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Liquidity-Saving Mechanisms

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Abstract

We study the incentives of participants in a real-time gross settlement system with and without the addition of a liquidity-saving mechanism (queue). Participants in our model face a liquidity shock and different costs for delaying payments. They trade off the cost of delaying a payment against the cost of borrowing liquidity from the central bank. The heterogeneity of participants in our model gives rise to a rich set of strategic interactions. The main contribution of our paper is to show that the design of a liquidity-saving mechanism has important implications for welfare, even in the absence of netting. In particular, we find that parameters will determine whether the addition of a liquidity-saving mechanism increases or decreases welfare.

Key words: liquidity-saving mechanism, real-time gross settlement, large-value payment systems

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1 Introduction

Large-value payment systems are an increasingly important part of monetary economies. In recent decades, for example, the turnover on U.S. dollar large-value payment systems has increased from 68 times annual GDP per year in 2000, to 102 times annual GDP in 2004. Correspondingly, increasing attention has been concentrated on features of their design and operation. Most notably, designs known as "real-time gross settlement" (RTGS) systems have proliferated widely in the last 15 years. More recently, various liquidity savings mechanisms (LSMs) have been designed to operate in conjunction with RTGS systems. An LSM takes the form of a queue in which payments wait to be released according to some criterion; for example, a common criterion is that a payment is released from the queue if and only if an offsetting payment is received.

The efficiency of the operation of these monetary transfer systems depends on the strategic behavior of their participants. We examine a model of an RTGS system and an LSM in which this behavior is influenced by two key features. First, participants face idiosyncratic liquidity shocks and carrying negative balances is costly for the system participants, while having positive reserves has no direct benefits. Second, participants face heterogeneous cost of delaying payments. Within this context participants interact by playing a timing game in which they attempt to minimize their own costs of making payments.

The strategic interaction in RTGS timing games has been shown to be characterized by strategic complementarities that can lead to multiple Pareto-ranked equilibria. The features of our model allow us to reproduce all prior results in the literature and extend the analysis to more realistic environments. In particular, we consider environments in which behavior is not symmetric but dependents on the type of shock and costs faced by agents.

When we introduce an LSM in the model we find two novel results. First, the strategic complementarity of the underlying RTGS environment is attenuated as agents can choose a conditional strategy using the LSM, i.e., a strategy that results in agents making a payment conditional on receiving a payment. Depending on parameters, the strategies themselves are no longer subject to strategic complementarities (for example, in some cases, the strategy to queue one's payments is a dominant strategy). As a result, the multiplicity of equilibria is eliminated. Second, it is generally believed that LSMs must improve welfare. We show that an LSM can reduce welfare compared to pure RTGS, for some parameter values. This is because an LSM can undo incentives for participants to make payments early, eliminating some beneficial coordination that can arise in RTGS.

Our results challenge the conventional wisdom about LSMs in another way. It is often assumed that LSMs are beneficial because they allow multilateral netting of queued payments. We show that an LSM can improve welfare even when netting does not occur, because it allows payment system participants to condition the release of a payment on the receipt of an offsetting payment. This provides insurance against the risk of having to borrow at the central bank. This feature is a direct result of the way the strategic interaction changes under an LSM, relative to an RTGS system, and has not been found in previous work.

We also consider an alternative design for an LSM, first proposed by Johnson, McAndrews, and Soramaki (2004), called an receipt-reactive LSM. A standard LSM can be thought of as a state-contingent mechanism as participants can specify a level of reserves above which payments committed to the LSM will settle. In contrast, the receipt-reactive LSM can be thought of as a mechanism that is independent of the liquidity-shock received by the participant. It releases payments dedicated to the LSM in accordance purely with a participant's momentary receipt of payments and not its previous balance on account.

A receipt-reactive LSM makes agents decisions independent of each other so that there is a unique equilibrium. While welfare with a receipt-reactive LSM can be higher or lower than with a standard LSM, for different parameter values, we find it it is always higher than welfare with RTGS.

Our model maintains some assumptions that influence our analysis. We assume that participants can obtain funds during the day at a proportional cost. This approximates the policies of many central banks that provide intraday credit to participants either for a small fee or against collateral. We assume that there is no probability of default. In exploring this model, we are concerned with the efficiency of the operation of the system to settle the participants' obligations where the efficiency criterion is to minimize the sum of the delay costs suffered by participants and the costs of borrowing funds intraday. These concerns are fundamental to more general models that would include risks of default by participants. In any case, adding default in our model is straightforward and is left for future research. Finally, we assume that participants cannot have access to an intraday market within which they could borrow and lend funds on account.

The remainder of the paper proceeds as follows, Section 2 provides background information on RTGS systems and LSMs. It also summarizes the related literature. Section 3 describes the model. Section 4 studies the equilibria associated with RTGS and the welfare these equilibria yield. Section 5 does the same for LSMs. Section 6 studies a receipt-reactive LSM. Section 7 concludes.

2 Real Time Gross Settlement Systems and Liquidity Savings Mechanisms

Modern banking systems use large-value transfer systems to settle payment obligations of commercial banks. The payment obligations can represent obligations of bank customers or obligations of the commercial banks themselves. In an RTGS system, now the common design used by most central banks (Bank for International Settlements, 1997), payment orders submitted by an individual participant (typically a bank) to the system are processed individually and released against funds in the bank's account, or against an extension of credit, up to some limit, by the central bank. Individual payments are processed and released in a "gross" fashion; that is, the complete value of the payment is transferred from the sender to the receiver when released. Because of this feature, the RTGS system is widely recognized to require large amounts of liquidity in the form of available balances or central bank credit. Alternative systems, such as a netting system in which payments are deferred and released on a "net" basis and only non-offsetting values are transferred between the accounts of banks, require much less liquidity, but impose delays relative to alternatives, such as an RTGS system.

Banks use RTGS system for both customer payments and their own payments. Among the bank's own payments we would note three types. First, a bank often uses an RTGS for the return and delivery of money market loans. The return of money market borrowings are fully known at the time the RTGS opens for business on a particular day. A second type of payment is a payment to a special-purpose settlement system, such as a securities settlement system or a foreign-exchange settlement system. In the U.S., for example, the Continuous Linked Settlement Bank (CLS Bank) is a special-purpose bank that settles foreign-exchange trades on its books. Banks use Fedwire, the Federal Reserve System's RTGS system, to make payments into and to receive payouts from CLS Bank early in the morning hours. The amounts of the payments into CLS Bank may not be known precisely at the start of the Fedwire business day. Finally, another type of payment made by banks on an RTGS are settlement or progress payments under a derivatives contract with another party. The interest rate on a particular day may trigger one of the parties to make a payment to the other; the amount of the payment may not be known in advance.

Both customer-initiated payments and a bank's own payments may or may not be time-sensitive. Consider a payment to settle a real estate transaction of a customer, in which many people are gathered in a closing or settlement meeting. The customer's demand for the payment is highly time-sensitive. Alternatively, a customer may be funding an account of their own at a brokerage firm; as long as the transfer is made on the particular day the customer's demand has been met.

The considerations just outlined suggest that banks are subject to liquidity shocks on any day. They may be required to use the RTGS to pay-in (at least on a net basis) more or less on a particular settlement system that day. In addition, a bank may find itself with many or few time-sensitive payments to make on a particular day.

Liquidity savings mechanisms to be used in conjuction with RTGS systems are a fairly recent phenomenon.[1] At least in part, LSMs are one way to attempt to reduce the demands for liquidity in the RTGS system, while maintaining the flexibility to make timely payments. There are many possible design alternatives for a LSM, but some features are common among all such LSMs. An LSM offers to the bank participating in the payment system two alternatives by which to submit payment orders. The first alternative (sometimes called the "express" route) is to submit the payment order for immediate settlement as though the system were a plain RTGS system. The second alternative is to submit payment orders to the LSM–a queue in which the payment order remains pending some event that will release the payment (this route is sometimes called the "limit order" route). The types of events that could trigger the release of payment orders from the limit queue would be the arrival into the bank's account of sufficient funds so that the bank's balance rises above some threshold, or the appearance in another bank's queue of an offsetting payment, or the

[1]See McAndrews and Trundle (2001) and Bank for International Settlements (2005) for reviews of LSMs.

receipt by the bank of a payment equal in size to the pending payment order. In all these cases, the release of the payment order in the limit queue is contingent on some state of the world. An LSM offers a new alternative, not available in RTGS, to make the settlement of payments state contingent in a particular way.

2.1 Relevant literature

Several papers examine the theoretical behavior in RTGS systems. Angelini (1998, 2000) considers the behavior of banks in an RTGS systems in which they face delay costs for payments as well as costly borrowing of funds. He shows that the equilibria of RTGS systems involve excessive delay of payments, as banks don't properly internalize the benefits to banks from the receipt of funds. Bech and Garratt (2003) carefully specify a game-theoretic environment in which they find that RTGS systems can be characterized by multiple equilibria, some of which can involve excessive delay. Mills and Nesmith (forthcoming) study an environment similar to the one in this paper. Their approach is complementary to our as they focus on the effect of risk, fees, and other factors on the incentives of banks to sent their payments early, or delay, in RTGS systems without LSMs.

Some recent work studying LSMs includes Roberds (1999), who compares gross and net payment systems with systems offering an LSM. He examines the incentives participants have to engage in risk-taking behavior in the different systems. Kahn and Roberds (2001) consider the benefits of coordination from an LSM in the case of CLS. Willison (2005) examines the behavior of participants in an LSM and is most similar to our paper. In contrast to our work, Willison models the extension of credit from the CB as an ex-ante amount to be borrowed by participants. Our model extends the analysis of Willison in a couple of dimensions that turn out to be important. A wider array of LSMs is considered and, crucially, liquidity shocks are considered.

3 The environment

The economy is populated by a continuum of mass 1 of risk neutral agents. We call these agents the core payment system participants or simply the participants when there is no risk of confusion. There is also a nonstrategic agent which we identify with settlement institutions.[2] Each core participant makes two payments and receives two payments each day. One payment is send to another core participant while the other payment is sent to the nonstrategic agent. Similarly, one payment is received from another core participant and one is received from the nonstrategic agent. Both the payment sent to and received from core participants have size μ. The payments sent to and received from the nonstrategic agent have size $1-\mu$. Consistent with our interpretation of the nonstrategic agent as settlement institutions, we assume that $\mu \geq 1/2$. It is straightforward to extend the model to the case where $\mu < 1/2$.

