Fragile wholesale deposits, liquidity risk, and banks' maturity transformation

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Resumen:

We investigate the impact of large-scale investment fund redemptions on bank lending. Using detailed data on the link between commercial banks and investment funds in an emerging economy, we document that redemptions lead to a decrease in the demand for certificates of deposit and increasing volatility in this wholesale funding market. We f ind that banks subject to the fund-induced fragility in their funding markets adjust credit terms: while credit volumes remain stable, terms of credit deteriorate. Affected banks raise interest rates and reduce the maturity of newly issued loans. These findings showcase that wholesale deposit runs affect banks' incentives to engage in maturity transformation.

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Focus

Recent episodes of financial distress have highlighted fragilities associated with wholesale deposits. In the absence of runs, non-bank financial intermediaries (NBFIs) seek to roll over wholesale deposits. However, they lack a credible liquidity backstop to prevent runs, creating a source of liquidity risk. We examine how liquidity risk stemming from wholesale deposits affects banks' credit supply and maturity transformation. We use data from Colombia linking banks and investment funds through certificates of deposit issued by banks and held by funds. Funds faced sudden redemptions triggered by the Covid-19 shock. We first estimate the effect of redemptions on funds' demand for certificates of deposit. We then estimate the effect of banks' exposure to fund redemptions on credit supply conditions.

Contribution

We provide evidence on how banks adjust credit conditions in the face of liquidity risk. The granularity of our data allows us to establish a causal link between fund redemptions, the stability of wholesale deposit funding and the terms of bank loans. Thus, we identify bank-funds links as a potential source of changes in loan terms and show a previously unexplored link between loans' maturity and liquidity risk.

Findings

For a period following the outbreak of the Covid-19 pandemic, we first show that funds exposed to larger redemptions were associated with a significant decrease in demand for certificates of deposit, after controlling for supply factors. However, the effect arises mostly in the first three months after March 2020. Timely central bank interventions helped in part to stabilise market conditions quickly. We find that banks adjust credit conditions also in the medium term, despite the shock being short-lived. While credit volumes remained relatively stable, banks shortened maturities and raised interest rates on new corporate loans up to 12 months after the shock. Thus, our results demonstrate that even short-lived shocks can have medium-term real effects.