

NAVIGATING BANKING LIQUIDITY- FACTORS, CHALLENGES, AND STRATEGIES IN CORPORATE LOAN PORTFOLIOS

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Abstract

This study examines the relationship between banking liquidity and corporate loans influenced by internal and external factors through central bank policies, regulations, business cycles, technology changes, loan covenants, and contracts.

Changes in central bank policies- monetary policy changes, discount rates, and QE, make bank liquidity partially predictable. Their effects can manifest through changes in borrowing, drawdowns, or interest rates, thus affecting the bank's liquidity.

Regulatory changes, though rare, apply to all banks and usually have an extended duration for implementation, giving the bank time to adjust liquidity accordingly.

In contrast, the rapid and unforeseeable nature of technological advancements necessitates prudent risk planning within banks to prevent potential destabilization, as evidenced by the examples of Knight Capital in 2012 and RBS in 2015.

The impact of these factors on bank liquidity is predictable to a certain extent. The factors are much harder to manage when combined, because of the evolving nature of banking. This is especially true when a bank's portfolio consists primarily of corporate loans.

Corporate loans and facilities pose the greatest challenge due to loan contracts/covenants and a shallow secondary market for corporate loans. This results in locked-down liquidity, causing that stress to permeate to other parts of the bank, when combined with the drawdown of OBS facilities.

Loan contracts restrict banks from adjusting interest rates or selling loans.

The bank would benefit from a combined system that can identify the degree of correlation between the five essential factors as a combined system instead of individual elements.

Keywords: Business, Covenants, Impact, Interest, Liquidity, Loans, Management, Monetary, Portfolio, Pricing, Regulation, Regulations, Risk, Survival, Technology

Declarations

Funding statement

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Ethical compliance

The authors declare that the research conducted for this study adhered to the highest ethical standards. The investigation did not involve any experimentation on human subjects. All data were analyzed in compliance with relevant regulatory guidelines and institutional policies. The research procedures were designed to ensure integrity, transparency, and the advancement of scholarly inquiry, contributing to the broader understanding of the dynamics between banking liquidity and corporate loans while upholding ethical research principles.

Conflict of interest declaration

The authors declare that they have NO affiliations with or involvement in any organization or entity with any financial interest in the subject matter or materials discussed in this manuscript.

Author contribution:

Anandasubramanian contributed to the design and implementation of the research and writing of the manuscript. Dr. Jansirani conceived the topic and supervised the project.

Structure of this paper

This paper is organized as follows:

1. Starts with an introduction of this niche topic and explaining the interconnected factors impacting liquidity and loan pricing.
2. Review the existing literature, identifying gaps in them and connecting them into a single theme.
3. Explains why corporate loans cause and are impacted by liquidity changes and needs.

Introduction

This study examines how a combination of correlated external and internal factors that impact liquidity, affects corporate lending and the pricing¹ of such loans.

The external factors in this study include regulatory needs, interest rate fluctuations, business cycles, monetary policy, the impact of existing loan contracts, liquidity preference of depositors in the economy, market volatility, maturity of payment systems, and operational requirements. We examine each factor's role in lending and pricing decisions, individually and in correlation.

The primary internal factors in this study include asset and liability management (ALM), risk appetite and policy, customer management, profit targets, and economic capital, among other factors unique to each bank. However, these internal factors have not been individually examined.

They are paired with correlated external factors to identify multiplying factors that impact a bank's liquidity and, subsequently, its corporate loan portfolio.

A bank is a unique institution that converts illiquid assets into liquid assets, thereby making itself illiquid in the process, based on a future expectation that the bank's liquid assets would be returned to it later. It does this by accepting deposits, frequently payable on demand, and lending these funds to borrowers, frequently on longer terms. This creates an illusion where both parties think they have immediate and complete access to the money.

Liquidity management is the art and science of managing the expectations of depositors and borrowers in such a way as to convince them that the bank has enough assets to meet their reasonable demands for liquidity.

