Second, our paper highlights that the line between traditional and shadow banks from a functional perspective is not clearly demarcated. Well-capitalized banks indeed behave as traditional models of banking suggest: they take deposits and use them to make loans, which they hold to maturity. Poorly capitalized banks, on the other hand, do not have balance sheet capacity and behave like shadow banks, originating loans and selling them off. The ability to do so allows these banks to originate loans despite depressed capital, offsetting some of the effects of capital tightening. Thus, without considering banks' responses on the balance sheet retention margin—deciding to sell instead of retaining loans on the balance sheet—traditional policy tools, including capital ratios and other bank capital regulatory requirements, may have limited effectiveness. On the other hand, disruptions in secondary loan markets have significant impacts on aggregate lending volume and pricing as they adversely affect the ability to lend for both shadow banks and poorly capitalized traditional banks.

More broadly, we suggest taking a broad view of government insurance subsidies and regulation in order to understand their impacts on the financial intermediation system. On one hand, traditional banks exploit cheap insured deposit financing. On the other hand, shadow banks and poorly capitalized banks predominantly rely on GSE mortgage guarantees. Our results suggest that as subsidies for banks in one sector decline, for example because of restrictive capital requirements, they tilt their activity toward other sources of taxpayer financed subsidies. Understanding the web of subsidies and regulations that pervade the financial system, their equilibrium interactions, and their impact on systematic risk and welfare remains a fruitful area for future research.