

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

## Discussion

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The Capital Group Companies

*Financial Frictions and Monetary Policy in an Open Economy*

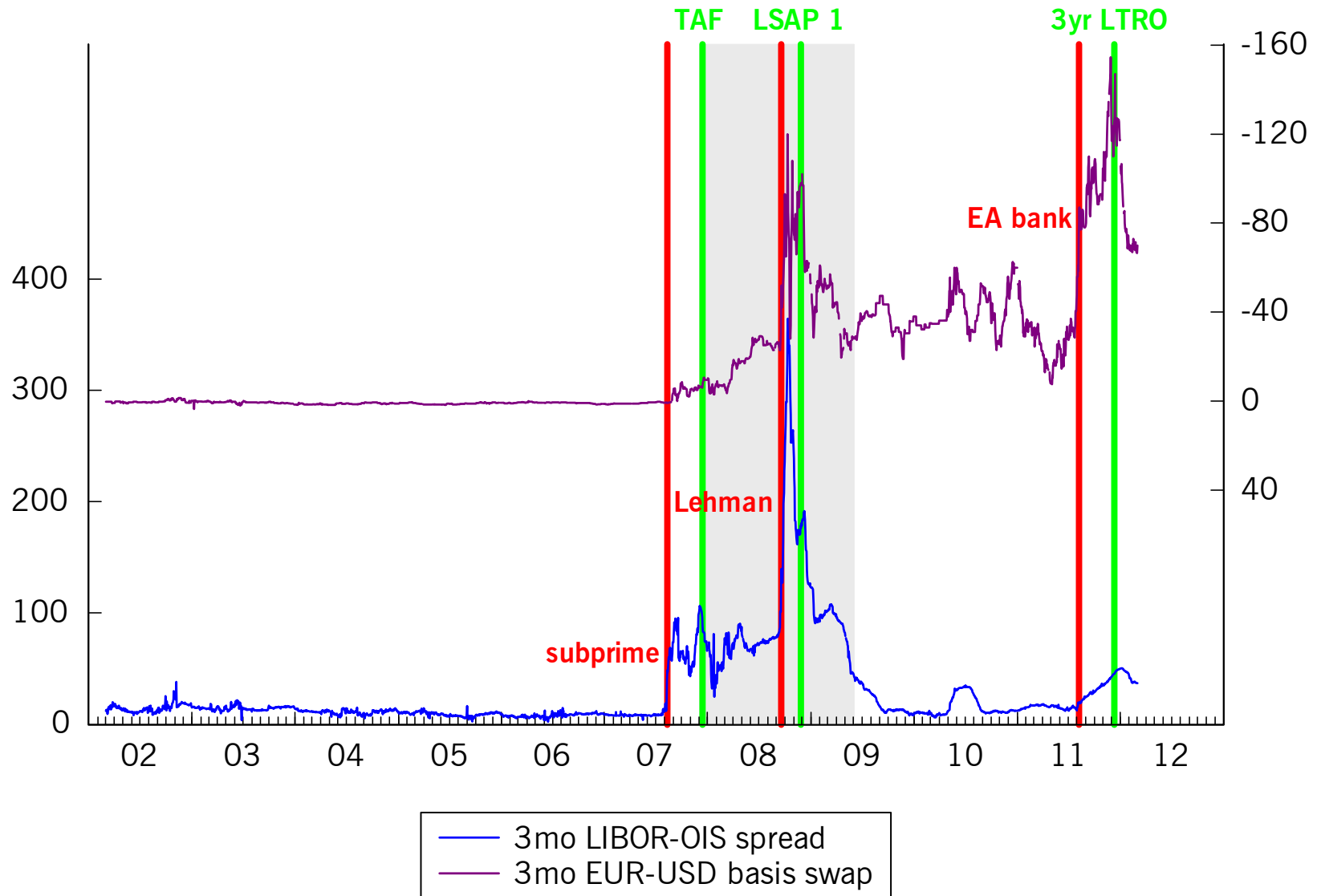
Federal Reserve Bank of Dallas, March 16-17, 2012

