BANK FOR INTERNATIONAL SETTLEMENTS

Discussion of "Intermediaries as Safety Providers"

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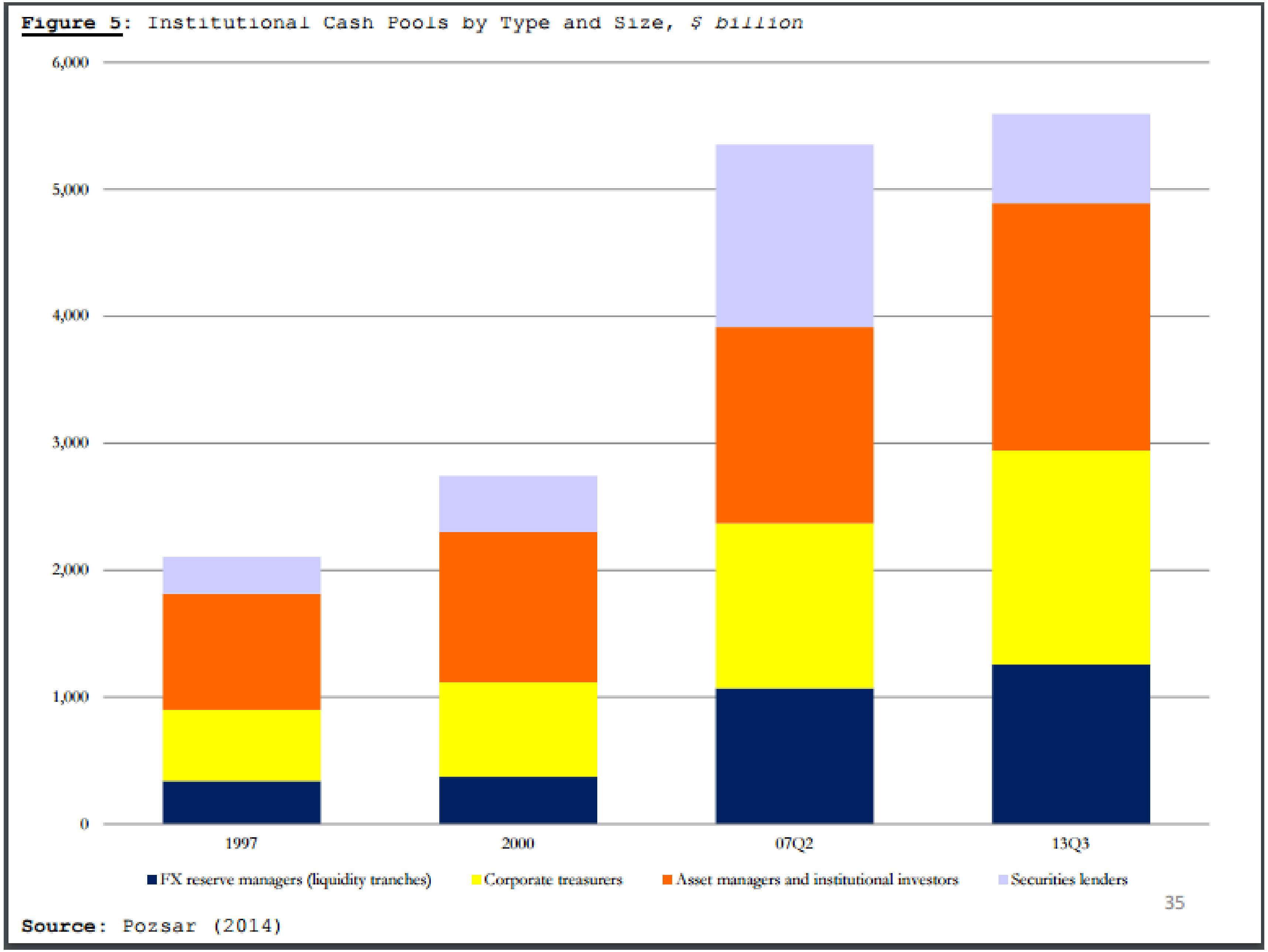
This paper

- **Question:** Is there a role for intermediation when agents have a demand for safety around a subsistence level of consumption?
  - Stone-Geary (farmers in India and cash-rich corporates have the same utility).
  - Agents demand pure safety by construction, need to store for safety.
  - Most of the literature since DD focuses on liquidity.

- **Answer:** Yes.
  - Agents better at storage become intermediaries to improve upon self-storage.
  - Intermediaries and the intermediated disagree on risk choices → Agency conflict.
  - Demandable debt can achieve the first-best with an option to withdraw.

Background: Institutional cash pools, "Do not lose" mandate



Model

- 3 periods. Risky technology, two period storage, liquidation possible.
- Agents differ in returns from storage. Liquidation value < subsistence → everyone stores.
- Three states in period 1: Good, bad, no info. The action is in the no info state.
- Subsistence level of consumption, once reached: risk-neutral.
- Autarky: Too much storage. Inefficient. The worst store the most (?).
- First best: SP issues ST debt and LT debt. Commits to liquidate in the no info state.
- Intermediaries:
  - Agents who reach safety become intermediaries issue debt.
  - Disagree on liquidation with agents with no safety → Agency issues. Demandable debt
- Public debt – yield on public debt works as a shifter for storage returns:
  - Supply of public debt low → Yields low → Storage ret. for bad storers low → more private int.
- Induced Runs: if good storers have exo. liquidity needs (hence hold demandable debt): they might withdraw to avoid dilution.

Comments on the paper

- Simple theory: Nice! I wanted to see more of how this way of seeing the world differs from DD.
- Storage: two-period. Induced Run, DD where only a fraction of late consumers are ALLOWED to run. The same thing would have happened in DD.
- Runs are not really runs as in DD (except for the induced run case).
- Financial stability: LT creditors lose? Intermediaries never fail?
- DD: deposit insurance key. Here no need for deposit insurance. What are the frictions that would require deposit insurance, LoLR?
  - Intermediaries as liquidity providers or safety providers? Which view takes us further?
- Public provision of safe assets is not only a shifter. It has general equilibrium effects through collateralizability. Repos as safe assets.
  - Gorton and Ordonez (2016), Lenel (2017)

Literature

- The lit. on safe assets has grown. Some papers that are very relevant and not cited:

- HSSV (2015, JFE): safety by early liquidation choice. $U=C1+\beta E[C2]+\gamma M$
  - Whatever is safe is discounted less.
  - Traditional banks: deposit insurance + costly equity: Banks are patient fixed income investors.
  - "Shadow banks": Early liquidation.
  - Many of the insights similar, but HSSV (2015) has many testable predictions and tests.

- Moreira and Savov (2016,JF): Private sector carves out safe assets from risky investments.
  - Can talk about booms, crises, recovery, growth, asset prices, tranching, policy interventions.

- Gorton and Ordonez (2016): Public vs private provision of safe assets.

- Sunderam (2015,RFS): Shadow money creation.

Conclusion

- S-G might be promising, but the authors need to differentiate this paper from other papers out there.
- Does S-G predict something that the other papers don't?
- How far can we take liquidity vs. safety? Maturity?
  - ST, LT; safe; liquid

- Deeper Questions:
  - Is there really a demand for absolute safety, why?
  - Are there other reasons? Accounting, tax etc. (MMF reform)
  - S-G is very reduced form, need to understand the micro-foundations.
  - Key is to understand institutional cash pools and their incentives