Discussion of "Financial Risk Capacity" by Saki Bigio

10 Minute Discussion by Bob Hall

7th Banco de Portugal Conference on Monetary Economics
15 June 2012

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Lower intermediation and lower activity persist for an extended period because only retained earnings rebuild bank equity

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This paper adds the adverse-selection mechanism

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Adverse selection is the answer because it erodes all bank profits

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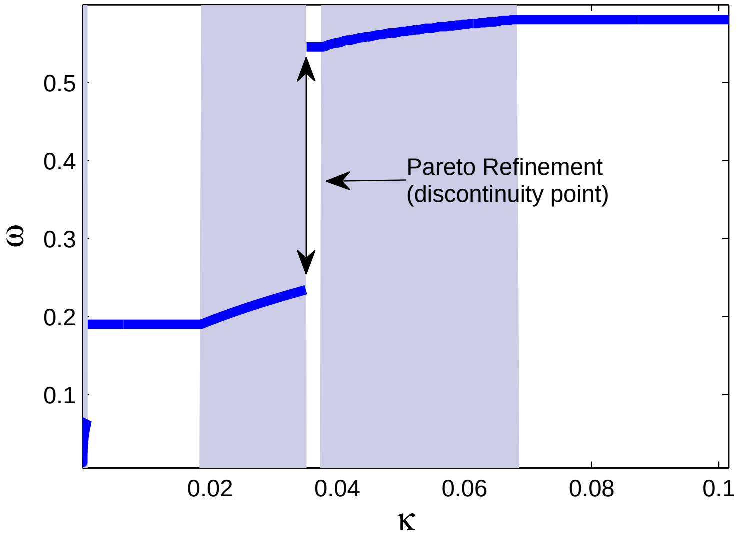
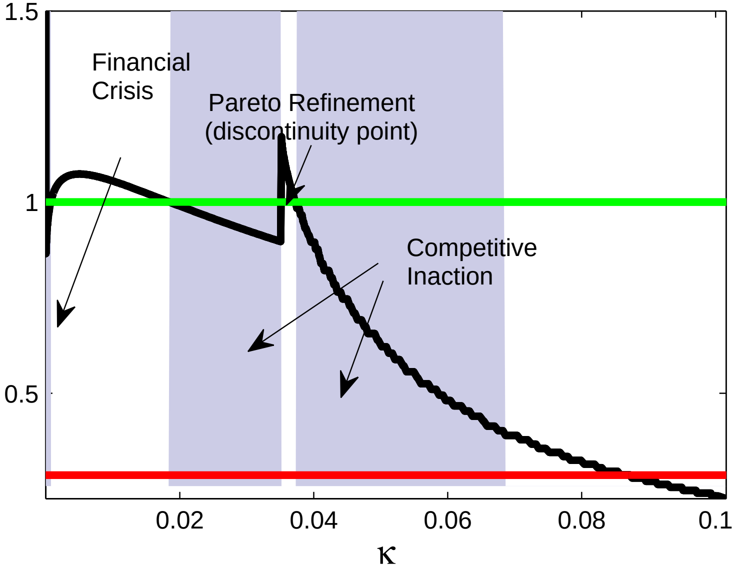
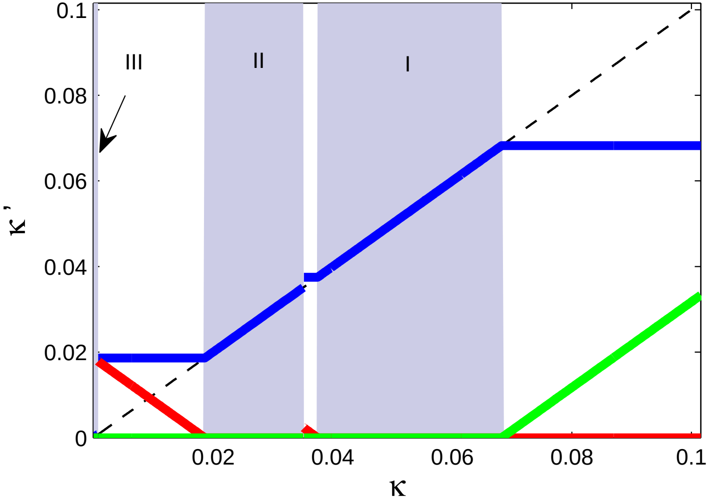
Volume of Intermediation



