Discussion of "Global Investors, the Dollar, and U.S. Credit Conditions" by Niepmann and Schmidt-Eisenlohr

Discussant: Egemen Eren (BIS)

New economics of exchange rate adjustment

Cambridge, March 2019

The Dollar and US Credit Conditions – Well done.

- There is a "puzzling" correlation between the dollar and supply of C&I loans in the US.
- I would have shrugged it off (rate expectations). Authors followed and have come a long way.
- The hypothesis: $ ↑ -- secondary markets less liquid – US banks' supply of loans ↓
  - SLOOS says it is important, but unfortunately it is a survey.
  - A lot of other evidence for the existence/importance of the secondary market channel.

Global Investors? – Need to push this ***MUCH*** more.

- Where does the paper fit?
  - Dollar as a barometer of risk appetite? Sure.
  - Peek and Rosengren etc.? Much more so.
- What's missing: Global investors – Foreign banks/investors – Japanese banks and investors.
- It is very important to "unpack" global banks/investors (Aldasoro, Ehlers, Eren (2018)).
  - Plus, it will give you a much better shot at clarity and causality (more on that later).

Let’s start from the correlation and channels

Some channels they address:

- $ ↑ -- Reflect expectations of high i or other US macro -- demand for loans ↓
  - more on that later.
- $ ↑ -- business for exporters fall -- demand for loans ↓
- $ ↑ -- funding costs for US banks rise – supply of loans ↓
  - more on that later.
- and many more…

Paper currently preliminary, but very promising – some emojis

- **emoji** comes from **Japanese:** e (絵, "picture") + moji (文字, "character")
- On a scale of: 😭 ☹️ 😐 😊 😁

What do you want the main message to be?	**How interesting would I find it?**	**How convincing is the way this paper addresses it?**
There exists a “secondary market channel.”	☹️	😁
It is an important channel.	😐	😊
It is the most important channel.	😊	😐
Global investors are key in such and such way.	😁	☹️

- ”Unpacking” global investors can get you mileage in all dimensions.

The role of foreign banks and investors

- Aramonte, Lee, Stebunovs (2019): Importance of foreign banks at origination.
- They use the SNC data, they show a much more granular picture. Should have access?

Table 2: Lender market share at origination and one or two quarters after origination
The table reports the market share of each lender type at origination and after one or two quarters. The sample includes loans whose origination date is within the reporting quarter.

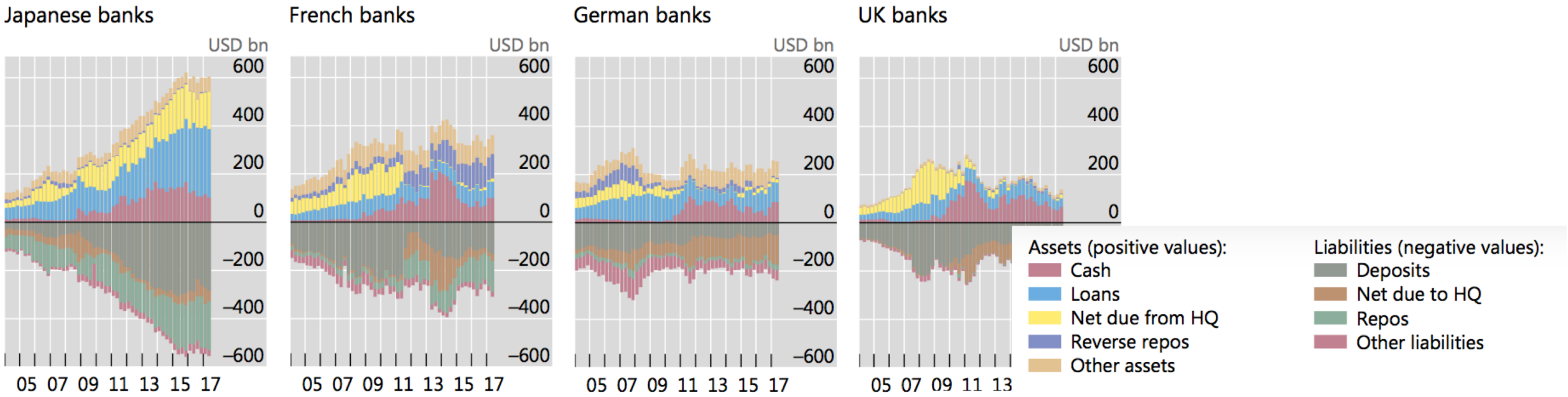
	Share held by lender type (in %)			Share held by lender type (in %)		
	At orig.	+1 qrt	Δ	At orig.	+2 qrts	Δ
U.S. banks and BHCs	25.7	22.3	-3.4	25.7	22.2	-3.5
Non-U.S. banks and BHCs	18.1	15.4	-2.7	18.1	15.1	-2.9
Insurance cos./Pension funds	3.6	3.9	0.4	3.6	3.9	0.3
U.S. CLOs/CDOs	8.3	9.2	0.9	8.7	9.7	1.1
Non-U.S. CLOs/CDOs	5.8	6.7	0.9	5.8	7.1	1.2
U.S. inv. funds and others	30.3	32.7	2.4	30.1	32.3	2.2
Non-U.S. inv. funds and others	8.3	9.8	1.5	8.1	9.7	1.6

