Working Papers on Economics - Monitoring the Unsecured Interbank Funds Market

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A core goal of regulators and financial authorities is to understand how market prices convey information on the financial health of its participants. From this viewpoint we build an Early-Warning Indicators System (EWIS) that allows for identifying those financial institutions perceived as risky counterparts by the participants of the interbank market. We use micro-level data from bilateral overnight unsecured loans performed in the interbank market between January 2011 and December 2014. The EWIS identifies those participants that systematically pay high prices for liquidity in this market. We employ coverage tests to estimate EWIS' robustness and consistency. We find that financial institutions with an elevated frequency of signals tend to exhibit a net borrower liquidity position in the interbank market, hence suggesting they are facing recurrent liquidity needs. Those institutions also exhibit higher probability of insolvency measured by the Z-score indicator. Thus, our results support the existence of market discipline based on peer-monitoring. Overall, the EWIS may assist financial authorities in focusing their attention and resources on those financial institutions perceived by the market as those closer to distress.

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