Hence, the bank is forced constantly to maintain a balance of liquid assets, whose nature changes rapidly and unpredictably. An investment that's liquid today may not be so tomorrow.

Corporate borrowers offer a complicated challenge. The amounts involved are much more significant individually, structured into unique contracts and covenants that the bank cannot unilaterally revoke, and are unpredictable regarding drawdowns and the activation of credit guarantees in the case of OBS facilities.

On average, approximately 10% to 48% of a bank's lending portfolio is allocated to corporate lending or facilities, which may be either an on-balance sheet or an off-balance sheet.

Changes in external liquidity factors beyond the bank's control will negatively impact corporate lending and loan pricing more than other lending facilities. When banks face a liquidity crisis, it is usually due to a combination of multiple factors that become correlated and multiply the impact. Such combinations force the bank to adopt processes it would not undertake if exposed to a pure retail market for its loans.

This paper seeks to identify a combination of liquidity factors impacting corporate loan lending decisions and pricing.

We use the terms commercial bank and bank interchangeably to indicate a bank specializing in corporate lending.

Literature review

A review of the existing literature reveals the factors that cause liquidity restrictions and their effect on the cost of commercial loans.

As Attakrit, Mark, and Suresh (2011) observe, corporations that face a liquidity crunch attempt to utilize their loan commitments to manage the same. This would mean that a corporation would more likely draw down on a bank facility if it faced a liquidity crunch. If this environmental condition impacts the bank simultaneously, it loses liquidity when it needs it the most.

Mikael and Soren (2015) state that during financial stress, especially on days with large payment activity, banks short on liquidity tend to pay a higher cost when borrowing in the market.

Berlin and Mester (1999) conducted a seminal study that illuminated the issue of information asymmetry by highlighting the significance of personal relationships in determining business loan prices. This vital work paved the way for subsequent research by Delis and Kouretas (2011), who proved that low-interest rates substantially increased bank risk-taking.

Jiménez et al. (2012) and Ioannidou et al. (2020) state that monetary policy easing results in lower loan spreads for riskier firms. Their extensive research provides a solid foundation for comprehending the far-reaching effects of economic volatility on loan pricing.

Santos and Winton (2018) state that banks charge higher rates to corporate customers if the customer has limited access to outside funding options, including access to the public debt market. Conversely, the loan spreads are lower if the company has access to public debt markets, even during a recession.

Poddar, et al (2023) state that a significant interaction and correlation exist between bank competition, liquidity, and loan pricing during economic upcycles.

Kozo Harimaya and Toshiki Jinushi (2023), state that the Bank of Japan's QQE² helped promote bank lending, thus proving a positive correlation between monetary policy and bank lending.

Carpenter. S, et al (2014) state that bank lending to businesses increased when monetary policy was eased using non-standard policies in the aftermath of 2008 crisis.

Boot and Thakor's (2020) analysis contributes to a comprehensive understanding of the interplay between legislative changes, technological advancements, and broader industry dynamics, yielding significant implications for bank management.

Yota, Delis, et al (2016) describe how formal enforcement actions against banks hurt loan pricing and positively affect non-price terms.

Our literature review concludes with the works of Kashyap et al. (2002) and Adrian and Shin (2010), which delve into the complex realm of liquidity constraints, mark-to-market pricing, and their significant impact on loan pricing.

Why corporate loans are impacted more

A commercial bank generally lends two types of loans: retail and commercial/corporate.

The retail market consists of low-value, high-volume loans with standardized contracts because of the similarity of borrower types and limited standardized products. These loans have a deep secondary market, thus ensuring that the bank can meet unforeseen liquidity demands at a minimal cost. The retail loan market is also tightly regulated regarding interest rates and associated fees.