Value of Equity



Equity Injections and Dividend Payouts



Financial friction

$$f_t = \frac{1}{q_t}\left[\alpha\frac{y_t}{k_t} + (1-\delta)q_{t+1}\right] - 1 - r_t.$$

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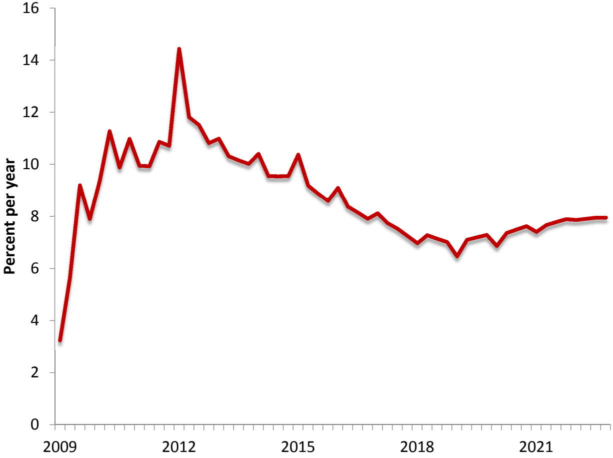
The Implied Values of the Financial Friction

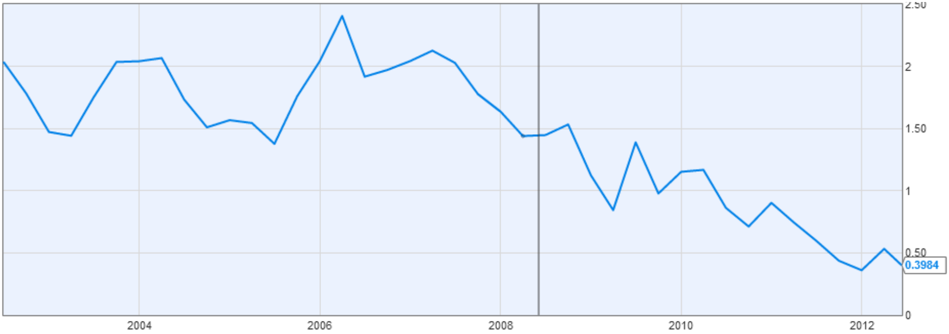


Bank of America Market to Book Ratio

CitiGroup Market to Book Ratio

Deutschebank Market to Book Ratio

Nomura Market to Book Ratio



JP Morgan Chase

Beganau, Piazzesi, and Schneider (2012)

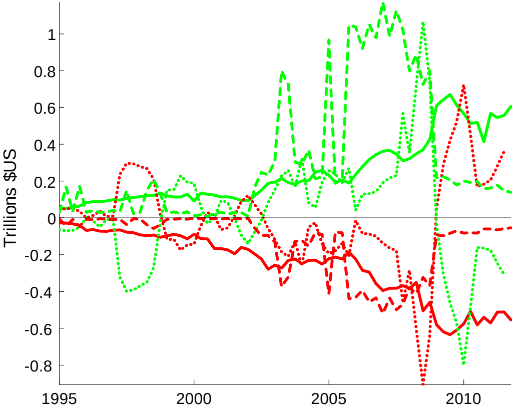


Figure 5: Replication portfolios for JP Morgan Chase. The portfolios are holdings of cash (in red) and a 5-year riskless zero coupon bond (in green). Solid lines are replicating porfolios for the traditional fixed income position, while dotted lines are for derivatives and dashed lines are for bonds held for trading.