A Crisis of Banks as Liquidity Providers

VIRAL V. ACHARYA*, NADA MORA**

First draft: September 2011***
This version: July 2013

ABSTRACT

Can banks maintain their advantage as liquidity providers when they are exposed to a financial crisis? While banks honored their promised credit lines drawn by firms during the 2007-09 crisis, this provision of liquidity by banks was only possible because of explicit, large support from the government and government-sponsored agencies. At the onset of the crisis, aggregate deposit inflows into banks weakened and their loan-to-deposit shortfalls widened. These patterns were more pronounced at banks exposed to greater undrawn commitments. Such banks sought to attract deposits by offering higher rates, but the resulting private funding was insufficient to cover loan-to-deposit shortfalls and they reduced new credit.

JEL Codes: E4, G01, G11, G21, G28.
Keywords: Liquidity risk; Solvency risk; Financial crisis; Flight to safety.

---

* C.V. Starr Professor of Economics, Department of Finance, Stern School of Business, New York University. E-mail: vacharya@stern.nyu.edu.

** Federal Reserve Bank of Kansas City. E-mail: nada.mora@kc.frb.org.

*** The views expressed herein are those of the authors and do not necessarily reflect the positions of the Federal Reserve Bank of Kansas City or the Federal Reserve System. This paper previously circulated as "Are Banks Passive Liquidity Backstops? Deposit Rates and Flows during the 2007-2009 Crisis". Jacob Schak, Paul Rotilie, Thad Sieracki, Jon Christensson, and Kristen Regehr provided valuable research assistance. We are grateful to Ruth Judson for her help with the Bank Rate Monitor data. We thank Sumit Agarwal, Heitor Almeida, David Backus, Morten Bech, Lamont Black, Francisco Covas, Bob DeYoung, Cam Harvey (the Editor), Charlie Kahn, Bill Keeton, Michal Kowalik, Lubo Litov, Jamie McAndrews, Ouarda Merrouche, Chuck Morris, Wayne Passmore, Jack Reidhill, Joao Santos, Anthony Saunders, Ken Spong, Philipp Schnabl, Phil Strahan, an Associate Editor, anonymous referees, and participants at the Financial Management Association's 2011 Meeting, the Federal Reserve's "Day Ahead" 2012 Conference on Financial Markets and Institutions, the Chicago Fed's 48th Conference on Bank Structure and Competition, the Financial Intermediation Research Society 2012 Meeting, the Office of Financial Research, the World Bank, and the Federal Reserve Banks of New York, Philadelphia and San Francisco for helpful comments. All errors are our own.