Discussion of "The Liquidity Coverage Ratio and Security Prices" By Fuhrer, Müller and Steiner

Alain Chaboud

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Overview

- The main question: Did the introduction of the LCR create an HQLA premium? If so, how large was that premium for CHF securities?
- Very nicely done, careful, honest, interesting, well written paper. Sets up the empirical analysis with a nice theoretical discussion.
- But the paper has a very difficult job to do:
  - 1) The event used for identification is very subtle, perhaps not well defined
  - 2) The SNB's policy likely makes Switzerland a very difficult place to detect an HQLA premium.

The Timeline

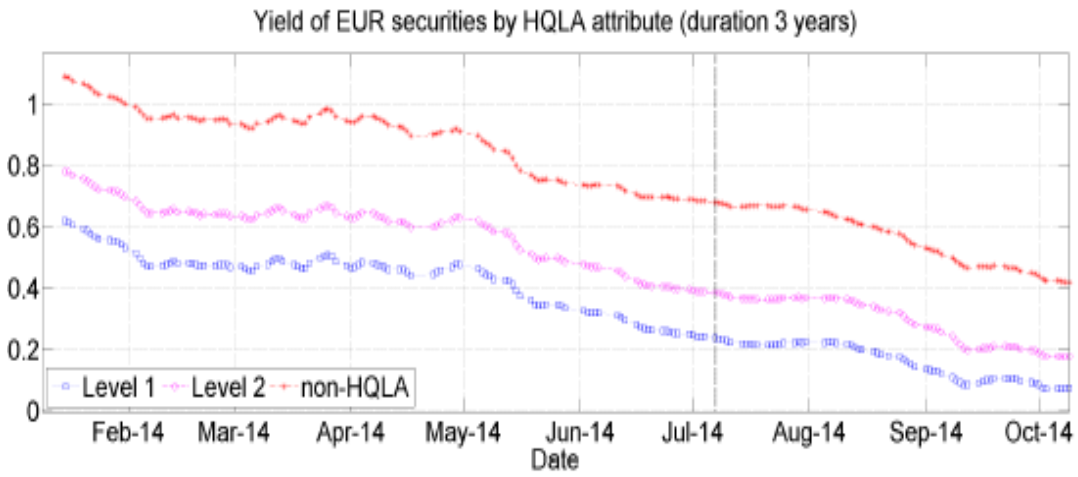
- The LCR becomes operational on January 1, 2015 in Switzerland and the Eurozone
- Ahead of that event, precise information about LCR is released at different times:
    - Switzerland: 7 July 2014
    - Eurozone: 10 October 2014
- The pre-period for the diff-in-diff: 9 Jan 2014 to 6 July 2014
- The post-period: 7 July 2014 to 9 October 2014 (the “treatment” period)
- Is July 7 really a breakpoint? How much new information about CHF non-HQLA?
- Maybe not that much:
    - Footnote 11, page 13: “This list was available as of 2 May 2014, already.”
    - My first observation: The authors are much too honest.

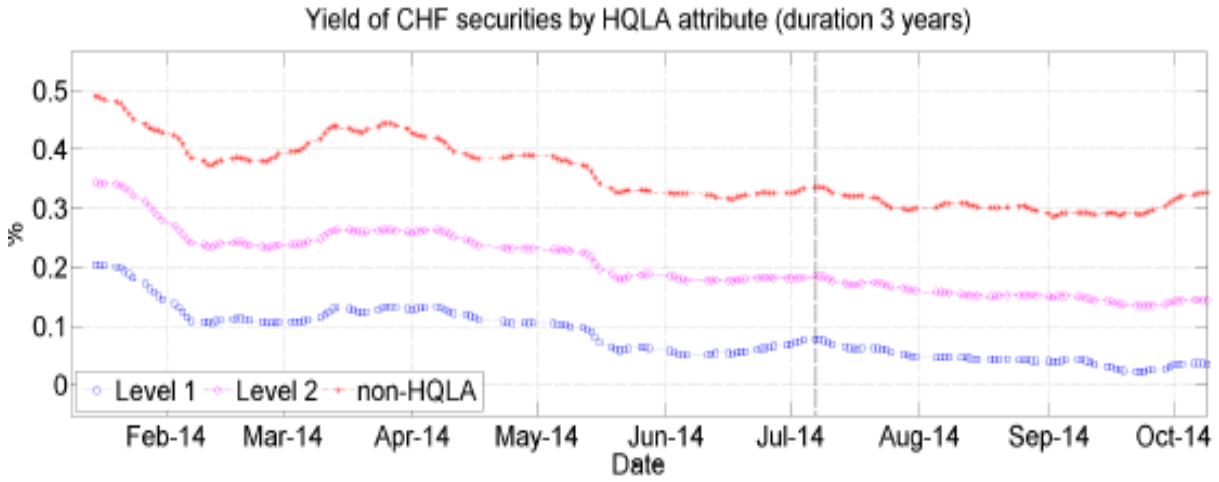
The Timeline (2)

