Non-bank financial intermediaries and financial stability by Sirio, Andreas, and Hyun

Discussion by Valentina Bruno
Summary of the paper

Leverage enables greater leverage

Source: H.S. Shin (2015)
Summary of the paper

Parable for excessive leverage

Sutyagin House, circa 2008

Source: H.S. Shin (2015)
Summary of the paper

Dual role of prices

Feedback in Financial Systems

Bridge moves

Pedestrians adjust stance

Prices change

Banks adjust balance sheet

Adjust leverage

Stronger balance sheets

Increase B/S size

Asset price boom

Adjust leverage

Weaker balance sheets

Reduce B/S size

Asset price decline
Leitmotiv – Prices as imperative to action

• The action-inducing nature of market prices are the most dramatic during crisis episodes, but they are the most damaging in boom times

The received wisdom is that risk increases in recessions and falls in booms. In contrast, it may be more helpful to think of risk as increasing during upswings, as financial imbalances build up, and materialising in recessions.

Andrew Crockett -- General Manager of the BIS and Chairman of the Financial Stability Forum (2000)
Elements of a VaR model

- **Supply of credit channel (Bruno and Shin, 2015, REStud)**
- Borrowers with currency mismatch, lenders with no mismatch
  - Weak dollar reduces credit tail risk, Bank’s lending capacity ↑ in presence of VaR constraints, dollar funding ↑, leverage ↑, credit supply ↑, financing conditions loosen
  - Reversed when dollar strengthens – tighter dollar credit conditions
Broker-Dealers

Leverage (assets/equity)

Security brokers and dealers
Risk doesn’t disappear, it evolves

• Market-based intermediation has migrated elsewhere:

  1. Hedge Funds and the March 2020 “Dash for cash”

  2. Pension Funds and the September 2022 stress in UK gilts

  3. Mutual Funds and Local Currency Sovereign Debt

Three different contexts, one common theme: Market Risk
1. Hedge Funds

Source: FSB, November 2020, Holistic Review of the March Market Turmoil
Price declines may beget more sales

“The repo market ructions of September 2019 appear to have been a canary in the coal mine for March 2020 turmoil” (BIS Bulletin #2)
History repeating - LTCM Redux

Long-short strategy of hedge funds

Borrow $99 by pledging $100 worth of Treasury
Need only $1 of own funds to hold Treasuries worth $100
$100-fold leverage

When Russia defaulted, volatility picked up and margins surged. LTCM was no longer able to meet margin calls.

Margin Spiral – Analogy of the Millennium Bridge
2. Another canary in the coal mine

Source: Gabor Pintor, 2023, An anatomy of the 2022 gilt market crisis, BoE WP No. 1019
3. Original Sin Redux

US investors holdings in 16 EME local currency sovereign bonds.

Source: Bertaut, Bruno, and Shin, 2023, *Original Sin Redux: Role of Duration Risk*
Original Sin Redux: Role of Duration Risk

Source: Bertaut, Bruno, and Shin, 2023, Original Sin Redux: Role of Duration Risk
Rewriting the textbooks

Traditional way

• Increase leverage by reducing equity

• Credit/Default risk

• Risk in the banking sector

• Currency/maturity mismatches

New Reality

The power of leverage: Leverage enables greater leverage

Price risk even with safe assets

You should never try to catch a falling knife

Risk has moved to NBFI

Market/duration risk

Dual role of prices. When central banks hit the brakes, someone flies out the window.
Main References


Andreas Schrimpf, Hyun S. Shin and Vladyslav Sushko, 2020, Leverage and margin spirals in fixed income markets during the Covid-19 crisis. BIS Bulletin #2


Gabor Pintor, 2023, An anatomy of the 2022 gilt market crisis, BoE WP No. 1019.