Systemic Risk and Monetary Policy: The haircut gap Channel of the Lender of Last Resort

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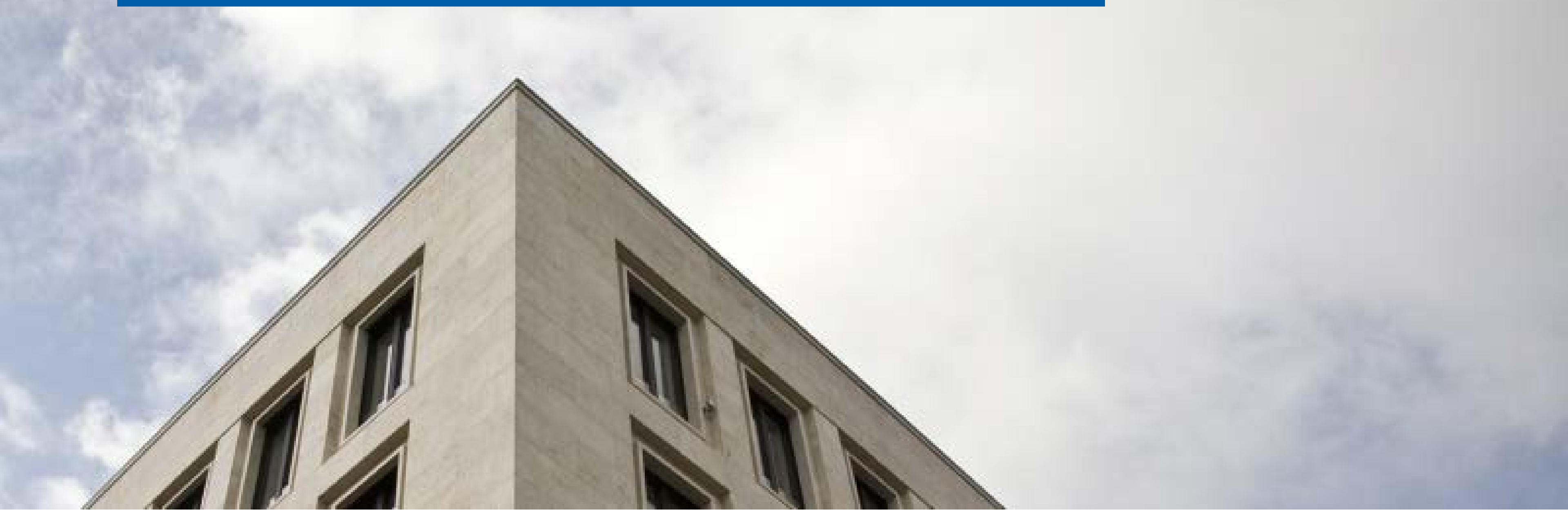
Sustainable Architecture for Finance in Europe



Paper Overview

Research question: LOLR policy, via *haircut gap*, contributes to:

- higher banks' interconnectedness
- buildup of systemic risk in the banking sector

Methodology: relate the banks' bond pledging to the haircut gap and look to:

- Domestic vs foreign in the Periphery vs Core
- Correlation between pledged bonds and the bonds of the bank pledging them
- SRISK/Size
- Cross-Holding

Paper Overview

Main Results: Haircut gaps provide incentives to:

- *peripheral* banks to pledge low-quality bonds at the ECB instead of going to the private repo market and face a higher haircut (home bias)

- Banks (peripheral?) hold and pledge domestic bonds with higher haircut gaps issued by other interconnected banks and systemically important banks (bailout expectation)

- Haircut gaps stimulates banks’ bond issuance in peripheral countries

Comment

Very interesting paper!

- New database
- Interesting questions
- The identification strategies are smart and elegant

Main Comments:

- Contribution to the literature
- Results interpretation

Comments

How different are the results with previous literature?

- Drechsler et al. 2016, document collateral policies too generous
- Fecht et al. (2016) systemic arbitrage German banks funnel credit risk and low-quality collateral to the central bank
- This paper shows instead that this behavior is largely for banks in peripheral countries, so it is related to home bias i.e. this risk taking is related to only one subset of banks.

Why is it the case? How do we reconcile the two results?

Comments

Why is it the case? How do we reconcile the different results?

