FEDERAL RESERVE BANK *of* ATLANTA

# *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**

# OVERVIEW

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- 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

# YI LI PAPER

- 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

# PRIVATE LIQUIDITY CREATION AND REGULATION

## Why private creation

- 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 LIQUIDITY CREATION AND REGULATION





- 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

# GETE & REHER PAPER

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- 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

# FURTHER DISCUSSION

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