The economy lasts two periods, morning and afternoon. At the beginning of the morning, core participants learn whether they receive a payment from the nonstrategic agent in the morning or in the afternoon. The probability of the payment being received in the morning is $\bar{\pi}$. We assume that $\bar{\pi}$ also denotes the fraction of core participants who receive a payment from the nonstrategic agent in the morning. More generally, throughout the paper we assume that if x represents the probability of an event occurring for a participant, then the fraction of participants for whom this event occurs is x as well. Core participants also learn whether they must make a payment to the nonstrategic agent in the morning or in the afternoon. The probability of having to make the payment in the morning is $\bar{\pi}$ and is independent of receiving a payment from the nonstrategic agent. Payments to the nonstrategic agent cannot be delayed. Let $\sigma \equiv \bar{\pi}(1-\bar{\pi})$. A fraction σ of agents receive a payment from the nonstrategic agent in the morning and do not need to make a payment until the afternoon. We

[2] We think of the nonstrategic agent as aggregating several distinct institutions such as the CLS bank, CHIPS, and DTC.

say that these agents receive a positive liquidity shock. A fraction σ of agents must make a payment from the nonstrategic agent in the morning and do not receive an offsetting payment until the afternoon. We say that these agents receive a negative liquidity shock. The remaining agents, a fraction $1-2\sigma$, make and receive a payment from the strategic agent in the same period, either in the morning or in the afternoon. We say that these agents do not receive a liquidity shock.

Core participants also learn whether the payment they must make to another core participant is time-critical. The probability that a payment is time-critical is denoted by θ. If an agent fails to make a time-critical payment in the morning a cost γ is incurred. Delaying non-time-critical payments until the afternoon has no cost. Core participants must choose whether to make the payment in the morning or in the afternoon before they know if they will receive a payment from another core participant in the morning, but after they know their liquidity shock. Participants form rational expectations about the probability of receiving a payment from some other core participant in the morning. We denote this expectation π.

Each core participant starts the day with zero reserves. Reserves can be borrowed from the CB at an interest cost of R. Participants who receive more payments that they make in the morning have excess reserves. We assume that these reserves cannot be lent to other core participants so that participants receive no benefit from excess reserves.[3] Payments received and sent in the same period offset each other. Hence, a core participant only needs to borrow from the CB if the payments it makes in the morning exceed the payments it receives in the morning.

[3]We could allow lending between core participants without changing our results as long as the return to lending is strictly less than R. This corresponds to an assumption that there is some cost associated with lending.

4 A real-time gross settlement system

In this section, we study a real-time gross settlement system. First we derive the participants' decision rules, then we characterize equilibria, and finally we consider welfare.

4.1 Participants behavior under RTGS

The expected cost of making a payment in the morning depends both on the decisions of other core participants and on the pattern of payments made and received from the nonstrategic agent. We let π denote the probability that a payment from another core participant is received in the morning. We show in the next section how this probability is determined in equilibrium. In what follows, we consider the decision rules of core participants conditional on their liquidity shock.

We first derive the cost of making a payment early for participants who receive a positive liquidity shock. With probability π, a payment from another core participant is received in the morning and participants with a positive liquidity shock do not need to borrow. With probability $1-\pi$ no payment is received from another core participant in the morning. In that case, an amount $\mu-(1-\mu)=(2\mu-1)$ must be borrowed from the CB. This amount is the difference between the amount sent to another core participant and the payment received from the nonstrategic agent. Hence, the expected cost of making the payment to another core participant in the morning is $(1-\pi)(2\mu-1)R$ for participants who receive a positive liquidity shock.

The cost of delaying a time-critical payment is γ for participants with a positive liquidity shock, since they do not need to borrow. We assume that a participant sends her payment in the morning if she is indifferent between sending it in the morning or the afternoon. Consequently, participants who receive a positive liquidity shock choose to send a time critical payment early if $\gamma \geq (1-\pi)(2\mu-1)R$. Since delaying a non-time-critical payment has no cost, such a payment is paid early only if $\pi = 1$.

Using similar steps, we can show that participants who receive no liquidity shock send a time-critical payment early if $\gamma \geq (1-\pi)\mu R$.[4] Non-time-critical payments are paid early only if $\pi = 1$. Finally, participants who receive a negative liquidity shock send their time-critical payment early if $\gamma \geq [\mu - \pi(2\mu - 1)] R$. Non-time critical payments are delayed since $\mu < 1$. It can be verified that $\mu - \pi(2\mu - 1) \geq (1-\pi)\mu \geq (1-\pi)(2\mu - 1)$.

We can summarize the results of this section in a proposition.

Proposition 1 *Core participants delay all non-time-critical payments, unless $\pi = 1$. They make time-critical payment according to the following rules:*

1. *If $\gamma \geq [\mu - \pi(2\mu - 1)] R$, then all core participants make time-critical payments in the morning.*

2. *If $[\mu - \pi(2\mu - 1)] R > \gamma \geq (1-\pi)\mu R$, then core participants who receive a negative liquidity shock choose to delay time-critical payments. Other core participants do not.*

3. *If $(1-\pi)\mu R > \gamma \geq (1-\pi)(2\mu - 1)R$, then only core participants who have received a positive liquidity shock choose to make time-critical payments in the morning. All others delay their time-critical payments.*

4. *Finally, if $(1-\pi)(2\mu - 1)R > \gamma$, then all core participants delay time-critical payments.*

4.2 Equilibria under RTGS

The probability of receiving a payment in the morning depends on the behavior of the participants in the economy. Hence, π must be determined in equilibrium. We

[4]Details are provided in the appendix.

focus on symmetric subgame perfect Nash equilibria in pure strategies. We use the decision rules derived in the previous section to determine equilibrium strategies.

First, we note that if $\bar{\pi}$ and $(1-\mu)$ are strictly positive, then non-time-critical payments are always delayed. Indeed, for such parameters core participants who receive a negative liquidity shock must borrow from the CB if they make a payment early, regardless of what other participants do. Since these agents delay, $\pi < 1$ and other non-time-critical payments are delayed as well.

Proposition 2 *Four different equilibria can exist:*

1. *If $\gamma \geq [\mu - \theta(2\mu - 1)]\, R$, then it is an equilibrium for all time critical payments to be made in the morning.*

2. *If*

$$\{\mu - \theta\,(1-\sigma)\,(2\mu - 1)\}\, R > \gamma \geq [1 - \theta\,(1-\sigma)]\,\mu R,$$

then it is an equilibrium for core participants who received a negative liquidity shock to delay time-critical payments while other participants pay time-critical payments in the morning.

3. *If*

$$(1-\sigma\theta)\mu R > \gamma \geq (1-\sigma\theta)(2\mu - 1)R,$$

then it is an equilibrium for only core participants who received a positive liquidity shock to make time-critical payments in the morning.

4. *If $(2\mu - 1)R > \gamma$, then it is an equilibrium for all core participants to delay time-critical payments.*

Proofs are provided in the appendix.

The equilibria of proposition 2 can co-exist. For example, equilibria 1 and 2 co-exist if $\theta(2\mu - 1) > \gamma \geq \theta\,(1-\sigma)\,(2\mu - 1)$. In fact, for some parameters all four equilibria co-exist, as shown in the following lemma.

Lemma 1 *The four equilibria described in proposition 2 can co-exist if*

$$\frac{1}{1+\sigma} > \mu > \frac{1+\theta}{1+2\theta}.$$

The condition $\mu > \frac{1+\theta}{1+2\theta}$ holds if μ and θ are sufficiently large. In particular, for any $\theta > 0$, there is a μ large enough that the condition hold. Note, however, that the condition cannot hold if $\mu < 2/3$.

4.2.1 Equilibria without liquidity shocks

In this section we assume that there are no liquidity shock, $\bar{\pi} = 0$, and we normalize the size of the payment to other core participant to one, $\mu = 1$. This allows us to consider the role played by liquidity shocks in the previous section.

Participants who must make a time-critical payment strictly prefer to delay if $\gamma < (1 - \pi)R$. Participants who must make a non-time-critical payment delay unless all participants make their payment early.

Since we focus on pure strategies equilibria, there are three candidates: Either all participants pay in the morning ($\pi = 1$), or only participants who must make time-critical payments pay in the morning ($\pi = \theta$), or all participants delay ($\pi = 0$).

If $\gamma < (1 - \theta)R$, then core participants delay time-critical payments if non-time-critical payments are delayed. In this case, either all payments are made in the morning, $\pi = 1$, or no payments are made in the morning, $\pi = 0$. If $\gamma \geq (1 - \theta)R$, then core participants make time-critical payments in the morning even if non-time-critical payments are delayed. Hence, $\pi = 0$ is not an equilibrium if γ is large enough. It can be shown that $\pi = 1$ is an equilibrium, for the same reason as above, and $\pi = \theta$ is also an equilibrium if participants decide to delay non-time-critical payments.

It is interesting to note that the equilibrium with $\pi = 1$ exists when there are no liquidity shocks but does not exists with liquidity shocks. Coordination is more difficult to establish when agent are more heterogenous. With summarize these results in the next proposition.

Proposition 3 *Absent liquidity shocks, $\pi = 1$ is an equilibrium for all parameter values. In addition, $\pi = 0$ is an equilibrium if $\gamma < (1-\theta)R$ and $\pi = \theta$ is an equilibrium if $\gamma \geq (1-\theta)R$.*

4.3 Welfare under RTGS

Welfare is defined as the expected utility of a participant before the liquidity shock and time-criticality of the participant's payment is know. Equivalently, it is a weighted average of the welfare of all participants in the economy, where the weights are given by the population sizes.

First, we calculate the welfare of participants under equilibrium 1 of proposition 2, denoted by W_1, if such an equilibrium exists. Recall that under this equilibrium $\pi = \theta$. With probability $1-\theta$, a participant has to make a non-time-critical payment. In this case, the participant delays the payment at no cost. However, conditional on having to make a non-time-critical payment, the participant receives a negative liquidity shock with probability σ and incur an expected borrowing cost of $(1-\theta)(1-\mu)R$.

