly so since ~2000

repo fails data

- This scarcity has an important financial stability component
  - leads private sector creates short-term debt as a substitute
  - which may initially seem safe … but is subject to panics, etc.

think of MBS/ABS in mid 2000s

⇒ Requiring that banks hold more safe assets can backfire

- it makes these particular, regulated bank liabilities safer
- but leads to creation of other, unstable short-term debt

- Interesting idea. Is there evidence of this mechanism?

The National Banking System

- In earlier banking panics, people rushed to convert bank notes into gold/silver
- Under NBS, bank notes were backed 100% by Treasuries
  - this made these notes safer → no need to rush to redeem
- Stock of Treasury debt declined (relative to GDP) over time

⇓ (causal link?)

- Increased use of demand deposits
- These deposits turned out to be fragile
  - people rushed to convert deposits into (now safe) banknotes
- The “liquidity” regulation was ineffective at preventing panics

- What should we take away from this episode?
- Authors conclude:

  "The LCR is 'structurally identical' to the National Banking System."

  and therefore

  "The LCR is unlikely to reduce financial fragility and may increase it."

- My question: Is this conclusion warranted?
- Suppose we accept that this mechanism is present …
  - does it follow that the LCR is a bad idea?
  - I am not so sure …

LCR ≠ NBS

- The National Banking System rules were rigid
  - each banknote was backed 100% by Treasuries
- The LCR framework is much more flexible

$$LCR = \frac{\text{Stock of unencumbered high-quality liquid assets}}{\text{Net cash outflows in a 30-day stress scenario}} = \frac{HQLA}{NCOF} \geq 1$$

policy choices

- HQLA: cash, reserves, govt. bonds, certain other securities (subject to haircuts, limits)
- NCOF: small fraction of some liabilities (~3% of insured deposits), larger fraction of others (100% of many wholesale deposits)

Q: Is the criticism here about the LCR framework?

- or just about the choice of parameters?

On the liability side (NCOF)

- With no LCR: banks choose a liquidity position …
  - by (explicitly or implicitly) assigning runoff rates to their liabilities
- Do we think they will choose these runoff rates optimally?
  - remember the fire sale externality
  - perhaps now there is a scarce-asset externality
  - seems likely there is still a case for regulation here
- Can I interpret the message here as:
  - there is a cost of “immobilizing” safe assets on bank balance sheets
  - regulators did not seem to fully take this cost into account

  ⇒ we may need to rethink the assigned runoff rates?

On the asset side (HQLA)

- The LCR rules *have* a mechanism for dealing with a scarcity of safe assets
  - in some places (Australia), government debt is really scarce
- Central bank can create a Committed Liquidity Facility (CLF)
  - banks purchase the right to borrow a certain amount from the CB (against illiquid collateral)
  - pay fee for the right, plus the usual fee for any actual borrowing
  - quantity of rights counts toward bank's HQLA

In other words:

- Central banks can *create* a type of safe asset to back short-term bank liabilities

- This approach raises some concerns, of course
  - may shift risk into the public sector
- But remember how the problem of runs on demand deposits was solved: deposit insurance
  - perhaps there is an interesting analogy here
- Stein (2012) advocated using a CLF for other reasons
  - regulation through prices rather than through quantities
- Can I interpret the message here as:
  - when we recognize that safe assets are scarce

⇒ a committed liquidity facility seems much more appropriate (even in the U.S.)?

Takeaways

- This is an interesting paper
- The National Banking Era offers a cautionary tale
  - regulators need to recognize the costs of tying up ("immobilizing") safe assets on bank balance sheets
- Conclude:

"The LCR ~~is 'structurally identical' to~~ the National Banking System."

has some features in common with

(but is a much more flexible tool)

and therefore

"~~The LCR is unlikely to reduce financial fragility and may increase it.~~"

We may need to rethink some design issues to properly account for the scarcity value of safe assets.