As a result, banks tend to maintain a retail loan portfolio as a steady source of income, with less unpredictable outcomes as a low-risk, low-return approach. Usually, banks are rarely distressed liquidity-wise because of on-balance sheet retail loans. Individual defaults, even when they rise to 8% of the total retail portfolio, are manageable risks due to a deep secondary market³ for retail loans.

Commercial loans, specifically corporate loans, are of much higher value, have a wide variety of products, and are usually customized for each business need, with no similarity between various products or business entities. In addition, contingent facilities like Letters of Credit or Credit guarantees come under OBS⁴. Called facilities, OBS introduces drawdown risk, margin calls, and unexpected liquid asset outflows, which can impact a bank's asset-liability mismatches. For example, a common loan product corporations use is the credit line. A credit line offers liquidity to the company when needed the most. The pricing of a credit line comprises an undrawn fee and an all-in-drawn fee. The undrawn fee consists of both a commitment fee and an annual fee. The commitment fee is the price that the company pays the bank to access liquidity on tap. It provides the bank with a price for the risk it assumes by guaranteeing access to funds anytime during the duration of the commitment.

While loan or facility agreements may share some similarities, each contract is extensively customized to the individual borrower, rendering them challenging to trade on the secondary market. Additionally, borrowing corporations may place certain conditions on banks, such as non-disclosure agreements or a complete ban on selling the loan to another financial institution without the borrower's express permission.

As explained by Anurag, et al, banks price their loans based on expected liquidity in secondary markets, at least for syndicated loans. Bereft of this secondary market should cause a bank to reprice loans. However, the bank would be limited by other factors like relationship-based pricing or the danger of the company foregoing the bank when it has access to other direct access to markets.

Banks can't and won't be able to prevent the corporate borrower from drawing down on credit lines when the bank is facing liquidity issues and trying to raise liquidity in the open market. This negates any addition of liquidity by the bank. Similarly, the bank can't foreclose or call in most outstanding corporate facilities, which were borrowed at lower rates. These features of corporate loans impose constraints on liquidity, thus exacerbating the outcomes of other factors impacting liquidity.

Hence, in retrospect, these loans and facilities are the first to be impacted by changes to liquidity brought on by external factors.

Impact of monetary policy and ALM

Monetary policy, which combines federal funds rates, open market operations, QE⁵, and reserve requirements, plays a vital role in the bank's ALM⁶ and directly impacts commercial loan pricing.

Every central bank action is examined through a narrow spectrum of its impact on NIM or bank liquidity. For instance, an increase in interest rates of the central bank could lead to higher borrowing costs for banks, which directly and immediately impacts the bank's NIM⁷. Corporations that had signed contracts at lower rates would find it prudent to draw down on those credit lines to repay any higher-rate debt they might have. This would lead to a reduction in the liquidity of the bank. Unless the bank raised deposit rates, depositor funds would be diverted to money markets offering better rates. This would result in further reduced liquidity. This was one of the reasons that resulted in the bankruptcy of Silicon Valley Bank.

If the central bank lowers interest rates, it results in more offtake of new loans at lower rates, while existing higher rates loans are in danger of being refinanced at lower rates via other banks. This would increase the bank's liquidity as loans are repaid but would result in the liquidity flowing out at lower rates. This depresses the NIM until a new equilibrium is reached. If the bank had offered committed credit lines at higher rates to corporates, these lines would see reduced drawdowns as corporates look to lower-cost funds elsewhere. While this would reduce the liquidity outflow, it would also reduce the NIM as the fee from an unused credit line is much lower.

The outcome of all reductions is for the commercial bank to "search for yield" by investing in projects of marginal value and inefficient from an investor point of view. The bank may justify this lending to maintain the profit targets and a lower cost of acquiring funds from the central bank, should liquidity needs arise.

