Effects of diversification and capital buffers on the EU sovereign-bank network

2018 EBA Policy Research Workshop

November 28, 2018

Discussant: Andrea Pirrone

Brief summary

The paper analyses:

- The dependence structure of EU countries' sovereign risk
- The tendency of banks to concentrate their sovereign holdings on debt issued by their home country
- Risk and diversification in the sovereign portfolios of major EU banks
- The effects of regulatory requirements for diversification on the tail risk of sovereign portfolios

One of the main findings

With the new diversification requirements, regulators may be ineffective in reducing portfolio (tail) risk.

Main comment

The authors are upfront about their assumptions on how banks may respond to the new requirements.

And they focus on the case where **banks choose a portfolio of sovereign debt that closely matches the risk-return of their current portfolio**.

I believe this assumption may complicate the interpretation of the results.

Why the assumption is problematic

Narrative. The paper argues that banks are affected by home-bias. If banks are biased, then the current risk-return of their portfolio is biased. So, by assuming that, after the regulation, banks are still matching their current risk-return profile is like assuming that the regulation will not be very effective.

Pairing groups of countries/sovereign debts (I suspect). The home bias also links banks to their countries, while the assumption links groups of countries/sovereign debt as follows:

Why the assumption is problematic

	High risk	Low risk
Big country	Italy, Spain	Germany, France
Small country	Ireland, Portugal	Austria, Belgium

Consequences of the assumption

From the paper:

“This result in a new EU portfolio with a slightly better level of diversification and higher risk but almost same return rate.”

And by pairing these groups, correlations and contagion effects probably affect the estimated tail risk.

Minor comments

- Maybe analysing other portfolios would help
- Finding other portfolios which do not correct the bias would also help.
- Factor 2 and 3 in Figure 3 are well explained, but Factor 1 is not
- In Section 3, going factor by factor would help the reader.
- Pg 16, “It is widely acknowledge”, by who?
- Pg 17, D and FC formulas should be inverted because you show variables before explaining them.
- Pg 19-20, the discussion is a bit difficult to follow.
- Section 5 on fire-sales is clear and well-written, but its content is influenced by the assumptions made in the previous sections.
- Where is Greece?