Bank Regulation under Fire Sale Externalities

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Motivation and research question

- The recent crisis was characterized by severe liquidity problems and fire sales.

- Basel III supplements capital regulations with liquidity requirements (such as LCR and NSFR) and focuses on macro-prudential measures.

- We investigate the optimal design of capital and liquidity regulations in a model characterized by fire sale externalities. Our research question is:

  “Can we trust the institutions to properly manage their liquidity, once excessive risk taking has been controlled by the capital requirement?” (Jean Tirole, 2011)
Related literature

Liquidity and financial regulation

Cost and benefits of liquidity requirements

Financial amplification and asset fire sales

Pecuniary externalities
The model: Basic setup

Agents: A continuum of banks and consumers, each with a unit mass, and a financial regulator.

Three dates: $t = 0, 1, 2$.

Two goods:
- A consumption good (safe asset)
- An investment good (risky asset)

Consumers are endowed with $\omega$ units of consumption goods at $t = 0, 1, 2$.

Consumers supply their endowments to banks inelastically at $t = 0$ and earn zero net expected interest.

Banks can convert consumption goods into investment goods 1-to-1 at $t = 0$. 
## Bank balance sheet

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risky $(n_i)$</td>
<td>Deposits $(l_i)$</td>
</tr>
<tr>
<td>Safe $(n_i b_i)$</td>
<td>Equity $(e)$</td>
</tr>
</tbody>
</table>

Banks choose risky asset level, $n_i$, and how many safe assets to hold per unity of risky assets, $b_i \in [0, 1]$.

Banks are endowed with $e$ units of fixed equity capital and raise $l_i = (1 + b_i)n_i - e$ units of consumption goods from consumers.

The operational cost of a bank is $\Phi((1 + b_i)n_i)$, where $\Phi$ is increasing and convex.

Risk weighted capital ratio of bank is $e/n_i$. 

Kara and Ozsoy (Fed/OzU)
Good state: no shocks
- Bank’s assets yield $Rn_i + n_ib_i$ units of consumption goods at $t = 2$.

Bad state: a restructuring shock
- Investment distressed, has to be restructured by incurring $c$ units per risky asset to remain productive.
  - Banks can use safe assets $n_ib_i$ to carry out the restructuring.
  - A combination of limited-commitment and debt-overhang problems prevents banks from raising external finance.
  - Banks sell risky assets to firms in the traditional sector (owned by consumers) to raise liquidity (fire sales).
Asset market equilibrium at $t=1$

**Downward Sloping Demand:** Traditional sector has a concave technology and is less efficient than banks.

**Downward Sloping Supply:** Banks need certain amount of liquidity. If the price is lower, they need to sell more assets.
Atomistic banks ignore the effects of their choices \((n_i, b_i)\) on the equilibrium price, \(P(n, b)\).

**Lemma:** A higher initial risky investment \((n)\) or a lower liquidity ratio \((b)\) leads to lower asset prices and more fire sales: \(\frac{\partial P}{\partial n} < 0\) and \(\frac{\partial P}{\partial b} > 0\).
What we do next

We will compare and contrast:

- Competitive Equilibrium: No regulation \((n, b)\).
- Constrained Planner’s Problem (Second Best): \((n^{**}, b^{**})\).

How can we implement second-best allocations?

- Complete Regulation: Both capital ratio \((e/n_i)\) and liquidity ratio \((b_i)\) are regulated, as in Basel III.
- Partial Regulation: Only capital ratio \((e/n_i)\) is regulated, i.e. pre-Basel III regulation.
- Optimal single linear rules that combine capital and liquidity requirements
Full insurance is not optimal

Lemma

It is optimal for both banks in the unregulated competitive equilibrium and the constrained social planner to take fire sale risk; that is, to set $b_i < c$.

- The amount ($c$) and frequency ($q$) of the aggregate liquidity shock are exogenous in the model, but whether and to what extent a fire sale takes place are endogenously determined.

- In principle, it is possible to insure banks perfectly against the liquidity shock by setting $b_i = c$.

