Effects of asset commonality among banks on interbank liquidity allocation and economic fluctuations

Kenta Toyofuku[1]

Abstruct

This paper considers why banks hold a common asset to manage their investment risks and how it affects stability in the banking sector and fluctuations of economic activities.

- First, we show that asset commonality among banks arises not only because of each bank's diversification but also because of their coordinated behavior to share the investment risks among them.
- As the investment risks become higher, banks rely more on *ex ante* common asset holding rather than *ex post* interbank borrowing as a mean to share risks among them.
- The asset commonality among banks generates comovement of their productivity, which helps smooth *ex post* liquidity allocation among banks and maintain their solvency.
- However, as the asset commonality among banks proceeds, the economy is more influenced by shocks to the common asset, which increases fluctuations in other economic activities.
- To enhance both banking stability and economic efficiency, we derive policy implications about committed liquidity support by the central bank and regulation of bank heterogeneity.

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[1] Professor, College of Economics, Nihon University