“Where Do Banks End and NBFIs Begin?”
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Basic Argument of the Paper

Identifies two prominent views of Banks vs. Nonbanks and proposes a third view that they believe better characterizes the current financial ecosystem

1. *Parallel*: Banks and NBFIs perform different functions

2. *Substitution*: Banks and NBFIs perform similar functions

3. *Transformation*: Banks and NBFIs depend on each other

Basic Argument of the Paper

Identifies two prominent views of Banks vs. NBFIs and proposes a third view that they believe better characterizes the landscape

1. *Parallel*: Banks and NBFIs perform different functions

2. *Substitution*: Banks and NBFIs perform similar functions

3. *Transformation*: Banks and NBFIs depend on each other, with NBFIs being more dependent on banks than vice versa

Implication: Policy needs to take this dependence into account

My comments:

- Agree on the transformation, but will try to expand on the driving factors
- Explore implications for financial stability

Speculation on Changes in Direction of Bank-NBFI Dependence

- Salient pre-GFC examples mainly involve *bank dependence on NBFI and market funding*
  - Money market mutual fund (MMF) financing of banks, largely non-U.S. banks
  - CLO purchases of bank syndicated loans
  - Securitization of residential mortgages
  - Asset-backed commercial paper with bank liquidity backstops

- Salient post-GFC examples involve *NBFI dependence on bank funding*
  - Bank lending to private credit funds and fintechs, including credit facilities
  - Warehouse lines to mortgage originators
  - Purchases of senior tranches of CLOs

- Bank dependence on NBFIs and markets seems to be less important than it once was (MMF, RMBS, ABCP)

Why So Much Growth in NBFIs and Bank Funding of NBFIs?

- One explanation: Increased capital requirements post-GFC, move activity to less regulated, more leveraged NBFI sector.
  - This explanation fails: NBFI sector is generally ***less*** leveraged than the banking sector, particularly in private credit even on a risk-adjusted basis (Chernenko, Ialenti and Scharfstein, 2025) and in nonbank mortgage origination (Jiang et. al., 2024)

- A number of other factors combine to help explain the growth:
  - Post-GFC capital regulation and supervision has made safe lending relatively more attractive than risky lending (Implicit risk weight on leveraged loan is greater than 100%, while risk weight on loan to private credit fund is just 20%)
  - Banks have no origination/underwriting/servicing edge in lending to private equity sponsored firms, homeowners, consumers and small business owners. May even be disadvantaged given supervisory costs and restrictions
  - Increasing institutional demand for fixed income assets

- Low-risk lending to NBFIs exploits the edge that banks do have, namely low-cost funding, and does not require costly origination platform

Risks Associated with Bank Funding of Private Credit Funds

- In "Private Credit and Financial Stability," joint work with Sergey Chernenko (Purdue), we examine private credit fund performance and behavior during a severely stressed scenario

- Use data on business development companies (BDCs), a type of private credit fund that is required by SEC to disclose detailed portfolio and financing information

- Banks have capital of ~50% of assets when not risk weighted and ~30 – 40% when risk weighted. Stress tests reveal very high stressed capital buffers.

- Typically, bank loans to private credit funds require that assets backing their loans exceed ~150% of the borrowed amount (i.e., Asset Coverage Ratio > 150%). Overcollateralization is key to getting favorable capital treatment (20% risk weight on bank lending to NBFIs) and generating attractive ROE

Risks Associated with Bank Funding of Private Credit Funds

- Key findings:
  - Overcollateralization protects bank lenders against losses over the stressed scenario
  - But ACR loan covenants and regulatory requirements lead private credit funds to deleverage to stay in compliance
    - Use loan repayment proceeds to pay down debt rather than reinvest
    - Sell assets, if possible; if not, loan covenants will be violated and banks will need to renegotiate loans, waive covenants
  - Extent of deleveraging will depend on a variety of factors; efficiency implications are ambiguous.
  - The risks to banks are limited, but credit creation may be hampered

- During GFC, banks were protected even as a number of risky BDCs defaulted on loan covenants and significantly deleveraged

Implications and Questions

- Main risks are related to deleveraging
  - Bank capital regulation has incentivized banks to overcollateralize their loans and limit their exposures.
  - Risks are mainly borne by private credit funds, which are likely to restrict credit and deleverage during stressed conditions.
  - Credit line drawdowns by private credit funds during stressed conditions could limit ability of banks to lend to others

- Questions
  - Do deleveraging risks of this sort require a policy response?
    - Is deleveraging excessive relative to a plausible benchmark?
    - Would there be less deleveraging if NBFI loans were on bank balance sheets?
    - Are there policy responses that mitigate the problem without exacerbating others?
  - Should NBFI growth funded by bank lending be a cause for concern or celebration?
    - \+ De-risks bank balance sheets
    - \+ Moves credit creation to less leveraged entities, maybe less deleveraging
    - \- Excessive leverage of nonfinancial sector
    - \- No access of NBFIs to LOLR