Discussion of “Markets, banks, and shadow banks” (by Martinez-Miera & Repullo)

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These are my private views and do not necessarily reflect those of the ECB or the Eurosystem

Main message

Does capital regulation lead to more shadow banking?

Yes

Flat requirement → shadow banks finance medium risk firms

Risk-based (VaR) → shadow banks finance high risk firms

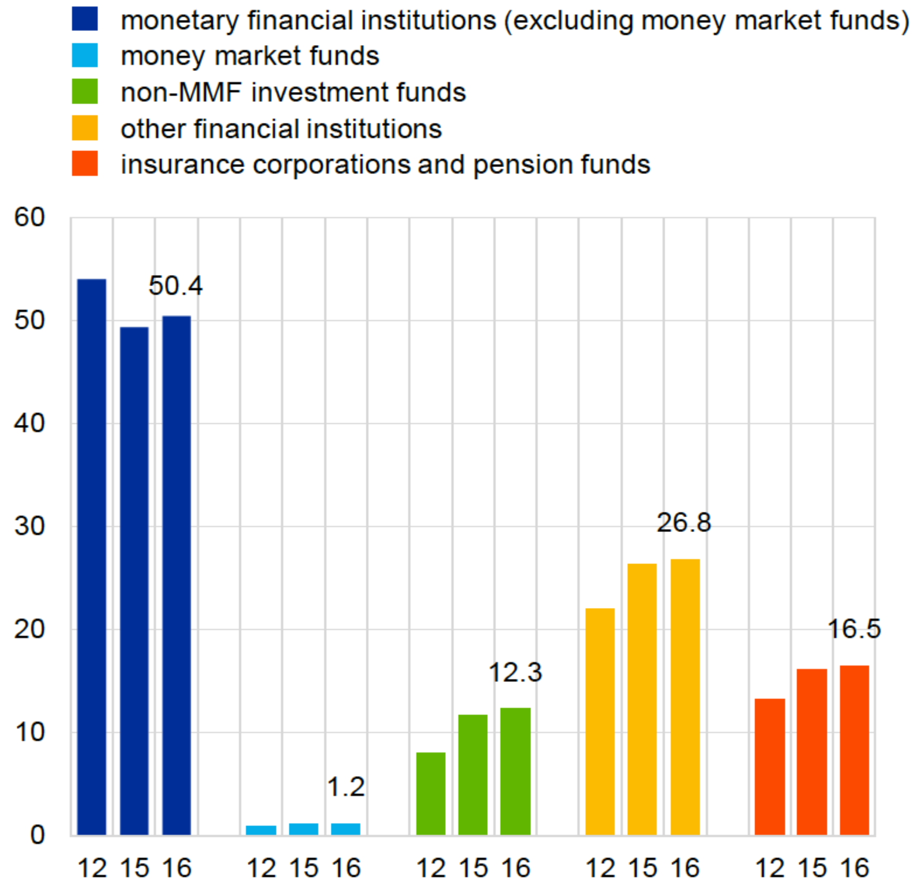
Other results

Current regulation too tight

Welfare optimal requirement → no shadow banking

Low safe rate, high cost of equity → more shadow banking

Importance of EU shadow banking



ESRB (2017) "EU Shadow banking monitor"

Main ingredients

Bank screening lowers cost of borrowing

More equity increases banks' incentive to screen

→ Risky firms borrow from banks

Equity is more costly for shadow banks

"Private certification is more costly"

But they do not have to hold a minimum amount

Intuition (flat requirement)

Medium-risk borrowers are driven to shadow banks

They want some screening to reduce cost of borrowing

Regulated banks have to hold a lot of capital

Screen a lot (capital and screening are complements)

Too costly for medium-risk borrowers

(Higher cost of equity for shadow banks ok, they do not screen much)

Optimal capital regulation

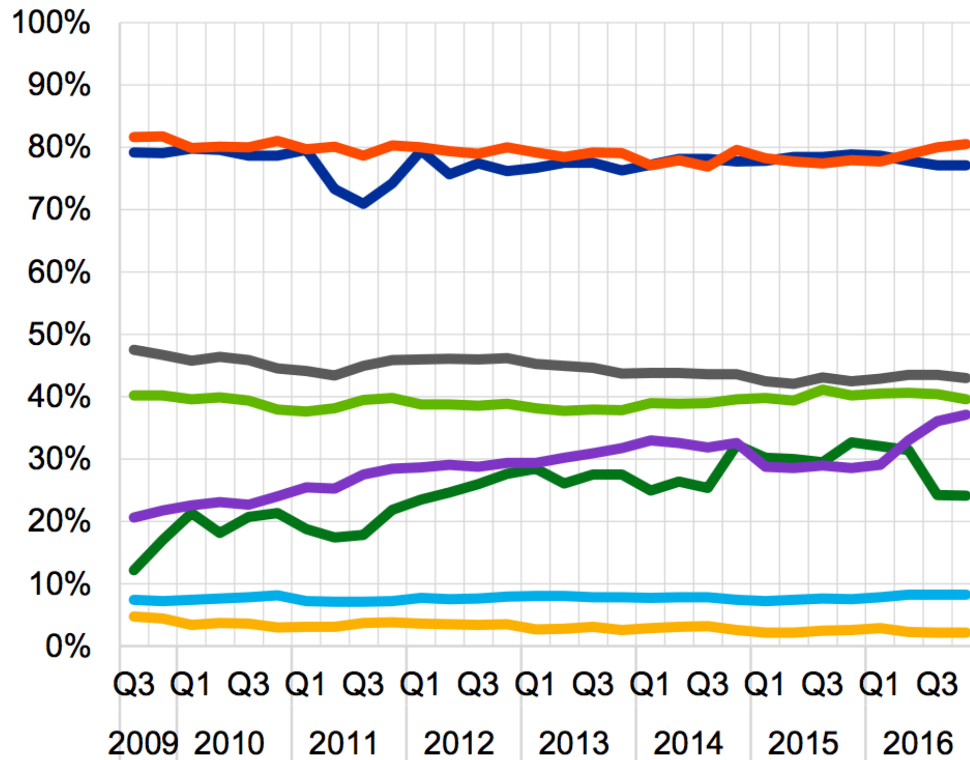
Welfare analysis is nice!

But why have capital regulation?

Does market equilibrium coincide with k_p^*?

If not, what is the externality?

Do shadow banks intermediate credit?



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Credit intermediation is

$$\frac{Loans + Debt}{Assets}$$

For euro-area banks

$$\frac{18 \text{ tn} + 4 \text{ tn}}{31 \text{ tn}} = 71\%$$

A word on the model

Screening…?

- Types are observable
- Each type knows that it can obtain cheaper funding if bank screens (?) more

Would be nice to have outside equity

- Here equity pays cost of capital/certification even if firm fails

Why does k need to be certified?

- How exactly does the market "certify" capital?

Summary

Very creative model

Novel take on shadow banking

Needs better intuition

Better motivation of “certification”

Does it apply to all shadow banking?