Liquidity and Transparency in Bank Risk Management

Discussion by

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Bank of Finland-JFS Conference on *Financial Instability, Supervision and Central Banks*

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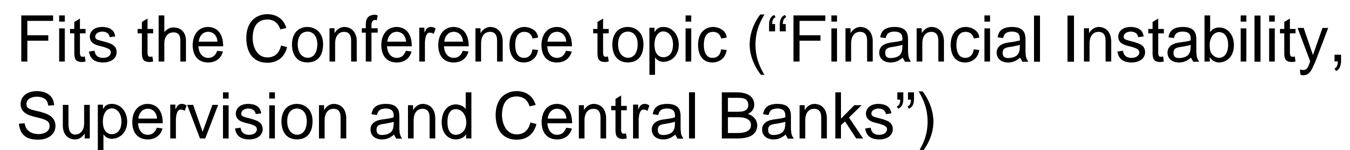
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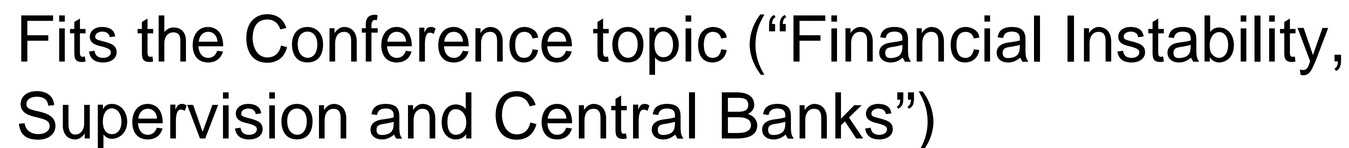
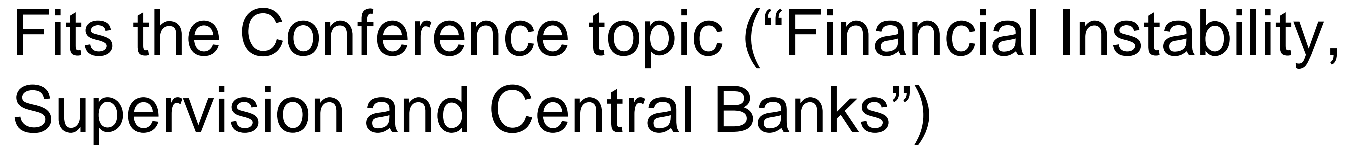


♦ Bank liquidity a long-standing systemic concern: are "runs" contagious?



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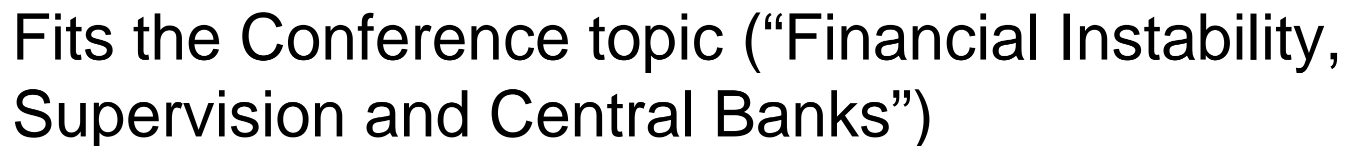
- ♦ Bank “runs” a long-standing systemic concern.

- ♦ Similar “liquidity” considerations apply to hedge funds today (e.g. Shleifer-Vishny 1997)



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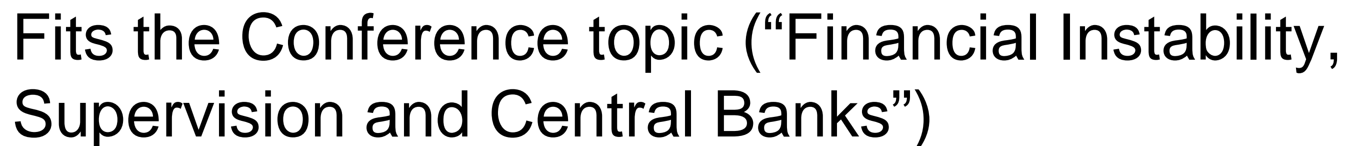