- The repo market in Europe is largely segmented. In some cases banks became completely cut off from the wholesale funding markets and this further increased their dependence on the LOLR funding (see e.g., Alves et al., 2016)”

- The ECB charges an interest rate on the main refinancing operations (MRO) higher than the one charged on private repo funds. This represents a `penalty' for borrowing from the LOLR and imposed a cost on banks for taking up haircut subsidies“. Are results different for LTRO where the rate was fixed?

Comments

Why is it the case? How do we reconcile the different results?

- Why the ‘penalty' for borrowing from the LOLR is not enough to prevent peripheral countries banks to pledge banks bonds (as it seems to be the case for core countries banks)?
- What are the specific frictions of collateral banks’ bonds with respect to sovereign bonds?

- Why are banks not holding cross border banks bonds?

Segmentation might explain why banks in peripheral countries massively use CB liquidity facilities or LOLR more than those that have the option to borrow in the „private“ repo market. Then exploiting the haircut gap seems perfectly rational

- Is it the Haircut Gap channel that drives the results or some mkt segmentations?

Comments

The Haircut Gap is calculated with respect to the “private” repo market as well as the rate.

- *How large is the repo market for banks bonds? What are the volumes? According to Eisenschmidt et. al. (2021) not so large.*

- *Why the private market haircuts are not available at a monthly basis for the different bonds?*

- *106k unimputed observations for private mkt haircuts vs 2.6m for the analysis filled with the Random Forest procedure. Is it because there are no transactions?*

- *The results are robust also for the unimputed observations, but more statistics should be provided.*

Comments

What is the role of Sovereign risk and sovereign risk ratings in driving the results on correlation/SRISK/Size for peripheral countries?

- *interconnectedness/correlation might be driven by common exposure to sovereign risk*

- *Size (and bailout) might be related to the evolution of sovereign risk (not captured by Bank FE)*

It would be nice to see if all the results regarding interconnectness and systemic risk are related to sovereign risk and ratings sovereign risk ceiling (Almeida et al. (2017)

Comments

What are the alternatives for the peripheral banks to get funding?

Why does the ECB set up a haircut system that is generally detached from the market's perceived riskiness of the underlying asset?

- *Is ECB generally "bad" at monitoring the collateral value?*
- *Is this ECB policy a conscious policy decision because the "counterfactual" would be even more systemic?*
- *Is this decision justified by some market frictions?*

Comments

Why banks hold banks' bonds?

- *Is this cross holding a substitute of the uncollateralized interbank mkt (i.e. banks loans)? Bluhm at al. (2016) Interbank intermediation*
- *Is the structure of the cross-holding similar to the structure of the interbank mkt before the crisis (home bias)?*

Why does the ECB allow banks to pledge their own banks' bonds?

How large is the volume of the own banks' bonds pleadged?

…….

Comments

The Haircut Gap channel stimulates bank bonds' issuance in distressed economies.

(b) Issuances

- Is it good or bad? Does it increase leverage? Is it substituting other source of funding (for example the uncollateralized interbank market)?

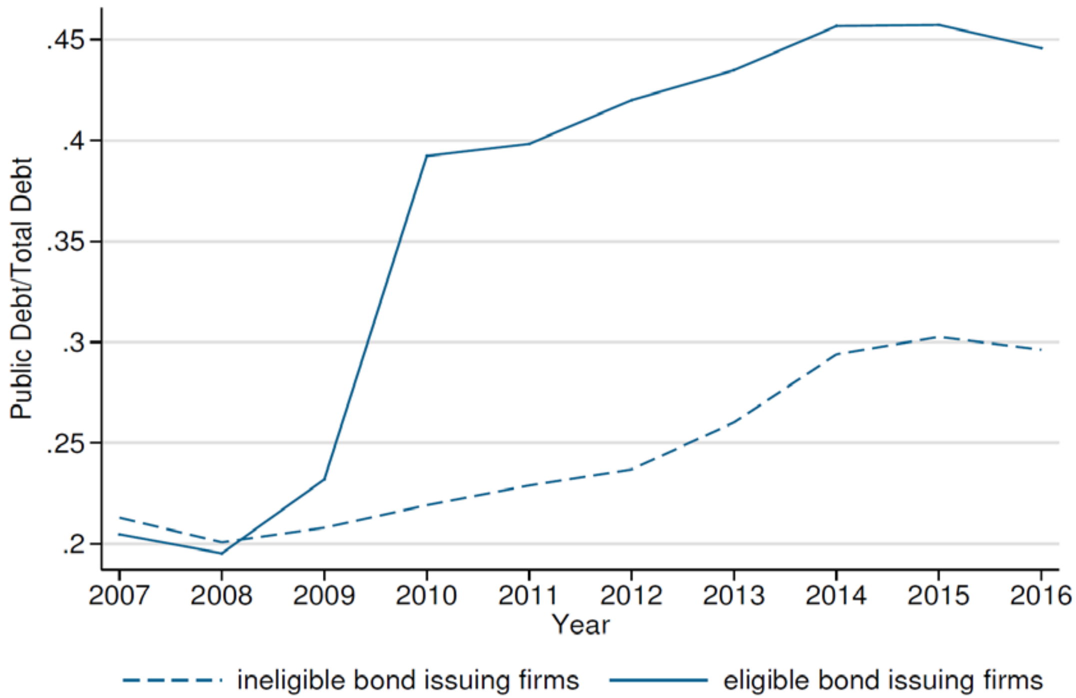
What about the collateral eligibility channel?