With probability θ, the participant has to make a time-critical payment. Under equilibrium 1, such payments are paid in the morning. Conditional on having to make a time-critical payment, a participant will receive a positive liquidity shock with probability σ and incur an expected borrowing cost of $(1-\theta)(2\mu-1)R$. A participant will receive no liquidity shock with probability $1-2\sigma$ and incur an expected borrowing cost of $(1-\theta)\mu R$. A participant will receive a negative liquidity shock with probability σ and incur a cost an expected borrowing cost of $(1-\theta\mu)R$. Putting these costs together, we obtain

$$\begin{aligned} W_1 &= -(1-\theta)\sigma(1-\theta)(1-\mu)R - \theta\sigma(1-\theta)(2\mu-1)R \\ &\quad -\theta\left[1-2\sigma\right](1-\theta)\mu R - \theta\sigma(1-\theta\mu)R. \qquad (1) \end{aligned}$$

With similar steps, and a little algebra, we obtain the welfare of participants under equilibrium 2 of proposition 2, denoted by W_2, if such an equilibrium exists.[5] Under this equilibrium, $\pi = \theta(1-\sigma)$.

$$\begin{aligned} W_2 &= -(1-\theta)\sigma\left[1-\theta(1-\sigma)\right](1-\mu)R - \theta\sigma\left[1-\theta(1-\sigma)\right](2\mu-1)R \\ &\quad -\theta\left[1-2\sigma\right]\left[1-\theta(1-\sigma)\right]\mu R - \theta\sigma\left\{\gamma + \left[1-\theta(1-\sigma)\right](1-\mu)R\right\}. \end{aligned} \tag{2}$$

Under equilibrium 3 of proposition 2, $\pi = \sigma\theta$. The welfare of participants under this equilibrium, if it exists, is denoted by W_3 and given by the following expression.

$$\begin{aligned} W_3 &= -\theta(1-\sigma)\gamma - (1-\theta\sigma)\sigma(1-\mu)R \\ &\quad -\theta(1-\theta\sigma)\sigma(2\mu-1)R. \end{aligned} \tag{3}$$

Under equilibrium 4 of proposition 2, $\pi = 0$. The welfare of participants under this equilibrium, if it exists, is denoted by W_4 and given by the following expression.

$$W_4 = -\theta\gamma - \sigma(1-\mu)R. \tag{4}$$

Proposition 4 $W_1 \geq W_2 \geq W_3 \geq W_4$ *whenever the corresponding equilibria exist.*

The proof is provided in the appendix. One way to think about this result is in terms of the two sources of costs in this model: payment delay and borrowing from the CB. Bunching of payments, either in the morning or in the afternoon, reduces the cost of borrowing because payments can offset. Making payment in the morning, however, reduces the delay cost. If a participant decides to make her payment in the morning rather than in the afternoon, the effect is to reduce the offsets in the afternoon and increase the offsets in the morning. These two effects cancel each other out to some extent. The benefit from reduced delay means that welfare is higher in an equilibrium in which more payments are paid in the morning.[6]

[5]Details of the calculations for W_2, W_3, and W_4, are provided in the appendix.

[6]It can be shown, however, that forcing all participants to make their payments early may not maximize welfare.

5 A liquidity saving mechanism

In this section, we consider an arrangement that shares important features with liquidity saving mechanisms. This arrangement allows payments to be sent conditionally on the receipt of an offsetting payment. At the beginning of the morning period, after they observe their liquidity shock and the time criticality of their payment, core participants have the choice to put the payment they must make to another participant into a queue. The payment will be released if an offsetting payment is received by the participant or if the payment is part of a multilaterally offsetting group of payments all residing in the queue. We assume that the non-strategic agent does not use the queue. Payments to the non-strategic agent are not put in the queue either since such payments cannot be delayed.

This arrangement allows agents to insure themselves against the risk of having to borrow from the CB. The drawback, however, is that a payment put in the queue may not be released in the morning.

5.1 The queue

In this section, we describe the way the queue works and derive the expressions for the probability that a participant receives a payment conditionally on being in the queue or not. The first thing to note is that the set off all payments must offset multilaterally. There may be one or more groups of payments that offset. We call any such group a cycle. At one extreme, the set of all payments could constitute the only cycle, as illustrated in Figure 1, so that any two participants are connected through a sequence of payments. At the other extreme, all cycles could be of length 2, as illustrated in Figure 2, so that all payments form pairs.

[Figures 1 and 2]

Turning to the queue, a payment in the queue may belong to a cycle having the property that all other payments in the cycle are also in the queue, as illustrated in Figure 3. In this case the payments are released by the queue since they offset multilaterally (or bilaterally if the cycle is of length 2). A payment in the queue may also be part of a cycle having the property that at least one payment in the cycle is not in the queue, as illustrated in Figure 4. In this case, the payment belongs to a path (within the queue).[7] Payments in a path cannot offset multilaterally. However, it is possible that the participant who must make the "first" payment in the path receives a payment from outside the queue. In that case, the first payment in the path is released, creating a cascade of payments until eventually a payment is made to someone outside the queue. We denote by χ the probability that a payment in the queue is part of a cycle and $1 - \chi$ the probability that it is part of a path.

[Figures 3 and 4]

We consider the value of χ for the two extreme cases described above. We use λ_e to denote the fraction of participants who send their payment early, λ_q to denote the fraction of agents who put their payments in the queue, and λ_d to denote the fraction of agents who delay their payments. Clearly, $\lambda_e + \lambda_q + \lambda_d = 1$.

If all payments form only one cycle, then the probability that a payment in the queue is in a cycle is zero unless all participants put their payment in the queue. Formally, $\chi = 0$ if $\lambda_q < 1$ and $\chi = 1$ if $\lambda_q = 1$. Under this assumption, the queue releases the fewest payments. This case is also interesting because the role of the queue is only to allow agents to send their payment conditionally on receiving another payment. The queue no longer plays the role of settling multilaterally offsetting payments.

[7] Of course, a queue could contain both payments in cycles and payments in paths.

At the other extreme, if all payments are in cycles of length 2, then the probability that a payment in the queue is in a cycle is λ_q.[8]

Next, we can derive the expressions for π^o, the probability of receiving a payment conditionally on not putting the payment in the queue, and π^q, the probability of receiving a payment conditionally on putting a payment in the queue. The latter probability is equivalent to the probability that a payment in the queue is released.

Suppose that there are no payments in the queue. Then, the probability of receiving a payment is given by the mass of participants who send a payment outright divided by the total mass of participants. Formally, $\pi^o = \lambda_e/(\lambda_e + \lambda_d)$. It turns out that the expression for π^o does not change when there are payments in the queue. Indeed, note that every payment made early by some participant outside the queue to a participant inside the queue must ultimately trigger a payment from a participant inside the queue to a participant whose payment is outside the queue. From the perspective of participants outside the queue, this is the same as if the payment had been made directly from a participant outside the queue. For this reason, we can ignore the queue. In summary, the expression for π^o is

$$\pi^o \equiv \frac{\lambda_e}{\lambda_e + \lambda_d} = \frac{\lambda_e}{1 - \lambda_q}. \tag{5}$$

If a participant puts a payment in the queue, the payment will be in a cycle with probability χ, in which case it is released for sure. With probability $1 - \chi$, the payment is in a path. The probability that a payment in a path is released is equal to the probability of receiving a payment from outside the queue. This probability is equal to π^o. So the expression for π^q is given by

$$\pi^q \equiv \chi + (1 - \chi)\frac{\lambda_e}{\lambda_e + \lambda_d} = \chi + (1 - \chi)\pi^o. \tag{6}$$

[8]Note that participants cannot take advantage of the fact that they know who they receive a payment from because they do not know whether that agent has received a liquidity shock or must make a time-sensitive payment. Moreover, since we consider a one shot game, it is not possible to sustain dynamic incentives. Even if we considered repeated versions of our one shot game, the probability that the same participants are paired more than once is zero.

Under our "long-cycle" assumption, $\chi = 0$ if $\lambda_q < 1$ so that $\pi^o = \pi^q = \lambda_e/(\lambda_e+\lambda_d)$. If $\lambda_q = 1$, then $\pi^o = 0$ and $\pi^q = 1$, since all the payment are put in the queue. Under our "short-cycles" assumption, $\chi = \lambda_q$ so that

$$\pi^q = \lambda_q + (1-\lambda_q)\frac{\lambda_e}{\lambda_e+\lambda_d} = \lambda_q + (1-\lambda_q)\pi^o.$$

5.2 Participants' behavior

Now we turn to describing the behavior of the participants. There are six types to consider. Participants who must send a time-critical payment may have a negative, a positive, or no liquidity shock. Similarly for participants who must send a non-time-critical payment. We first consider participants who must send time-critical payments.

For participants who must make a time-sensitive payment and have received no liquidity shock, the cost of delay is γ, since they do not need to borrow from the CB. The expected cost of putting a payment in the queue is $(1-\pi^q)\gamma$. Since $\pi^q \geq 0$, the cost of delay is at least as large as the cost of putting the payment in the queue. The expected cost of sending the payment early is $(1-\pi^o)\mu R$, since with probability $1-\pi^o$ no offsetting payment is received and μ must be borrowed at the CB. Hence, participants who must make a time-sensitive payment and have received no liquidity shock make their payment early if

$$(1-\pi^q)\gamma \geq (1-\pi^o)\mu R, \tag{7}$$

and put their payment in the queue otherwise.

Using similar steps, we can show that participants who must make a time-sensitive payment and have received a positive liquidity shock make their payment early if

$$(1-\pi^q)\gamma \geq (1-\pi^o)(2\mu-1)R, \tag{8}$$

and put their payment in the queue otherwise.[9]

[9] Details are provided in the appendix

The behavior of participants who must make a time-critical payment and have received a negative liquidity shock can be characterized as follow: If

$$(1-\pi^q)\gamma \geq (1-\pi^o)\mu R, \tag{9}$$

then these participants choose to send the payment early. If

$$(1-\pi^o)\mu R > (1-\pi^q)\gamma \quad \text{and} \quad (1-\pi^q)\gamma \geq (1-\pi^o)(1-\mu)R, \tag{10}$$

then these participants choose to put the payment in the queue. Finally, if

$$\pi^o(1-\mu)R > \pi^q\gamma, \tag{11}$$

then these participants choose to delay their payment.

Next we consider participants who must make a non-time-critical payment. By setting $\gamma = 0$ in the analysis conducted above, we can see that participants who face no cost of delay always prefer to put a payment in the queue rather than send it early. We have also seen that participants who receive a positive or no liquidity shock do not need to borrow from the CB if they queue or delay their payment. Hence, these participants are indifferent between delaying and putting non-time-critical payments in the queue. As a tie-braking rule we assume that the participants queue their payments

This reasoning does not apply to participants who have received a negative liquidity shock because these agents must borrow if they put their payment in the queue while they may be able to avoid borrowing if they delay. Hence, if $\lambda_e > 0$, which implies $\pi^o > 0$, these agents prefer to delay. Otherwise they are indifferent between delaying and queuing and we assume that they put their payment in the queue. We can summarize these results in the following proposition.

Proposition 5 *Participants behavior with LSM.*

1. *Participants who receive a positive liquidity shock queue their payments unless* $(1-\pi^q)\gamma \geq (1-\pi^o)(2\mu-1)R$*, in which case they send time-critical payments early.*

2. *Participants who receive no liquidity shock queue their payments unless* $(1-\pi^q)\gamma \geq (1-\pi^o)\mu R$*, in which case they send time-critical payments outright.*

3. *Participants who receive a negative liquidity shock delay non-time-critical payments unless* $\pi^o = 0$*, in which case they queue those payments. These participants*

   (a) *send time-critical payment early if* $(1-\pi^q)\gamma \geq (1-\pi^o)\mu R$*,*

   (b) *queue time-critical payments if*

   $$(1-\pi^o)\mu R > (1-\pi^q)\gamma \quad \textit{and} \quad (1-\pi^q)\gamma \geq (1-\pi^o)(1-\mu)R,$$

   (c) *delay time critical payments if* $\pi^o(1-\mu)R > \pi^q\gamma$*.*

5.3 Equilibria under a liquidity saving mechanism

In this section we consider equilibria when there is a liquidity saving mechanism under our two assumptions concerning the underlying pattern of payments.