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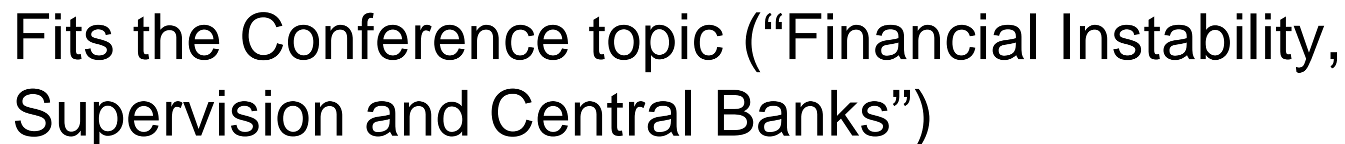

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2. Banks create liquidity
   - Diamond-Dybvig, reflecting insurance nature
   - Diamond-Rajan, inducing application of inalienable human capital
   - Calomiris-Kahn, Flannery, reflecting the nature of bank assets

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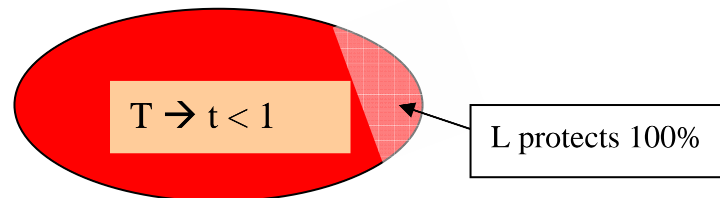

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5. Liquid assets on the balance sheet
    a) are observable → can be mandated, and
    b) have private benefits (Myers-Rajan)

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5. Liquid assets on the balance sheet
6. Therefore, L likely to come first and bankers likely to under-invest in transparency.

"Good" is enemy of the "Best" under the modeled liquidity risks.

Basel II's Third Pillar seems like a response to this observation.
How does "Transparency" relate to "Disclosure"? (Return later.)

Diamond, *Optimal Release of Information By Firms (JF 1985):*
credible pre-commitment to release information at specific times …

- Saves traders from private info-gathering efforts and
- Enhances initial risk-bearing.

Gatev and Strahan (JF 2006): macro uncertainty drives funds into commercial banks. Why?

- Relative transparency?
- Conjectured government guarantees?

1 . Assumption of deposit insurance does not offset the main results?

2. Do “reserve requirements” provide liquidity? (perhaps semantic?)

3. “T” could include revelation of inside information, which lowers future rents.

Implications for Transparency

- The model helps illustrate why transparency is important to banking firms.
- But it does not tell us much about <u>how to be</u> transparent.
- Same questions for Pillar 3 as for accountants: does enforcing homogeneous reporting help or harm
  - On average?
  - In the situations that pose greatest threat?
- "Transparency" vis-à-vis whom? Sophisticated market participants, not necessarily the "man in the street."
  - Pre-arranged equity or line of credit or
  - RCD converts some debt to equity at low capital ratio, making outsiders more willing to lend

Interesting Model Extensions

1. Initial endogenous choice of equity, to go with the $1 deposits. Bank Equity would protect the ability to borrow at $t = 1$

2. Continuous level of
   a. L and (especially)
   b. Transparency: $t = t(T)$, $t' > 0$.

3. Sale of non-liquid assets.
   a. Endogenous *ex ante* choice of asset types.
   b. Systemic effects.

- Unlikely through bank loan exposures.
- Rather, through effects of asset sales on market prices.
- The dangers of short-selling and leverage have been explored previously.
    - Do they apply qualitatively differently in the case of hedge funds today?
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