COMMENTS ON

"MARKET LIQUIDITY AFTER THE FINANCIAL CRISIS"

FSB WORKSHOP ON EVALUATING FINANCIAL REGULATORY REFORMS

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Paper summary

- Frequent concerns are mentioned that regulatory changes after the financial crisis reduced dealers' ability to make markets and hurt liquidity in bond markets:
  - Enhanced capital and liquidity requirements
  - Volcker Rule that restricts trading
- The paper does not find evidence for decreased liquidity
  - Evaluating measures like bid-ask spread and price impact
  - Examining market ability to absorb shocks such as the taper tantrum and the Third Avenue liquidation
- These are interesting results and the paper is very carefully and thoughtfully done

Challenges

- Does the paper capture overall effect of reforms on liquidity?
  - I would argue that there are dimensions of liquidity that are not easy to capture with traditional analysis
  - One needs to think of alternative data sources or identification exercises
- How do we translate the effect on liquidity to reform evaluation?
  - Reform affects many aspects of financial markets
  - Negative implications could arise in various ways that might be hard to capture in one study

How Do We Measure the Effect on Liquidity?

- As dealers find it more difficult to hold bonds in their inventory, they shift to a different model of liquidity provision
  - Instead of being a principal, buying and selling bonds against liquidity demanders, they act like agents matching between buyers and sellers
- A direct result could be that the cost of liquidity is lower because less liquidity is provided, but other dimensions deteriorate
  - In particular, the time to buy and sell increases and so liquidity is overall worsened

Incorporating the Time Dimension of Liquidity

- Dick-Nielsen and Rossi (2017)
  - Identify trading situations in which the motive to obtain immediacy is so strong, that liquidity seekers do not orchestrate alternative trading arrangements
  - Compute liquidity costs around bond exclusions from the Barclay Capital investment-grade corporate bond index. In this natural experiment, index trackers request immediacy from the dealers in order to minimize their tracking error
  - Empirical analysis shows that the price elasticity of the supply of immediacy has increased significantly after the crisis
    - For safe bonds, the cost of immediacy has approximately doubled, while for more risky bonds, the cost has more than tripled
- Results challenge the idea that liquidity has not worsened after the crisis

