Unintended Consequences of Post-Crisis Liquidity Regulation

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Abstract

We find post-crisis liquidity regulation has unintentionally increased banks' borrowing from government-sponsored enterprises known as the Federal Home Loan Banks (FHLBs) by $200 billion. Using a model of liquidity regulation, we show that regulatory arbitrage was an important motive behind banks' increasing reliance on the FHLBs. In particular, because the FHLBs are subject to looser liquidity requirements than banks, they can issue short-term money-like claims at lower costs and then lend to banks. This regulatory arbitrage compromises the effectiveness of liquidity regulation to reduce excessive liquidity transformation and creates potential fragilities in the financial system. We argue that imposing regulation on the FHLBs may not fundamentally eliminate this type of regulatory arbitrage because liquidity transformation may shift to other unregulated intermediaries. Instead, increasing government supply of money-like assets may help to crowd out the supply from the private sector.

Speaker Profile

Suresh Sundaresan is Chase Manhattan Bank Professor of Economics and Finance at Columbia University. More details can be found at https://www0.gsb.columbia.edu/faculty/ssundaresan/cv.html