Nonbanks and Lending Standards In Mortgage Markets. The Spillovers From Liquidity Regulation. By Pedro Gete and Michael Reher

AND

Reciprocal Lending Relationships in Shadow Banking By Yi Li

Comments by Larry D. Wall Federal Reserve Bank of Atlanta

The views expressed here is the discussant’s and not necessarily those of the Federal Reserve Bank of Atlanta, or the Federal Reserve System.
• Liquidity rules justified on microprudential grounds of promoting “resilience” of individual institutions
  – BCBS: “short-term resilience … of banks”
  – SEC: “resilience of money market funds”
• Both papers invite us to take a more financial system approach
  – Li with interaction of banks and MMFs
  – Gete & Reher on impact on mortgage markets
• Bank and MMF regs have different windows
  – 30 days for bank LCR
  – 1 day, 1 week, & weighted average maturity for MMF
• Creates opportunity for arbitraging regulations
  – Banks help with 1 day investments (and unexpected excess funds)
  – MMFs reciprocate with LT and lower cost funds
  – These are valuable findings on bank—MMF relations
• But to be relevant for analyzing the liquidity regulations we need more information
  – MMF invested in bank liabilities pre-crisis and similar problems existed prior to the liquidity regs
  – Post-crisis many other relevant factors changed
  – We need some help separating out changes due to these other factors
• Demand for safe, liquid assets exceeds supply of riskless, short-term real assets
• Excess demand satisfied by carving out very low risk cash flows from other assets to create liquid claims
• Claims on the sovereign partially satisfies demand
• Private intermediaries provide additional liquid claims
  – Backed by low credit risk cash inflows
  – Rely on diversification of flows to hold only fractional reserves
• Providers
  – Banks
  – Money market mutual funds
    • Allow liquidity demanders to diversify across banks
• Private claims are credit risky & subject to runs
• Government reduces risk of private claims
  – Subsidizing the production of private liquidity
  – Resulting in the creation of excess private liquidity
• Government also regulates liquidity creation
  – Microprudential benefit – reduce risk of failure
  – Macroprudential benefit – reduces excess creation
  – Macroprudential cost – some risks migrate to places where they are less easily managed
• Two goals for optimal liquidity regulation
  – Constraining “excessive” liquidity creation
  – Incenting liquidity risk to migrate to where it will be best managed
• The relative HQLA weights affect relative prices
  – GNMA MBS weight=1, GSE MBS weight=.085
  – Resulting premium estimated at 25 OAS bp
  – Result is nonbanks do more GNMA lending which is riskier

• What are the implications for liquidity regulation?
  – Weights are consistent with LCR logic
  – Could argue that increased risk taking justifies changing risk weights
    • Paper notes GNMA may do more for home ownership
  – But goal of LCR is not to regulate credit risk or manage incentives for home ownership
  – There are other ways to reduce GNMA credit risk
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