Discussion of: “Regulating the Doom Loop”

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Summary

- The paper simulates reallocations of euro area banks' sovereign bond holdings under different potential regulatory regimes:

  ✓ ***Price-based*** vs ***quantity-based*** tools
  ✓ Targeted at ***concentration*** or ***credit risk***

  ➡ 2 X 2 matrix

Objective

Shed light on the two following questions:

- Would regulatory reforms on banks' sovereign exposures induce banks to reduce concentration in those exposures?
- Would reforms reduce banks' exposures to sovereign credit risk?

Summary

***Three key assumptions*:**

- Aggregate holdings of euro area sovereign bonds are inelastic with respect to their regulatory treatment.
- Banks prefer to maintain their current composition of sovereign bonds.
- Banks' portfolio composition is elastic with respect to regulation.

In response to regulatory reform, banks retain their aggregate sovereign bond holdings but adjust portfolio composition to minimize capital requirements.

***Results*:**

- **Tension in regulatory design** between lowering concentration and lowering credit risk.
- The existence of a **euro-denominated asset that embeds both low concentration and low credit risk** would make financial markets more complete by expanding the set of investible securities.

Comments

- Based on the simulation results (section 5 of the paper), would it be adequate to conclude that **quantity-based tools** may be less effective than **price-based tools** in achieving the aforementioned objectives (and that the former may even lead to "unintended consequences")?
  - ✓ "quantity-based tools to target credit risk can be less effective than price-based tools in reducing credit risk exposures, including price-based tools that are calibrated to target concentration."
  - ✓ **Quantity-based tools to target credit risk**: credit risk may even increase in some scenarios.
  - ✓ **Quantity-based tools to target concentration**: the increase in sovereign credit risk may be quite substantial.

- Can the results of the paper be used in the debate about the regulatory treatment of an **area-wide low-risk assets** (Sovereign Bond-Backed Securities)?

Comments

- Is the simulation method, including the three reinvestment rules (prudent/base/imprudent cases), adequate/sufficient to assess the adjustment in banks' portfolio composition taking into account, not only the regulatory requirements, but other factors that influence such composition (such as the expected return)?
- **General vs Partial Equilibrium Analysis**
  - ✓ The literature review shows that there are many trade-offs underlying the introduction of the regulatory treatment of the sovereign.

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  - ✓ General equilibrium discussion may be needed.
  - ✓ e.g.: market depth for public debt and reallocation of bank sovereign exposures across banks; deleveraging needs; interaction with other regulatory requirements (e.g., liquidity requirements); impact on national sovereign debt markets, especially in periods of stress.

Comments

- **Normal vs Crisis Times**
  - Any potential change to the RTSE should take into consideration its impact, not only in normal times, but also in crisis times.
  - Which shock absorbers would be in place to replace the role that domestic banks played in the past, taking into account that the Banking Union is still incomplete?