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

# Context

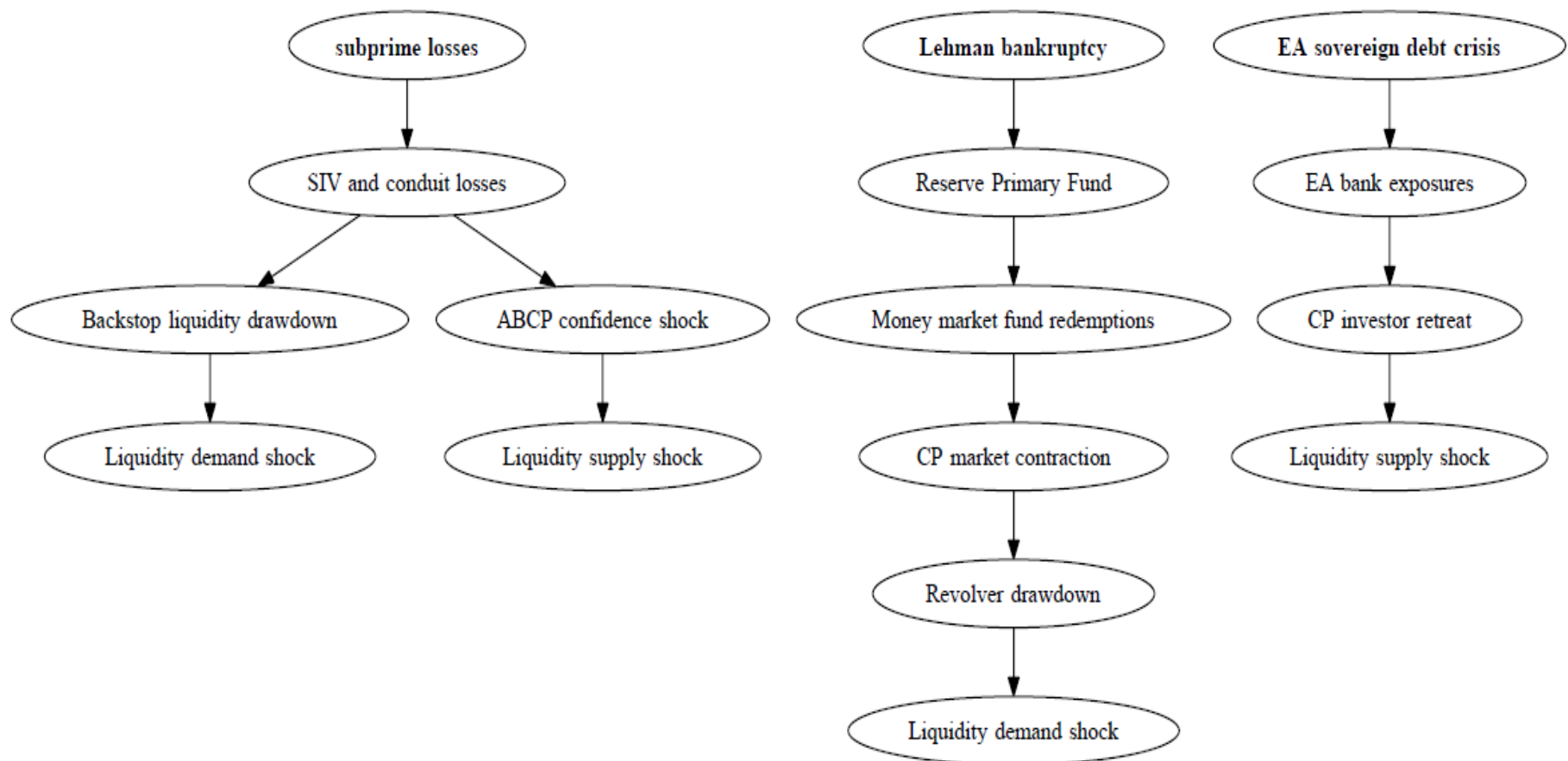
- Research agenda for macro-prudential regulators
  - Financial system structure and linkages
  - Sources of shocks to liquidity, solvency, confidence
  - Transmission of shocks through the system
  - Impact of monetary and regulatory policy
- Practical relevance of research findings
  1. Financial system 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)



# 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  $\sim 1/5$  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:  $\exists$  national discretion in retail deposit runoff assumptions
      - More lax assumption in host country  $\rightarrow$  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