

# Threats to Financial Stability

Discussant Remarks by  
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30 November 2017

Slides and remarks are Carey's opinions, not those of the Federal Reserve

# Franks, Serrano-Velarde, Sussman

- Peer-to-peer small business lending
- Studies the original auction system for pricing such loans and allocating them to lenders
- Finding: The system extracted useful information about PDs
- A lot of sophisticated attention to issues found in the microstructure literature
- My focus: How much information, really?

# Franks, Serrano-Velarde, Sussman (2)

- Average loan size: about £50,000
- Average interest rate: about 8 percent
  - Policy rate 0.005
- Average annual PD: About 3 percent
- Table 4 OLS regressions on default dummy:
  - Include interest rate, “rating” dummies for indicators produced by Funding Circle credit department, other variables
  - $R^2$  only about 0.003 !!! Implicitly mostly ratings

# Franks, Serrano-Velarde, Sussman (3)

- Contrast with regressions on default of U.S. privately placed bond obligors 1991-2002:
  - Also OLS
  - Rating dummies, Year dummies, interest spread at origination as explanatory variables yields  $R^2 = 0.0240$
  - Drop spread:  $R^2 = 0.0233$
  - Drop year dummies (so only ratings):  $R^2 = 0.0218$
- Almost 10x the  $R^2$  .

The absolute amount of information appears tiny relative to that in even nontraded securities' characteristics

# Franks, Serrano-Velarde, Sussman (4)

- Carey's conclusion: These are tiny loans for which little information with predictive power is available
  - Although most statistical results are as expected, I question how much we can learn about information production
- Lenders may simply be pricing the average risk
- And the spread they earn is huge, roughly 450 bps above expected loss
- It makes sense that FC abandoned the auctions
- This incarnation of fintech does not look to me like a major threat to established lenders

# Korinek

- For some parameter combinations in a stylized model, “bankers” will, in essence, sell derivatives to households that pay the bankers in *good* states and that pay the households in bad states, and the bankers are able to pay the households in bad states because they receive bailouts from the households.
  - In the model, the derivatives are “financial innovation” but do not have to be innovations.
  - Differences between individually and collectively optimal actions
- The broad point is not novel:
  - It is well known that expected bailouts increase risk-taking
- If we are not able to forbid bailouts AND ensure correct pricing of all risks, then the social planner must be alert to imprudent risk taking and try to limit it
  - Sounds like “supervision”

# Korinek (2)

- The agents in the model are better described as “Buffets” rather than as bankers
  - They are equity investors
  - There is no leverage
  - They capture any rents from real-economy production
  - Problem of motivation: Buffets are rarely bailed out

# Korinek (3)

- There is some open space between the model and the real-world examples of innovations in the paper
- The examples:
  - Deposit insurance
    - Debt (deposits) is central
  - Fannie-Freddie ignoring of secondary financing of down payments
    - Tranched financing is common, not an innovation
  - Avoidance of bank capital requirements
    - Is “avoidance” “innovation”?
  - Euro-area breakup...seems to rely on FX risk within euro area

# Buchak, Matvos, Piskorski, Seru

- Nonbank mortgage originators' market share (of the *conforming* and *FHA* segments) has increased since 2007)
- Increased regulatory costs for banks (at the margin?) and greater convenience provided by fintech nonbanks appear to be responsible
- Lots of data and facts

# Buchak, Matvos, Piskorski, Seru (2)

- Key facts:
  - Fintech lenders charge higher spreads
    - Fintech-originated loans are more likely to prepay. How much of that is because their interest rates are higher?
  - Fintech lenders focus more on the refi market
  - A smaller proportion of interest rate variations among fintech lender originations is explained by hard information
    - The authors' suggestion that this is use of different info is speculation. Might just be poorer analysis.

# Buchak, Matvos, Piskorski, Seru (3)

- The allocation model forces all variation into regulatory and technology categories
- What if something is missing?
- One possibility: “Discrimination”
  - Less-informed borrowers are charged more
    - Intentional: Rent extraction
    - By-product of poorer credit analysis
      - Safer borrowers self-select out of each pool due to higher average interest rates
  - Key test “falsifying” this accounts for only about 1 bp of 17 bp difference in spreads in later part of sample

# Summary

- Three good, thought-provoking papers
- All are worth reading
- Thank you for your attention!