BANK POLICY INSTITUTE

Bank Intermediation in Financial Markets Under Stress

Remarks by Pat Parkinson | July 29, 2020

During March and early April of this year, the COVID-19 crisis caused U.S. financial markets to freeze up. Even the markets for U.S. Treasury securities, normally the most liquid financial markets in the world, were disrupted. On July 29, the Bank Policy Institute held a Zoom Webinar on bank-intermediated markets under stress to discuss the causes of those disruptions and the implications for public policy. The panelists who made presentations at the webinar were distinguished academics, former regulators, and bankers and market experts. Other participants included bankers, academics, and public sector representatives. This post is a presentation that was made during the webinar by Pat Parkinson, a Special Adviser to BPI.

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The liquidity of U.S. fixed-income markets remains critically dependent on intermediation by a small number of large U.S. and foreign banks. In March and April of this year, the COVID-19 crisis caused those markets to freeze up. A "dash for cash" caused the balance sheets of those banks to blow up, which, given the regulatory constraints under which they operate, made them temporarily reluctant to meet further demands for use of their balance sheets. Josh Younger's paper identifies the sources of the demands for use of those banks' balance sheets.[1] Gordon Liao's paper provides a wealth of information on how the banks responded to those pressures, on the regulatory constraints that constrained their responses, and on how the functioning of the Treasury repo and FX swap markets was impaired when those constraints induced the banks to curtail intermediation in those markets.[2]

Liao and his co-authors conclude that there is a tradeoff between resilient regulatory policy and effective monetary policy and that maintaining ample reserves likely mitigates that tradeoff. I will argue that, with respect to market liquidity in bank-intermediated markets, maintaining ample reserves magnifies disincentives to bank intermediation created by some elements of banking regulation. I will then identify potential adjustments to banking regulation that I believe can make monetary policy more effective and also enhance financial stability, without impairing bank safety and soundness. I will conclude by identifying what I believe to be a fundamental weakness in the architecture of key U.S. financial markets that deserves greater attention.

As Liao's paper points out, almost all reserves necessarily are held by the banking system and, in practice, a disproportionately large share of bank reserves is held by the large banks that intermediate in the fixed income markets. Reserves are a riskless asset and banks should not be required to hold capital against them. But leverage requirements on banks require them to hold substantial amounts of capital against reserves. These requirements impose substantial costs on banks and, given that they are imposed on all

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[1] Younger, Joshua, Henry St. John and Sejal Aggarwal. "Scary Stories to Tell in the Dark," J.P. Morgan, North American Fixed Income Strategy, June 29, 2010.

[2] Correa, Ricardo, Wenxin Du, and Gordon Liao. "U.S. Banks and Global Liquidity" Working Paper No. 2020-89, Becker Friedman Institute, International Economics Initiative.

large banks, those costs tend to be passed on to their customers. In the case of bank intermediation in the fixed income markets, those costs will be reflected in wider bid-asked spreads, less market depth, and ultimately in higher interest costs to issuers of debt. Worse yet, during a crisis central banks typically flood the financial system with reserves, which magnifies the costs and can severely impair bank intermediation. In March, as it became clear that the explosion of reserves was doing so, the Federal Reserve temporarily excluded reserves and portfolio holdings of Treasury securities from the bank holding company SLR, one of two US leverage requirements applicable to bank holding companies. This eased an important constraint on intermediation by their broker-dealer subsidiaries, which generally are the legal entities through which bank intermediation occurs.

How might market liquidity in bank-intermediated markets be promoted without jeopardizing bank safety and soundness? I would recommend reviewing the definition and calibration of the leverage ratios (both the SLR and the Tier 1 leverage ratio) and the calibration of the risk-based ratios. The goal would be to ensure that, even during periods of financial market stress, when reserves are likely to be increasing rapidly, the leverage ratios are functioning as backups to the risk-based ratios, as regulators intend.

If regulators want to avoid reducing the amount of required capital for large banks, any loosening of the leverage ratios could be accompanied by offsetting adjustments to other capital requirements applicable to large banks, of which there are many. But it would enable banks to intermediate more effectively in financial markets under stress. This is because the risk-based ratios recognize that bank intermediation in the fixed-income markets is a relatively low-risk activity that requires relatively small amounts of capital support. For example, the treatment of repos and other securities financing activities in risk-based ratios appropriately reflects that risks are substantially mitigated by collateral. Facilitating the provision of reverse repos and other securities financing transactions by banks would in turn facilitate the provision of market liquidity by hedge funds and other leveraged nonbank market participants.

I would note that this would support market liquidity not only in the Treasury markets but throughout the fixed income markets. Liao has focused on the Treasury repo markets, not only because of their importance but presumably also because daily data on banks' Treasury repos are available. If Treasury repo markets functioned poorly in March, it is reasonable to assume that other markets reliant on bank intermediation were if anything more severely disrupted. Indeed, research by the Fed's Jonathan Goldberg has shown that declines in Treasury market liquidity resulting from reductions in liquidity supply by dealers have been associated with persistent declines in liquidity in a wide range of dealer-intermediated markets, including the corporate bond and MBS markets.[3]

To be sure, as laid out so clearly by Liao and his coauthors, in addition to the SLR, numerous other post-GFC banking regulations, most notably the GSIB surcharges but also certain elements of liquidity regulations, also constrain bank intermediation in fixed-income markets. All of those requirements should be reexamined with the goal of identifying changes that could enhance market liquidity in bank-intermediated markets under stress. In a financial system like that of the United States which is so heavily dependent on market-based finance, regulations that enhance bank safety and soundness but are designed in ways that unnecessarily impair market liquidity could well be contributing to financial instability.

As I remarked at the outset, I see a fundamental weakness in the structure of U.S. fixed-income markets, most notably in the repo markets. Huge amounts of short-term funding are being provided by highly risk-averse asset managers, such as money funds and securities lenders. And with the rapid growth of hedge funds and other leveraged nonbank financial institutions, huge amounts of short-term funding are needed by unrated and often opaque nonbank borrowers. The asset managers are unwilling to provide funding

[3] Goldberg, Jonathan. "Dealer Inventory Constraints During the COVID-19 Pandemic: Evidence from the Treasury Market and Broader Implications. FEDS Notes, July 17, 2020.

directly to the nonbank borrowers (or even to assume short-term counterparty credit exposures to those firms), so the fixed income markets are dependent on bank intermediation by a small number of U.S. and foreign banks. This seems to me to be an inherently fragile state of affairs that has received inadequate attention. Stanford Professor Darrell Duffie has recommended expanded CCP clearing in the Treasury repo markets, which clearly has the potential to improve the functioning of those markets, especially under stress.[4] However, CCP-cleared markets are also dependent on bank intermediation between CCPs and nonbank market participants. And that intermediation typically is provided by many of the same banks that intermediate in bilateral (non-cleared) markets.

Financial stability goals would be advanced by the entry of more banks into intermediation in bilateral and CCP-cleared markets. Banking regulations and other public policies should be reevaluated to ensure that they are not creating unnecessary barriers to entry. There is a precedent for this, albeit it a narrow one. In 2019, the Basel Committee eased the leverage ratio treatment of client cleared derivatives, because it concluded that the revision balanced the need for a robust leverage ratio with the need to promote central clearing to mitigate systemic risk in the derivatives markets. This is precisely the kind of analysis that needs to be applied generally to bank intermediation that supports market-based finance.

[4] Duffie, Darrell. "Still the World's Safe Haven? Redesigning the U.S. Treasury Market After the COVID-19 Crisis." Brookings Institution, June 22, 2020.