Discussion: "Transformation of Risks across Banks and NBFIs"

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Summary

Current perspective on the relationship between regulated banks and non-bank financial intermediaries (NBFIs)

"parrell" view vs "substitution" view

- implies that NBFIs and banks' risks are insulated

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   - i rationalizes increased NBFI share (i.e., cost of capital difference b/w banks and NBFIs, bank capital regulation)
   - ii highlights challenges in setting bank capital regulation to prevent regulatory arbitrage

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3. Model
   - i rationalizes increased NBFI share (i.e., cost of capital difference b/w banks and NBFIs, bank capital regulation)
   - ii highlights challenges in setting bank capital regulation to prevent regulatory arbitrage
4. Policy recommendations include
   - i increase data collection & monitoring
   - ii require banks to internalize externalities

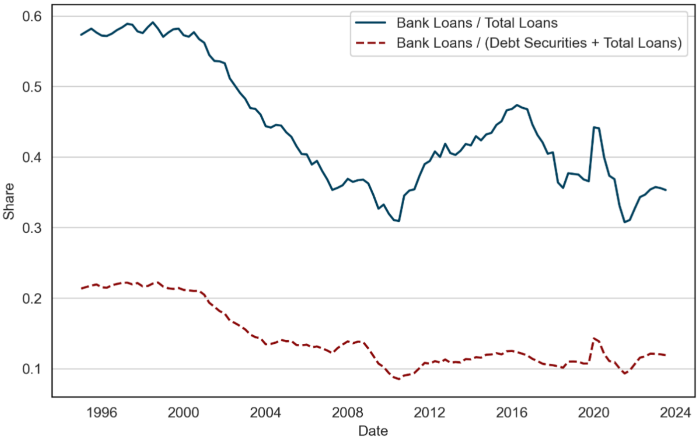
Discussion

- Nice paper on an important question
- Integrates existing contributions into a unified view
- Questions regarding
  framing, definition, quantifying aggregate financial risk

Framing

1. Long-term trend of lending moving to non-banks

   Hanson et al. "The Evolution of Banking in the 21st Century: Evidence and Regulatory Implications" (2024)



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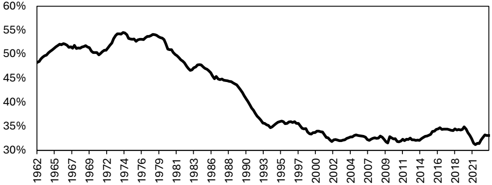
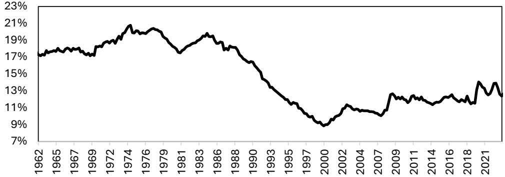
   Buchak et al. "The Secular decline of bank balance sheet lending" (2024)



(a) Bank Balance Sheet Lending Share out of Total Lending to HH & Firms



(b) Deposit share of domestic non-financial sector financial assets

2. Non-banks rely on bank funding

- Financial Stability Oversight Council annual report 2019:
  - *"Among the 25 largest originators and servicers, nonbanks currently originate approximately 51 percent of mortgages and service approximately 47 percent, up from just 10 percent and 6 percent in 2009."*
  - *"Nonbanks often obtain liquidity from warehouse lines provided by banks, and these lines can be a significant portion of nonbank liabilities. In times of significant stress, warehouse lenders may face strong incentives to cancel the lines ...."*

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Jiang, Matvos, Piskorski, Seru "Banking without Deposits: Evidence from Shadow Bank Call Reports" 2020

- *Shadow banks finance themselves primarily with short-term debt and originate long term loans, similar to banks. Shadow bank debt is much more concentrated than bank deposits and is provided primarily by, potentially informed, large banks in the form of credit lines."*

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- Transformation view useful perspective but aligns closely with existing literature; could benefit from sharper differentiation

Definition

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- Broader perspective useful, but which entities are NBFIs?

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  Flow of funds definition Batty, Holmquist, Kurtzman (2023)

  > NBFIs (shadow banks) "money market funds, mutual funds, closed-end funds, exchange-traded funds, issuers of asset-backed securities, equity real estate investment trusts, mortgage real estate investment trusts, finance companies, security brokers & dealers, & other financial business."

Definition

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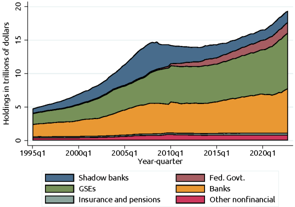
- Broader perspective useful, but which entities are NBFIs?

  Flow of funds definition Batty, Holmquist, Kurtzman (2023)
  - Holders of household and nonprofit organizations liabilities



- Here: GSEs, pensions, and insurers included: why? (pension liquidity risk real but not new or unique)
- Many brokers & dealers are part of BHCs (i.e., included in bank R^E)
- General concern: data reporting fractured across different regulatory agencies with some overlap. FSOC calls for use of Legal Entity Identifier (LEI) to keep track of institutions

Implications of the "transformation view" for agg. risk?

When banks provide short-term funding to NBFIs, is there more financial risk-taking overall?

- SRisk correlation and stock return regressions suggest more comovements but overall risk level may be lower
- NBFIs less levered (Jiang et al. (2020)) & fewer guarantees

$\Rightarrow$ potentially internalizing lending risks more than banks.

(e.g., Begenau and Landvoigt 2022)

- Instead of cutting credit lines to businesses banks can cut credit lines to NBFs
- But rerouting the plumbing structure of the financial system may entail additional risks that could lead to more overall risks

$\Rightarrow$ open questions whether total quantity of financial stabiltiy risks has changed

- Side Q: interesting that return regressions showed an increase of banks' exposure to non-financial sector firms

Conclusion

- Nice paper
- Highlights a first order regulatory challenge
- Questions regarding framing, definitions, measuring aggregate financial stability risk