5.3.1 Equilibria under the long-cycle assumption

Under the long-cycle assumption, the value of χ can be either 0 or 1, depending on whether λ_q is strictly smaller or is equal to 1. We consider each case separately.

If $\lambda_q = 1$, then all payments are put in the queue and are released in the morning. Participants who receive a liquidity shock must borrow $1-\mu$ from the central bank and cannot avoid that cost since $\lambda_e = 0$. No delay cost is incurred so it is an equilibrium for all participants to put their payment in the queue regardless of the size of that cost. However, we will see below that if γ is high enough, then this equilibrium does not survive deletion of weakly dominated strategies.[10]

Since $\lambda_q < 1$ is an equilibrium only if $\lambda_e > 0$, we need to find the parameter values for which the latter condition can hold. The conditions for participants to prefer to pay early rather than queue are given by equations (7), (8), and (9). Since $\mu \geq 2\mu - 1$, we only need to consider equation (8). The condition $\lambda_q < 1$, implies $\chi = 0$ and $\pi^o = \pi^q$. It follows that if

$$\gamma < (2\mu - 1)R, \tag{12}$$

then $\lambda_e > 0$ cannot be an equilibrium and the unique equilibrium is such that $\lambda_q = 1$.

We now assume that $\gamma \geq (2\mu - 1)R$ and consider equilibria such that $\lambda_e > 0$. If $\mu \geq 2/3$, then $2\mu - 1 \geq 1 - \mu$. This guarantees that participants who have a negative liquidity shock and must make a time critical payment do not want to delay their payment. If $\mu R > \gamma \geq (2\mu - 1)R$, then only participants with a positive liquidity shock make time-critical payment early. In this case, $\lambda_e = \theta\sigma$, $\lambda_q = 1 - \sigma$, $\lambda_d = (1 - \theta)\sigma$, and $\pi^o = \pi^q = \theta$.[11] If $\gamma \geq \mu R$, then all time-critical payments are made early. In this case, $\lambda_e = \theta$, $\lambda_q = (1 - \theta)(1 - \sigma)$, $\lambda_d = (1 - \theta)\sigma$, and $\pi^o = \pi^q = \theta / (\theta + (1 - \theta)\sigma)$.

If $\mu < 2/3$, then $1 - \mu > 2\mu - 1$. For such parameters, we need to consider three cases: Either $(1 - \mu)R > \gamma \geq (2\mu - 1)R$, or $\mu R > \gamma \geq (1 - \mu)R$, or $\gamma \geq \mu R$. If $(1 - \mu)R > \gamma \geq (2\mu - 1)R$, then participants who receive a negative liquidity shock delay time-sensitive payments. In this case, $\lambda_e = \theta\sigma$, $\lambda_q = 1 - \sigma(1 + \theta)$, $\lambda_d = \sigma$, and $\pi^o = \pi^q = \theta/(1 + \theta)$. The other two cases are similar to the two cases studies above when $\mu \geq 2/3$.

[10]As an alternative to refining out equilibria using the criterion of delation of weakly dominated strategies, we could assume that a small fraction of agents who must make non-time-critical payments and do not have a negative liquidity shock always "forget" to put their payments in the queue. This is a weak assumption since these agents are indifferent between using the queue or delaying their payments.

[11]Recall that whenever $\lambda_e > 0$ participants who have a negative liquidity shock delay non-time-critical payments while other non-time-critical payments are put in the queue.

We have shown that there can be multiple equilibria in some regions of the parameter space. However, with the appropriate refinement there is a unique equilibrium as is shown in the following lemma.

Lemma 2 *If both the equilibrium with $\lambda_q < 1$ and the equilibrium with $\lambda_q = 1$ exist, then the equilibrium with $\lambda_q = 1$ does not survive the deletion of weakly dominated strategies.*

This result is in contrast to section 4.2, where we found multiple equilibria that are robust. In the remainder of this paper, we focus on the equilibrium with $\lambda_q < 1$ when it exists. The results of this section can be summarized in the following proposition

Proposition 6 *Under the long-cycle assumption, we have the following equilibria:*

1. *If $\gamma < (2\mu - 1)R$, then all participants put their payment in the queue*
2. *If $\gamma \geq (2\mu - 1)R$ and $\mu \geq 2/3$, then*
   (a) *If $\gamma \geq \mu R$, then all time-critical payments are made early. Participants with a negative liquidity shock delay non-time-critical payments and other non-time-critical payments are put in the queue.*
   (b) *If $\mu R > \gamma \geq (2\mu - 1)R$, then only participants with a positive liquidity shock make time-critical payment early. Participants with a negative liquidity shock delay non-time-critical payments and all others put their payment in the queue.*
3. *If $\gamma \geq (2\mu - 1)R$ and $\mu < 2/3$, then*
   (a) *If $\gamma \geq \mu R$, the equilibrium is the same as under 2a.*
   (b) *If $\mu R > \gamma \geq (1 - \mu)R$, the equilibrium is the same as under 2b.*

(c) *If* $(1-\mu)R > \gamma \geq (2\mu - 1)R$, *then participants who receive a negative liquidity shock delay their payment. Participants who receive a positive liquidity shock send their time-critical payment early. All other payments are put in the queue.*

5.3.2 Equilibria under the short-cycles assumption

Under the short-cycles assumption, $\chi = \lambda_q$. The analysis is similar to the analysis conducted above. For the same reason, it is an equilibrium for all participants to put their payments in the queue. This equilibrium is unique if γ is sufficiently small. If γ is not so small, there exists an equilibrium where some agents send their payments early while some agents delay.

We want to characterize the equilibria having the property that some payments are not put in the queue. First, consider the case where $\mu \geq 2/3$. Since $(1-\pi^o)/(1-\pi^q) \geq \pi^o/\pi^q$, it must be the case that

$$\frac{1-\pi^o}{1-\pi^q}(2\mu - 1)R \geq \frac{\pi^o}{\pi^q}(1-\mu)R.$$

This implies that equation (11) holds whenever equation (8) holds. Hence, if some participants with a positive liquidity shock choose to send time-critical payments outright, participants with a negative liquidity shock prefer to put time-critical payments in the queue rather than delay. In this case, only participants who have a negative liquidity shock and must make a non-time-critical payment delay. Formally, $\lambda_d = (1-\theta)\sigma$. We also know that other participants will put non-time-critical payments in the queue.

We need to determine what participants do with time-critical payments. We have seen that participants with a positive liquidity shock send payments early if $\gamma \geq \frac{1-\pi^o}{1-\pi^q}(2\mu - 1)R$ and other participants send payments early if $\gamma \geq \frac{1-\pi^o}{1-\pi^q}\mu R$. Payments are put in the queue otherwise. So we need to focus on the ratio $(1-\pi^o)/(1-\pi^q)$.

Recall, from equation (6), that $\pi^q = \chi + (1-\chi)\pi^o$, which implies

$$1 - \pi^q = 1 - \chi - (1-\chi)\pi^o = (1-\chi)(1-\pi^o),$$

Thus, we can write

$$\frac{1-\pi^o}{1-\pi^q} = \frac{1}{1-\chi} = \frac{1}{1-(1-\lambda_e-\lambda_d)} = \frac{1}{\lambda_e+\lambda_d}. \tag{13}$$

Since λ_d is known, we need to find the value of λ_e. We focus on pure strategies.[12] Note that λ_e can take three values: Either no participants make time-critical payments early, or only participants with a positive liquidity shock make time-critical payments early, or all participants make time-critical payments early.[13]

If no participants make time-critical payments early, $\lambda_e = 0$, then

$$\frac{1-\pi^o}{1-\pi^q} = \frac{1}{(1-\theta)\sigma}. \tag{14}$$

If only participants with a positive liquidity shock make such payments early, $\lambda_e = \sigma\theta$, then

$$\frac{1-\pi^o}{1-\pi^q} = \frac{1}{\sigma}. \tag{15}$$

If all participants make time-critical payments early, $\lambda_e = \theta$, then

$$\frac{1-\pi^o}{1-\pi^q} = \frac{1}{\theta+(1-\theta)\sigma}. \tag{16}$$

It can be verified that

$$\frac{1}{(1-\theta)\sigma} > \frac{1}{\sigma} > \frac{1}{\theta+(1-\theta)\sigma}. \tag{17}$$

In the next proposition, we assume that $\lambda_d = (1-\theta)\sigma$ and consider whether time-critical payments are sent early or queued. Note that if all time-critical payments are queued, the resulting equilibrium is such that all non-time-critical payments are also be queued and $\lambda_d = 0$.

[12]As is standard when there are multiple equilibria in pure strategies, there also exists equilibria in mixed strategies. We ignore such equilibria here.

[13]Recall that the condition for a payment to be sent early is the same for participants with no liquidity shock, equation (7), and for participants with a negative liquidity shock, equation (9).

Proposition 7 *Let* $\mu \geq 2/3$. *If* $\gamma \leq \{(1-\theta)\sigma\}^{-1}(2\mu-1)R$, *then there exists an equilibrium such that no time-critical payments is made early.*

In addition, the following cases can arise:

1. *If* $\gamma \geq \frac{\mu R}{\sigma}$ *then it is an equilibrium for all participants to make time-critical payments early. If* $\gamma \geq \frac{(2\mu-1)R}{\sigma}$ *then it is also an equilibrium for only participant with a positive liquidity shock to make time-critical payments early.*

2. *If* $\max\{A,B\} > \gamma \geq \min\{A,B\}$, *where*

$$A \equiv \frac{\mu R}{\theta + (1-\theta)\sigma} \quad \textit{and} \quad B \equiv \frac{(2\mu-1)R}{\sigma},$$

   two cases can arise:

   (a) *If* $\sigma^{-1}(2\mu-1)R > \gamma > [\theta+(1-\theta)\sigma]^{-1}\mu R$, *then it is an equilibrium for all participants to make time-critical payments early, but it is not an equilibrium for only participants with a positive liquidity shock to make time-critical payments early.*

   (b) *If* $[\theta+(1-\theta)\sigma]^{-1}\mu R > \gamma > \sigma^{-1}(2\mu-1)R$, *then it is an equilibrium for only participants with a positive liquidity shock to make time-critical payments early but it is not an equilibrium for all time-critical payments to be made early.*

3. *If* $\min\left\{[\theta+(1-\theta)\sigma]^{-1}\mu R; \sigma^{-1}(2\mu-1)R\right\} \geq \gamma$, *then all participants queue time-critical payments.*

These expressions are obtained by substituting the values of $(1-\pi^o)/(1-\pi^q)$ given by equations (14), (15), and (16) into equations (7), (8), (9), and (10). Case 2a can arise if μ is close to 1 and σ is sufficiently small, for example. Case 2b can arise if μ is sufficiently close to 1/2, for example.