Unpacking global banks – Aldasoro, Ehlers, Eren (2018)

- The literature mostly treats non-US banks/investors as a homogenous group.
- Our paper shows: Banks are heterogenous. Japanese banks are very large/different.
- These differences have an economically significant effect on $ funding costs.

Figure 2

Balance Sheets of US Branches and Agencies of Foreign Banks



https://egemeneren.files.wordpress.com/2019/03/aee_2019_new-1.pdf

Source: US FFIEC 002 Call Reports; authors' calculations.

Let's dig deeper into Japanese banks/investors…

From 29 Nov 2007:

Japanese investors have been the only investors in AAA tranches of collateralized loan obligation in recent months. **Shinko Securities**, **Norinchukin Bank** and **Bank ofTokyo-MitsubishiUFJ** are the firms who have been most active recently, according to various CLO managers and bankers. No officials from the firms ...

From 16 Dec 2018:

LONDON/HONG KONG – Japanese banks might have snapped up a third of the loans made to highly indebted U.S. companies, propelling the size of the market past $1 trillion, a new estimate from UBS Group AG suggests.

Japanese banks have been buying the top-rated AAA pieces of CLOs because they have higher yields than like-rated sovereign debt, according to UBS, with the lenders making up about 33 percent of inflows into the asset class in the past several years. While the demand is vulnerable to a pullback, it should help provide stability to the market in the face of a recent sell-off, the bank said.

- https://www.globalcapital.com/article/k64q75bt0z6n/japanese-investors-carry-clo-aaas
- https://www.japantimes.co.jp/news/2018/12/16/business/fate-1-trillion-risky-u-s-loans-may-japans-hands/#.XIz6FhNKjVp

It is one example of a broader trend of Japanese investors looking for returns overseas after being faced with zero yields at home. Many of the CLOs were bought through so-called repacks, in which dollar-denominated assets are essentially repackaged into yen using a special purpose vehicle and a currency-swap agreement with another bank.

Japanese banks may be buying between half and three-quarters of AAA-rated CLO tranches, UBS said, citing evidence from clients and analysis of the market for cross currency basis swaps. Without the Japanese bid for AAA-rated CLO paper, top-rated CLO spreads would likely widen back to at least 2014 levels, or 50 basis points wider, the bank estimated.

An indicative estimate by the Bank of England in November said "international banks, particularly U.S. and Japanese banks" held one-third of the stock of global CLOs, concentrated in less-risky tranches.

https://www.japantimes.co.jp/news/2018/12/16/business/fate-1-trillion-risky-u-s-loans-may-japans-hands/#.XIz6FhNKjVp

Again, CLOs make up about 60% of the buyer base for U.S. leveraged loans, according to LCD, and analysts at UBS estimate that Japanese banks make up anywhere from 50-75% of the total CLO AAA demand, which in turn accounts for 60% of a CLO's financing costs. Among the new issues that have priced in Europe this year, Norinchukin has been the main buyer of AAA notes, sources said.

