Discussion of

"A Pyrrhic Victory? Bank Bailouts and Sovereign Credit Risk"

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Extensive Paper

- Explores facets of relationships between banks & sovereigns
  - **Theoretical model**
    - Solves for optimal transfer from govt to banks under different scenarios
    - Shows feedback effects between solvency of banks and sovereign
    - Extends results to scenario of uncertainty about future output
    - Extends results to scenario with govt. guarantees
  - **Empirical analysis**
    - Different patterns for changes in sovereign & bank CDS in different periods
    - Estimates effect of financial sector risk & debt levels on sovereign risk
    - Estimates effect of sovereign credit risk on bank credit risk—in aggregate and with various bank-level controls
    - Estimates effect of holdings of foreign govt. bonds on bank credit risk
  - **Specific country examples:** Ireland versus Iceland
  - **Summary of related literature**

My Comments

- Overall contribution
- Key questions
- Suggestions

Overall Contribution

- Key findings:
  - When countries bailout financial sector, this transfers risk from financial sector to sovereign
  - When sovereigns guarantee financial system, changes in sovereign risk are correlated with changes in risk to overall financial system
- Is this surprising?
  - Logical
  - Historic examples
- But was this given appropriate consideration in recent policy decisions?
  - Irish bank bailout in 2008
  - Spanish bank support
- Paper important: highlights key issues and channels for policymakers
  - Shows "possible effects" can be significant and important in magnitude

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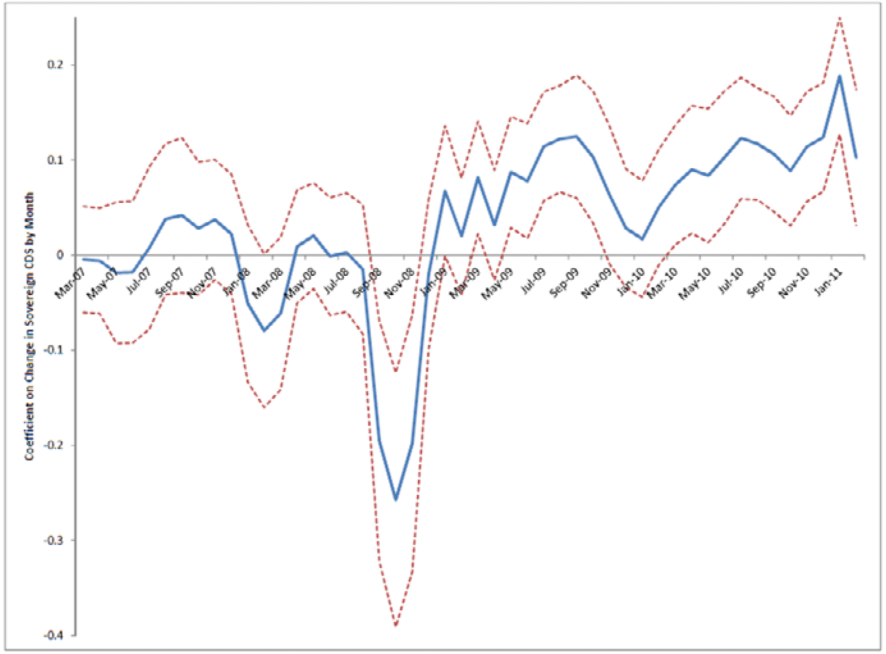
Key Questions (1)

- Why don't relationships between sovereigns and banks exist pre-crisis?
  - Does relationship only exist in periods of stress to banks? Or to sovereigns?
  - Or only during periods of heightened global stress?
  - Are there nonlinearities? What triggers them?
  - Is the post-Lehman period unique?

Figure 9: Correlation of Bank and Sovereign CDS



- Answer has important implications

  Does support for banks need to come from entity other than sovereign in perpetuity?

  Is euro area enough?

