

Discussant Comments on:

**EVIDENCE OF DIFFERENCES IN THE  
EFFECTIVENESS OF SAFETY-NET  
MANAGEMENT IN EUROPEAN UNION  
COUNTRIES**

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Views are my own and do not necessarily represent the views  
of the Federal Reserve

# Outline of Comments

- A brief summary
- Some big picture issues
- Specific comments

# Brief Summary

- A key shortcoming in EU directives and Basel agreement
- Provides incentives for EU banks to shift losses between home and host country
- Conduct empirical analysis, by country:
  - relation between leverage and asset risk
  - relation between IPP and asset risk

# Brief Summary

- Found significant x-country differences in safety-net subsidies
- X-border M&A activities pose policy issues for EU

# Big Picture Issues

- Arbitrage and the Basel Capital Accord
- Ex-ante risk-shifting versus ex-post loss-shifting
- Sources of differences in effectiveness of safety net management

# Big Picture Issues

- What limits the arbitrage
- Level versus change

# The Model

$$B/V = \alpha_0 + \alpha_1 \sigma_V + \varepsilon_2 \quad (2)$$

$$IPP = \beta_0 + \beta_1 \sigma_V + \varepsilon_3 \quad (3)$$

- **Guarantee value must not rise with volatility:**  $\beta_1 \leq 0$ .
- **Capital must increase with volatility:**  $\alpha_1 < 0$ ,

$\alpha_1$  measures the strength of capital market discipline

$\beta_1$  measures the effectiveness of safety-net management

# Specific Comments

- Test for structural break
- Simultaneity and non-linearity

# Finding: Ireland

- Very negative  $\alpha_1$  suggests strong market discipline.
- Very high  $\beta_1$  suggests weak safety-net administration.
- A strategic policy trade-off?
- The level (not the change) in risk-taking is economically more important.

# Finding: Austria

- Both  $\alpha_1$  and  $\beta_1$  are insignificant.
- Suggests weak market discipline but strong safety-net management.
- Going forward, Basel 2 advocates strong banking supervision (pillar 2) while harnessing market discipline (pillar 3).