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

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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**

- **Final Good & Capital Producer**
  - $K$: Capital
  - Loan for Final Good Producer

- **Government**
  - Bailout
  - Government bonds
  - Acc. Taxes

- **Bankers**
  - Loan for Final Good Producer
  - Deposits
  - Equity

- **Workers/Households**
  - Labor
  - Own Funds
  - Deposits

How likely is default:
G defaults according to random function that depends on Gov. Bonds/GDP

How much is defaulted upon:
Random fiscal limit
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 properly 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

Eurozone equity issuance running at record pace

- Deal value ($bn, year-to-date)
- Number of deals (year-to-date)

Sources: Dealogic, Eric Platt/FT