Threats to Financial Stability

Discussant Remarks by
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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.
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
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
• Nonbank mortgage originators’ market share (of the \textit{conforming} and \textit{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.
• 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!