“Liquidity management of U.S. global banks: Internal capital markets in the great recession”

Discussion

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The views expressed here are mine alone, and not necessarily those of the Capital Group Companies.
Context

• Research agenda for macro-prudential regulators
  – Financial system structure and linkages
  – Sources of shocks to liquidity, solvency, confidence
  – Transmission of shocks through the system
  – Impact of monetary and regulatory policy

• Practical relevance of research findings
  1. Financial system design, regulation and oversight
  2. Monitoring and early warning systems
  3. Crisis response formulation and assessment

• Where this paper fits in
  – Object of study: internationally active US banks; *intra*-firm transmission
  – Shock: focus on 2007 liquidity shock (ABCP funding) and TAF response
  – Data: non-public quarterly country exposure reports (FFIEC 009)
Adverse shocks, policy responses

Source: Capital Group Companies
Transmission (incomplete)

- Subprime losses
  - SIV and conduit losses
    - Backstop liquidity drawdown
      - Liquidity demand shock
    - ABCP confidence shock
      - Liquidity supply shock
  - ... (incomplete)

- Lehman bankruptcy
  - Reserve Primary Fund
  - Money market fund redemptions
  - CP market contraction
    - Revolver drawdown
      - Liquidity demand shock
  - EA bank exposures
  - EA sovereign debt crisis
    - CP investor retreat
      - Liquidity supply shock
This paper

• How do shocks affect intra-bank flows?
  – Want to understand how global banking flows respond to funding shocks
    • Specific focus on intra-bank flows, which are comparable to interbank flows
  – Compare two hypotheses:
    • “Locational pecking order”: preserve local franchise value and profitability
    • “Organizational pecking order”: focus on survival of parent
  – Use non-public data provided to regulators on a quarterly basis

• Data, shock identification and method
  – Analyze 2007 funding shock and policy response (Fed liquidity provision)
    • ABCP exposure as proxy for firm’s exposure to shocks; are there other proxies?
      – Shock 1: could also use change in CDS spread (always public) as a proxy
      – Shock 2: could also use TAF usage (now public) as a proxy
    • Classify foreign subsidiaries as important sources of deposit funding (available to parent), vs. important lending centers (making use of funding from parent)
  – Also look at Lehman 2008 shock; but identification problems are difficult
Findings

• More exposed banks pulled more liquidity home
  – Did this depend on the nature of ABCP exposure (multi-seller vs. single-seller mortgage warehouse vs. securities arbitrage vs. SIV)?

• Decisions consistent with locational pecking order
  – Less convincing results when Cayman Islands records are excluded
    • Many ABCP SPVs, especially SIVs, were based in Cayman Islands or Jersey
  – Some evidence that foreign-owned banks behave differently
  – Question: Was there anything special about Citigroup’s behavior?
    • Had ~1/5 of assets in sample, and a uniquely large presence in some markets
  – Analysis of response to shock 2 yields consistent results, but...
    • Dropping Cayman Islands records may have a different meaning, since many ABCP SPVs (or their assets) were consolidated by 2008Q1-2

• Lehman shock different: indiscriminate decisions?
  – But cf. Vogel & Winkler (2011) on European intra-bank CESEE flows
    • They look at capital flows post-Lehman but pre-Vienna Initiative
Implications

1. Financial system design and regulation
   - Simulating cross-border capital flows in a crisis
     • Moderate shock to capital → use locational pecking order assumption
     • Large shock to capital → use organizational pecking order assumption
   - Will forthcoming G-SIFI capital standards allow us to assume the former?

2. Monitoring and early warning systems
   - Real time information on intra-bank flows is clearly useful
   - How much can be gleaned from cross-border payment systems?

3. Crisis response
   - Cost/benefit mode: general liquidity provision appears to suffice
   - Emergency/survival mode: coordination, bailouts, entity-specific measures
   - How to determine in real time? Implications for source-of-strength doctrine
   - Importance of cross-border coordination, cf. Vienna Initiative
Implications (continued)

• Assess the potential impact of regulatory changes
  – Meaning of liquidity
    • Group-level liquidity versus entity-specific liquidity and “ring-fencing”
    • Funding of cross-border investment banking subsidiaries
  – National concerns
    • Subsidiarization: cf. BBVA versus BBVA Bancomer – liquidity not fungible
    • Regulatory home bias: can regulators tell banks what to do with liquidity?
    • Liquidity standards: ∃ national discretion in retail deposit runoff assumptions
      – More lax assumption in host country → more important funding location?

• Implications for investors
  – What do domestic regulators tell banks to do? (E.g. EA crisis 2011)
  – What should banks tell us? (E.g. SIV/sec arb asset buy-out: still vague)
  – Implications for availability of private capital to parent firms in a crisis
  – Implications for availability of private liquidity in host countries
Suggestions for further research

• Expand research to other relevant financial firms
  – Not just banks: off-b/s entities, securities firms, hedge funds, insurers,…

• Differentiate between liquidity shocks
  – Shocks to funding sources: specific ST and LT funding channels shut off
  – Shocks to liquidity demand: unexpected drawdown of liquidity facilities
  – Shocks to solvency/confidence: shift in investor perceptions

• Examine the context of intra-bank flow decisions
  – “Automatic” responses *versus* discretionary decisions by management
  – Autonomous responses *versus* regulatory pressure *versus* coordination
    • Compare regulatory disclosures with what investors are told at the time

• Explore macroeconomic impact
  – Does Figure 5 map well to liquidity conditions within each country?
  – Project country exposures *ex ante* to formulate coordinated policy response