The equilibrium such that all participants put their payment in the queue can be robust if it is one of multiple equilibria. Proposition 2 applies whenever time-sensitive payments are queued only if no payments are delayed. In this section, we have seen that for some parameter values time-critical payments are queued even if some payments are delayed. In such a case, the equilibrium in which all payments are queued is robust.

We now turn to the case where $\mu < 2/3$. For such values of μ, it is possible that

$$\frac{\pi^o}{\pi^q}(1-\mu)R > \gamma > \frac{1-\pi^o}{1-\pi^q}(2\mu-1)R,$$

in which case all participants who receive a negative liquidity shock have an incentive to delay. If these inequalities do not hold, the analysis is the same as above. For the remainder of this section, we assume the above inequalities hold.

Since

$$\frac{1-\pi^o}{1-\pi^q}\mu R \geq \frac{\pi^o}{\pi^q}(1-\mu)R,$$

if an equilibrium exists such that participants with a negative liquidity shock delay time-critical payments and participants with a positive liquidity shock make time-critical payments early, then it must be the case that participant with no liquidity shock queue their payment. In that case we have $\lambda_e = \sigma\theta$.

Restricting our attention to equilibria in pure strategies, λ_d can take two values. If only participants who must make a non-time critical payment and receive a negative productivity shock delay their payment, then $\lambda_d = \sigma(1-\theta)$ and $\pi^o/\pi^q = [1-\sigma(1-\theta)]/\theta$, where the expressions for π^o and π^q are given by equations (5) and (6). This case was studied in the previous section. If all participants who receive a negative liquidity shock delay their payment, then $\lambda_d = \sigma$ and $\pi^o/\pi^q = [(1-\sigma)(1+\theta)]/\theta$. This case is summarized in the following proposition.

Proposition 8 *If*

$$\gamma \leq \frac{1}{\sigma(1+\theta)}(2\mu-1)R,$$

then the unique equilibrium is for all agents to put their payment in the queue.

If

$$\frac{\theta}{(1-\sigma)(1+\theta)}(1-\mu)R > \gamma > \frac{1}{\sigma(1+\theta)}(2\mu-1)R,$$

then it is an equilibrium for participants who receive a positive liquidity shock to make their time-critical payment early, for participants who receive a negative liquidity shock to delay all payments, and for other participants to put their payment in the queue.

5.4 The case with no liquidity shock

To illustrate the role played by the liquidity shock in the previous section, we consider what happens there are no such shocks. Recall that without shocks and without LSM, three equilibria can occur: $\pi = 0$, $\pi = \theta$, and $\pi = 1$.

Absent liquidity shocks, putting a payment in the queue weakly dominates delaying a payment. Indeed, if the payment in the queue is not released in the morning, then both strategies yield the same outcome. If the payment in the queue is released in the morning, then the delay cost is avoided. Since participants do not need to borrow from the CB when the payment is released early, there is no borrowing cost with either strategy.

If delaying is a (weakly) dominated strategy, then either payments will be put in the queue or they will be paid in the morning outright. In either case, all payments are released in the morning and $\pi = 1$. Hence, the liquidity saving mechanism eliminates all equilibria with $\pi < 1$. This can be summarized in the following proposition.

Proposition 9 *Absent liquidity shock, $\pi = 1$ is the unique equilibrium with an LSM.*

In this case, all participants achieve the highest possible payoff of zero. This is similar to Willison's (2005) result that an offsetting mechanism in the first period with no liquidity shocks results in the first-best outcome of all payments settling.

5.5 Welfare under a liquidity saving mechanism

In this section we consider welfare when there is a liquidity saving mechanism under our two assumptions concerning the underlying pattern of payments.

5.5.1 Welfare under the long-cycle assumption

There is no systematic relationship between the equilibria described in proposition 6. To illustrate this, we show in the appendix that depending on parameter values equilibrium $2a$ can provide more or less welfare than equilibrium $2b$.

Next, we would like to compare equilibria with and without a LSM. To prove that an equilibrium with LSM yields higher welfare than an equilibrium without LSM, it is enough to show that the value of $\pi^o = \pi^q$ corresponding to the equilibrium with LSM is higher that the value of π corresponding to the equilibrium without an LSM. The argument is the same as in the proof of proposition 4.

If the size of the liquidity shock, $1 - \mu$, is small enough, then a LSM achieves higher welfare.

Proposition 10 *If $\mu \geq 2/3$, then welfare is higher with a LSM that without.*

If the size of the liquidity shock is small, then participants who receive a negative liquidity shock always prefer to put their payment in the queue rather than delay. This increases the probability of receiving a payment and makes it always greater the the probability of receiving a payment without a LSM.

If the delay-cost of time-critical payments is sufficiently high, or sufficiently low, a LSM helps achieve higher welfare.

Proposition 11 *If $\gamma > [\mu - \theta(2\mu - 1)]\, R$ or if $\gamma < (2\mu - 1)R$ then the level of welfare is at least as high with a LSM than without.*

If the cost of delay is sufficiently high, participants who must make time-critical payments have strong incentives not to delay their payments, whether or nor a LSM is available. Adding a LSM increases welfare because it allows participants who must make non-time-critical payments to make payment conditional on receiving a payment. This protects them from the risk of having to borrow from the CB. If the cost of delay is sufficiently low, no participant has an incentive to make a payment early. When this occurs, no participant has an incentive to delay and all payments are put in the queue. This allows all payments to be released from the queue. Below we provide an example showing that if the cost of delay is intermediate, it is possible that welfare is higher without a LSM.

If the fraction of time critical payments is small, the benefit from putting a large fraction of non-time-critical payment in the queue is large and an LSM provides higher welfare.

Proposition 12 *If $\sigma/(1-\sigma) > \theta$, then higher welfare is achieved with a LSM than without.*

We can show by an example that for some parameter values the welfare under an equilibrium without an LSM can be higher the the welfare with an LSM. Details are provided in the appendix.

Example 1 *Let $\mu = 1/2 + \delta$, $\gamma = \mu R - \varepsilon$, where $\delta, \varepsilon > 0$. For these parameters, welfare with a LSM is smaller than without a LSM, if δ and ε are small enough.*

If γ is not too large participants with a negative liquidity shock who must make time-critical payment may choose to delay them. At the same time, γ must not be too small, so that participants with a positive liquidity shock prefer to send their payment rather than put it in the queue. In this case, the queue participants who have not received a liquidity shock and must make a time-critical payment have the option not to make the payment early, but to put it in the queue instead. This is beneficial for these agents, because it protects them from having to borrow from the CB. However, from the perspective of society, the decrease in the fraction of participants who make their payment early decreases welfare. In other words, the queue can eliminate some beneficial coordination between agents by giving them the option to send a payment conditionally on receiving once. This reduction in coordination has a cost for society.

5.5.2 Welfare under the short-cycles assumption

Propositions 10 and 12 carry over to the case with short-cycles without modification. Proposition 11 is slightly modified. We restate it without proof.

Proposition 13 *If* $\gamma > [\mu - \theta(2\mu - 1)]\, R$ *or if*

$$\gamma < [\sigma(1+\theta)]^{-1}\,(2\mu - 1)R$$

then the level of welfare is at least as high with an LSM than without.

Now we provide one example showing that for some parameters, welfare can be lower with an LSM. Details are provided in the appendix.

Example 2 *Assume* $\theta = 1$*,* $\sigma = 1/4$*, and* $\mu = 1/2$*. If* $\gamma/R \in (3/8, 1/2)$*, the unique robust equilibrium with an LSM offers lower welfare than the unique equilibrium without an LSM.*

6 Balance vs. receipt-reactive mechanisms

In this section we compare the standard LSM studied above, which we also call balance-reactive LSM (BRLSM), to an alternative design that we call receipt-reactive LSM (RRLSM). A RRLSM is a mechanism in which payments received during a given interval of time are used to offset and release payments in the queue, regardless of the level of the participant's balance. This is in contract to a BRLSM in which a participant can specify a level of its balances below which no payment is sent from the queue.

Under a BRLSM, participants can condition the release of a queued payment on their level of balance. This is equivalent, in our environment, to conditioning the release of a payment on the participant's liquidity shock. As a consequence, BRLSM equilibria in this section are equivalent to the equilibria described in section 5. Under a RRLSM, we assume that participants must make the decision to send, delay, or put a payment in the queue before they learn their liquidity shock. All other aspects of the environment are unchanged. In particular, participants know whether their payment is time critical or not before they decide to delay, queue, or send it. The remainder of the section focuses on the RRLSM.

6.1 Participants' behavior under a receipt-reactive LSM

If a payment is delayed, the participant must pay the delay-cost for a time-critical payment, regardless of the liquidity shock. If the participant receives a positive or no liquidity shock, no other cost is incurred. With probability σ, a participant receives a negative liquidity shock and must also borrow an amount $1-\mu$ if an offsetting payment is not received. The expected cost of delay is thus given by

$$\gamma + \sigma(1-\pi^o)(1-\mu)R. \tag{18}$$

A queued payment is not released with probability $1-\pi^q$, in which case the delay cost is incurred for time-critical payments. In addition, participants who receive a negative liquidity shock must borrow $1-\mu$. Hence, the expected cost of putting a payment in the queue is

$$\sigma\left[(1-\pi^q)\gamma + (1-\mu)R\right] + (1-\sigma)\left(1-\pi^q\right)\gamma. \tag{19}$$

If a payment is sent early, then participants who receive a negative liquidity shock must borrow 1 if they do not receive a payment in the morning, which occurs with probability $1 - \pi^o$. Otherwise they must borrow $1 - \mu$. Participants who receive no liquidity shock must borrow μ if they do not receive a payment in the morning. Finally, participants who receive a positive liquidity shock must borrow $(2\mu - 1)$ if they do not receive a payment in the morning. It follows that the expected cost of sending payments in the morning is

$$\sigma\left[(1-\pi^o)+\pi^o(1-\mu)\right]R+(1-2\sigma)(1-\pi^o)\mu R+\sigma(1-\pi^o)(2\mu-1)R. \qquad (20)$$

The behavior of participants under a RRLSM is described in the next proposition

Proposition 14 *Assume* $\bar{\pi} \in (0,1)$ *and* $\mu \in [0.5, 1)$*, Under a receipt-reactive LSM, participants who must make a time-critical payment*

1. *delay the payment if* $\pi^o\sigma(1-\mu)R > \pi^q\gamma$,
2. *queue the payment if* $(1-\pi^o)\left[\mu R - \sigma(1-\mu)R\right] > (1-\pi^q)\gamma$ *and* $\pi^q\gamma \geq \pi^o\sigma(1-\mu)R$,
3. *make the payment early if* $(1-\pi^q)\gamma > (1-\pi^o)\left[\mu R - \sigma(1-\mu)R\right]$.

