

A photograph of a modern building facade with a curved, metallic, gold-colored exterior and large windows. The building is set against a clear blue sky.

Discussion of "Global banks and synthetic funding: the benefits of foreign relatives"

By Fernando Eguren-Martin, Matias Ossandon Busch and Dennis Reinhardt

Discussed by Előd Takáts

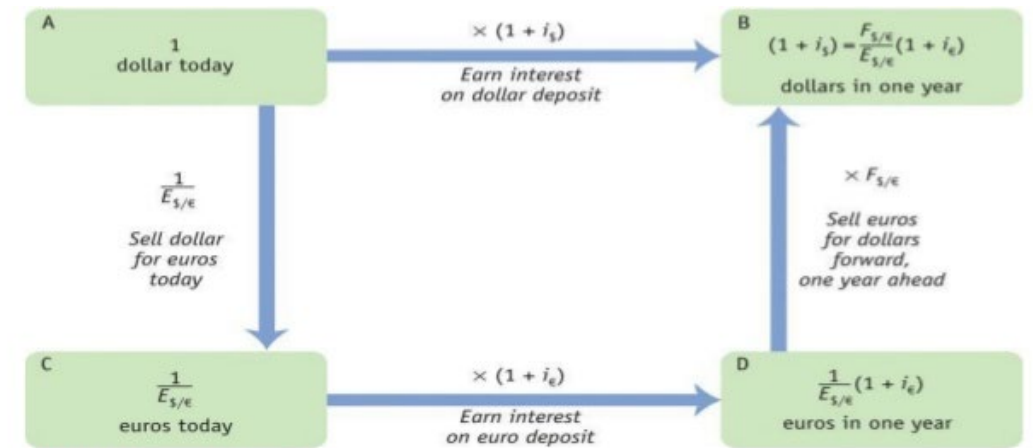
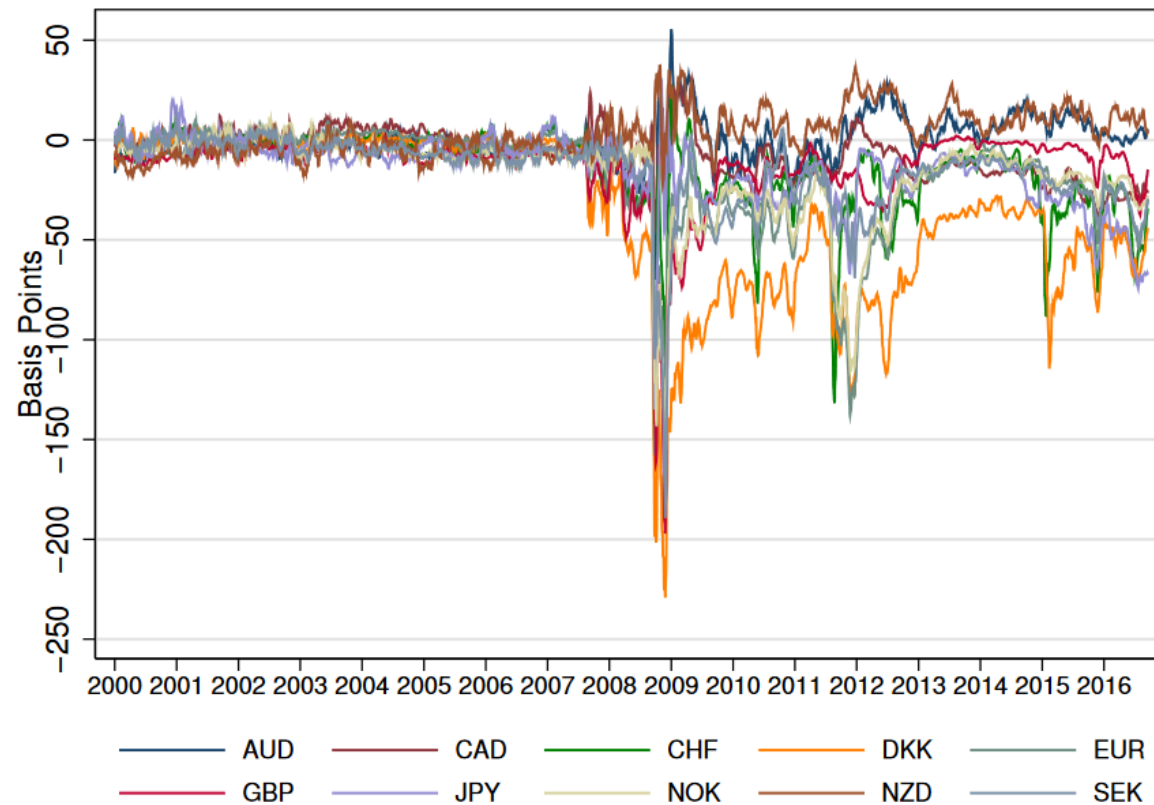
4th BIS-CGFS workshop on "Research on global financial stability: the use of BIS international banking and financial statistics"

The views expressed in this presentation are those of the author and do not necessarily reflect the views of the Bank for International Settlements

What does the paper analyze?