Another monetary tool is QE, which results in the central bank buying large quantities of financial assets and providing liquidity in exchange. This was done in 2008 GFC and during the COVID-19 crisis. An outcome of this would be an economic system that suddenly has much liquidity and a lower cost to acquire them. As stated by Carpenter et al., banks increase their lending at times of QE. However, corporations with access to public funds, like bonds, would find it cheaper to borrow directly from bond markets. Other lending restrictions and capital surcharges based on asset quality would probably prevent the bank from lending to firms whose credit ratings aren't stellar but present a profitable ROI. So, unless associated regulations are adjusted, QE as a tool to increase bank lending would not benefit banks or corporations.

Impact of business cycles on liquidity and loan pricing

Business cycles of boom and growth profoundly impact a bank's liquidity and commercial loan pricing.

Examining the start of a business cycle, we find that it starts with a low-interest rate regime coupled with relaxed capital or liquidity standards. During this stage, banks tend to have higher liquidity. They would be willing to explore lending to riskier ventures in pursuit of expected returns. Since banks generally create and inflate asset bubbles during periods of excess liquidity, corporations would find it cheaper and easier to borrow from banks for longer durations. This would lead them to explore marginally profitable projects with longer timelines.

This results in a surge of investment funded by borrowings, leading to higher demands for goods and services. Banks will see reduced liquid assets in their portfolio as lending increases.

Once the bank uses this excess liquidity, it will try to conserve it by curtailing lending or increasing rates. This would raise the borrowing costs for marginal projects that would stop or reduce borrowings.

By this time, the investment projects with longer timelines would be nearing completion and starting their production cycle. This would cause increased demands for the same limited resources and increased prices of those input resources.

Since the projects had been started with money borrowed at lower rates, the higher resource costs would partially stress the project's profit margins. Banks seeing lesser liquidity in their asset base would raise lending costs to accommodate scarcity, thus increasing the costs of fresh borrowing.

Increasing prices would raise inflation at this stage, causing the central bank to increase its lending/discount rates. This automatically raises the cost of borrowing for banks, which now seek to borrow from central banks to shore up their liquidity needs. This rate increase would be transmitted to fresh borrowing from those banks, affecting new projects. The bank would re-examine existing lending facilities. This would result in many marginal projects which thrived on low interest rates and resource prices becoming unprofitable.

This would lead to failures of those projects and defaults on bank loans, causing banks to lose massive asset bases and liquidity. This would make the banks borrow at much higher prices in the open market or from the central bank. A mix of rising defaults and increasing cost of money would make the commercial banks raise their lending rates, and maybe their deposit rates too, if they want to retain deposits.

The remaining viable projects would be investments least impacted by these rapid fluctuations.

Under the ABCT⁸ theory, F.A. Hayek states that the prices of lower-order goods closest to the consumer are least affected by volatility. In contrast, prices of higher-order goods like semi-finished goods and raw materials are most affected. According to Hayek, time plays a critical factor in the production cycle, and hence, processes closest to raw materials, like mining, are immediately affected by changes in their output prices and investments. As the material flows through the production process into refining and manufacturing, its marginal utility reduces, and

the material is less amenable to being used for alternative purposes. Hence, a borrower who produces higher-order goods would see their profitability more quickly affected by changes in business cycle, thus increasing their propensity to draw down on credit lines, or to default on existing loans- both scenarios resulting in reduction of a bank's liquidity.

As the produced good goes up the value chain into finished goods, its purpose and usage become clearer. Companies that had to wait for these semi-finished goods to make consumer-usable products, like cars, have already invested resources. Hence, they would be least affected by business cycle changes and less likely to affect a bank's liquidity.

Impact of regulations on liquidity that impacts pricing

Regulations, in the context of this study, force a bank to take either of two kinds of actions: they either force the bank to not invest or lend or force the bank to lend. This denial or forced approval applies to entities the regulators deem necessary. For example, the CRA (1977) forced banks to lend to specific communities by imposing penalties and regulatory actions on the banks not complying. Similarly, the Dodd-Frank Act forced the bank to have HQLA⁹ to meet liquidity needs, thus curtailing lending.