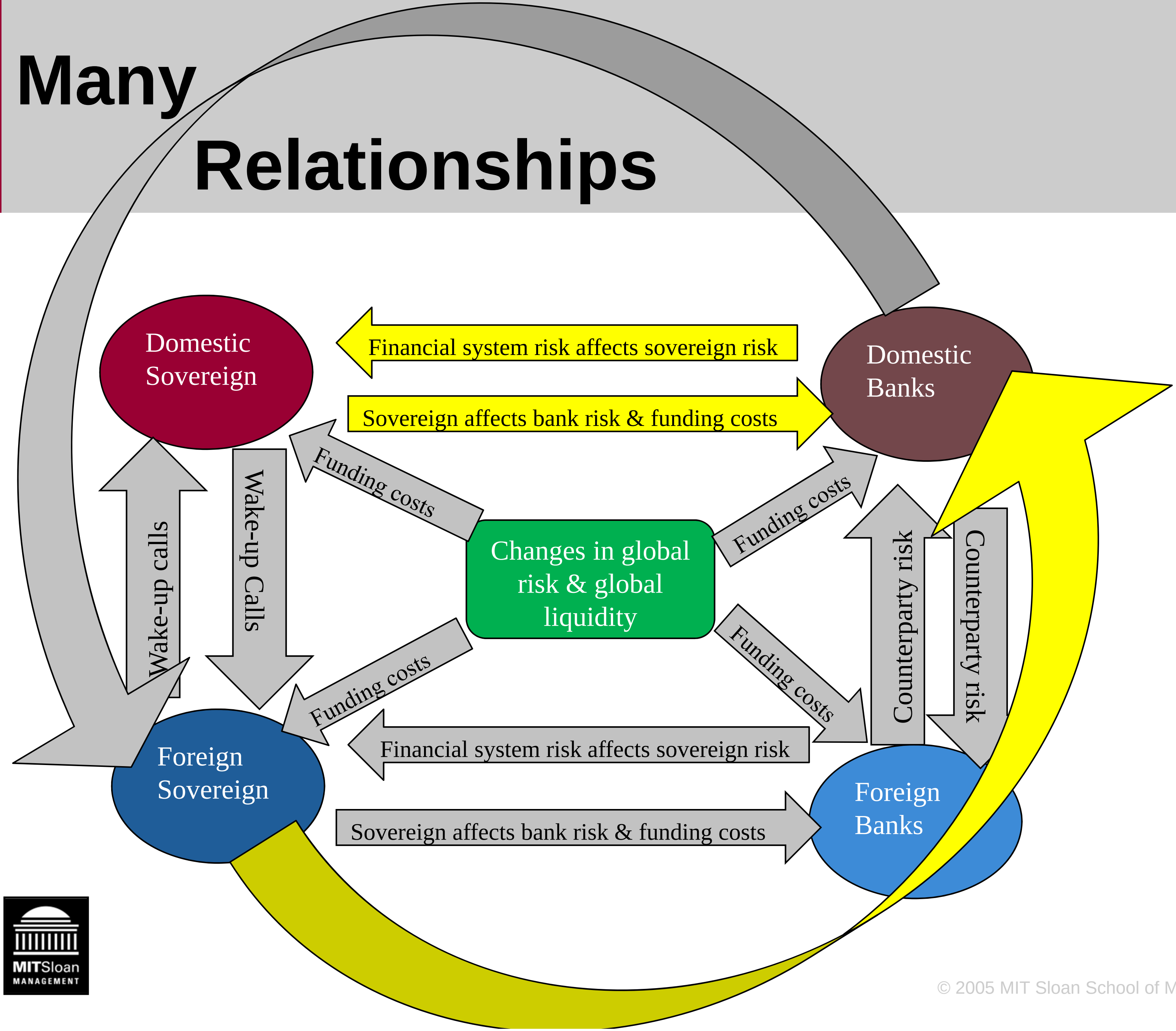
Key Questions (2)

- Exactly what is driving these relationships?
  - Paper proposes one model
- Hard to isolate causality and channels
  - Results support models predictions
  - But could also be other explanations for observed patterns
  - Authors are careful, readers need to be also
- Some examples:
  - Omitted global variables (risk)—which could explain changes in relationships across all countries at same time
  - Endogeneity?

    (1) $\log(\text{Sovereign CDS}_{jt}) = \alpha + \gamma \log(\text{Financial Sector Distress}_i) + \beta(\text{Pre-Bailout Debt}_i) + \varepsilon_i$

    (2) $\Delta\log(\text{Bank CDS}_{jt}) = \alpha + \beta\, \Delta\log(\text{Sovereign CDS}_{jt}) + \gamma\Delta\chi_{ijt} + \varepsilon_i$

Many Relationships



Suggestions

- Focus on more concrete tests of channels:
  - Extended analysis using bank-level data to identify channels
    - Some existing results a start
    - But why are many results controlling for firm-level variables in current draft insignificant?
  - Promising: results at end using bank-level holdings of foreign sovereign
    - But why not also include measure for holdings of own country debt?
- Bankscope data—only information on larger banks
  - What about Spanish cajas, German landesbanks, etc?

Final Thoughts

- Important paper pushing forward discussion of relationship between banks and sovereigns
  - Verifies many patterns would expect
  - Pushes deeper to understand relationships
- But extremely complex interrelationships
- Will need many more papers to fully understand
  - Key question—why do these relationships only exist at certain times?
  - Promising path—utilize differences across banks within countries to identify effects