



"The Value of Internal Sources of Funding Liquidity: US Broker-Dealers and the Financial Crisis

Caglio, Copeland, and Martin (2024)

Discussion: Matthieu Chavaz (BIS)

In a nutshell

- Question: do dealers benefit from affiliation to a bank holding in a financial crisis?
- Hypothesis: Affiliated get internal funding liquidity (from the bank subsidiary of the BHC); unaffiliated dealer must rely on external funding.
- Test: GFC as shock to funding liquidity → do unaffiliated dealers “fly to liquidity”?
- Answer: Yes: ↑ trading in Treasuries; ↑ net Treasury holdings
- Policy implication:
 - Central bank provision of liquidity to dealers is valuable (eg SRF)
 - Extending liquidity provision to more dealers would support market functioning

Overall comments

- Very interesting coverage of dark but key corner of the nonbank landscape (new data)
- Very **timely** (not only for the US).
 - Covid: Treasury market dysfunction
 - Potential fix: Increased nonbank access to central bank balance sheet
 - Literature to date: banks' reduced appetite / capacity to intermediate (leverage req)
 - This paper: rebalancing towards dealers more exposed to funding liquidity stress.
- Connects **important literatures**
 1. Bright and dark sides of internal capital markets
 2. Difference between banks and nonbanks (Gatev and Strahan, etc.)
 3. Effect of Glass-Steagall-type regulations (Puri et al; Chavaz and Elliott, etc.)
- Some room to further sharpen the interpretation and implications → four suggestions.

1. Interpretation of main results

- Main finding (unaffiliated shift towards Treasuries) hard to interpret because no obvious benchmark.

Paper's interpretation:

- Friction: Access to external funding constrained in stress.
- Outcome: Unaffiliated dealers forced to become more cautious.
- Policy implication: more (central bank) liquidity to unaffiliated dealers

Alternative interpretation:

- Friction: BHCs have access to subsidised funding (access to public safety net (deposit insurance; implicit bailout; LoLR).
- Outcome: affiliated dealers can take more risk (trade in riskier assets and lower Ty buffers)
- Literature: Farhi and Tirole; Freixas
- Policy implication: reinforce BHC regulation; Glass-Steagall to remove implicit subsidy

Shadow Banking and the Four Pillars of Traditional Financial Intermediation

EMMANUEL FARHI
Harvard University and NBER
 and
 JEAN TIROLE
TSE and IAST

First version received December 2017; Editorial decision July 2020; Accepted August 2020 (Eds.)

Traditional banking is built on four pillars: small and medium enterprise lending, insured deposit taking, access to lender of last resort (LoLR), and prudential supervision. This article unveils the logic of the quadrilogy by showing that it emerges naturally as an equilibrium outcome in a game between banks and the government. A key insight is that regulation and public insurance services (LoLR, deposit insurance) are complementary. The model also shows how prudential regulation must adjust to the emergence of shadow banking and rationalizes structural remedies to counter bogus liquidity hoarding and financial contagion: ring-fencing between regulated and shadow banking and the sharing of liquidity in centralized platforms.

- (Imperfect) fix: make more of finding that effect is weaker for smaller BHCs (assuming these BHCs also have lower implicit subsidy).

2. Implications for Treasury market functioning

- To motivate broader central bank liquidity provision, there should not only be inefficiencies in private markets, but also some negative externalities detrimental to welfare.
- **The benign interpretation**
 - Liquidity provision in Treasury market shifts from affiliated to unaffiliated dealers.
 - In risky securities, it shifts from unaffiliated to affiliated dealers.
 - Specialization: risk increasingly borne by intermediaries with better ability to support it. Market functioning could become more efficient as a result.
 - Unaffiliated dealers become less risky (more government bond holdings)
- **Fix**: To strengthen link to policy implications, the paper could e.g. show that:
 - Overall liquidity provision in risky assets went down (not just rebalancing)
 - Use \$ amounts rather than balance sheet % as dependent variable
 - Greater reliance on unaffiliated dealers made Treasury market less resilient (eg during Covid)
 - Use post-GFC rebalancing as instrument for nonbank presence during Covid.

