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

Discussion by Gaetano Antinolfi
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