- Remember Norinchukin from their CDO exposures during the financial crisis?
- They now hold $62 billion in CLOs.

https://www.spglobal.com/marketintelligence/en/news-insights/trending/r8PUq3LvRJTauq3gUmVclQ2

What to do about it?

- Most of what I have shown was about CLOs, might also apply to mutual funds.
- Add Japanese macro variables to regressions. Especially JGB term structure. Slope.
- Look at before and after the implementation of the yield curve control.
- Check for the USD/JPY exchange rate, the basis. They need to swap yens to invest.

- Is it: $ app. – funding costs for Japanese investors rise – supply of loans falls?
- ”Non-US bank channel” instead of “secondary market channel”: Peek and Rosengren (2000)

- Alternative hypothesis: It may well be a primary market channel.
  - $ app. – funding costs for foreign banks rise – US banks cannot easily put together a syndicate.
  - This would operate similarly to a foreign bank driven secondary market channel.
  - Need to look at the Dealscan data to look at the nature of the syndicates.

- Japanese FSA: changes rules for Japanese banks and their CLO holdings.
  - Exogenous shock to demand/liquidity in the US CLO market.

New Japanese regulatory proposal could hit US CLOs

Kristen Haunss, Loan Pricing Corporation

6 MIN READ

NEW YORK, Jan 18 (LPC) - A new regulatory proposal could curb Japanese investment in US Collateralized Loan Obligation (CLO) funds. Reduced appetite from these major buyers could push CLO pricing higher and hamper issuance after a record US$128bn of US volume in 2018.

The Japanese Financial Services Agency (JFSA) is proposing to introduce risk retention as part of regulatory capital rules for some investors seeking to invest in securitizations, according to a report from law firms Anderson Mori & Tomotsune and Milbank Tweed, Hadley & McCloy.

https://www.reuters.com/article/japan-clo/new-japanese-regulatory-proposal-could-hit-us-clos-idUSL1N1ZH1CS