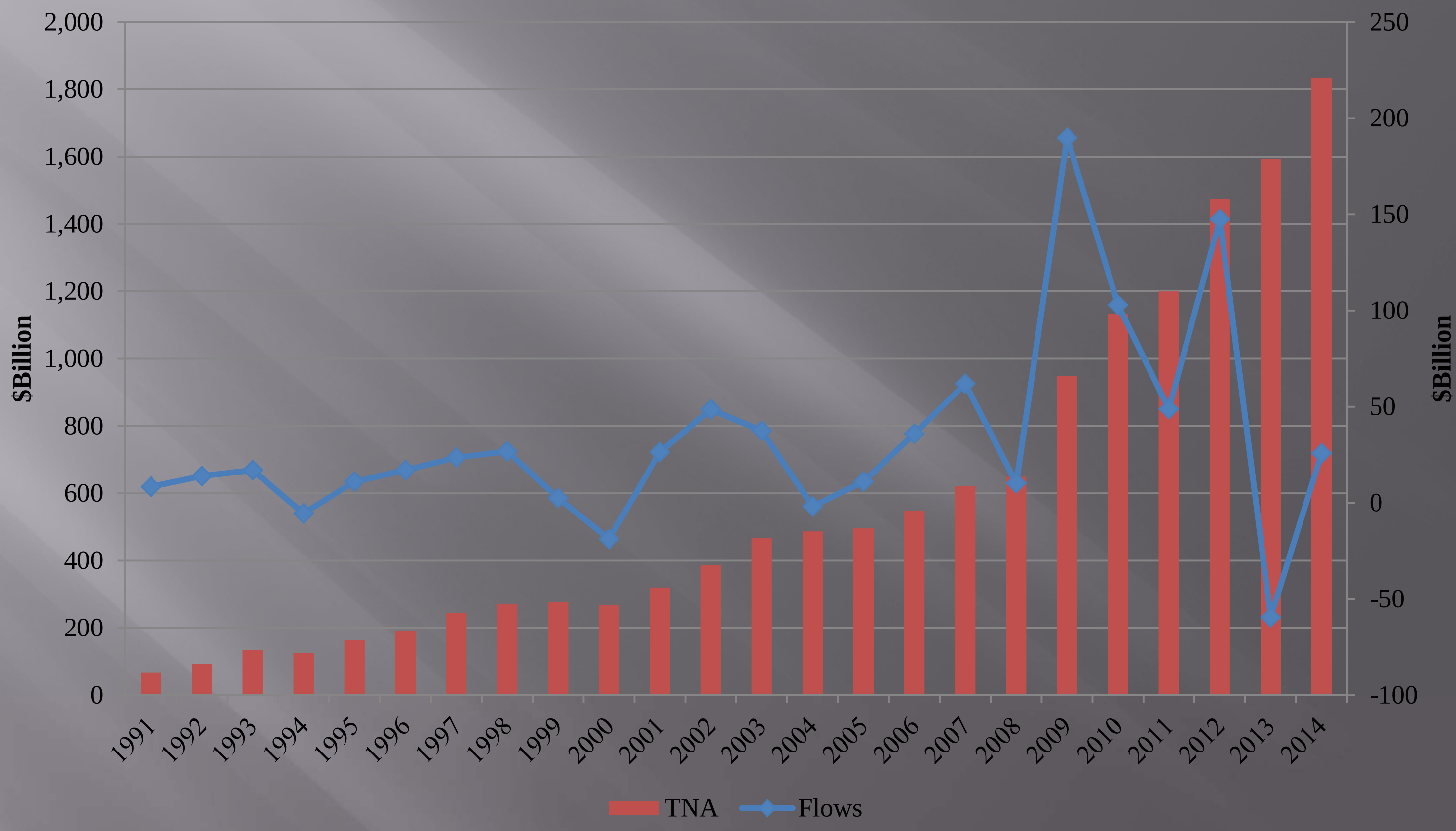
Incorporating the Time Dimension of Liquidity – Cont’d

- Dick-Nielsen and Rossi (2017) offer fairly clean identification of the decrease in liquidity by focusing on a setting where immediacy cannot be compromised and measuring the costs of liquidity
- More generally, one would like to get an idea of the extent to which trading speed has deteriorated after the crisis
- For example: exploring data of transactions of insurance companies in the bond market to assess if they require more time now to trade in and out of their positions
- It is then important to evaluate the overall change in welfare as a result of combined changes in liquidity
  - This will allow us a more complete assessment of the effects of policy reforms
- As a follow up, we could think of desirable changes in the market structure to alleviate effects of reforms on liquidity