Participants who must make a non-time-critical payment delay unless time-critical payments are queued, in which case they are indifferent between delaying and putting the payment in the queue.

Proof. The boundaries for delaying, queuing, or sending payments in the morning come from comparing equations (18), (19), and (20). Since $(\pi^o/\pi^q)\sigma(1-\mu)R > 0$, participants who must send non-time-critical payments prefer to delay unless $\pi^o = 0$, which occurs if time-critical payments are put in the queue. ■

6.2 Equilibria under a receipt-reactive LSM

We can now describe the equilibria. With a RRLSM, either all participants put their payment in the queue or time-critical payments are paid early and non-time-critical payments are delayed.

Proposition 15 *There are two equilibria. Either all participants put their payment in the queue, in which case $\pi^o = 0$ and $\pi^q = 1$, or time-critical payments are paid early and non-time-critical payments are delayed, in which case $\pi^o = \pi^q = \theta$. If $\gamma > [\mu - \sigma(1-\mu)]\, R$, only the latter equilibrium survives deletion of weakly dominated strategies.*

Proof. First, we show that it cannot be an equilibrium strategy for time-critical payments to be delayed. Indeed, if such payments are delayed, then no payment is made early and $\pi^o = 0$. Participants who must make non-time-critical payments are indifferent between delaying and putting payments in the queue and we assume that they queue payments so that $\pi^q > 0$. In that case, the condition $\pi^o\sigma(1-\mu)R > \pi^q\gamma$ indicates that for any $\gamma > 0$, time-critical payments are not delayed.

If time-critical payments are put in the queue, participants who must make non-time-critical payments are again indifferent between delaying and queueing. In this case, $\pi^o = 0$ and $\pi^q = 1$. This implies that the conditions for all participants to put payments in the queue are satisfied for all γ.

Finally, if time-critical payments are made early, then participants who must make non-time-critical payments strictly prefer to delay. In this case, $\lambda_e = \theta$, $\lambda_d = 1-\theta$, and $\lambda_q = 0$, which implies $\pi^o = \pi^q = \theta$. This equilibrium exists only if $\gamma > \mu R - \sigma(1-\mu)R$.

Lemma 2 applies in this case so that if $\gamma > \mu R - \sigma(1-\mu)R$, the equilibrium such that all participants queue their payment is not robust. ■

6.3 Welfare under a receipt-reactive LSM

If the cost of delay is sufficiently high, we can show that a BRLSM provides higher welfare than a RRLSM.

Proposition 16 *If* $\gamma \geq \max\left\{[\mu - \sigma(1-\mu)]\,R; \frac{\theta}{\theta+(1-\theta)(1-\sigma)^2}(1-\mu)R\right\}$, *then welfare under a balance reactive LSM is higher than welfare under a receipt-reactive LSM.*

Proof. To prove this result, we need to show that the values of π^o and π^q are higher under the RRLSM than under the BRLSM. Since $\gamma > [\mu - \sigma(1-\mu)]\,R$ the unique robust equilibrium with a RRLSM has $\pi^o = \pi^q = \theta$. The value of π^o and π^q will be at least as large with a BRLSM if time-critical payments are not delayed. The corresponding condition is $\gamma \geq \frac{\theta}{\theta+(1-\theta)(1-\sigma)^2}(1-\mu)R$. ■

The next examples show that when the cost of delay is not too high and θ not too small, welfare under a RRLSM can be higher than under a BRLSM.

Example 3 *If* $\gamma \leq [\mu - \sigma(1-\mu)]$ *and* μ *is sufficiently small, then welfare under a RRLSM is higher than under a BRLSM.*

Details are provided in the appendix.

Finally, we compare welfare between a RRLSM and a system without LSM.

Proposition 17 *A system with a RRLSM provides at least as much welfare as a system without LSM.*

Proof. We have seen that the probability of receiving a payment early can be no greater than θ in the absence of a LSM. With a RRLSM, the probability of receiving a payment early is no smaller than θ. ■

7 Conclusion

We have studied a model in which banks settle daily payments while seeking to minimize the costs of payment delays and intraday borrowing. The novel feature of our model is that the participants are subject to two types of shocks. First, banks are randomly assigned to have either time-critical payments, whose late-period settlement imposes a cost on the bank, or non-time-critical payments. Second, banks are subject to liquidity shocks at the start of the day because of the operation of settlement institutions. These two shocks yield a rich array of strategic situations. The important parameters in our model are the costs of delay, the cost of borrowing intraday funds from the CB, the relative size of the payments made to the settlement system versus other payments, and the proportion of time-critical payments.

We illustrate the importance of liquidity shocks by comparing the equilibria of an RTGS system with and without the shocks. The liquidity shocks eliminate the "all pay early" equilibrium that exists without the shocks. With liquidity shocks, the participants who have a negative shock and non-time-sensitive payments choose to delay hoping to avoid the borrowing costs they would otherwise incur. This simple intuition is important because it reminds us that coordination of parties that have different types of payments and who are subject to liquidity shocks is more difficult than if we assume all parties are identical.

To model the working of an LSM, we consider the likelihood that payment messages assigned to the LSM offset one another. We study two extreme cases. In the "long-cycle" case no strict subset of payments is offsetting. In the alternative "short-cycles" case, payments offset each other bilaterally. These two models provide different motives for using the LSM. In the long-cycle case, participants don't assign payments to the LSM queue in the hopes of offsetting them within the queue; instead, they assign them to the queue to have them settle only conditional on receiving another payment. In the short-cycles case, participants can also anticipate that some of the time their queued LSM payments will be offset and will settle directly.

Under both RTGS and a balance-reactive LSM there can be multiple equilibria. Introducing a balance-reactive LSM has two effects on that multiplicity. On the one hand, being able to condition the release of a payment on the receipt of an offsetting payment eliminates strategic interactions and thus reduced the multiplicity of equilibria. This is particularly clear under the long-cycle assumption, where the equilibrium is unique. On the other hand, when payments settle bilaterally or multilaterally in the queue then a new set of strategic interactions emerge and multiplicity of equilibria reappears, as in the short-cycles case.

In most parts of the parameter space, the presence of a balance-reactive increases welfare compared to an RTGS system alone but, perhaps surprisingly, welfare may also be reduced. A balance-reactive LSM provides higher welfare if the cost of delay is high enough of low enough, and if the size of the outside settlement system and the proportion of time-critical payments are relatively low. When this is not the case, the RTGS can achieve higher welfare. The intuition is that RTGS creates some beneficial coordination of payments which can be undone by the presence of a queue. In our example, some participants who send their payment early under the unique RTGS equilibrium choose to put their payment in the queue when it is available. The resulting reduction in payments settled early leads to lower welfare.

Under receipt-reactive LSM the welfare achieved is always at least as high as the level achieved in RTGS. Here the intuition is simpler. As participants cannot condition on their balance, they either submit all their payments to the queue, or simply pay all the time-critical payments in the early period.

In comparing balance-reactive and receipt-reactive LSMs we find that when delay costs are high, and the settlement systems are not too large, the balance-reactive system yields a better outcome than the receipt-reactive LSM. As a result, while our results point to LSMs being at least weakly preferred to RTGS for all parameter configurations, the practical choice can present more of a dilemma to the operator of the large-value payment system. The dilemma is that our results show that the LSM design matters. If the wrong LSM is implemented it can yield either lower welfare than RTGS, or lower welfare than a competing LSM design. The difficulty for an operator is knowing the sizes of the four parameters of interest. In addition, we considered basic design elements in choosing the LSMs to model; more complex designs would introduce other behavioral considerations that are beyond the scope of this paper.

Another quantity that our research shows is important is the probability that queued payments offset. Some evidence on this subject is available in simulation studies of LSMs and in the practical experience of large-value payment systems that employ LSMs. Future research in this area can usefully focus on the question of the empirical magnitudes of the parameters of interest. The cost of delaying payments and the proportion of payments that are time-critical are especially important to measure and difficult to observe. Further research employing alternative distributions of these parameters is a subject for the future, as is extending the current model to include many periods.

8 Appendix

Cost of delaying and sending payments early under RTGS

I. *No liquidity shock*

Cost of sending a payment early: With probability π, an offsetting payment is received in the morning and no borrowing is necessary. With probability $1 - \pi$, no offsetting payment is received and μ must be borrowed. Hence, the expected cost is $(1 - \pi)\mu R$.

Cost of delay: The cost is γ since these participants they do not need to borrow when they delay.

II. *Negative liquidity shock*

Cost of sending a payment early: With probability π, a payment is received in the morning and only $1 - \mu$ must be borrowed. With probability $1 - \pi$, no payment is received in the morning and 1 must be borrowed. Hence, the expected cost is $[\pi(1 - \mu) + (1 - \pi)] R = (1 - \pi\mu)R$.

Cost of delay: With probability π a payment is received in the morning and, since $\mu > (1 - \mu)$, the participant does not need to borrow from the CB. With probability $1 - \pi$ no payment is received in the morning and $1 - \mu$ must be borrowed. Hence, the expected cost of delay is $\gamma + (1 - \pi)(1 - \mu)R$.

Proof of proposition 2

If $\gamma \geq [\mu - \pi(2\mu - 1)] R$, then from proposition 1 we know that all core participants make time-critical payments in the morning. Since the fraction of time-critical payments in the economy is θ, then we have $\pi = \theta$.

If $[\mu - \pi(2\mu - 1)] R > \gamma \geq (1 - \pi)\mu R$, then from proposition 1 we know that core participants who received a negative liquidity shock choose to delay time-critical payments. There is a fraction σ of such participants in the economy. If all other participants sent time-critical payments early, then we have $\pi = \theta (1 - \sigma)$.

If $(1-\pi)\mu R > \gamma \geq (1-\pi)(2\mu-1)R$, then from proposition 1 we know that only core participants who received a positive liquidity shock choose to make time-critical payments in the morning. This implies that the fraction of delayed time-critical payments is $1-\sigma$ and that $\pi = \sigma\theta$.

If $(1-\pi)(2\mu-1)R > \gamma$, then from proposition 1 we know that all core participants delay time-critical payments and $\pi = 0$.