Loans vs corporate bonds

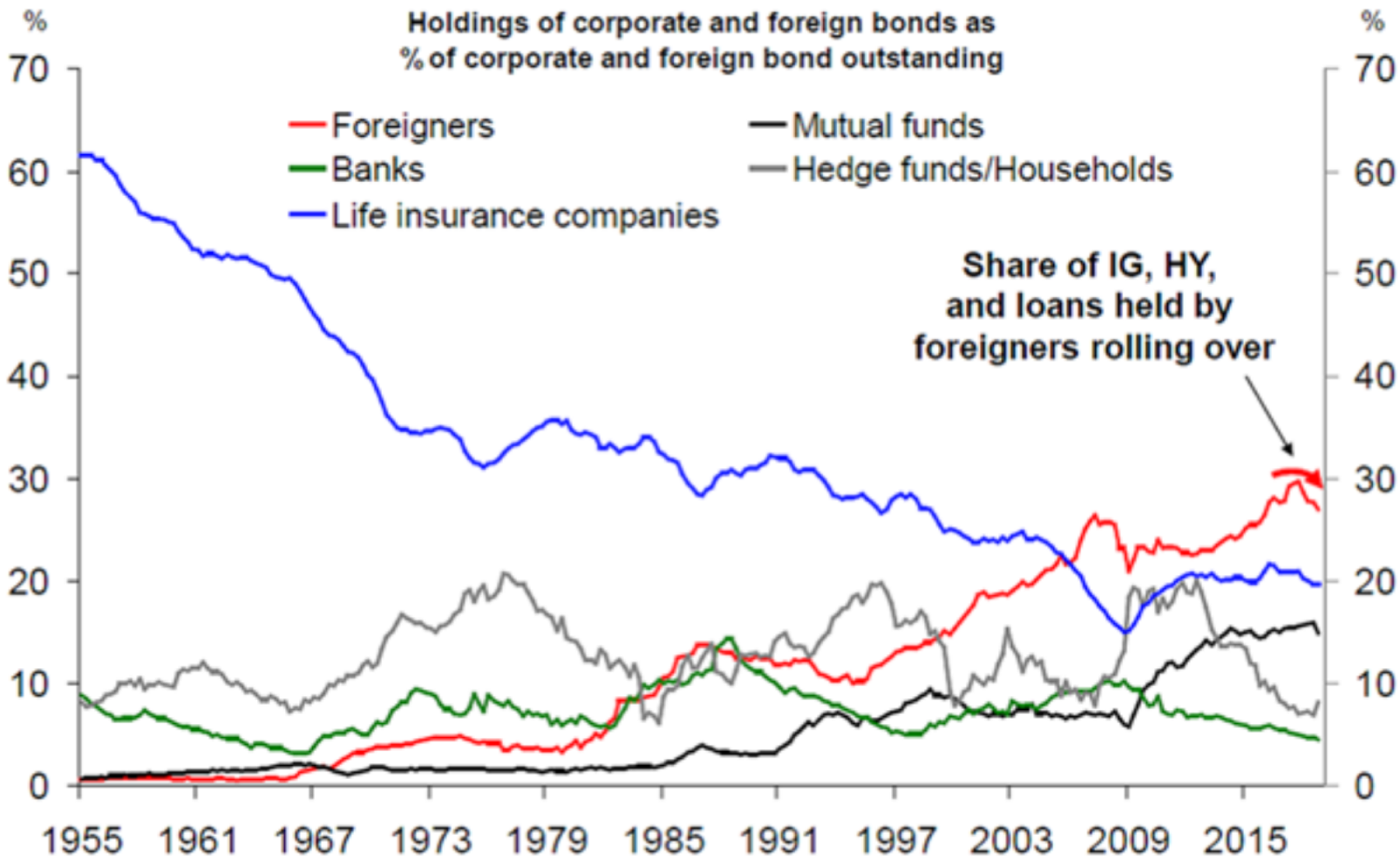
- Alternative hypothesis:
  - Any substitution between corporate bonds and bank loans by firms that correlates with the dollar?

- They rightly note at the very end of the paper that similar effects should be present in other markets. They look at yields. Comes quite late and more can be done.

- I did a quick check on yearly corporate bond issuance (from SIFMA) and the broad $ and also quarterly FCI with $:

Time period	Corr(all issuance, $)	Corr(IG issuance, $)	Corr(HY issuance, $)	Corr(FCI, $)
2000-2018	-0.65	-0.55	-0.65	0.71
2009-2018	-0.71	-0.48	-0.78	0.78

