Liquidity Coverage Ratio and Bank Behavior

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Abstract

The Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio ($NSFR$) were introduced into the regulatory framework of Basel III to guarantee short-term and long-term liquidity of banks. How do banks react to this form of regulation concerning their optimal volume of deposits and loans and their sensitivity to risk? This paper modifies a Monti-Klein model that was extended by Pausch (2014). In a two-period industrial organization approach the effect of the LCR is analyzed first in an isolated framework and then combined with the already existing results of the effects of the $NSFR$. While the deposit volume increases as a consequence of regulation via LCR, the optimal loan volume only decreases when the relative attractiveness of an investment in the interbank market increases compared to the loan business. These results hold when combining the LCR with the results of the $NSFR$. Furthermore risk aversion cannot be established by the LCR, while risk aversion can be achieved in the case of a combined regulation driven by the effect of the $NSFR$.

Keywords: regulation, liquidity risk, risk aversion
JEL classification: G21, G28, G32

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