Comments

What about collateral eligibility channel for non-financial corporate bonds?

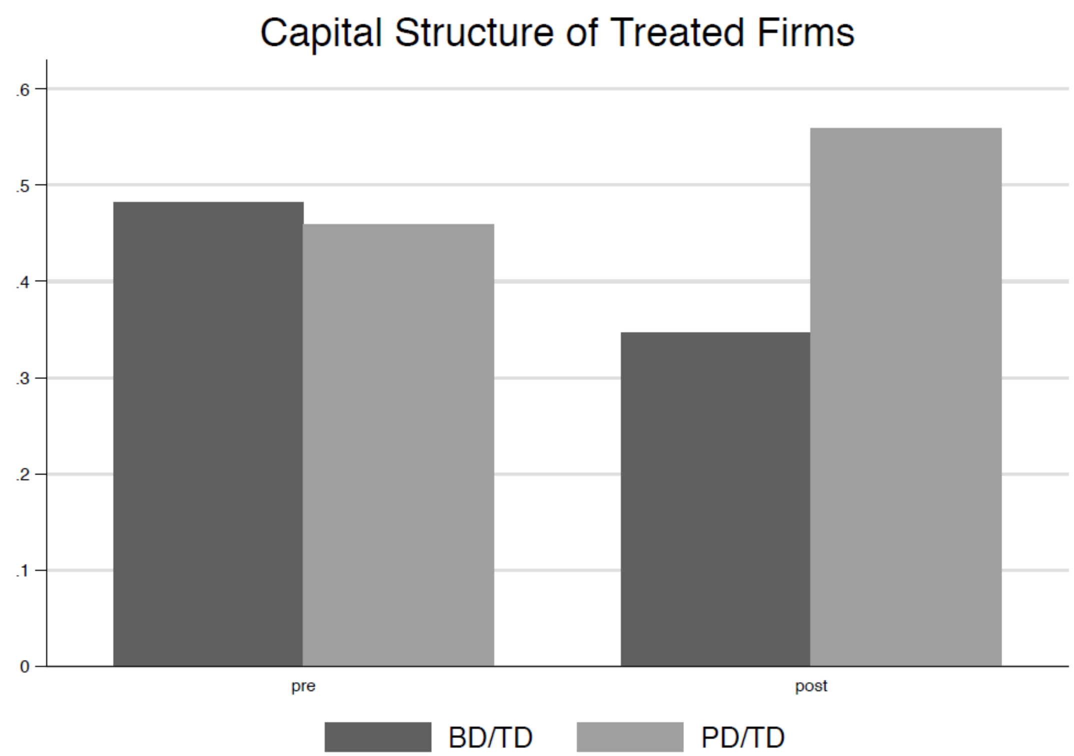
Pelizzon et al. (2020) Collateral Eligibility of Corporate Debt in the Eurosystem

Capital structure effects of collateral policy:
Public debt share of bond issuing firms (Unconditional analysis)



Comments

What about collateral eligibility channel for non-financial corporate bonds?



Pelizzon et al. (2020) Collateral Eligibility of Corporate Debt in the Eurosystem

Very interesting paper!

Enjoy reading it!