- How about for the EUR securities?
- "The LCR legislative principles in the EU were published on 10 October 2014."
- What if EU banks mostly knew the LCR EUR securities buckets before then?
- The authors argue: "*This violation of the exogeneity assumption* [Swiss institutions anticipating the precise LCR rules] *would lead to an underestimation of the HQLA premium. The same is true if securities in the euro area had been re-priced in anticipation of the regulatory change*." (page 27)
- My view: Mechanically, in a narrow way, the argument the authors make here is absolutely valid. But this is a dangerous argument to make. If true, then the entire diff-in-diff exercise is in doubt. There would be no clear before and after, and relative movements in the HQLA premium could not be solidly attributed to information about LCR being released at different times.

The Timeline (3)

- The CHF HQLA premium drops to less than 2 bp if the diff-in-diff stops on September 4, and includes level 2 securities.
- Much of the results seem to be driven by the end of the sample. Also, non-HQLA CHF yields (not spreads) are little changed in the post period. The driver of the diff-in-diff seems to be more a change on the EUR side. That may be OK, or not OK.





Could other factors drive the observed spreads?

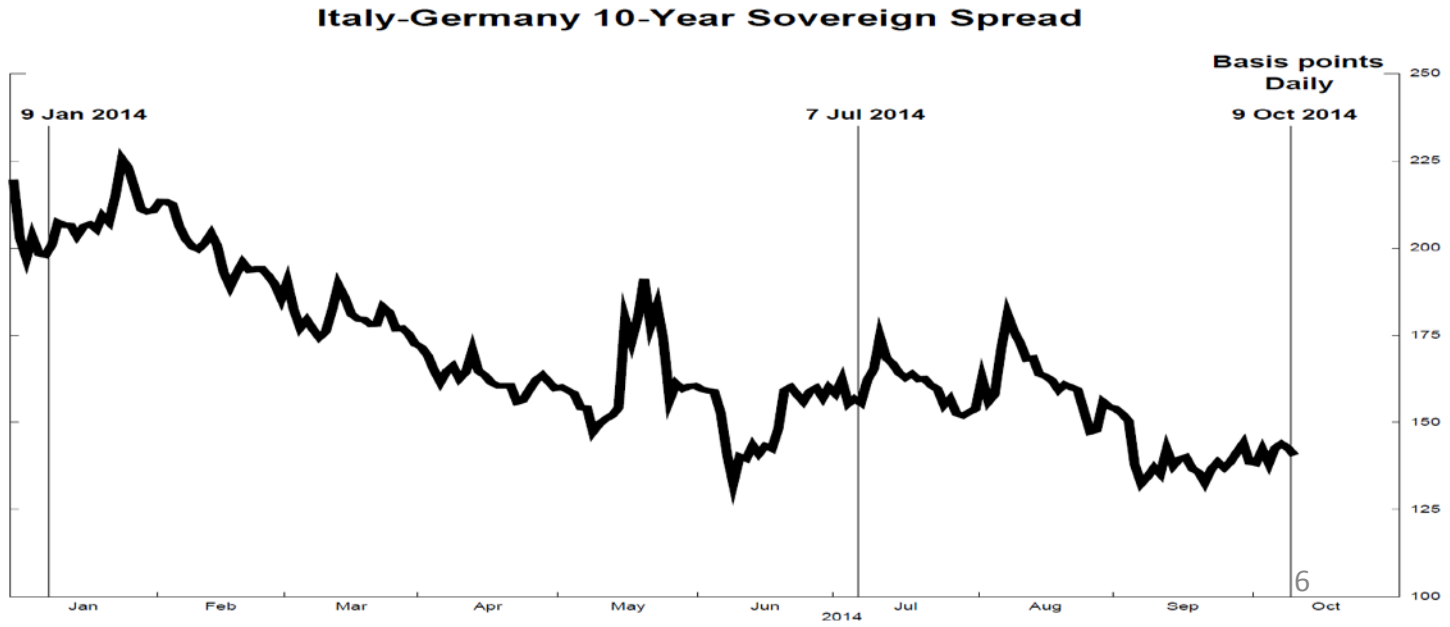
- The authors have obviously thought about this, at least on the CHF side:

	(1) HQLA spreads	(2) HQLA spreads
Post	0.0198***	0.0201***
	(8.56)	(8.82)
VIX		0.000893*
		(1.83)
Constant	0.154***	0.142***
	(33.56)	(18.16)
Observations	1840	1840
Adjusted R^2	0.958	0.958
Duration FE	Yes	Yes
SE	Newey-West (4)	Newey-West (4)

t statistics in parentheses
* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

- How about on the EUR side?

