Discussion of
"Inefficient Liquidity Creation"
by Luck and Schempp

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This Paper

Questions:

- What is the optimal mix between “market-based intermediation (MBI)” and hold-to-maturity (HTM) banking?
- What is the optimal regulation when both co-exist?

Key driver:

- HHs get a convenience yield from safety. Intermediaries create safe assets.
- HTMs: by issuing equity and holding-to-maturity.
- MBIs: by selling assets when interim bad news arrives at fire sales prices.
- Eqm mix: choosing between investing in “recovery skills” vs. cost of fire-sales (pec. ext.)
- Intermediaries cannot write state-contingent contracts.

Main Results:

- Fire sales are excessive (as in the literature).
- Liquidity creation: too high/too low compared to the constrained efficient benchmark.
- Best regulation is subsidies to HTM banking, capital and liquidity regulation can be useless if liquidity creation is already too low.

Literature: What do we already know and what we don’t know

- Stein (2012): create safety by selling off risky assets to outside investors upon the realization of adverse macroeconomic news.
  - Has a similar safety constraint. No choice of being HTM or MBI.
  - “unregulated private money creation can lead to an externality in which intermediaries issue too much short-term debt.”
  - Focuses on what monetary policy can do to correct the externality.

- Lorenzoni (2008), Davila and Korinek (2018) etc: collateral constraints.
  - Market prices determine the borrowing capacity of the intermediary.

- *Literature: There is too much leverage, liquidity creation and fire sales.*

Key insights of the paper:

- This paper agrees with the literature on fire sales: It is excessive.
- But liquidity creation: It depends.

- The model introduces “recovery skills”. Investing in them is costly. So are fire sales.
  - In eqm: there is a mix of intermediaries as both types of intermediation entail costs.
  - Moreover, fire sales also has social costs (same as in lit.). Hence inefficient.
  - Also, HTMs always invest in recovery skills, MBIs never do. (*authors*: this is really an assumption not a result).

- However, at the same time, MBIs sell assets to outside investors who come in only at the interim period (more on them later). They choose between buying fire sale assets or operating their own technology.
- Fire sale prices are endogenous: MBIs do not take into account their effect on outside investors’ decisions. Depending on parameters, if fire sales prices are too low, they cannot credibly sustain a lot safe debt. So, liquidity in eqm is ambiguous.

Comments: too low liquidity – relevance, easy fixes, implications

- We already know about fire sales, pecuniary externalities etc. and policy responses.
- In my opinion, your main contribution is the theoretical "too low liquidity" result.
- At the same time, not being able to contract with outside investors is driving all results.
  - If you could, you could achieve first best.
- Who are these outside investors? Where is the public sector debt in all this? Why don't governments or CBs issue safe claims? QE? Wouldn't that fix the externality?
- Do you think this result applies to pre-crisis? Was there too little liquidity then?
- Or can I interpret the model as: if CB cannot commit to provide liquidity in crises times, there could be too little liquidity? So is there too little liquidity now as CBs are slightly more constrained?
- So if there is too little liquidity creation today, are regulations useless? Should we relax them?

Comments: Shadow banks – regulation or this paper's channel?

- Conventional view: The existence and the rise of "shadow banks" is largely driven by regulation. (Reg Q etc.)
  - Implication is: investor bases of HTMs and MBIs are very different.
  - The moneyness of ST debt by by sectors is different, the returns are different.
  - Gammas are very different. Bank deposits can make payments, safer etc.
  - MBIs are inherently risky, bank runs.

- This paper: shadow banking just arises from a trade-off between recovery vs fire sales.
  - Investors are indifferent. No reason why investor bases should differ.
  - Everyone is safe. There is no bank run. No real reason for deposit insurance. Authors go in that direction towards the end. I think they could explore those issue further.

- How important do you think your channel is compared to regulation? Important in comparing your policy implications to their policy implications?

Comments: JP Morgan, lending standards, wholesale funding

- Banks can only invest in recovery skills. Moreover, when a bank sells an asset, the buyer can only get a higher value if they had already invested in recovery skills.
- There is a also a separation of business models.
  - HTMs invest in recovery and only do HTM activities. Then they have no incentives to do anything else.
  - MBIs only fire sell and never invest in recovery.

- Three interesting extensions that I would love to see – and would improve the paper:
  - How do I think about JPMorgan, Wells Fargo etc. who do both activities? Would they have incentives to cross-subsidize between types of intermediation?
  - If you allow intermediaries to invest either in recovery when the bad state happens, or improve lending standards, how would their trade-offs change?
  - In reality, MBIs invest in bank liabilities. Welfare higher or lower if MBIs invest in “recoverable” assets through investing in HTMs rather than investing in them?

Conclusion

- The paper introduces an interesting theoretical channel.
- Main results are regarding the mix between HTM & MBI and too low liquidity.
- The authors should show/discuss that "too low liquidity" has empirical relevance.

- Policy implications:
  - Subsidy to HTM banks. These subsidies are already there implicitly, payments, deposit insurance etc. Why are they not enough?
  - Capital and liquidity regulations could be irrelevant when there is too little liquidity.

- It is important to establish the empirical relevance of your theory/outside investors.
  - Aren't there other policy tools already available to create more liquidity?

- Extensions currently in the paper are going in the right direction.
  - More of these would improve the paper.