Comments on

Jose A. Lopez and Mark M. Spiegel

International Evidence on Bank Funding and performance: Are Banks “Overbanked”
What motivates the paper:

How does the liquidity structure of a country’s banking system affect financial stability?

Does reliance on deposit funding of intermediaries reduce or increase financial vulnerability?

Can a country or bank be “overbanked” – too reliant on deposits?

How should regulation address bank liquidity?
What the paper investigates:

The effect of a bank’s liquidity structure on its return to assets
The external effects of the overall liquidity structure of the banking sector (national) on individual bank returns
The role of liquidity on each side of the balance sheet

The data are cross country for a single year (three samples).
Hypotheses

Liability side:

Deposits are not a readily expandable source of financing so that greater access to non-deposit bank funding promotes stability.

It is not just leverage that matters. The deposit to asset ratio also matters (that is, assets not equity capital in the denominator).

Asset side:

Reducing the loan portfolio is costly. Cash balances allow a bank to accommodate deposit fluctuations and weather loan losses.
Hypotheses

Individual bank deposits to assets, cash to assets, leverage and the composite measure NSFR affect bank returns.
These measures for all the other banks in the national market also affect a bank’s returns.

This external effect is a key part of the paper.
Country effects measure variations in the regulatory and economic environment for finance.
Comments

The results are interesting enough for a paper to focus on.
The econometrics are straightforward.
What is missing is a theory that helps us understand the results:
  why does the share of cash in assets have a positive effect on the return to assets?
  why does the deposit ratio of a bank matter?
  what do the external effects show?
Bank liquidity

Risk:

The risk of aggregate deposit withdrawals or loan losses creates a self-insurance role for cash holdings on the asset side of balance sheets.

The same applies to average holdings of non-deposit liabilities by each bank.

A model could start by assuming risky deposits and transactions costs for selling or liquidating loans.

Then you need cash on the asset side and debt or equity on the liability side to be imperfect substitutes.
Bank liquidity

Flexibility:

Holding more cash can be consistent with taking advantage of randomly arriving opportunities to lend well.

That is, there may be both precautionary and speculative reasons for banks to hold a higher share of liquid assets at a positive opportunity cost in interest.

How important could a speculative motive be for issuing debt or holding more equity rather than taking more deposits? Why not just borrow as needed if banks can access debt markets?
External effects

The possible benefits of liquidity of the rest of the banking sector is motivated by the importance of overall market liquidity. The inclusion of country effects leads to dropping out each bank’s own data.

Another way to think about this is that there are external effects. If the other banks are more liquid, hence financially more stable, then the financial environment will be less volatile, and our bank should face better terms on which to borrow in need, requiring less self-insurance.

Are bank holdings of cash complements or substitutes?
External effects and country effects

The external liquidity variables could reflect country characteristics, particularly regulation.

The robustness check substituting national macro variables for fixed effects addresses this:

Cash_cn is significant at a higher level in model (1) but not in model (3) (with/without inclusion of the deposit ratio).

Small point: the average NSFR_cn values differ from the average NSFR values because the denominators are weighted (the measures are nonlinear).