DISCUSSION OF:

Bailouts, Moral Hazard, and Banks' Home Bias for Sovereign Debt

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The issue

- Banks in the Eurozone are holding a lot of govt. bonds
  - which might seem like a good thing, except …
- Holdings are strongly concentrated in home-country bonds
  - despite the lack of exchange-rate risk in other govts' bonds
  - and the obvious gains from diversification
- Why?
- "Usual" story involves moral suasion by domestic govt.
- But this home bias creates a dangerous situation
  - fiscal health of govt and domestic banks are tied together
  - either govt is shortsighted or something else is going on

Incentives

- Perhaps: who holds the debt affects the govt's incentives
  - home bias could emerge as a way to alter govt behavior
  - is this far-fetched? Let's think about an example
- If domestic banks are important to the economy …
  - because losses at banks create a credit crunch
- … then having them hold the debt encourages govt to repay
  - ≈ hostage-taking (or a doomsday device)
- In fact, domestic banks may be willing hostages (in eqm)
  - because the bonds are worth more in their hands

⇒ Home bias as an incentive mechanism seems plausible

This paper

- Identifies another possible incentive channel: Bailouts
- Key elements of the environment:
  - govt is tempted to enact bailouts following a bad shock
  - anticipation of bailout undermines bankers' ex ante incentives
  - bailout hurts current bond holders through price effect
- Instead of preventing default, focus is now on preventing bailouts
- But the mechanism has a similar flavor
  - to deliver the government from temptation …
  - make sure that the action hurts banks …
  - by having banks be the existing bond holders ⇒ home bias

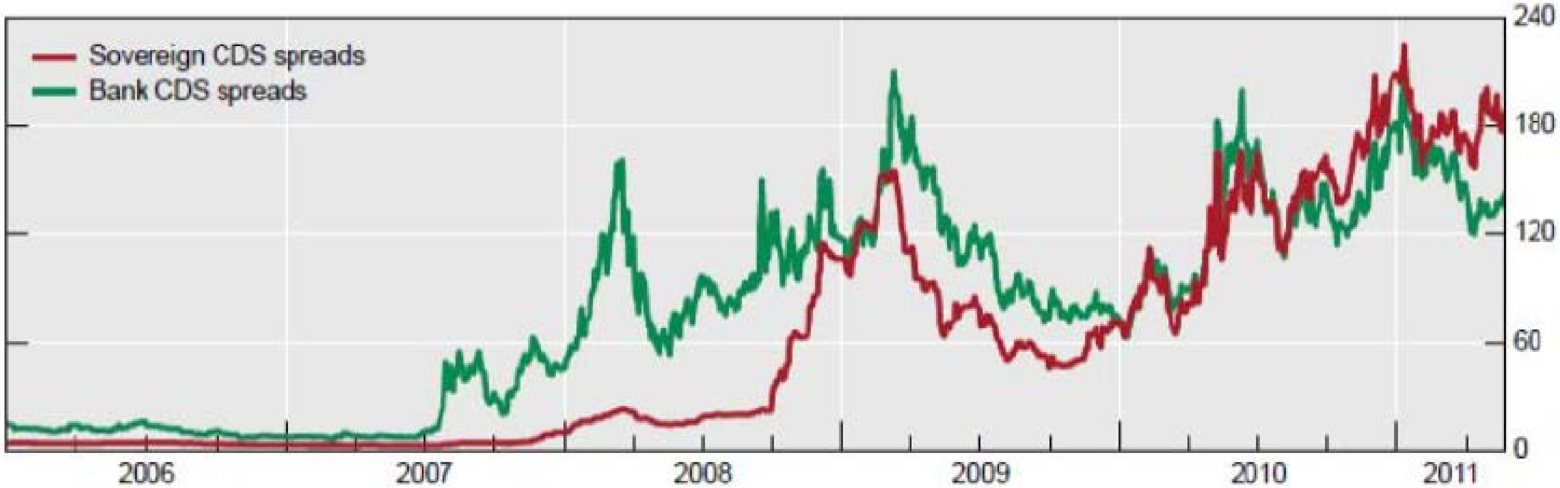
Comments

- Interesting paper
  - identifies a novel mechanism that may be important
- Raise some questions:

1. Do bailouts of banks hurt existing bond holders?
2. Do we want to prevent (all) bailouts?
3. Are (individual) banks willing hostages?

1) Do bailouts hurt existing bond holders?

- In the paper, bailouts increase the probability of default by the government
  - a key step in the mechanism of home-bias-as-commitment
- At first glance, evidence seems consistent with this view



Source: JPMorgan Chase.

- But we need to be careful about the comparison

- Negative shocks to the banking system are bad news for govt bond holders for two reasons
  - if govt bails out ⇒ increase in debt outstanding
  - if no bail out ⇒ likely decrease in tax revenue
- In the paper, only the first channel is present
- Suppose instead the govt taxes banks in final period
  - or, more generally, revenue depends on health of banks
  - then enacting a bailout may *decrease* the likelihood of default (need to save the banks to have any hope of repaying the debt)
- Which channel is stronger in practice?
  - to what extent does the 2nd remove the benefits of home bias?

2) Do we want to prevent (all) bailouts?

- In many settings, constrained efficiency requires ex post allocation to be inefficient in some states
  - here: threat of inefficient liquidation induces effort from bankers
- Ex post, govt may want to intervene, restore efficiency
  - this is one view of what a "bailout" is
  - here: govt raises resources to prevent liquidation
- Private agents anticipate this intervention, of course
  - undermines their ex ante incentives → constrained inefficiency
- Goal: find a way to commit/convince the govt to stay out
  - in all states of nature

A different view

- In other environments, bailouts bring *ex ante* benefits
  - part of an efficient social risk-sharing arrangement
  - also may help prevent/mitigate self-fulfilling runs
  - see Green (2010), Bianchi (2016), Keister (2016)
  - and (in a way) Champ, Smith and Williamson (1996)
- Constrained efficient allocations then involve bailouts
- But decentralized outcomes may be still be inefficient
  - may require restrictions on their size/scope of bailouts
  - and perhaps other regulation to offset incentive distortions

Q: Would home bias be useful in these settings as well?

In other words

- The paper shows how home bias in bank bond holdings can prevent bailouts
- Suppose we don't want to go that far
  - want only to limit the size or scope of govt action
  - or offset its effects on incentives without eliminating the risk sharing
- Is home bias in bond holdings helpful in these situations?
  - now comes with a real cost when a bailout occurs
- Or are the results special to situations where a no-bailouts commitment is desirable?

3) Are (individual) banks willing hostages?

- Going back to the case of preventing default:
  - we said banks are willing hostages (i.e., want to hold the debt) collectively
  - but there may be a free-rider problem
- If other banks are holding enough debt to convince the govt to repay …
  - … I might prefer to hold other, higher-earning assets
  - seems especially true if default happens in some states
- Q: Does the same issue arise for the case of bailouts?
  - if so, what arrangements are needed to overcome it?
  - role for (far-sighted) moral suasion?