Supply of Private Safe Assets: Interplay of Shadow and Traditional Banks

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This is a very interesting paper!

This paper shows how the creation of private safe assets by shadow banks (FHLBs) can crowd out traditional banks' supply of safe assets (deposits) with careful identification:

- IV
- Numerous robustness checks

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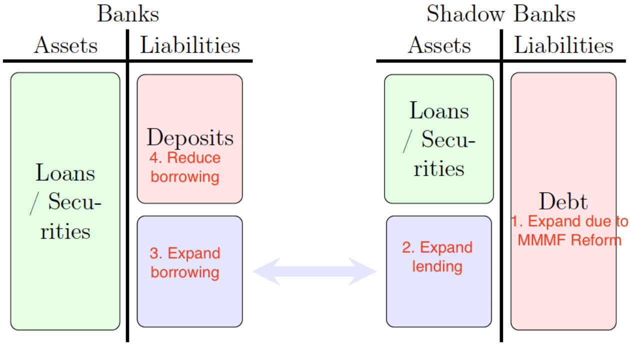
I will focus on a few big picture questions:

1. What does more frequent repricing mean?
2. What does crowding out mean?
3. What result would we *want* to see?

What does more frequent repricing mean?

"Only banks with historically more frequent repricing of liabilities increased their use of FHLB loans"



What does more frequent repricing mean?

But why do some banks have more frequent repricing of liabilities than others to begin with?

- Banks' asset and liabilities are jointly decided
- Currently, banks' asset side is taken as an outcome
- Results are a little hard to understand
  - Cash holdings of more exposed banks are found to decline by more for both OLS and IV specifications
  - Explanation: less deposit funding also reduces reserve requirements
  - But this is a period when excess reserves way exceeded reserve requirements...

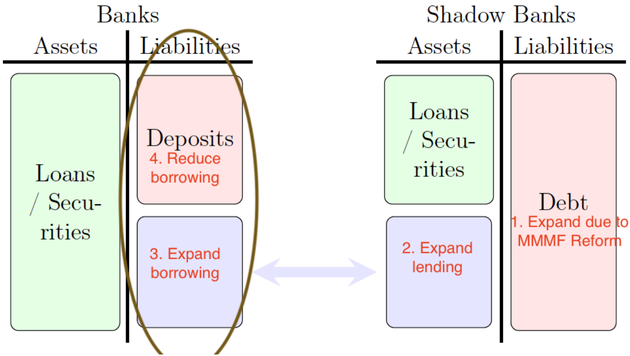
What does more frequent repricing mean?

Suggestion: check why banks have different liability side repricing maturities and understand how it relates to the interpretation of results. For example,

- Do they also have short maturity assets e.g. securities over loans?
- Do they compete in more competitive deposit markets?
- Do they have different leverage ratios?
- Do they have different cash holdings?

What does crowding out mean?

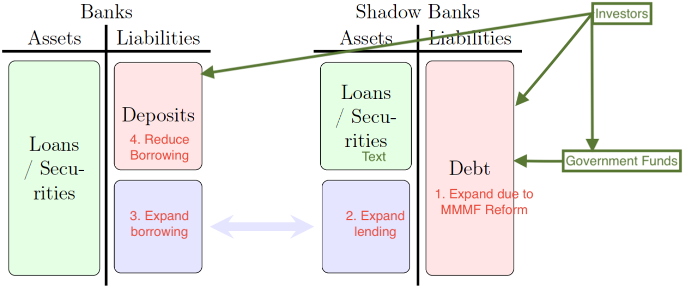
"We show that the creation of private safe assets by shadow banks can crowd out traditional banks' supply of safe assets"



The estimation implies that crowding out arises from the substitution between deposits and FHLB borrowing as commercial bank funding

What does crowding out mean?

It is not the crowding out in the safe asset literature, where investors have a demand for safe assets and substitution is at the investor level. e.g. Krishnamurthy and Vissing-Jorgensen (2012,2015), Gorton, Lewellen and Metrick (2012), Sunderam (2014), Xiao (2018), Li, Ma and Zhao (2018)

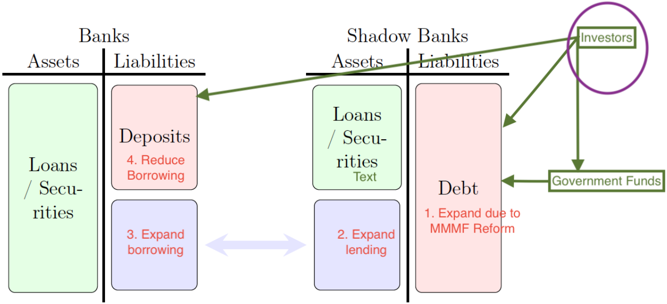


Q: If deposits were not safe assets e.g. CP, would the same story/results hold?

What does crowding out mean?

Suggestions:

1. Introduce investors into the conceptual framework
   - May take a look at model in Sundaresan and Xiao (2019)
2. Look at investor portfolio holdings empirically and see if proportion of gov MMMF holding and deposit holdings changed
   - Should test the channel's existence and importance instead of ruling it out



What result would we *want* to see?

Let us take a step back and think about the findings

- Taking results at face value, the demand for safe assets by gov MMMF ultimately reduces the supply of bank deposits
- BUT this is not because of gov MMMF investing directly in banks
- Why?

What result would we *want* to see?

Gov MMMFs are only supposed to invest in **government**-backed assets!

- But they managed to invest in commercial banks through FHLB
- Paper says FHLB are private shadow banks except for a credit line from the Treasury and perceived implicit guarantee
- Either way, this does not seem to be what should be happening:
  - If private, MMMF portfolio regulation seems flawed
  - Otherwise, government guarantees are sponsoring an arbitrage

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Funding chain highlighted here may have important financial stability implications in addition to affecting deposit supply.

Conclusion

Important topic + careful identification!!!

To interpret the results, it would be nice to know more about:

1. What drives the repricing exposure
2. What "crowding out" implies
3. What the funding chain implies for financial stability