Discussion of
Allen, Covi, Gu, Kowalewski, & Montagna’s

“Trust and the Interbank Market Puzzle”

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11 March 2022

*The views expressed do not reflect official positions of the Federal Reserve Bank of Chicago or the Federal Reserve System. This presentation contains no discussion of current or prospective monetary policy.

Three papers in one!

How does “trust” affect levels of interbank borrowing in a large panel of countries?

1. Panel regressions
2. Network analysis on Euro area banks
3. Case study of Veneto Banca failure

- Lot’s of work. Impressive data collection effort.
- It’s clear that there are significant differences in interbank size across countries.
- Results linking interbank activity to past banking crises are robust and convincing.

Outline of comments

1. How important are other possible differences across countries?
2. Is the authors’ statistical significance overstated?
3. Are lower levels of interbank borrowing interpretable as lower willingness to lend to banks?
4. Are the authors really picking up a “trust” effect?

1. Cross-country differences

- 96 countries -- potentially big institutional differences
- Need to know more about failure resolution regimes.
  - Where are interbank loans in the waterfall?
  - What are prompt corrective action rules like?

- If the story is about trust, do we see similar patterns in other types of uninsured liabilities?

2. How many observations are there really?

- 76,000 bank-quarters.
- But “trust” metrics are specific to country-quarter
  - # of crises; # of years spent in crisis; % of assets in failing banks
- And these don’t even vary much over time.
  - This becomes obvious when they allow for region fixed effects
- So this is really a cross-sectional study.
  - United States appears as 4,600 observations per quarter but is really just 1.
- Econometrically, if bank-level observations are used, standard errors should be clustered.

3. "Puzzle" is about quantities borrowed,… … but this is only half the story.

- Interbank lending quantities are determined in equilibrium.
- To understand what is going on, we also need to know something about prices.
  - Interbank rates are an important margin of adjustment

    (Furfine, 2001; King, 2008; Taylor and Williams, 2009; Afonso et al., 2015; King and Lewis, 2020)
  - If banks with low borrowing also pay low rates, the solution to the puzzle may have to do with demand, not supply.
- Also other potential margins of adjustment – maturity, collateralization.

4. What are the authors trying to measure?...

- Authors’ definition:

  Trust = “*A bank’s belief in its peers’ honesty and good-faith commitments*”

- Not the same thing as “low probability of failure.”
- Trust suggests that banks would be able to borrow more *conditional* on a given objective failure probability.

… and what are they actually measuring?

- Authors’ measures of “trust” are based on severity of past banking crises.
- Cannot rule out that this simply captures unobserved differences in failure probabilities.
  - Maybe some countries are just more failure-prone.
  - It would be rational to incorporate this into failure-probability assessments, even without assessing peers’ honesty.
- Even if not, is “few past crises” the same as “trust?”

- Similarly, does the reduction in activity after the failure of Veneto Banca reflect less trust, or something else?