

Can Agency Mortgage-backed Securities Function as Liquidity Buffer?

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Abstract

The deterioration of market condition of mortgage-backed securities during the recent financial crisis can only be partially explained by the decreasing credit quality of the particular assets; moreover, the disintegrated mechanism of market participants' role as liquidity providers is another factor which will affect the market stability. In this paper, I develop an empirical analysis on whether agency MBS can function as a buffer to funding liquidity shocks before, during and after the recent crisis and the implications on how banking institutions failed to provide liquidity in the market of mortgage-backed securities. The results imply that the collapse of liquidity buffer can undermine liquidity provision in banking system.