RESEARCH

Discussion of:

"When is Less More? Bank Arrangements for Liquidity vs Central Bank Support"

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24th BIS Annual Conference
Basel, Switzerland
June 27, 2025

Summary of the paper

- Extends Stein (2012) allowing for private-based arrangements where investors provide funds to banks in bad times and earn a premium in good times.
- Shows private arrangement restores the first-best allocation (eliminates overinvestment) and uses historical examples to support this result.
- Compares private insurance to public policies (bailouts, ex-post lender-of-last-resort, and pre-committed liquidity facilities), shows these policies crowd out the private solution, and could be inefficient if not priced appropriately.
- Extends the framework to consider speculative investments and shows that the results continue to hold in this setting and government interventions increase speculative investments.

Main Comments

1. Consider broadening the framing of the interventions examined
2. Discuss upfront how model assumptions influence results. These relate to:
    a. Frictions in private insurance markets
    b. Pricing of public interventions vs private insurance
    c. Correlation between shocks faced by investors and banks
3. Consider the challenges related to convertible debt

1. Consider broadening the framing of the interventions examined

- Couldn't the bailout case also correspond to equity injections by the government?
- Couldn’t the pre-committed liquidity case also be discussed as:
  - ✓ a public sector administered depositor insurance scheme?
  - ✓ a situation where the central bank imposes capital requirements ex-ante and provides ex-post liquidity?

2.a. Frictions in private insurance markets

- Assuming there are no contracting frictions in the baseline ignores the role of:

  (i) asymmetric information, a key impediment to the development of insurance markets,

  (ii) known commitment, enforcement, coordination problems in state-contingent contracts

- Frictionless assumption overstates the superiority of the private solution

  - ✓ When there are frictions, the private arrangement no longer solves the overinvestment problem.
  - ✓ In this case, could the public solutions improve upon the private one?
  - ✓ Would we care that the public solutions crowd out the private one if the latter is less efficient than the former?

2.b. Pricing of public interventions vs private insurance

Ex-post interventions

- When considering LOLR interventions, the model assumes actuarially fair pricing
- Why not consider interventions that are priced to eliminate moral hazard (i.e. a la Bagehot)? How do such interventions compare with private insurance? Would they implement the first best?

Ex-ante liquidity interventions

- Model shows that if CBs priced ex-ante funds appropriately (i.e. considering the costs of fire sales even though central bank intervention potentially alleviates fire sales), distortions disappear
- Paper argues this Pigouvian pricing (the same price private insurers charge) is politically infeasible
- A more thorough discussion of why this is not possible seems warranted
- In practice, we observe banks face taxes on their investments in the form of capital requirements

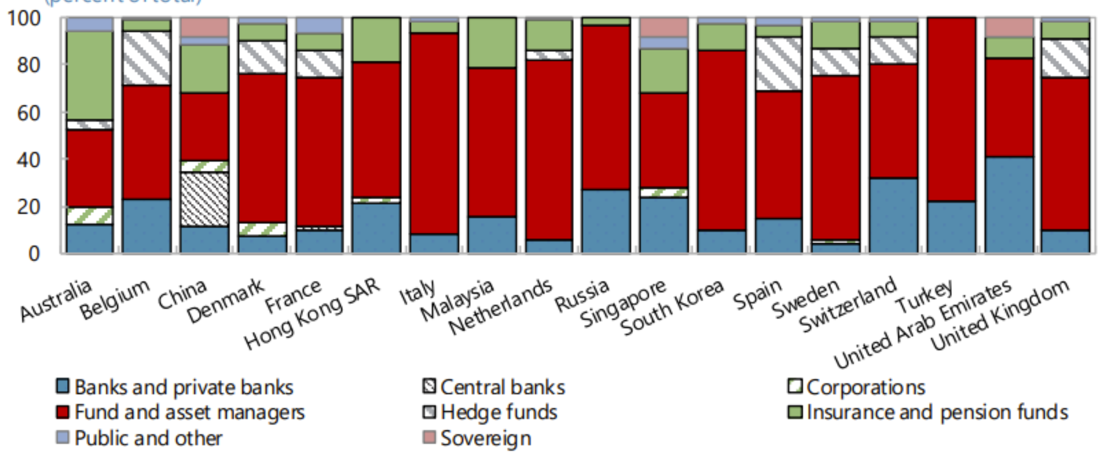
2.c. Correlation between shocks faced by investors and banks

- Private investors' ability to make state-contingent payments when banks are in distress requires that they are relatively unaffected or at least less affected by the same shocks

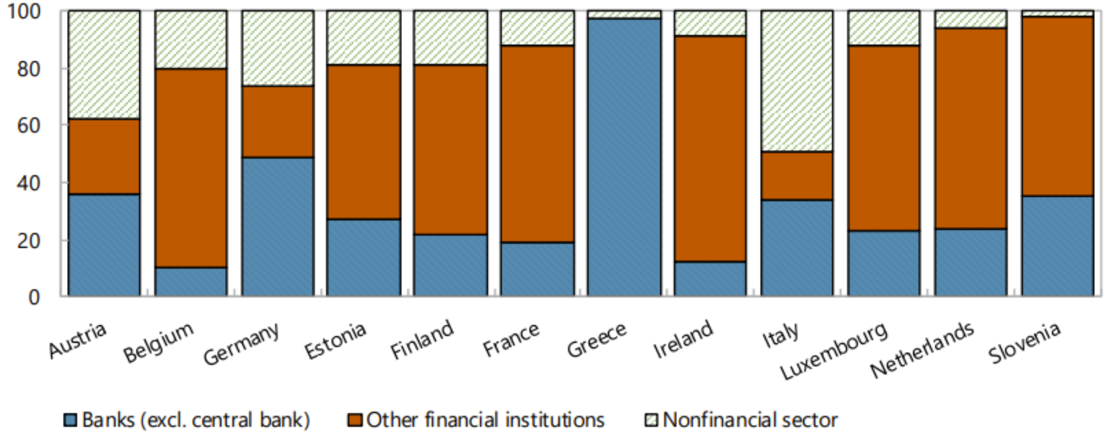
- This assumption is not likely to hold if crises are systemic

