Discussion: Fueki, Huertgen, and Walker "Zero-Risk Weights and Capital Misallocation"

Juliane Begenau

Harvard Business School

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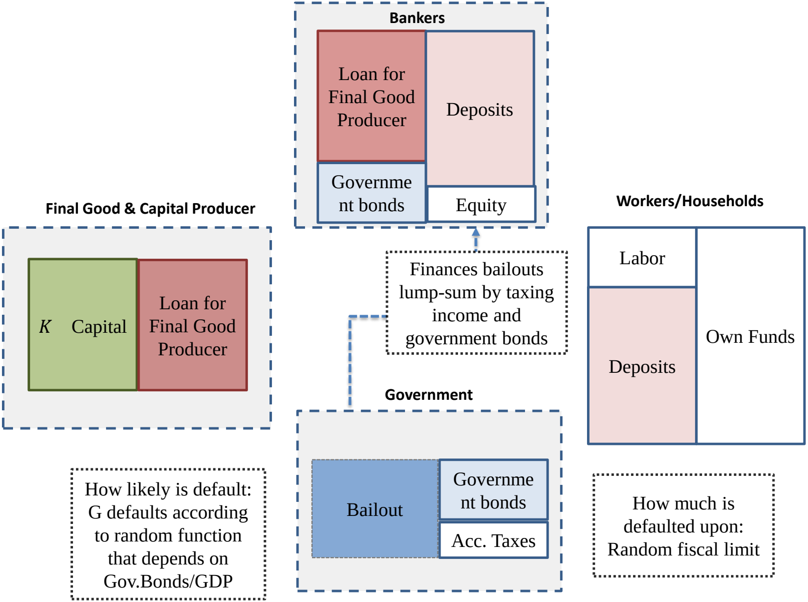
European Crisis

- Twin crisis of sovereign and banking sector
  - Weak sovereign charged with bailing out weak domestic banks
  - vice versa
- What is the mechanism?
- How *much* does it matter?
- What is the best policy responses to prevent twin crisis?

Model Overview



Problems of this economy

- Government:
  - taxes labor income to finance bailouts
  - random defaults (not distortionary per se just per feed back)
- Banks
  - subject to VaR constraint based on asset diversion threat
    - no weight on sovereign debt
      [key modelling innovation]
    - implies risks are incorrectly priced
  - choose excessive leverage because of bailout lump sum transfer
- Home bias in government debt

Key Mechanism [tentative]

- Banks own domestic government bonds
- VaR constraint gives banks incentives to ignore risk and load up on government bonds
- Government bonds crowd out valuable loans
- Government encourages excessive leverage and therefore fragility by "bailing out" banks
- Lower bank equity (higher losses) implies higher bailout transfers
- Increases: distortionary labor income tax, gov. debt, and default risk
- Increases riskiness of bonds - lowers bond payoff - lowering banks' profitability

Discussion

- Clearly an important question
- Discussion points
  - Inspecting the mechanism
    - Why do banks have a home bias for government debt?
    - Does sovereign debt crowd out loans?
    - Why don't banks properly charge for risk?
  - Policy implications

Why do banks have a home bias for government debt?

- Paradox? Home bias in sophisticated intermediaries?
- Farhi & Tirole, Matteo Crosignani's JMP:
  Government and banks benefit from symbiotic relationship
- Matteo Crosignani's JMP
  - Weak banks optimally choose to prefer domestic government debt:
  - banks buy government debt in bad times
  - government bails out banks in bad times
  - Italian bank data consistent model, i.e. highly levered banks own more government debt
- Policy implications:
  - impose diversification
  - rationale for supranational regulation

Do sovereign debt holdings crowd out lending?

- Causal?
  - e.g. Marco (2015) shows that banks that are exposed to more government debt tighten credit supply
  - can we rule out that weaker banks choose exposure to government debt ex-ante?
- More lending better?
  - no notion of excessive lending
  - what type of lending, how risky
  - example Spain: lot's of construction lending prior to bust
- Sovereign risk spillover through quantities or prices or both?

Why do banks don't charge properly for risk?

- Banks supposedly to be more sophisticated than households are not properly charging for risk
- This paper: moral hazard and bank run risk coupled w/ wrong regulatory rule
- [commercial banks: have deposit insurance preventing bank runs - perhaps rethink incentive constraint]
- In US, same rule and less problematic sovereign, still same phenomenon:
  Banks don't charge for risk properly
- Why not?
  - wrong incentives due to regulation or design of compensation
  - naive perception of risk
  - etc

Policy Implication

- Depend on mechanism
- Example:
  - View 1: weak banks choose sovereign debt over loans because they are betting for resurrection
    - valuable loans are not crowded out
  - View 2: misspecified regulation incentivizes banks to choose sovereign debt over valuable loans
    - valuable loans are crowded out
- Model implies "optimal" policy trivially: i.e. friction caused by policy - adjust policy

Conclusion

- Very interesting and ambitious question!
- Paper still work in progress
  - Mechanism and results not entirely spelled out
  - Worth to think about:
    What are the key frictions, i.e. channel of sovereign risk spill over?
    Why don't banks properfly charge for risk
    Why is there a home bias for domestic government bonds?
- Still: mechanism sounds interesting - worthwhile to see quantitative importance
- Harder to think about *optimal* policy in model with reduced forms

Note on equity issuance