- Analyze how CIP (covered interest rate parity) violations affect cross-border bank lending
 - Hypothesis: larger effect for those banks that are more reliant on synthetic funding
 - Logic: CIP deviation affects cost of funding – therefore loan supply
- Examine whether having foreign “relatives” changes this impact
 - Hypothesis: internal capital market lessons CIP deviation shock
- Use data on global bank operating from the United Kingdom
 - Ideal: financial center
- Use GBP-USD and GBP-EUR CIP deviations
 - Logic: easier access to GBP funding in the UK

What are CIP deviations?



Arbitrage and Covered Interest Parity Under CIP, returns to holding dollar deposits accruing interest going along the path AB must equal the returns from investing in euros going along the path ACDB with risk removed by use of a forward contract. Hence, at B, the riskless payoff must be the same on both paths:

$$(1 + i_s) = \frac{F_{\$/\epsilon}}{E_{\$/\epsilon}} (1 + i_\epsilon)$$

Not completely new: 1970s
See Frenkel and Levich (1981), for instance

Figure 2: Short-Term Libor-Based Deviations from Covered Interest Rate Parity:

Source: Du et al, 2018

What do the authors find?

- CIP deviations affect those banks more which are more reliant on synthetic funding
 - A bank with one standard deviation higher reliance on synthetic funding than average
 - And a 14 basis points (one standard deviation) widening in GBP-USD CIP deviations
 - This bank cuts back USD lending by 1.4 percentage point compared to the average bank
- Advantages of foreign relatives: access to internal capital markets lowers the impact

How do the authors undertake the analysis?

- Panel regression

$$\Delta L_{i,j,k,t} = \alpha + \beta_1 RSF_{i,k,t-5} + \sum_{l=1}^4 \beta_{2,l} \Delta CIP_{k,t-l} * RSF_{i,k,t-5} \\ + \beta_3 \Delta L_{i,k,t}^{\neq k} + \beta_4 X_{i,t-1} + \gamma_{i,j,k} + \delta_{j,k,t} + \epsilon_{i,j,k,t}$$

- Saturate with fixed effects to absorb confounding factors following Khwaja and Mian (2008)
- RSF: reliance in synthetic funding
 - Note lagged timing vis-à-vis CIP!

How could the authors further strengthen the paper?

– CIP deviation and big banks

- At first, straightforward logic: CIP deviation affects cross-border bank lending
 - Similar to say Takats and Temesvary (2016) on the currency dimension of cross-border bank lending which looks at the impact of monetary policy on cross-border bank lending
- However, when you think more about it: CIP deviation is (in good part) caused by the banks
 - Demand and supply: Abbassi and Brauning (2018); Cenedese et al (2018); Avdjiev et al (2016); Sushko et al (2018)
- Though the paper says it focuses on consequence and not drivers, it is not that simple
 - Timing helps but does not resolve the issue
- Constructive suggestion: repeat the analysis for smaller banks (for whom CIP deviation is reasonable exogenous)

How could the authors further strengthen the paper?

- co-determination of CIP deviation and RSF

- Co-determination of RSF and CIP deviations can be a problem
 - Banks might set up balance sheet expecting CIP deviation structure
 - Aggregate RSF positions affect CIP deviations, in turn
- Whereas authors implicitly assume independence
- Constructive suggestion:
 - Investigate independence of CIP and RSF empirically (eg regressions) to show that co-determination is no cause for significant concern
 - Again, dropping big banks for robustness could help

How could the authors further strengthen the paper?

– negative RSF

- RSF: reliance in synthetic funding
 - measured as residual of on balance sheet assets and liabilities in a currency

$$RSF_{i,k,t-l} = \frac{Claims_{i,k,t-l} - Liabilities_{i,k,t-l}}{Claims_{i,k,t-l}}$$

- But negative values are artificially set to zero (in footnote 10)
- Not clear why: CIP deviations would affect bank even if it is synthetic lender!
 - Omission of negative RSF can bias the results
- Constructive suggestion: allow negative values

Minor comments

- Show the two CIP deviation used in the paper (GBP-USD and GBP-EUR) in the chart
- Introduction sentence: could mislead some by focusing on a slightly different issue
 - USD originated outside the US is NOT USD originated backed by synthetic funding (Borio et al, 2017)
- To which degree can we generalize from UK experience? More discussion?
- GBP-USD and GBP-EUR CIP deviations are not independent: clustering
- Technical: RHS of panel regression does not have country j dimension?

$$\begin{aligned}\Delta L_{i,j,k,t} = & \alpha + \beta_1 RSF_{i,k,t-5} + \sum_{l=1}^4 \beta_{2,l} \Delta CIP_{k,t-l} * RSF_{i,k,t-5} \\ & + \beta_3 \Delta L_{i,k,t}^{\neq k} + \beta_4 X_{i,t-1} + \gamma_{i,j,k} + \delta_{j,k,t} + \epsilon_{i,j,k,t}\end{aligned}$$

Conclusion

- Clear, well-written and thoughtful paper
- Relevant question: what do CIP deviations imply on cross-border bank lending?
- Straightforward methodology: panel regression with saturating fixed effects
- Policy relevant and intuitive findings:
 - CIP deviations affect banks which are more reliant of synthetic funding
 - Access to internal capital markets lowers the impact