

Relationship lending in the interbank market and the price of liquidity

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The views expressed should not be interpreted as the views
of the Federal Reserve System

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Questions

- What the paper is about?
 - Relationship lending in a money market and access to and pricing of overnight loans
 - Changes in the relationship lending in early stages of the financial crisis
- Why these issues are important?
 - Academics/policy makers: existence and significance of relationship lending in money markets (private info, mutual insurance, liquidity reallocation)
 - If relationship lending is important then a bankruptcy of a large lender might set a domino chain in motion
 - Need to know if there was a change in relationship lending in early stages of the crisis, what was its nature

Methods and findings

- Use German payments system data to
 - Identify overnight loans in one of the German money markets from March 2006 to November 2007
 - Identify lending relationships over time
 - Run probit models to explain access to overnight loans
 - Run linear models to explain overnight loan pricing
- Find that
 - Past lending increases the probability of getting a loan again both before and in early stages of the crisis
 - Relationships result in higher loan prices (relative to that for arms length loans) before the crisis, but lower prices in early stages of the crisis
- “Relationship lenders have anticipated the financial crisis by charging higher interest rates in the run-up to the crisis”

The story is not complete?

- Why borrowers before the crisis stayed with their relationship lenders and paid higher prices?
 - Why borrowers would not seek other potential relationship lenders?
 - Was that investment into future access to loans? Why this implicit contract was time consistent?
 - Was that the price for a stable source of desired volumes of liquidity? Doesn't explain the crisis period
- Does the mutual insurance story hold? Higher correlation leads to higher loan probability and lower rates
- Left out: foreign banks and banks with U.S. exposures?

Identification of loans/relations

- “Traditional” Furfine’s algorithm identifies loans only
 - It relies on the actual distribution of federal funds rates for brokered transactions)
 - Its identification precision has been occasionally tested by the Federal Reserve
- Is it too much to ask a modified Furfine’s algorithm to identify both prices and volumes?
- Has the precision of this modified algorithm been tested on actual transaction data? Is it possible to use bank specific submissions for EONIA to identify loans?
- Identified relationships are not stable by construction? Switching relationship lenders is not really a problem?

Empirical models

- Probit models to explain access to overnight loans
 - A loan is observed if the transaction actually happens because an unobserved condition is met: observe a loan if a latent variable > 0
 - What is this latent variable? Is it utility from the match? Is it a spread between an opportunity cost and ask price? The definition of a latent variable likely matters for the choice of observables
- Linear models to explain overnight loan pricing
 - Why the RHS is the spread between a loan rate and the target rate, rather than EONIA?

Empirical models (continued)

- Shouldn't a benchmark model take into account the selection bias while explaining loan pricing?
 - Late in the paper the authors show that it does not actually make a difference whether the bias is modeled or not
- Shouldn't a benchmark model have fixed effects?
- The data set is rich—more interesting things to look at