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Liquidity Regulation, Bail-ins and Bailouts

(co-authored by Jean Tirole (Toulouse School of Economics and Institute For Advanced Study in Toulouse))

Abstract

A major regulatory innovation in the wake of the 2008 financial crisis was the introduction of liquidity requirements for banks in the Basel framework. While the philosophy of such requirements is intuitive, policymakers received little guidance from academia on a number of specific questions such as the measure of the liquidity buffer, its possible decomposition into multiple tiers (as is done for capital requirements), the treatment of interbank exposures or of the securitization of legacy assets, or the recognition of central-bank-eligible assets as part of the buffer. More fundamentally, the consistency between liquidity and solvency regulations has been under-researched. Accordingly, the introduction of layers of "bail-inable" liabilities to complement the Basel III framework occurred without a conceptual framework for thinking about liquidity and solvency regulation. The paper develops such a framework, integrates the asset and liability sides into an overall design of prudential regulation and assesses the regulatory reform.