Proof of lemma 1

Equilibrium 4 exists whenever $(2\mu-1)R \geq \gamma$. Equilibrium 3 exists whenever equilibrium 4 exists since $1-\sigma\theta < 1$. Equilibrium 1 exists whenever $\gamma > [\mu - \theta(2\mu-1)]\, R$. Hence, equilibria 1, 4, and 3 coexist if

$$(2\mu-1)R \geq \gamma > [\mu - \theta(2\mu-1)]\, R. \tag{21}$$

A little algebra shows that there exists a γ satisfying condition (21) whenever $\mu > \frac{1+\theta}{1+2\theta}$. Recall that equilibrium 2 exists if.

$$\{\mu - \theta\,(1-\sigma)\,(2\mu-1)\}\, R > \gamma \geq [1-\theta\,(1-\sigma)]\, \mu R.$$

It can be checked that $\{\mu - \theta\,(1-\sigma)\,(2\mu-1)\}\, R > (2\mu-1)R$ for all parameters. However, for $[\mu - \theta(2\mu-1)]\, R > [1-\theta\,(1-\sigma)]\, \mu R$ to hold, it must be the case that $\frac{1}{1+\sigma} > \mu$. With this restriction, the four equilibria coexist.

Derivation of the expressions for W_2, W_3, and W_4

First, note that the expression for W_2 is given by

$$\begin{aligned} W_2 &= -(1-\theta)\sigma(1-\pi)(1-\mu)R - \theta\sigma(1-\pi)(2\mu-1)R \\ &\quad -\theta(1-2\sigma)(1-\pi)\mu R - \theta\sigma\,[\gamma + (1-\pi)(1-\mu)R]\,. \end{aligned}$$

Recall that under this equilibrium, $\pi = \theta\,[1-\sigma]$. Replacing π we get

$$\begin{aligned} W_2 &= -(1-\theta)\sigma(1-\theta\,[1-\sigma])(1-\mu)R - \theta\sigma(1-\theta\,[1-\sigma])(2\mu-1)R \\ &\quad -\theta(1-2\sigma)(1-\theta\,[1-\sigma])\mu R - \theta\sigma\,[\gamma + (1-\theta\,[1-\sigma])(1-\mu)R]\,. \end{aligned}$$

The expression for W_3 is given by

$$
\begin{aligned}
W_3 &= -(1-\theta)\sigma(1-\pi)(1-\mu)R - \theta\sigma(1-\pi)(2\mu-1)R \\
&\quad -\theta(1-2\sigma)\gamma - \theta\sigma\left[\gamma + (1-\pi)(1-\mu)R\right] \\
&= -\theta\left[1-\sigma\right]\gamma - (1-\pi)\sigma(1-\mu)R - \theta(1-\pi)\sigma(2\mu-1)R.
\end{aligned}
$$

Under this equilibrium, $\pi = \theta\sigma$. Replacing π we get

$$
W_3 = -\theta\left[1-\sigma\right]\gamma - (1-\theta\sigma)\sigma(1-\mu)R - \theta(1-\theta\sigma)\sigma(2\mu-1)R.
$$

The expression for W_4 is given by

$$
\begin{aligned}
W_4 &= -(1-\theta)\sigma(1-\pi)(1-\mu)R - \theta\sigma\gamma - \theta(1-2\sigma)\gamma - \theta\sigma\left[\gamma + (1-\pi)(1-\mu)R\right] \\
&= -\theta\gamma - (1-\pi)\sigma(1-\mu)R.
\end{aligned}
$$

Under this equilibrium, $\pi = 0$. Replacing π we get

$$
W_4 = -\theta\gamma - \sigma(1-\mu)R.
$$

Proof of proposition 4

We show that, when comparing two equilibria, the equilibrium associated with the higher value of π yields higher welfare. Consider two equilibria, denoted by A and B, with π_A and π_B. Assume that $\pi_A > \pi_B$. Focus on a particular agent and let S_A and S_B denote the equilibrium strategies of this agent corresponding to each equilibrium. Let $W(S_A, \pi_A)$ and $W(S_B, \pi_B)$ denote the welfare of this agent associated with each equilibrium. Now note that $W(S_B, \pi_A) \geq W(S_B, \pi_B)$, since all the actions that system participants can take have a cost that is (weakly) decreasing in π. Further, by definition of an equilibrium, $W(S_A, \pi_A) \geq W(S_B, \pi_A)$. If follows that $W(S_A, \pi_A) \geq W(S_B, \pi_B)$.

Cost of delaying, queueing, and sending payments early under LSM

For participants who must make a time-sensitive payment and have received a positive liquidity shock, the expected cost of delaying a payment or putting the payment in the queue is the same as for participants who did not receive a liquidity shock. Hence, for these participants also, queuing a payment is better than delaying. The expected cost of sending the payment early is $(1-\pi^o)(2\mu-1)R$.

To find the expected cost of delay for participants who must make a time-critical payment and have received a negative liquidity shock, note that with probability $1-\pi^o$, no payment is received and these participants must borrow $1-\mu$ to cover the liquidity shock. With probability π^o, a payment is received and since $\mu > 1-\mu$ the participants do not need to borrow. These participants also suffer the delay cost γ, so the expected cost of delay is given by $\gamma + (1-\pi^o)(1-\mu)R$. If the payment is put in the queue, the participants must borrow $1-\mu$ from the CB whether the payment is released or not. If the payment is not released, which happens with probability $1-\pi^q$, then the delay cost must be added. So the expected cost of putting the payment in the queue is $(1-\pi^q)\gamma + (1-\mu)R$. If the payment is sent outright, the delay cost is always avoided. With probability π^o, a payment is received early and only $1-\mu$ must be borrowed from the CB. Otherwise, 1 must be borrowed. So the expected cost of sending the payment outright is $\left[(1-\pi^o) + \pi^o(1-\mu)\right] R$.

Proof of lemma 2

We need to show that for some participants, putting their payment in the queue is a weakly dominated strategy when both equilibria exist. Consider participants who receive a negative liquidity shock and must make a non-time-critical payment. These participants are indifferent between delaying or putting their payment in the queue if $\lambda_q = 1$. However, they strictly prefer to delay their payment if $\lambda_q < 1$. Hence, the strategy consisting of putting the payment in the queue is weakly dominated for these agents whenever both equilibria exist.

Welfare comparison of equilibria $2a$ and $2b$ of proposition 6

We use $W_{6,2a}$ and $W_{6,2b}$ to denote welfare under the corresponding equilibria in proposition 6. Note that

$$\pi_{6,2b} - \pi_{6,2a} = \frac{\sigma\theta(1-\theta)}{1-\sigma(1-\theta)} \geq 0.$$

Also, equilibrium $2b$ of proposition 6 exists if $\gamma = \mu R - \varepsilon$, where $\varepsilon \in (0, (1-\mu)R)$. Hence, we can write

$$\begin{aligned} W_{6,2b} - W_{6,2a} &= (1-\theta)\sigma\left(\pi_{6,2b} - \pi_{6,2a}\right)(1-\mu)R \\ &+\theta\sigma\left(\pi_{6,2b} - \pi_{6,2a}\right)(2\mu-1)R \\ &+\theta\left[1-2\sigma\right]\left[\left(\pi_{6,2b} - \pi_{6,2a}\right)\mu R - (1-\pi_{6,2a})\varepsilon\right] \\ &+\theta\sigma\left[\left(\pi_{6,2b} - \pi_{6,2a}\right)\mu R - (1-\pi_{6,2a})\varepsilon\right]. \end{aligned}$$

Given $\pi_{4,2b} - \pi_{4,2a} > 0$, we can choose $\varepsilon > 0$ so small that $W_{4,2a} - W_{4,2b} > 0$. Now set $\mu = 3/4$, implying $\varepsilon = (1-\mu)R = R/4$, and $\bar{\pi} = 1/2$, implying $\sigma = 1/4$. With these parameters, we have

$$W_{4,2b} - W_{4,2a} = \frac{1-\theta}{3-\theta}\frac{\theta}{16}\left[13\theta - 8\right],$$

so $W_{4,2b} - W_{4,2a} < 0$ if $\theta < 8/13$.

Proof of proposition 10

As we have seen in section 4.2, the largest value of π in an equilibrium without LSM is θ. In contrast, we have seen in section 5.3.1 that the lowest value of $\pi^o = \pi^q$ is θ, if $\mu \geq 2/3$. Hence, welfare is always at least as high with a LSM that without under our long-cycle assumption.

Proof of proposition 11

If $\gamma > \left[\mu - \theta(2(\mu-1)\right]R$, then equilibrium 1 of proposition 2 exists when there is no LSM. We already know, from proposition 4, that this equilibrium provides the highest welfare of all equilibria without a LSM. So we need to prove that LSM equilibria consistent with $\gamma > \left[\mu - \theta(2\mu-1)\right]R$ achieve higher welfare than equilibrium

1 of proposition 2. To do that, it is enough to show that the value of $\pi^o = \pi^q$ corresponding to these LSM equilibria are greater or equal than θ.

Note that $[\mu - \theta(2(\mu - 1)] > 1-\mu$. So we need to check the value of π for equilibria $2a$, $2b$, $3b$, and $3c$ of proposition 6. Simple algebra reveals that the values of $\pi^o = \pi^q$ corresponding to these equilibria are greater or equal than θ.

If $\gamma < (2\mu - 1)R$, all participants put their payments in the queue with a LSM, so that $\pi^q = 1 \geq \theta$.

Proof of proposition 12

It is enough to show that under this condition the highest π that can be achieved without a LSM is lower than the lowest π^o that can be achieved with an LSM. The highest π that can be achieved without a LSM is θ, under equilibrium 1 of proposition 2. The lowest π^o that can be achieved with an LSM is $\theta/(1+\theta)$ under items $3a$ in proposition 6. $\pi^o > \pi \Leftrightarrow \sigma/\left(1-\sigma\right) > \theta$.

Details of Example 1

It can be checked that if δ and ε are small enough, there is a unique equilibrium without an LSM given by equilibrium 3 of proposition 2. Let W_3 denote the welfare associated with this equilibrium. The equilibrium with a LSM is given by equilibrium $3a$ in proposition 6. Let $W_{4,3a}$ denote the welfare associated with this equilibrium. The probability of receiving a payment early without an LSM is $\pi = \theta(1-\sigma)$, while the probability of receiving a payment early with the LSM is $\pi^o = \pi^q = \theta/(1+\theta)$. Clearly, $\pi > \pi^o \Leftrightarrow \theta(1-\sigma) > \sigma$, which holds if σ is small enough. We can write

$$\begin{aligned} W_3 - W_{4,3a} &= \sigma(\frac{1}{2} - \delta)R(\pi - \pi^o) + \theta\sigma(2\delta)R(\pi - \pi^o) \\ &\quad + \theta(1-2\sigma)\left[\left(\frac{1}{2} + \delta\right) R(\pi - \pi^o) - \varepsilon(1 - \pi^o)\right]. \end{aligned}$$

If $\pi > \pi^o$ and ε is small enough, this expression is positive.