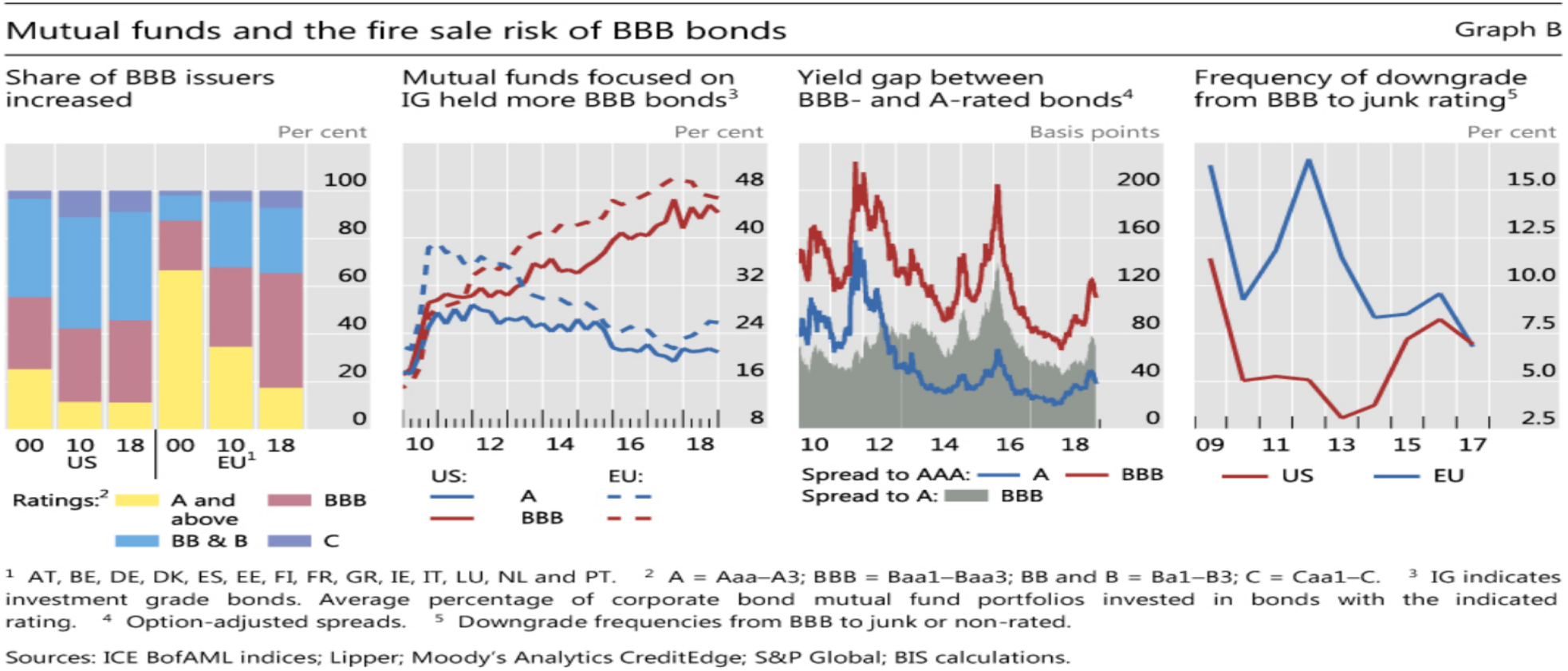
Foreign appetite for IG, HY, and loans rolling over



Source: FRB, Haver Analytics, DB Global Research

Downgrades or upgrades in/out of junk as exogenous variation?

- Exogenous effects on liquidity in secondary markets due to investment mandates of mutual funds or others (eg Japanese investors hold safe tranches).
- See Aramonte and Eren (2019) for more:



https://www.bis.org/publ/qtrpdf/r_qt1903u.htm

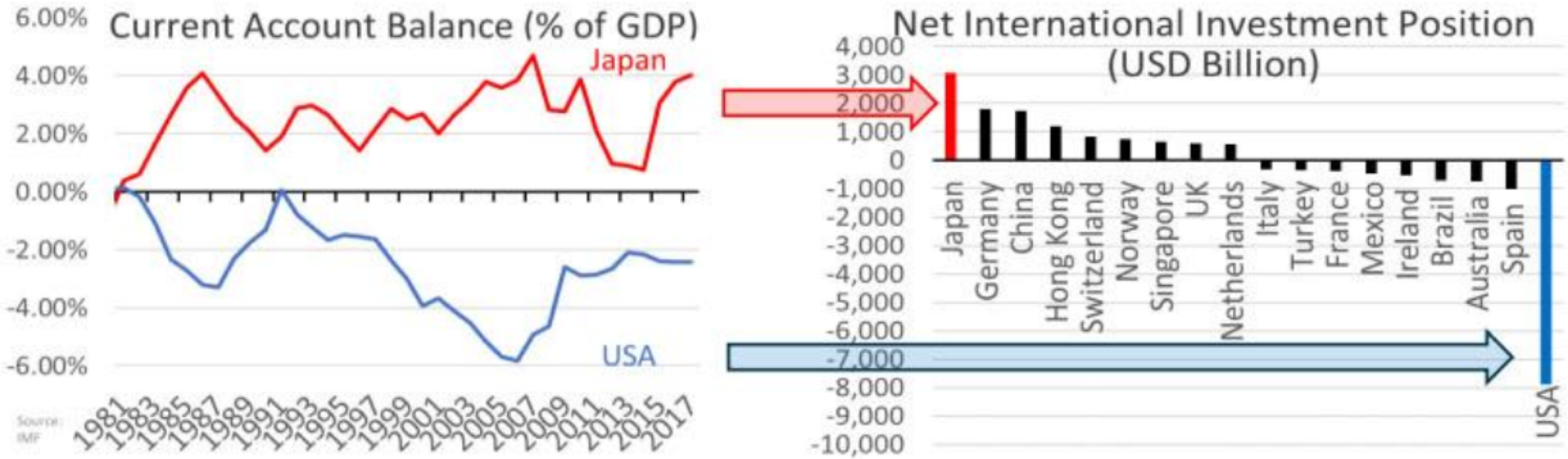
Other comments

- A lot of the lev. loans go to the energy sector. Putting oil prices weakens their results.
  - Seems like lower demand might be causing this.
  - Also look at M&A and LBO activity to somehow control for demand
- Loan origination takes time. Looking at contemporaneous changes appropriate?
- The results on foreign monetary shocks are weak and don't improve the paper much.
- Time series is rather short. Looks like one long period of $ dep. and other of $ app.
- It would help a lot if data description were clearer. It is hard to understand.
  - Also more summary stats and more cuts in the data.

Conclusion

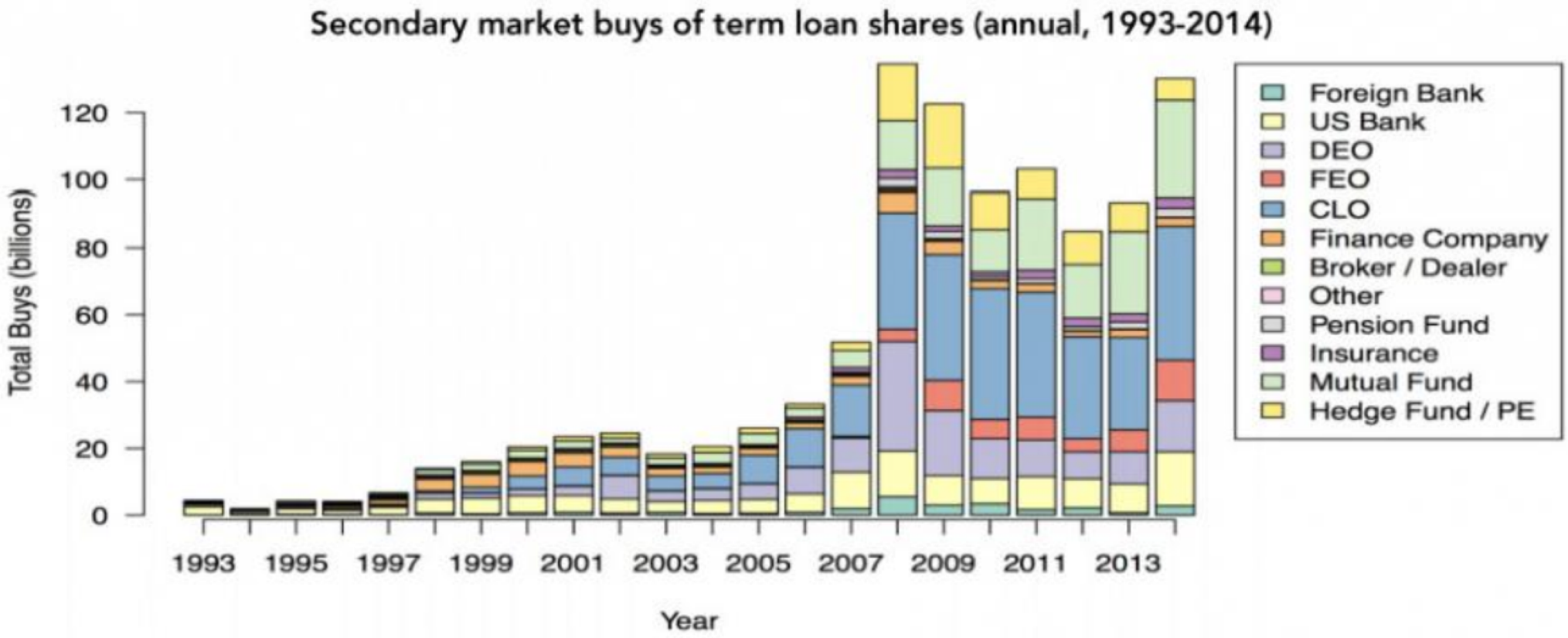
- It is not easy to write a paper with the dollar on the right hand side of the regression.
- The authors have tried hard and have come a long way. It is a very promising paper.
- Understanding global investors is key.