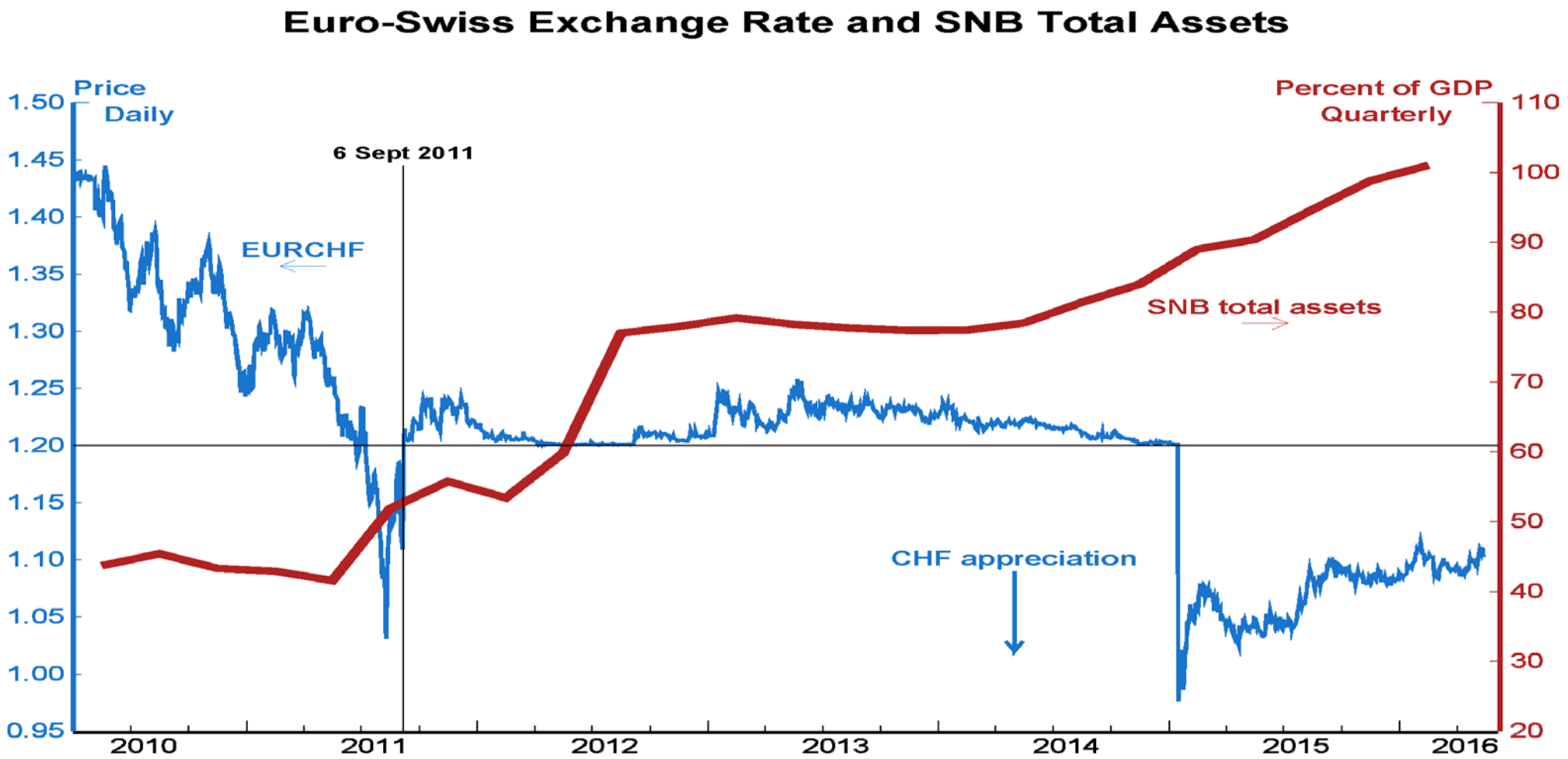
- Note drop in EUR peripheral spread
- Other factors can not be ruled out



