Lender of Last Resort, Buyer of Last Resort, and a Fear of Fire Sales in the Sovereign Bond Market

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The paper

Empirical puzzle

- Increase in sovereign and financial sector credit risk following LTRO1 (LOLR)
- Permanent stabilization of bank and sovereign risk after the OMT (BOLR)

Explanation

- Fire sale risk channel à la Diamond and Rajan (2011): weak banks holding illiquid assets worsen fire sales
- *In spite of* a holdings channel increasing the collateral value of sovereign bonds

Empirical evidence

- Rotation of GIIPS sovereign from non-GIIPS banks to GIIPS banks after LOLR
- Non-banks re-exposed themselves to GIIPS sovereign debt after the OMT (not LTROs)
- Bank risk predicts sovereign risk in the post LTRO/pre-OMT period, before the LTRO and after the OMT, it's the other way around
- The sensitivity of sovereign risk to bank risk increases when banks hold a larger fraction of their assets in home sovereign bonds

Discussion

1. Anticipating fire sales in a LTRO world
2. In defense of the holdings channel
3. Additional sources of heterogeneity to build the fire sale channel case

Anticipating fire sales in a LTRO world

- Diamond and Rajan (2011): weak banks holding illiquid assets will worsen fire sales
- Here: the fire sale risk is triggered by a reallocation of risky assets from sounder to weaker banks ... triggered by a LOLR intervention .... supposed to prevent fire sales
- Liquidity infusion as a fire sale channel solution in Diamond and Rajan (2011):

  > "if the government **could commit** to doing this on a sufficiently large scale the [...] fire sale would be eliminated"

- Implicitly, are we considering an ECB commitment issue at the time?
- Is the risk stabilization an OMT effect or a LOLR credibility effect?
- OMT is conditional on access to private markets
- What difference does the sovereign bond purchase program make, on top of 'whatever it takes'?

Suggestions:

i. Using OMT announcement date (August/September) instead of 'whatever it takes' speech date (July)

ii. Analyze behavior around OMT credibility shocks (June 13, June 15, June 16)

In defense of the holdings channel

The OMT effect documented in the paper is not related to bond holdings:

- Domestic sovereign bond holdings Explain the influence of sovereign risk on bank risk pre-LTRO only
- Beneficial effect on abnormal performance of sovereign holding around LTROs but nothing around the OMT

On the interbank market, the sovereign bond holdings channel was alive before the OMT (Gabrieli, Labonne (2018))

- Sovereign bond holdings raised interbank market rates post-LTRO/pre-OMT
- The OMT killed the pricing in of sovereign bond holdings on the interbank market
- Suggesting that the OMT effect is indeed sovereign bond holding related?
- Consistent with a reduced likelihood of fire sales story ?

Delineating holding and fire sale risk channels requires disentangling two very related questions: How much do you own? And who owns it?

- Holdings: sovereign bonds/assets
- Fire sales: sovereign bonds/Tier 1

Suggestion: Using the delay in portfolio allocation decision-making

- Insurance companies might take a while to come back to the market
- Extract the timing of the renewal in exposures using your own methodology
- Do you see the bank -> sovereign channel weaken further when they are back?
- Immediate effect would be a holding effect and the later effect would be the reshuffling associated with the fire sale channel

Additional sources of heterogeneity to build the fire sale channel case

The fire sale risk mechanism requires weak banks seeking illiquid assets

- Not necessarily *sovereign* bonds
- Not necessarily *domestic* bonds

In the paper, using domestic sovereign bonds in GIIPS opens a lot of room for endogeneity concerns

- Obviously, no perfect control group for this question!
- Can you make an ally of cross-country or cross-asset spillovers?

Suggestions:

i. Use capital ratios (EBA data) to interact the effect with banks' health (as in Appendix D)

  more flexible than GIIPS/non-GIIPS to separate sounder and weaker banks

ii. Use other asset classes (EBA data report corporate and retail assets):

  Are banks binging on any other illiquid assets?

  Do they have the same consequences on sovereign CDS?

  Do you see corporate CDS reacting to weak banks buying corporate debt?

Minor comments

Is a domestic sovereign bond more liquid than a foreign one?

- Does it make any difference that they buy domestic bonds and not other types of illiquid sovereign bonds?

Use a measure of market share instead of assets share to grasp concentration

- Replace sovereign bonds/assets with sovereign bonds/size of sovereign debt market
- Or control for the size of the market

In Diamond and Rajan (2011), there is contagion to sound banks’ lending because of the incentives to hold cash and benefit from high returns in the fire sale

- Any chance you could look into that with your data?

Why you should read it

A thought provoking take on the LOLR effects and the bank-sovereign nexus

- Who is holding the bonds modifies their pricing and creates all sorts of unexpected effects of a policy intervention

An impressive data exercise

- Allowing us to look into the sovereign debt crisis from the US MMFs all the way to GIIPS banks assets composition
- with a detour through non-banks behavior