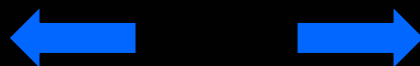




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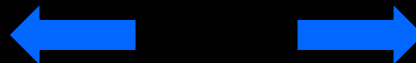


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# Discussion of “Liquidity Risk and Contagion” by R. Cifuentes, G. Ferrucci and H.S. Shin

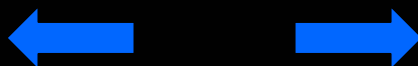
**Philipp Hartmann**  
**European Central Bank and CEPR**

Basel Committee, CEPR and JFI Workshop on “Accounting  
Transparency and Bank Stability”, BIS, 17 May 2004




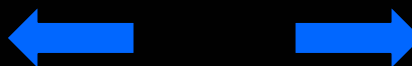
## Paper and discussion


- No third summary, very simple model and intuition
- Paper speaks to two topics
  - Market liquidity, capital requirements and contagion
  - Fair-value accounting and financial stability
  - First, academically timely, the second in terms of policy
- The discussion: Context, 3 questions and other model
  - Past academic and current policy debate
  - An epistemological perspective
  - A fundamental question: Correlation of illiquid assets
  - Behavioural issues
  - Market structure, asymmetry and liquidity

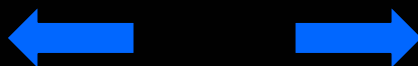


## Earlier discussions on fair-value accounting

- Old topic for the *Journal of Financial Intermediation*
- Maureen O'Hara, "Real Bills Revisited: Market Value Accounting and Loan Maturity", *JFI*, 3, 1993
  - Conclusion: "The desirability of MVA applied to loans is thus questionable"
  - Argument: In the presence of asymmetric information a bias against longer term illiquid loans emerges, which increases their interest rates and reduces banks' liquidity providing role
- Present paper adds another argument against
  - FVA may accelerate asset divestitures
  - With depression of  asset prices spilling over to others



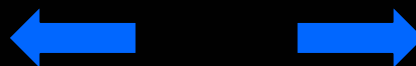
- President of the ECB, Jean-Claude Trichet, warned in front of the European Parliament on 16 February 2004 of the potentially adverse effects of FVA on bank stability
- Could increase volatility of bank balance sheets
- Echoed by February 2004 ECB Monthly Bulletin
  - Serious concerns that FVA may enhance the pro-cyclicality of lending
  - Possible negative effects of FVA on the stability of the financial system
- ECB Occasional Paper  no. 13, April 2004




- Plan that from 2005 onwards European companies (incl. banks) will have to adopt IAS for their consolidated financial statements
- Debate related to rule IAS39, which deals with the recognition and measurement of financial instruments
- “Exposure draft” of August 2001 proposed the option to all firms to use FVA for any instrument
- “Exposure draft” of August 2003 on “macro hedging”
- Various discussions, revisions and consultations since then

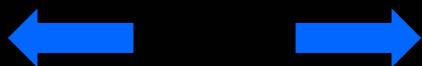


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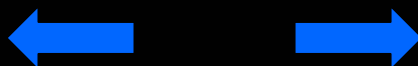
## A piece of epistemology

- Popper and other “positivists” argue that theories need to be “falsifiable”
  - Hypothesis: All swans are white
  - Falsifiable, as the detection of one black swan would reject the hypothesis
- Paper claims that present empirical tests of contagion underestimate it, because they neglect the value declines of non-marketable assets
- One often doesn’t know what the true market value of an illiquid asset is
- How can the claim that an illiquid asset has been sold below its fair value be  falsified ?



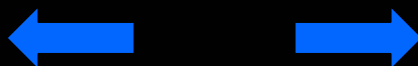
## Does the main argument hold in a strong sense ?

- Spillover effects appear quite strong in simulations
- Strength of contagion is very much related to the feature that the “fire sale” of one financial institution’s illiquid assets depresses the value of these assets to the same extent as the illiquid assets on other institution’s balance sheets
- Assets often illiquid because of specific risk
- Take the extreme example of loans
- The fact that loans of certain borrowers are liquidated does not necessarily imply that the value of loans by other borrowers are  repressed to the same extent





- “Typical” economic criticism of such an approach: No real behavioural component in the model/simulations
- For example, existence of interbank exposures introduces incentives for monitoring (Rochet and Tirole, 1996, or Leitner, 2004)
- Or, introduction of regulatory liquidity ratios changes banks’ investment behaviour (e.g., could induce greater risk-taking with other assets)
- Such effects could change the results

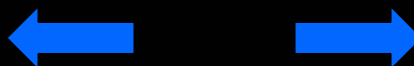


## Importance of market structures and asymmetry

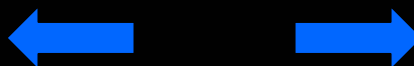
- There can be other forms of liquidity issues in interbank markets
- For example, Carletti, Hartmann and Spagnolo (2003), Bank mergers, competition and liquidity, ECB WP, no. 292, November
  - Loan differentiation model with deposit liquidity shocks
  - Market structures are important and asymmetries
  - Concentration can internalise part of the interbank market, potentially making liquidity shortages more likely
  - Asymmetries in balance sheets can amplify aggregate liquidity fluctuations



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- Complete literature and make links to it clearer
  - Exact relation to Eisenberg and Noe (2001) in introduction
  - Other papers that have used network arguments in related contexts, e.g., also analysing the role of “connectivity” (McAndrews and Wasilyew, 1995, and Leitner, 2004)
  - Cover Allen and Gale asset liquidation arguments
  - Not all empirical contagion papers suggest that “contagion is never significant in practice”
  - Beneficial effects of transparency on banking system stability (see e.g. Tadesse, 2004)

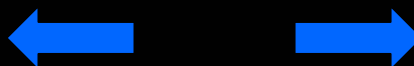


## Further suggestions (cont.)

- Other policies ? Ex post, like LLR
- Some features of simulation not in the model
  - Notably, bank default (bankruptcy costs ?)
- Motivate “parameterisations” in section 3
  - Balance-sheet composition
  - Capital adequacy ratio etc.
- Some parts in section 2 are more confusing than necessary
  - Some “arcane” notation of the model
  - Figure 1 and Propositions 2 and 3 are not aligned



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