3. Whose liquidity?

- Results: affiliated dealers receive liquidity support. But less clear where liquidity comes from.
 - **H1.** In internal capital markets literature, liquidity comes from internal pools.
 - Here: deposits flow into banks (and out of nonbanks) in crises (Gatev and Strahan).
 - **H2.** Liquidity could come from external sources, ie Fed programs (BHC being just conduit)
- Which hypothesis holds matters for:
 1. Contribution: are we learning about the benefits of access to internal funding, or access to public funding (see eg Farhi and Tirole AER)?
 2. Policy implication:
 1. H1: Extend guarantees to nondeposit funding / give dealers banking licenses (Marcus)
 2. H2: Extend access to Fed lending to more dealers.
- **Fix.** Try and test which of these hypotheses holds.
 - Is the main effect stronger for dealers affiliated to banks with greater deposit inflows initially during the GFC
 - How does the effect changes when Fed facilities are introduced and deposits temporarily stop flowing into banks (Acharya and Mora JF)



Fig: H1

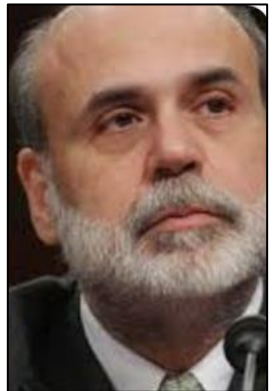
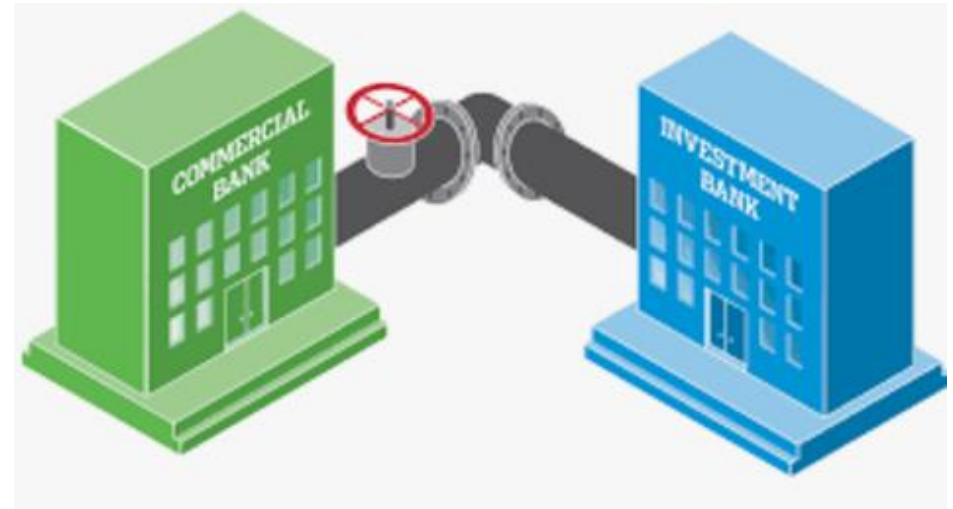


Fig: H2

4. How does liquidity flow to affiliated dealers?



- In normal times, intragroup funding is basically forbidden.
 - Legacy of Glass-Steagall (eg Section 23A)
 - Exception for Treasury sales (at market prices)
 - Incidentally: rationale for that carve-out is unclear, unless the transaction does not need to happen at market prices. Would be interesting to elaborate.
- Some of the restrictions got lifted (selectively) during the GFC.
- **H1**: Dealers to get liquidity through from intragroup Treasury sales → expect dealers to (precautionarily) want to hold *more* Treasuries, not less (contra main result).
- **H2**: Dealers got liquidity through crisis-times carve-outs → less clear that dealers should expect support outside of exceptional crises → also need to relax GS, not only extend LoLR to other dealers.
- **Fix**: use the timing of 23A exemptions to test these hypotheses.
 - Paper provides interesting results about equity investment into dealer subsidiary. But need more information to make sense of it.

5. Small comments

- Paper argues that tighter post-GFC regulation does not explain result because affiliated dealers should shift towards safer, not riskier activities. That does not need to be true for the leverage ratio, which makes it more costly to do business that uses up lots of balance sheet space with thin margins (eg making markets in Treasuries). Could provide more direct evidence for timing of these regs to further rule that out.
- To strengthen the link to the literature, could test whether main result is stronger depending on the dealer (not the BHC's) size. All else equal, smaller dealers should have worse access to external funding, and so even bigger disadvantage vs. affiliated dealers.

Congratulations and all the best with the paper!