Details of Example 2

First, we establish that the unique robust equilibrium with an LSM is such that all participants who receive a negative liquidity shock delay their payment while only participants with a positive liquidity shock send time-critical payments early.[14] Formally, $\lambda_e = \sigma\theta = 1/4$ and $\lambda_d = \sigma = 1/4$.

Since $\mu = 1/2$,

$$\gamma > \frac{1-\pi^o}{1-\pi^q}(2\mu - 1)R = 0$$

for all $\gamma > 0$. This implies that participants who receive a positive liquidity shock choose to send time-critical payments if γ is not zero. Other participants choose not to make time-critical payments early if

$$\frac{1-\pi^o}{1-\pi^q}\mu R > \gamma.$$

The smallest value that $(1-\pi^o)/(1-\pi^q)$ can take is 1, so the above condition becomes $R/2 > \gamma$

Participants who receive a negative liquidity shock choose to delay if $\frac{\pi^o}{\pi^q}(1-\mu)R > \gamma$. The smallest value that π^o/π^q can take is also 1, so the above condition is $R/2 > \gamma$.

Next, we show that the unique equilibrium without an LSM is equilibrium 2 of proposition 2. That equilibrium exists if $R/2 \geq \gamma > R/8$. Equilibrium 1 of proposition 2 does not exist if $R/2 > \gamma$ and equilibrium 3 of proposition 2 does not exist if $\gamma > 3R/8$.

To summarize, the conditions for the equilibria we consider to exist and be unique are $R/2 > \gamma > 3R/8$.

Now we can evaluate the welfare associated with each equilibrium. Equilibrium 2 of proposition 2 provides welfare $W_2 = -\gamma/4 - 3R/32$. The equilibrium with a LSM yields welfare $W = -3\gamma/8 - R/16$. If follows that $W_2 > W$ if $\gamma > R/4$. Hence $W_2 > W$ for all $R/2 > \gamma > 3R/8$.

Details of Example 3

[14] While it is an equilibrium for all participants to put their payment in the queue, lemma 2 applies here.

If $\gamma \leq [\mu - \sigma(1-\mu)]$, then the only equilibrium with a RRLSM is for all participants to queue payments. Any BRLSM such that not all payments are queued will yield lower welfare. The condition for participants with a positive liquidity shock prefer to send time-critical payments early is $(1-\pi^q) \geq (1-\pi^o)(2\mu - 1)R$. For any $\gamma > 0$, there exists a μ sufficiently close to 1/2 such that this condition is satisfied. In those cases, it is not a robust equilibrium for all payments to be queued when a BRLSM is available.

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Figure 2: A unique cycle

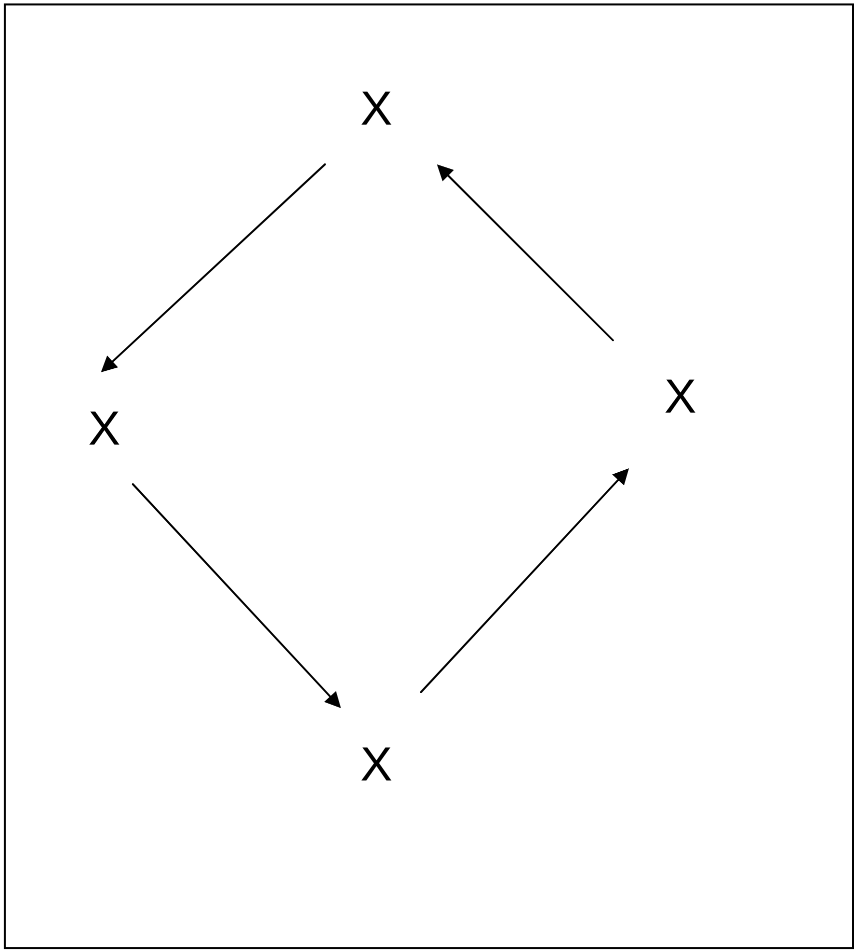

Figure 3: Several cycles

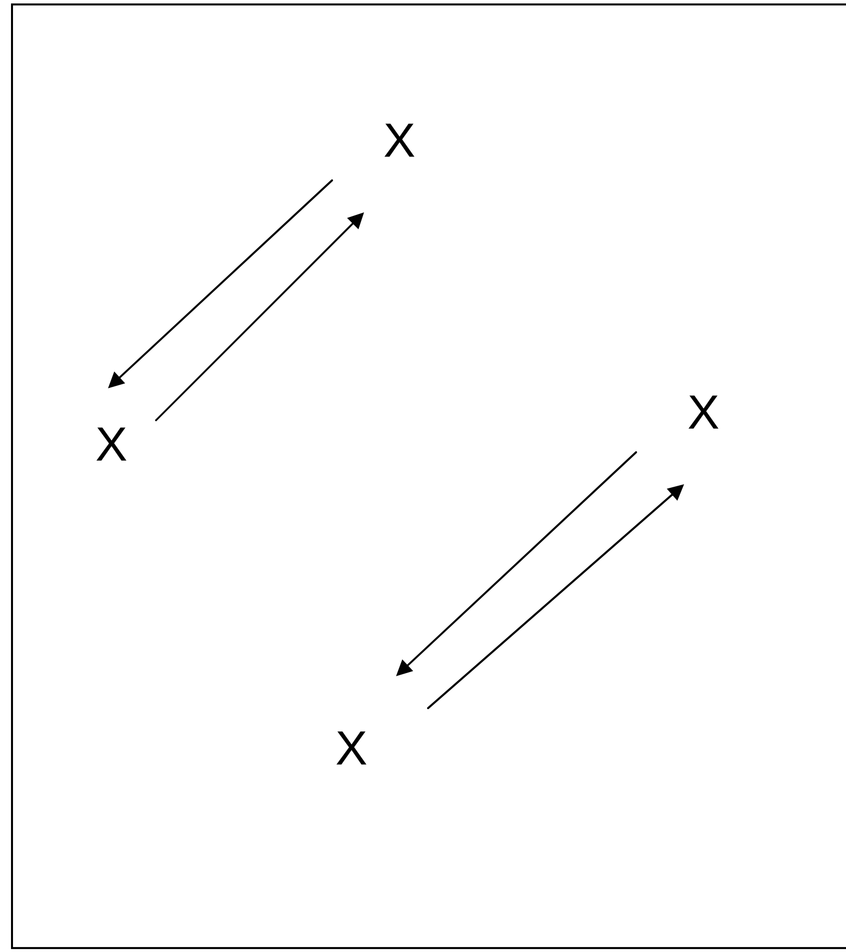

Figure 4: Queued payments in a cycle

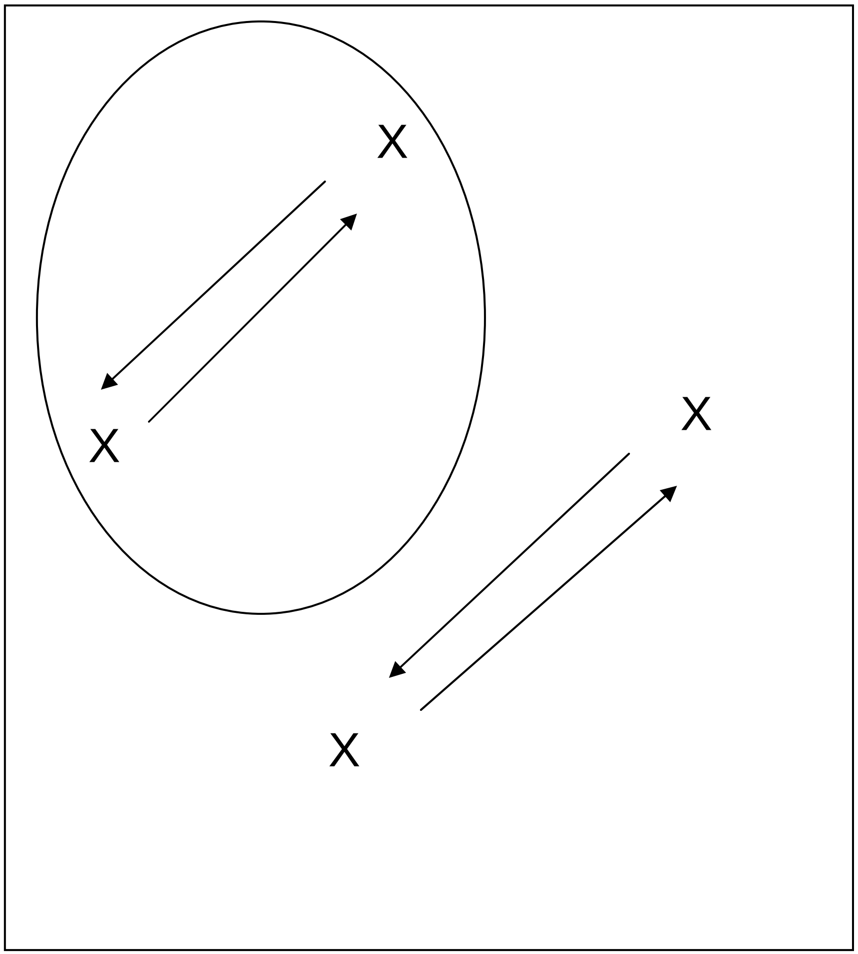

Figure 5: Queued payment in paths