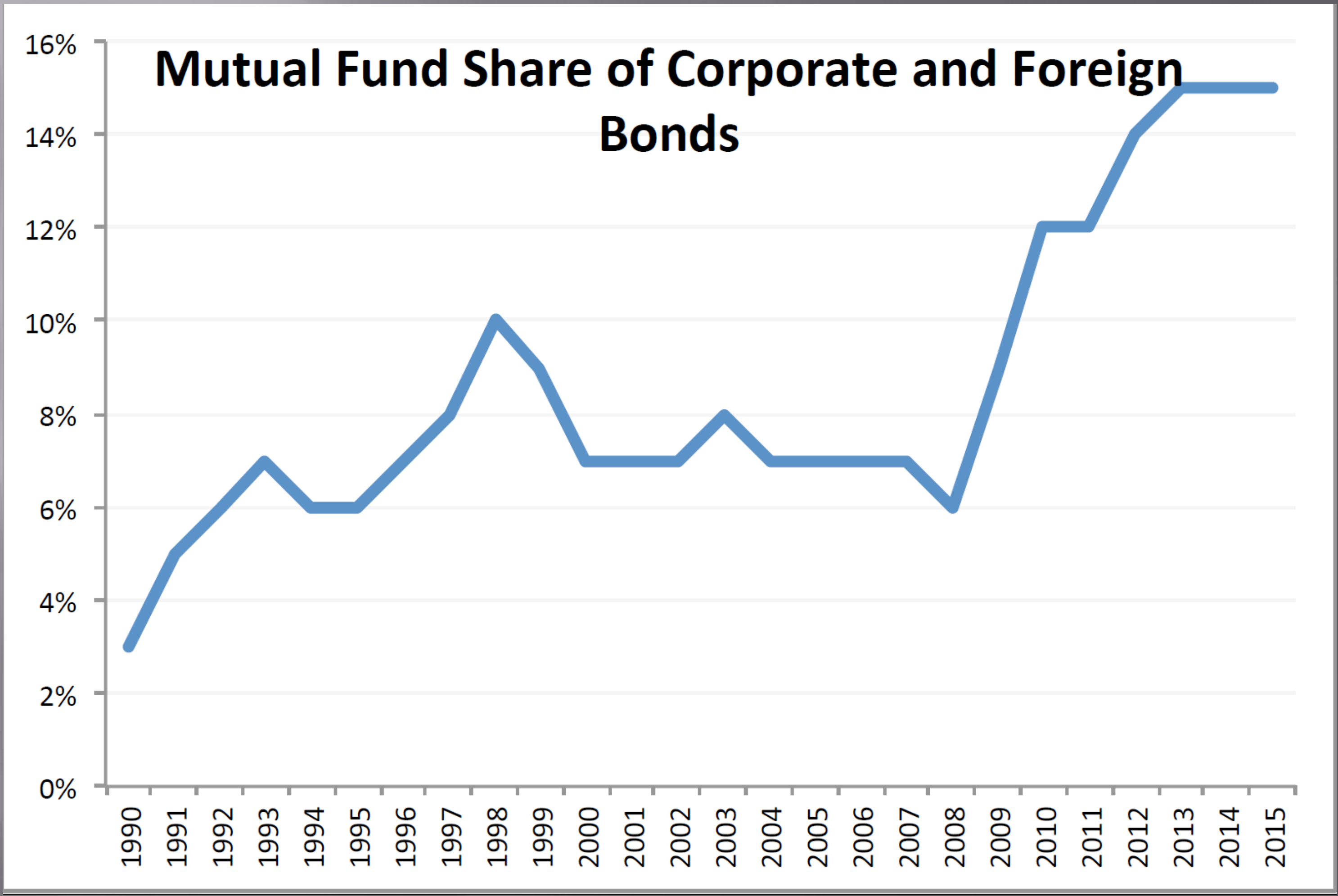
Other Effects of Reform

- The limitations imposed on traditional financial institutions after the crisis led to significant changes in the landscape of financial activities
- Leading example: Asset managers are growing in prominence
  - Managing higher amounts of money
  - Expanding their activities into illiquid assets
  - Filling the role of traditional financial institutions in liquidity transformation
- For example, in the context of corporate-bond funds, following graphs show remarkable transitions in recent years:
  - Chernenko and Sunderam (2016) and Goldstein, Jiang, and Ng (2016)

Total Net Assets and Dollar Flows of Active Corporate Bond Funds



Increasing Share of the Market



Evaluating Overall Effects of Reforms

- The concentration of illiquid assets at the hands of open-end mutual funds can be a source of fragility
- This is not something that can be captured in traditional measures of liquidity
- It is important to keep track of effects on different segments of financial industry, but this is hard to capture in one study
- Potential strategy:
  - Conduct comprehensive stress tests for different types of financial institutions
  - Compare results between pre-crisis and post-crisis setups

Conclusions

- Interesting study; carefully done; intriguing results
- Conclusions on effect of reform on market liquidity might not incorporate all aspects of liquidity
- Assessing overall impact of reform requires evaluating developments in different segments of the financial sector and their implications for fragility
- General takeaways for evaluation of regulatory reforms