Reciprocal Lending Relationships in Shadow Banking

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The Result

\[ \Delta CD_{i,j,t}^{>30 Days} = \beta \times \text{Time Deposit Dummy}_{i,j,t-1} + \ldots \]

\[ + \text{Controls}_{i,j,t-1} + \ldots \]

All in all, \( \beta > 0 \)

If, this quarter, an MMF had time deposits with a bank “J”, all else equal, it will increase its holdings of bank “J”’s CDs in the next quarter by 8 to 15 (USD million?)

(mean CD holdings $75M domestic, $92 foreign)
A Wishful Thought

• Cutting close, but still worth thinking about?

• Lack of “Before” and “After” handicaps the analysis; the testable hypothesis needs to be better conceptually grounded
Interpretation

- But it is not an eco-system of two; banks are not essential to the existence of MMFs (... unless there is some evidence that constraint is binding, and banks are the only solution)

- Regulation elevates the cost of interfacing with banks (as compared to other players!), it is not clear how or why banks & MMFs would try to undo it

- Although, foreign banks might desperately need U.S. MMFs for USD funding
Interpretation: The Foreign Banks’ Effect

- Although, foreign banks might desperately need U.S. MMFs for USD funding

- Fact: Much of the foreign banks’ lending is in USD

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<th>GBP</th>
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“U.S. Monetary Policy and Emerging Market Credit Cycles” (with Falk Braüning)

Too bad the Sovereign Crisis test (Table 9) doesn’t hold...

To be clear, it is not “reciprocity”: only one counterparty is desperate (foreign banks) – when in need of USD, a foreign bank would take any USD funding (CDs or Time Deposits) than an MMF is willing to give
What to Make of the Lower CD Yield

• To reiterate, it is not clear why an MMF needs a bank to satisfy its demand for short term investments

• But, say, MMFs and banks are mutually dependent, it is still unclear why would there be bundle pricing? MMFs take a hit by holding CDs, banks take a hit by engaging in short-term borrowing, why, on top of that, would there be any adjustment on yields?
What to Make of the Lower CD Yield (2)

• More evidence on plausibility of the “CD Discount”: The narrative here is that of MMFs being the “anchor investors” in CDs, are they? Who are the other investors?

• Credit risk is not ruled out: CD yield is a measure of credit risk
  • You can’t do much with a CDS quotes here, since it is a generic (not customized to security) and non-transactional measure of risk; you can always make an argument that CD yield captures credit risk
Motivation

• Without a fundamental link between MMFs and banks, “conflicting regulations” is not a strong motivation

• Worth thinking about who, if anybody is being hurt?
  • E.g., cross-selling in banking hurts small banks

• Is there a way to think about concentration of abnormal exposure to a single counterparty?