COMMENTS ON: "U.S. BANKS AND GLOBAL LIQUIDITY" BY RICARDO CORREA, WENXIN DU AND GORDON LIAO

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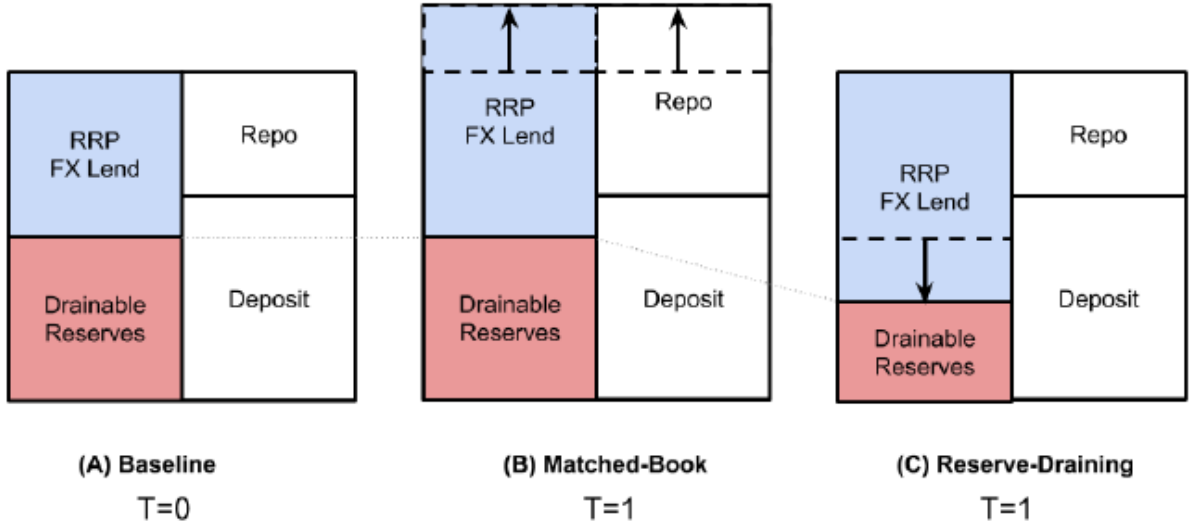
HOW DO BANKS ACCOMMODATE HIGH-FREQUENCY LIQUIDITY DEMANDS?

- Suppose banks face a demand spike for short-term funding from their clients—e.g., hedge funds want to finance their Treasury holdings.

- Can accommodate one of two ways:
  - Matched-book: bank borrows in tri-party repo market (e.g., from a money fund) and on-lends to the hedge fund. This increases size of its B/S.
  - Reserve-draining: bank draws down on its existing stock of reserves. This keeps B/S size constant.

- Paper's main finding: in a world with binding leverage-ratio constraints (and generally ample reserves), reserve-draining approach plays an important role.

Figure 5: An illustration of different types of dollar intermediation



NICE EMPIRICAL DESIGN

- Look at daily data on intermediation spreads and quantities around quarter-ends.
- Basic idea: foreign banks cut back on intermediation, because their balance sheets are "snapshotted" on those days for leverage-ratio purposes. This leads to significant increases in various spreads (e.g., SOFR-IOR, GCF repo-triparty repo, CIP basis).
- U.S. G-SIBs by contrast are held to leverage ratios based on daily average B/S, not quarter-end, so they can take up some of the slack on quarter-ends. Question is, how do they do so: matched-book or reserve-draining?

- Key finding: as intermediation spreads increase on quarter-ends, U.S. G-SIBs reduce reserve balances by $50B, increase lending in FX swap market by $20B, and increase net repo lending (by reducing repo borrowing) by $30B.
  - Implemented by the depository institution sub of G-SIB reducing its reserves to repo lend on internal basis to broker-dealer sub.
- Where do the reserves go? To smaller domestic banks, who appear to be passive.

WHY DOES THIS MATTER?

- Results suggest that leverage-ratio constraints impede matched-book type intermediation, potentially interfering with functioning of secured funding markets.
- But if reserves are ample, isn't reserve-draining intermediation a perfectly good substitute?

- However, "Reserves Were Not So Ample After All": Copeland-Duffie-Yang (2021).
  - See events of September 2019, March 2020.
  - Huge spikes in intermediation spreads, e.g., SOFR-IOR.

- How can reserves of $1.4 trillion (September 2019 value) not be enough?
  - Role of various post-GFC liquidity rules and supervisory practices.
  - Not technically the LCR, which treats reserves and Treasuries the same.
  - But supervisory liquidity stress tests (CLAR)
  - And Resolution Liquidity Adequacy and Positioning (RLAP)
  - As well as enhanced supervisory focus on intraday liquidity risks.

A CONSTELLATION OF CONFLICTING POLICIES

- Leverage ratio: constrains matched-book intermediation.
  - And creates a host of other problems: e.g., in March 2020, dealer banks can't expand balance sheets to make markets in risk-free Treasury securities.

- Liquidity regulations: dramatically increases demand for reserves, makes it harder for banks to substitute towards reserve-draining intermediation.

- QE and other Fed balance-sheet expansions (e.g., central bank swap lines): these help with reserve scarcity. And logic of Friedman rule says there is much to commend an ample-reserves regime. But since reserves go in the denominator of leverage ratio, this can make the leverage ratio even more binding.

WHAT ARE POSSIBLE WAYS OUT OF THE BOX?

- Defang the leverage ratio, i.e., make it less binding.
  - By dialing back ratio requirement. Or excluding reserves (and Treasuries?) from denominator.
  - Or dial up risk-based capital requirement, so it is more likely to bind. Ideally, put some non-zero (but smaller) risk weight on Treasuries.
  - Important to ensure that total dollars of capital in the banking system don't fall.

- Fed standing repo facility: to help when reserves are scarce, as in e.g., Sep 2019 and March 2020.
  - Given leverage-ratio constraints, crucial for facility to have broad access—i.e., to non-banks.
  - If Fed lends only to banks, they may be unwilling to on-lend to others, given increase in B/S.
  - May also help reduce bank demand for reserves generally, if banks know they can easily monetize their Treasury holdings at the Fed intraday.

- Central clearing of Treasury repo: netting benefits reduce B/S bloat caused by matched-book repo intermediation, makes it easier for banks to expand it in times of stress.
  - This is effectively happening with rapid growth of "sponsored" repo—itself a response to LR.
  - Banks sponsor their clients to clear with FICC, without clients having to meet all FICC membership obligations (e.g., fund contribution, loss mutualization).
  - Balances in this market currently in the $250B range, peaked at over $500B in March 2020.