Banks tend to hold liquidity buffers above the minimum requirement. This is determined by bank size, profit goals, and other factors internal to the bank, as explained by Bonner, et al.

These regulations, in turn, influence corporate loan pricing dynamics. Post the 2008 financial crisis, the Basel III regulations introduced two critical liquidity measures – the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR).

A direct result of these regulations means banks are forced to hold a more significant proportion of low-yield liquid assets. This imposes an opportunity cost on banks, which might be offset through higher pricing of corporate loans. However, an examination of actual bank actions by (Banerjee & Mio, 2018) indicates loan prices did not significantly increase due to increasing liquidity needs. The cost associated with maintaining longer-term stable funding, as NSFR prescribes, could also feed into higher loan pricing (Schmitz, 2017). Corporations prefer banks' credit lines to other finance modes as it protects them against shocks to their cash needs.

An indirect outcome of such regulations results in tighter capital regulations that can reduce a bank's risk-bearing capacity. This causes a shift towards safer but less liquid assets and subsequently influences loan pricing (Gambacorta & Mistrulli, 2004). In addition, introducing macroprudential measures targeting specific sectors or risks can lead to changes in banks' portfolio allocations, with implications for their liquidity management and loan pricing strategies (Aiyar, Calomiris, & Wieladek, 2014).

Impact of technology, AI and instant information on liquidity and loan pricing

Banks were the forerunners of adopting technology from the days of adding machines or pneumatic tubes, telegraphs, or mainframes to today's AI Models.

The introduction of technology in banks has accelerated the pace of information collection and data processing. However, it did not change the speed of decisioning, which is still human-dependent.

The introduction of AI brings in the first change where humans can be bypassed in such decisioning because of how AI perceives the market.

Hedge funds and high-speed trading already use limited AI to decide how the market can go and complete the trades. This type of decisioning is entering retail banking, where banks make decisions on lending to retail customers based on AI predictions with minimal or no human intervention.

Banks can and should use AI technologies to find correlations between economic factors, business cycles, liquidity needs, and company-specific information to price a loan in real-time.

While current commercial contracts prevent the implementation of dynamic pricing because of covenants between both parties, it is nevertheless a template for the bank to track the borrower's risk factor to adjust pricing. Therefore, new contracts are likely to offer this facility.

Banks use existing statistical tools to forecast liquidity needs. However, predicting the ideal liquid assets to carry each day requires a constant prediction of market conditions, business cycles, depositor preferences for liquidity and borrower capacity, and other factors. To some extent, the ability to predict exists today. The willingness of the bank to utilize that capability depends on external and internal [to the bank] factors.

Allowing technology to maintain liquidity is unlike setting cruise controls in a car. The bank needs to tell the technology what collaterals to track, how to track them, where to get additional funds, assets that can be sold or pledged, and track the dependency of those collaterals against others.

This was shown in the 2008 recession when banks tried to sell too much collateral simultaneously to maintain liquidity and shore up the quality of other collateral. They ended up depressing the values of all collateral in a downward spiral.

Similarly, the collapse of SVB started rapidly when it tried to sell perfectly good-quality collateral in a market where the values were down. This caused a run on the bank because of the rapid dissemination of information about the activities of the SVB. This quickly became self-feeding as depositors started withdrawing massive amounts of liquidity from the bank, causing it to collapse, as it could not meet the commitments because the liquidity it held was not sufficiently liquid.

Hence, while technology can improve financial stability, it can exacerbate certain risks. Overreliance on these tools may result in homogeneity in the decision-making processes across banks, potentially amplifying systemic risks. Such a scenario could have influenced Silicon Valley Bank's failure, emphasizing the importance of carefully implementing and managing these technologies.

How loan covenants restrict re-pricing of loans

Loan covenants are essential tools for lenders to mitigate loan risks. These stipulations are embedded in loan agreements that force the borrower to meet conditions or refrain from taking specific actions. If these conditions are not met, penalties, loan defaults, or loan recalls may occur.