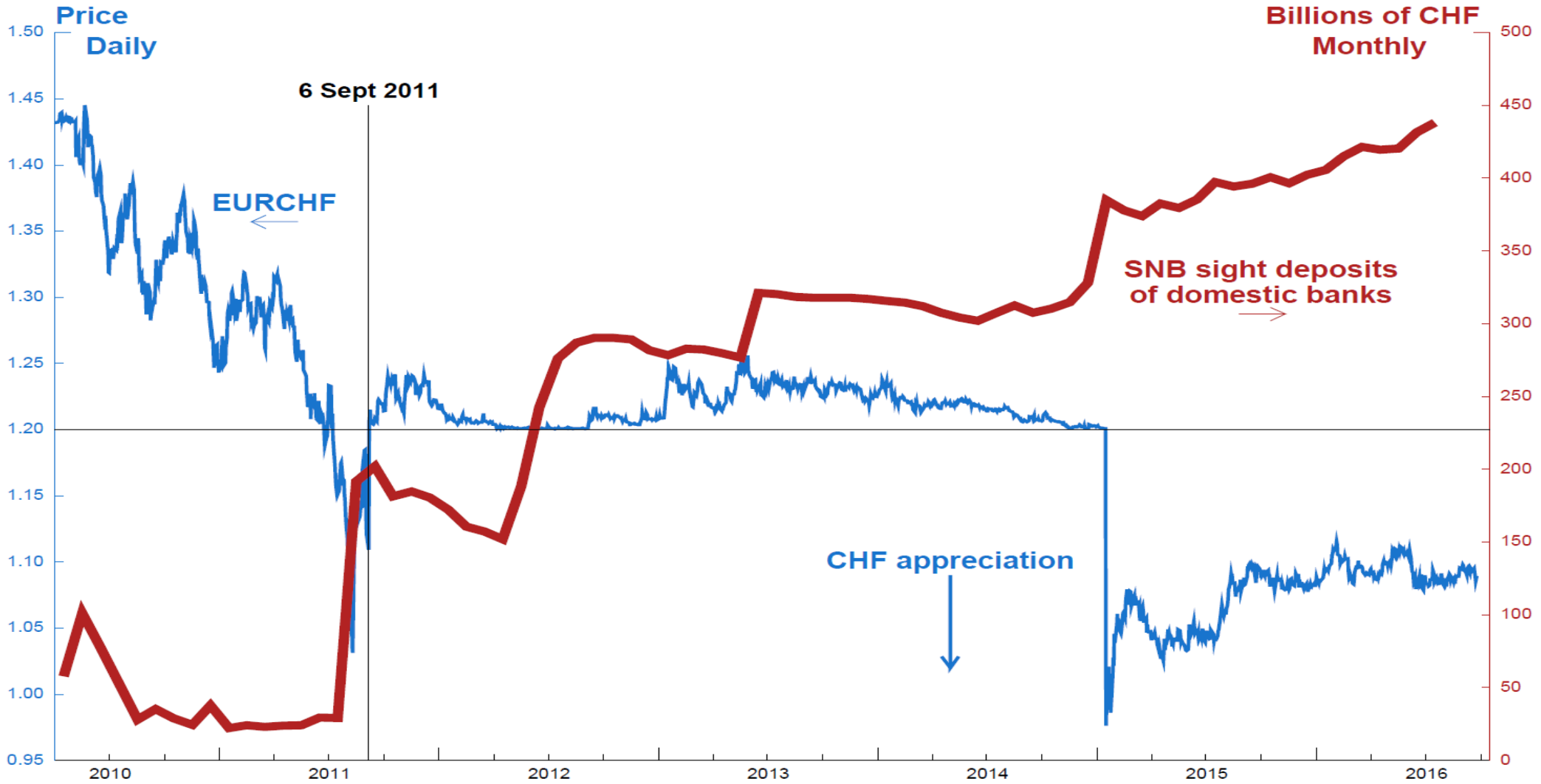
Is Switzerland a good test case for the HQLA premium?

- Well… Maybe not exactly.
- The authors have an excellent discussion of the substitutability of bank reserves (at the central bank) and of HQLA assets, particularly true when their yields are very close.
- Hypothesis 3 (page 12): *If the yield on HQLA securities is equal to the interest rate the central bank pays on reserves and banks are holding excess reserves, the HQLA premium is zero as banks are indifferent between holding reserves and HQLA securities in order to fulfill the LCR.*
- Switzerland fulfills these two conditions rather perfectly.
- More evidence that the authors are much too honest.

EUR-CHF and the SNB balance sheet



EUR-CHF and Sight Deposits of Domestic Banks at the SNB



Conclusions

- Very carefully done paper, with an interesting discussion of the issues and well-done data analysis (clever diff-in-diff setup).

- But can the authors hope to fulfill their own stated empirical mission?
  - *"What is the added value of a security which qualifies as an HQLA under the Basel III LCR?"*
- The "natural experiment " in July 2014 may not be a clean "information event."
- Switzerland may be too much of a special case. Why look for a CHF HQLA premium if you simultaneously argue that it should probably be zero?

- In my view, the value of the paper lies more in the discussion of the factors driving the HQLA premium and in the analysis of the specific aspects of the introduction of the LCR in Switzerland than in trying to measure the size of the HQLA premium.