Discussion of:

Global Banks and Systemic Risk:

The Dark Side of Country Financial Connectedness

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4th BIS-CGFS workshop, Basel, 12/12/2019

Paper investigates implications of banks' exposure to more financially connected countries for their systemic risk

- **analysis of relation between international exposures and banks' systemic risk**
  - accounting for countries' connectedness
  - covering major US BHCs over 2005-2016
  - utilization of most prominent market data based systemic risk measures
  - investigation of channels and accounting for bank heterogeneities

- **results point towards that …**
  - banks with foreign exposures in more financially connected countries are more risky

- **work contributes by …**
  - providing more differentiated view on international dimension of banks' systemic risk
  - possibly distinguishing good vs. bad diversification

Interesting and relevant analysis!

- **… very interesting & policy relevant question!**
  - relates to risk assessment and macroprudential regulation
- **… analysis is a huge data effort!**
  - many dimensional foreign exposures, risk measures and other
- **… well structured and written!**
- **but some questions remain:**
  - econometric specification
  - possible omitted variables
  - instrumental variable
  - some minor points

How does the weighting in the econometric model happen?

- **weighted regression approach is applied**

$$SystemicRisk_{i,t}=\alpha_i+\beta*FinancialConnectedness_{j,t}+\gamma*W_{j,t-1}+\delta*X_{i,t-1}+\zeta*Z_{t-1}+\varepsilon_{i,j,t}$$

  – is FinancialConnectedness (and W?) weighted by the country share in foreign exposures in t?
  – then, does the key variable vary by bank/country/quarter?
  → why not include bank*quarter and country*quarter FE?

  – could this be boiled down to a variable FinancialConnectedness*ExpWeight?
  – how does this variable vary, over time and cross-sectionally?
  → add descriptives!

Maybe ΣFinancialConnectedness*ExpWeight$_{i,t}$ captures something else?

- **risk variables are functions of equity returns**
  - can be rationalized in terms of standard balance sheet indicators of bank financial soundness and systemic importance [Brownlees and Engle 2010]
  - C&I lending is positively related to MES [Idier et al. 2013]

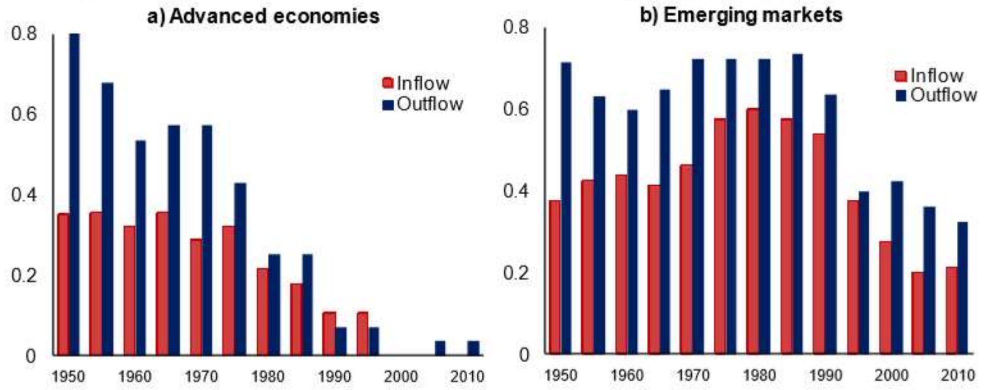
- **what changes over time in FinancialConnectedness$_j$ or ExpWeight$_i$ are observable?**
  - could C&I lending be the 'true' risk determinant?
  - → is interaction correlated with total C&I lending?

- **estimations include bank fixed effects**
  - *within*-variation is exploited
  - how much variation in risk and exposures across banks?
  - → consider RE estimations?

Is a 3-decade lag of capital controls an adequate instrument?

- Instrument: capital controls in 1975 for financial connectedness measure
- Observation: substantial reduction in capital controls over last decades.
- Question: does the cross-sectional distribution in 1975 match the distribution in the sample period?

Figure 6. Capital Controls in Advanced and Emerging Market Economies, 1950–2010



Source: Authors' estimates based on IMF's AREAER (various issues).
Note: Advanced countries include the G7 countries (Canada, France, Germany, Italy, Japan, United Kingdom, and United States). Emerging markets include those that were IMF members in 1950 (Argentina, Brazil, Chile, Colombia, Ecuador, Egypt, India, Indonesia, Korea, Malaysia, Mexico, Pakistan, Peru, Philippines, South Africa, Thailand, Tunisia, Turkey, Uruguay, and Venezuela). Indices are averages for the country groups (where for each country, the restrictions are coded as 0: none, 0.25: mild, 0.75: significant, 1: extreme).

Other points I

- Does **relationship change over time** (pre-GFC, post-GFC, LIR environment)?
  - CGFS report on post-crisis structural changes in banking
  - do your findings and observations fit with these trends?

- Maybe add a **control for institutional quality** of the counterparty countries?

- Are host country controls $\mathbf{W_{j,t-1}}$ **equally weighted**?

- Table 2, Panel B: **correlation** of risk measures and financial connectedness
  - what pairs are correlated here?

Other points II

- How is the **currency composition** of the foreign claims?
  - USD only? or fx-adjustment necessary?

- It's **a lot of text**. Maybe move some of the analyses to an Appendix?

- Why larger effects (market reactions) through **direct cross-border exposures**?
  - more information asymmetry?

- Why not include **RoA** as additional bank-specific control? [Idier et al 2013]

- Narrowing the event window and using **risk measures in higher frequency** could provide additional support of the findings.

Overall…

- … **very interesting & policy relevant question as well as promising analysis!**
- … **analysis is a huge data effort!**
  - many dimensional foreign exposures, risk measures and other
- … **well structured and written!**
- ☺

References

Brownlees and Engle (2010)
https://econ.au.dk/fileadmin/site_files/filer_oekonomi/subsites/creates/Seminar_Papers/2012/mes.pdf

Idier, Lamé and Mésonnier (2013) https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1546.pdf

Figure on capital controls: https://www.imf.org/external/pubs/ft/wp/2016/wp1625.pdf