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Title: “Safety” by Designation: How Regulatory Treatment Affects the Convenience Yield of Near-Safe Assets

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Abstract: We show that public policy can affect the convenience yield of near-safe assets merely by designation, in particular without directly changing the riskiness of their cash flows. We illustrate this mechanism using sequential changes in banking regulation related to the liquidity coverage ratio (LCR) and the supplementary leverage ratio (SLR). When municipal bonds were made eligible to qualify as high-quality liquid assets (HQLA) for the LCR, they became safer in terms of a greater co-movement of their yield changes with those of the U.S. Treasury and agency bonds. The temporary exclusion of Treasury bonds from the SLR during the COVID pandemic elevated their safety status relative to both municipal and agency bonds, with a reversal at expiration of the SLR relief. We further show that the co-movement is driven by that of respective convenience yields, i.e., the “service flows” of assets rather than promised cash flows, and that the level of their convenience yields alters at designation treatments in line with their altered ability to hedge aggregate (stock market) risks.