Discussion of Gofman’s ”Efficiency and Stability of a Financial Architecture with Too-Interconnected-to-Fail Institutions”

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1 The views expressed are those of the author and not necessarily those of the Federal Reserve Board or Federal Reserve System.
Outline

1. The point
2. A primer
3. An update
4. A consideration (or two)
The point of this paper

1. If "too big to fail" regulations puts limits on the number of counterparties, banking networks could become less, not more stable.
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Intuition: increases number of intermediaries in the network.
1. Bargaining model between two banks, where bargaining power of seller depends on the number of buyers.
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Calibrated the model to moments in Bech and Atalay (2010)
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Market inefficiency and bank failures are non-monotonic in the number of counterparties for the largest institutions.
The point

What I can add

1. A primer on the federal funds market

Klee (FRB)
What I can add

1. A primer on the federal funds market
What I can add

1. A primer on the federal funds market
3. A discussion of other things to consider
The federal funds market

1. **Unsecured** market for cash balances held by institutions at the Federal Reserve
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2. Pre-crisis, banks bought and sold **scarce** funds to satisfy reserve requirements and fulfill payment clearing needs
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2. Pre-crisis, banks bought and sold **scarce** funds to satisfy reserve requirements and fulfill payment clearing needs

3. Post-crisis, brokered market is primarily GSE sellers (FHLBs), with foreign banks using market to arbitrage interest on excess reserve balances
Then and now: Call Report federal funds volume
Network pre- and post-Lehman (Beltran, Bolotnyy, Klee (2014))
Fed funds network component size, 2007-2008

- June 2007 - August 2008: GIN shrinks by 25 percent
- Late Sept. 2008: GIN shrinks another 20 percent
- By end-2008: GIN just one-fourth of its June 2007 size

Note: Shaded region denotes sample period examined in Afonso, Kovner, and Schoar (2011)
Other things to consider

- Empirical results suggest two main factors led to shrinking of network:
  - Credit risk (**unsecured**)
  - Abundant liquidity (**scarce**)
- Barganing power and network structure likely a function of these two factors
Conclusion

Enjoyed reading the paper and nicely done

- Regulation doesn’t specifically ”limit” number of counterparties; author’s interpretation
- Super-patient application of primarily empirical study to this point
- Including liquidity and credit risk in future work would be helpful