Regarding loan pricing, covenants might indirectly affect a bank's ability to adjust the pricing of a loan. For example, a bank may impose covenants that bind loan pricing to specific financial indicators such as the Loan Value Ratio (LTV), Debt Service Coverage Ratio (DSCR), and Interest Service Coverage Ratio (ISCR). Such covenants can restrict a bank's freedom to modify its loan pricing based on changes in market conditions or the borrower's financial health.

Let us illustrate this using a couple of examples.

1. A bank provides a commercial loan to a company with a covenant that specifies that the interest rate will be adjusted if the company's DSCR falls below a certain level. This covenant restricts the bank's ability to alter loan pricing independently, as the change in interest rate is tied to the company's financial performance.
2. Another loan agreement includes a negative covenant that prevents the borrower from incurring additional indebtedness beyond a specified limit. Suppose the borrower wants to refine the loan at a lower interest rate because of improved market conditions. In this case, the bank may be unable to accommodate this request because it would breach the covenant's limit on additional indebtedness.

In both cases, loan covenants restrict banks' flexibility in adjusting loan pricing. This highlights the role of loan covenants in maintaining the lending agreement's stability while ensuring that the loan terms remain fair for both the lender and the borrower.

Conclusion

Banks stand as unique entities capable of generating liquidity, albeit often at the expense of their own liquidity reserves. This necessitates a vigilant management of liquid assets as a cornerstone for bank survival. Commercial loans, unlike their retail counterparts that benefit from a secondary market, are particularly vulnerable to external factors that influence a bank's liquidity. This study delves into five pivotal external factors that bear significant implications on a bank's liquidity and, by extension, its commercial loan portfolio.

Monetary policy mechanisms, encompassing federal fund rates, open market operations, and quantitative easing, wield direct influence over liquidity. Alterations in these rates trigger a repricing of assets and liabilities, thereby affecting the bank's Net Interest Margin (NIM). A diminished NIM may compel the bank to either elevate loan interest rates or curtail deposit rates, the latter potentially triggering a deposit exodus to other asset classes.

Business cycles, as conceptualized in Monetarist and Austrian economic frameworks, play a consequential role in shaping monetary policy, liquidity, and loan pricing. As liquidity contracts, interest rates ascend, jeopardizing the feasibility of marginally viable projects and escalating the likelihood of loan defaults or restructures.

Regulatory frameworks, notably BASEL-3, mandate banks to maintain a higher cache of low-yield liquid assets, thereby inflating the cost of commercial loans. Such prescriptive measures, although designed to fortify banks against runs, do not categorically preclude bank collapses.

Technological advancements exert immediate and palpable effects on liquidity. The agility in fund transfers enabled by technology can induce abrupt liquidity fluctuations, especially during liquidity crunches. Moreover, automated decision-making systems may inadvertently exacerbate liquidity issues.

Loan covenants, particularly in Off-Balance Sheet (OBS) facilities, further complicate liquidity management by restricting the tradability of loans, thereby influencing their pricing.

In summation, this inquiry illuminates the intricate nexus between external factors and bank liquidity, elucidating their downstream effects on the pricing of commercial loans. This understanding is indispensable for banks and commercial borrowers alike, particularly those bereft of public funding avenues.

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Footnotes

¹ Pricing includes interest for loans and fees for loans and guarantees.

² Qualitative-Quantitate-Easing

³ Due to the loan products being highly standardized across banks, with generally low risk of the overall portfolio, they are liquid. Dodd-Frank does impose limitations as to whom a retail loan can be sold.

⁴ OBS- Off-Balance-Sheet

⁵ QE- Quantitative Easing

⁶ ALM- Asset Liability Management

⁷ NIM- Net Interest Margin

⁸ ABCT- Austrian business cycle theory

⁹ HQLA- High Quality Liquid ssets as defined by BASEL-III