Discussion of "*Assessing bank leverage through flows: an early warning tool of risk-taking*" by Javier Villar Burke

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What does the paper do?

- This paper asks to reconsider and more precisely capture our concepts of leverage.
- In particular the paper points out that it is important to distinguish leverage on new lending from leverage in existing lending.
- The paper proposes a flow data based measure of leverage - the marginal leverage ratio - with respect to new lending for banks.

What does the paper find?

- Marginal leverage ratio captures conditions for new credit better than balance sheet based leverage definitions.
- Marginal leverage ratio shows a more pronounced effect of leverage built-up and deleveraging in the banking sector than balance sheet based leverage ratios.

Why are these findings important?

- Clearly for monitoring purposes a measure that more closely gauges new developments in credit is better than an instrument that captures more the average developments in the past.
- Leverage makes agents more sensitive to changes in asset prices. Monitoring leverage is monitoring systemic risk.
- The measure is conceptually attractive because it does not excessively rely on stochastic modeling.

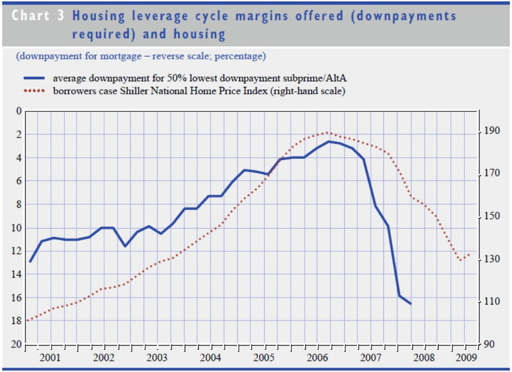
What would we like to capture in theory?

I think the link between leverage on new lending and the flow data could be made more precise by distinguishing

- Leverage at the level of asset classes.
- Leverage at the level of particular investors or individuals.
- Leverage at the level of institutions.

For the link with the economic theory of leverage, leverage at the level of asset classes is a key concept. It would be interesting to link the flow measure with such concepts. (See Geanakoplos and Pedersen, 2013, Monitoring Leverage.)

An Example from Geanakoplos 2010



Do the flow data capture the right thing?

- Leverage on new loans reveals the state of the macroeconomy more quickly than leverage on old loans. Often these leverage measures go in opposite directions.
- We have to ask whether the flow measure suggested in this paper is actually capturing new lending conditions.
- From a macro prudential perspective we would perhaps be interested to monitor leverage not only for banks and financial institutions but also for households and firms.

What can we take away from this analysis?

- The distinction between marginal and average leverage is important and a key distinction. If we want to monitor leverage, marginal leverage is the thing we would like to look at.
- The idea to capture new lending conditions by looking at flow data is interesting but the connection to a rigorous notion of marginal leverage and to the theory of leverage and the leverage cycle has yet to be analyzed more deeply.