

Liquidity Hoarding and Interbank Market Spreads: The Role of Counterparty Risk

Discussion by
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Summary of the paper

- The analysis is inspired by recent events in the interbank market and the sharp increase in the cost of liquidity
- Model of banking as portfolio allocation decision between liquid and illiquid assets in the spirit of Diamond and Dybvig (1983)
- Banks are also subject to different intensity of liquidity shocks as well as idiosyncratic, private solvency shocks

Summary – cont.

- The presence of risky banks can create adverse selection and impair the functioning interbank market
- “Ex-ante solutions:” liquidity requirements, transparency requirements
- “Ex-post solutions:” monetary injections, loan guarantees, government asset purchases

General Remarks

- The authors provide a good model to think about the interbank market and potential policy interventions to prevent financial troubles associated with it
- Some general modeling issues to think about
 - Aggregate versus idiosyncratic risk
 - Notions of liquidity
 - Some literature:
 - Allen and Gale (2000)
 - Fostel and Geanakoplos (2008)
 - Antinolfi and Keister (2006)
 - Antinolfi Kawamura (2008)

Specific remarks about the model

- Is the deposit contract optimal?
- Who is paying for deposit insurance? General versus partial equilibrium and ex-post versus ex-ante intervention
- How can we think about the implementation of ex-ante policies, especially liquidity requirements? (Weren't houses safe?)

Specific remarks – cont.

- Is it reasonable to assume that banks know their own type?
- The model “proves” that adverse selection of bank types can drive good banks away from interbank market and result too high a price for liquidity. Could a contingent claim market perform the same function? Interest rates are determined by arbitrage, like prices would be, same solution?
- Other arrangements, i.e. monopoly instead of perfect competition etc.
- Equilibrium investments tend to be dependent on parameter values and can affect general message of the paper