- However, liquidity has an opportunity cost in terms of forgone investment in the risky asset, which has a higher expected return.
Competitive equilibrium vs second-best allocations

Proposition

Competitive equilibrium is constrained inefficient and features:

\[ n > n^{**} \]
\[ b < b^{**} \]

- Banks overinvest in the risky asset and underinvest in liquidity in the unregulated competitive equilibrium.
- The inefficiency is created by the fire sale externality.
- The second-best allocations can be implemented using both
  - A minimum risk weighted capital ratio requirement:
    \[ \frac{e}{n_i} \geq \frac{e}{n^{**}} \iff n_i \leq n^{**} \]
  - A minimum liquidity ratio requirement: \[ b_i \geq b^{**} \]
Implementing the second-best allocations

- Two regulatory tools are sufficient to implement the second-best:
  - capital adequacy ratios and liquidity ratio requirements

- What if only one of these tools is used?
  - For example, can we use only capital ratio requirement, similar to the pre-Basel III era?

- We call this case “Partial Regulation” because liquidity is not regulated.
  - Regulator moves first and optimally chooses an upper limit on risky investment, $n$.
  - Banks set $n_i = n$ and choose the liquidity ratio, $b_i$, freely to maximize their expected profits.
Partial regulation

**Proposition**

*Banks decrease their liquidity ratio as the regulator tightens the limit on risky investment, i.e. \( b'_i(n) > 0 \).*

- Stricter limits on risky investment → lower liquidity ratios.
- Banks are restricted to take risk on the investment side, they switch to the liquidity channel.
- An unintended consequence of capital regulation: Making the system safer allows banks to take more risk on the liquidity side.
Comparing risky investment levels \((n)\)

**Proposition**

\(n > n^{**} > n^*\)

Graph showing the relationship between risky holdings and the size of liquidity shock, with different curves representing competitive equilibrium, partial regulation, and complete regulation.
Comparing liquidity ratios ($b$)

**Proposition**

$b^{**} > b > b^*$

![Liquidity Holdings Graph]

- **Liquidity Holdings**
  - **x-axis**: $c$ : size of liquidity shock
  - **y-axis**: $b$
  - **Legend**:
    - Red: Competitive Equilibrium
    - Blue: Partial Regulation
    - Green: Complete Regulation

Kara and Ozsoy (Fed/OzU)
Fire sale price of risky asset ($P$)

**Proposition**

$P^{**} > P^* > P$

**Prices under Fire Sale**

- Red: Competitive Equilibrium
- Blue: Partial Regulation
- Green: Complete Regulation

$c$: size of liquidity shock

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Severity of the crisis: Total amount of risky assets sold

Proposition 4 (c)

\[(1 - \gamma)n > (1 - \gamma^*)n^* > (1 - \gamma^{**})n^{**}\]
Proposition

\[(1 + b)n = (1 + b^{**})n^{**} > (1 + b^{*})n^{*}\]
Advantages of regulating liquidity

- More funds for high return projects: \( n^{**} > n^* \)
- More liquidity: \( b^{**} > b^* \)
- Less fire-sales:
  - Ratio: \( 1 - \gamma^* > 1 - \gamma^{**} \)
  - Level: \( (1 - \gamma^*)n^* > (1 - \gamma^{**})n^{**} \)
- Higher fire sale prices: \( P^{**} > P^* \)
Why not just regulate liquidity?

- Fire sales are triggered by a restructuring shock in the bad state. Banks are solvent otherwise.

- Can the second-best be implemented using liquidity regulation alone?

- The answer is negative: \( n_i(b^{**}) > n^{**} \).

- Again, when one channel is restricted banks switch to another channel to take their privately optimal fire sale risk.
Single linear rule

Can we instead implement the second-best allocations using more complex rules that combine capital and liquidity regulations?

Consider the following linear rule $\tau_n n + \tau_b b \leq k$.

If we choose $\tau_n, \tau_b$ properly the linear rule implements the optimal allocations.

The optimal weights satisfy: $\tau_n > 0$ and $\tau_b < 0$.

The banks can satisfy the constraint by decreasing risk investment or increasing liquidity ratio.
Conclusion

- Under fire sale externalities, banks overinvest in the risky asset and underinvest in the liquid asset in the unregulated competitive equilibrium.

- When we regulate capital but not liquidity, banks undermine the regulation by taking more risk through the liquidity channel.

- Pre-Basel III regulatory framework, with its reliance only on capital requirements, was ineffective in addressing systemic instability caused by fire sales.

- Macroprudential liquidity regulations that complement capital requirements implement second-best allocations, improve financial stability and allow for a higher level of investment in risky assets.