- Especially because private investors buying CoCos or other bail-inable debt are often banks

Investor Share for Select CoCo Issuances
(percent of total)



Investor Share for Bail-in-able Debt
(percent of total)

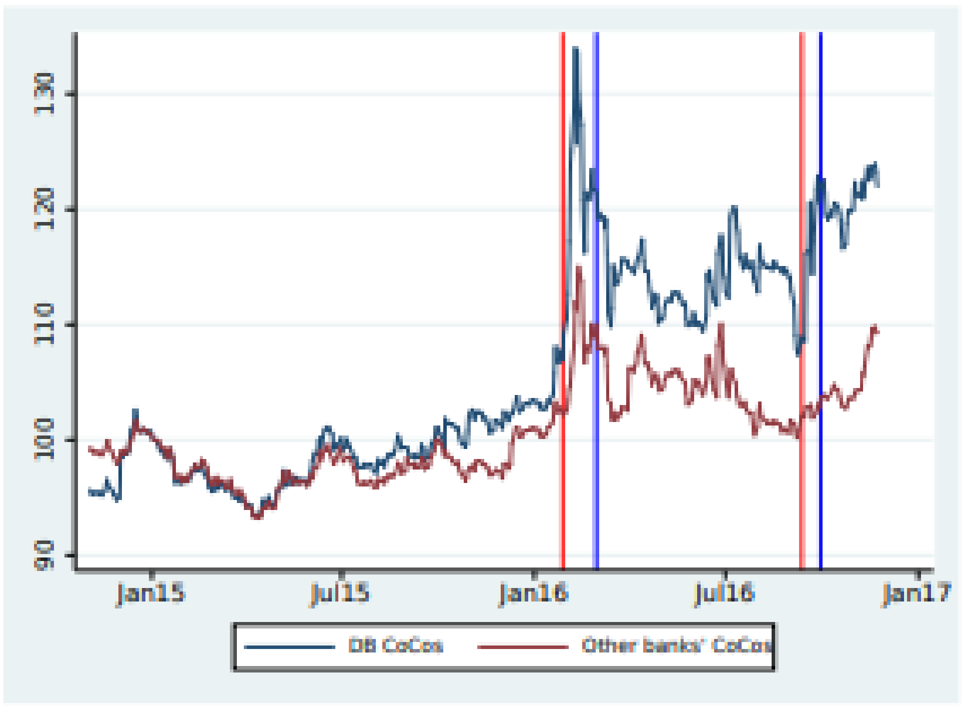


Sources: CapitalIQ; Dealogic Loan Analytics; ECB Securities Holdings database; and IMF staff calculations.
Note: Information on holders is available only for a subset of the contingent convertible bonds (CoCos) issued. Bail-in-able debt refers to senior unsecured and subordinated debt securities.

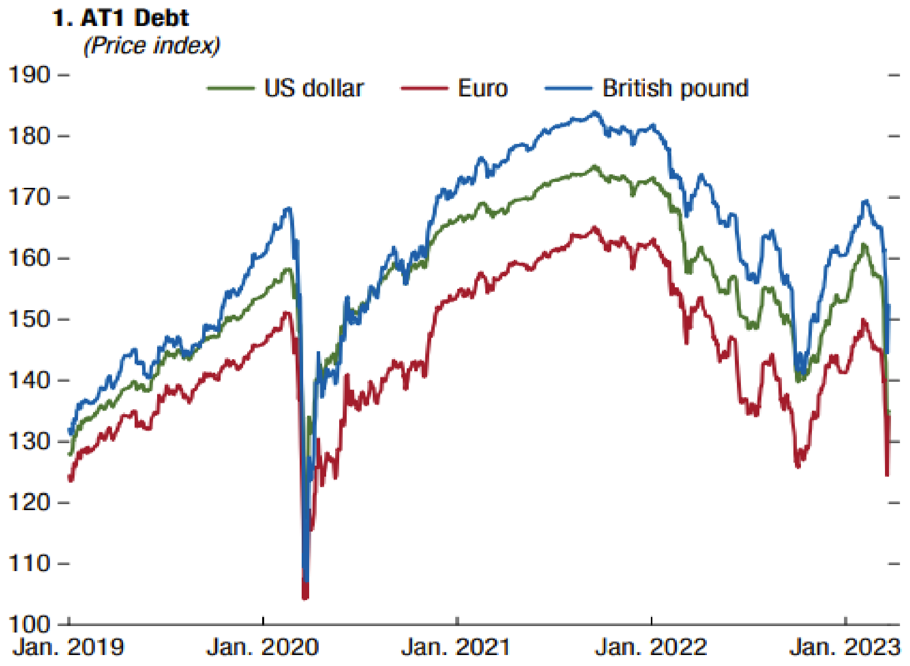
3. Challenges related to the use of CoCos

- Triggers are vague (regulatory discretion) and valuation uncertainty deters investors
- Spillover effects have been observed during episodes of distress for specific banks

CoCos yields during Deutsche's Bank distress episodes



AT1 price behavior during Credit Suisse's CoCos wipeout



Conclusions

- Interesting paper offering relevant extensions to Stein (2012)
- Paper should consider starting from a baseline with more realistic assumptions
- Given that private insurance is only efficient in the frictionless case, 2nd best comparisons with public interventions would be useful
- Real world challenges with CoCos should be acknowledged and discussed