More Graphs



https://matasii.com/credit-cycle-a-japanese-driven-tsunami-out-of-us-clos/

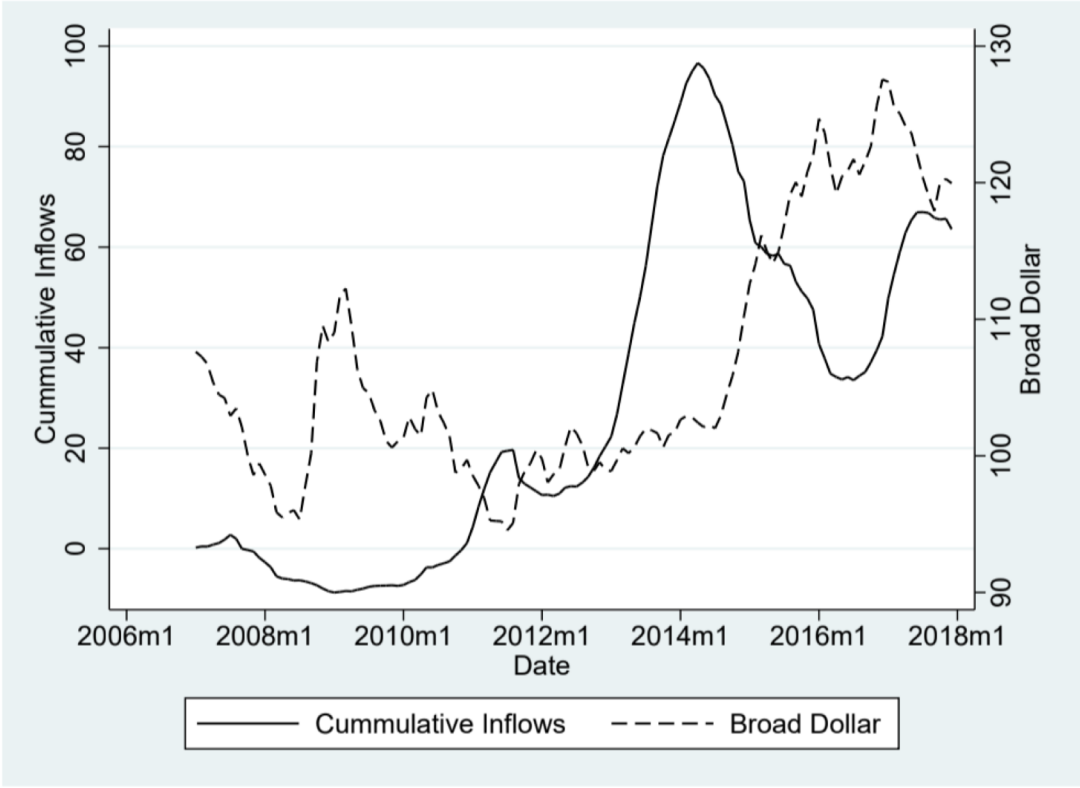
More Graphs



https://matasii.com/credit-cycle-a-japanese-driven-tsunami-out-of-us-clos/

More graphs – from the paper

Figure 5: U.S. mutual funds investing in corporate loans and the dollar



Note: This figure shows the monthly net inflows into U.S. domiciled, U.S. dollar denominated mutual funds that invest in bank loans exclusively in the United States together with the monthly broad dollar index from mid-2006 to 2017. Data on these mutual funds is from EFPR. Weekly data was summed within a month and aggregated over all funds in the data.