Discussion of

Research Agenda (4 papers by Correia-Luck-Verner) on Banking Crises: Understanding the Roles of Solvency and Liquidity

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General comment and outline of the discussion

- **Excellent research agenda/ papers on bank solvency vs liquidity** with **crucial implications for policy and theory**
  - This is my view but also the top journals' view ☺: 1 QJE, 1 R&R JF, 1 AR, 1 WP

Outline of my discussion:

1. Place these papers into the **general view of banking crises** (with a slightly different motivation than the authors)

2. Provide **some specific comments** on their findings & interpretations

3. **Provide some evidence** fully consistent with their solvency results (vs liquidity) but based on **deposit insurance** (which they do not analyze)

General view of banking crises and these set of papers

- Huge *ex-post* costs of banking crises (eg Bernanke AER 1983, …)

- **Why** do we experience **banking crises?**
  - Papers on ***ex-ante* massive credit and excessive risk-taking in booms** that predict —and potentially cause— crises (Kindleberger 1977; Jorda & Schularick-Taylor AER 2012…; Verner et al., QJE 2017; Peydro et al., ECMA 2014 & JF 2026; …). This is consistent with a ***solvency view as root cause***
  - After these booms, there may be a **Minsky moment**, and somehow **runs and change of beliefs** may be the ***immediate cause of the crisis***
    - The authors also care about bank-level failures, not necessarily in crises. In this case, in addition to massive increase in credit and risk-taking financed with debt, there are also idiosyncratic issues like fraud for bank failures

- A complementary way: bank failures due to **runs based on sunspots** (Diamond and Dybvig, JPE 1983) ***vs* failures due to runs in less solvent banks** (Goldstein & Pauzner, JF 2005) **vs failures in insolvent banks** (e.g., some Allen & Gale papers)

Why do we care about the causes of crises?

- **Huge *ex-post* costs of banking crises**, not just on real effects but also including populism & political extremism

- Hence, **policy makers** would like to reduce the probability of crises, and conditional on crises, reduce the negative real effects
  - That is, to increase the resilience of the banking system
  - Apart from policy, it is also **key for macro-finance models**

- **Two types of policies**:
  - **Solvency** ones: e.g. ex-ante **capital requirements**, including stress tests, and **supervision**, ex-post **capital injections**
  - **Liquidity** ones: e.g. **deposit insurance**
    - As they do not cover deposit insurance, I will present some micro evidence on deposit insurance which is fully consistent with their research agenda

Historical data is crucial

- **Collect historical bank-level data**, analyze bank failures and provide evidence that the solvency channel is the key one
  - The **liquidity channel is just a consequence of the solvency one**, and **banks that fail are insolvent** (rather than just less solvent but illiquid)

- **Crucial to also analyze the pre-deposit insurance era**, as with deposit insurance and central bank liquidity injections, liquidity problems may not be key just because of policy
  - See e.g. the massive policy intervention after SVB failure in 2023
  - That is, **currently we may have a biased sample** as we would only observe bank failures due to solvency, as the ones due to liquidity would have been prevented due to policy interventions

- As I said before, in sum, **the papers are fascinating**

Two further, specific comments (1): banks fail too late

- Are **predictable (based on fundamentals) key turning points?**
  - Like 9th of August 2007 in Europe with the runs on the interbank and wholesale markets and the ECB intervention of close to 100 billion?
  - Or massive bank runs in Austria & Germany in May-July 1931?

- **E.g. in 2006**, there were not low bank profits and/or higher loan losses, eg in Spain or in general in credit booms. **So just before the banking problems, balance sheet & market prices look very good**

- However, consistent with your evidence, eg in Spain, despite bank problems started in **2007, including dry up of liquidity, bank failures are especially strong after 2010**, so maybe policy makes that **banks tend to fail too late (allowing zombie banks**) and hence **closer to the actual bank failure there are bank losses over time (solvency view)**

Two further, specific comments (2): strategic complementarities in liquidity and credit

- Could it be your evidence consistent also with coordination problems (**strategic complementarities) at the system level for solvent banks?**

- Let's take the case of **2007-08 period**. Given all the boom, there may be **two equilibria**:
  - in the **negative one**, there are some **illiquidity problems & a strong cut in credit → negative real effects → crisis → banks that fail are then insolvent**
  - in **the other one**, the boom dies up without bank illiquidity and notably **without credit crunch**, so not so negative real effects → **banks do not fail**
  - So bank crises with insolvent banks may be a realization of strategic complementaries, and without those ones, the bank would be solvent, but maybe the key channel is not illiquidity and not only ex-ante credit booms, but **strategic complementaries in credit**
    - Maybe policy makers (or the market) can reduce the illiquidity with deposit insurance and central bank liquidity injections (or private solutions), but not so much credit crunches, and hence the very negative real effects on the economy, which also affect the solvency of banks

Deposit insurance evidence: Cucic-Iyer-Kokas-Peydro-Pica

- The expansion of the coverage of deposit insurance (DI) during financial crises, including DI creation, is one of the most widely used public policy tools
- A key rationale of deposit insurance is that bank runs have been crucial during financial crises throughout history and also recently
- But **banks mostly fail due to solvency** (**Correia-Luck-Verner** papers)

→ What do expansions of DI accomplish during financial crises?

- We analyze **Denmark around the 2008 Global Financial Crisis** with:
  i. Administrative data from Denmark, including e.g. the **universe of retail and corporate deposits**
  ii. **Reform from limited to unlimited deposit insurance** in October 2008

Our results are fully consistent with the solvency view (of Correia-Luck-Verner)

- Increasing deposit insurance coverage prevents weaker banks from further losing large (previously uninsured) deposits during the crisis, enabling continued credit supply

However,

- **Increasing deposit insurance** facilitates the **reallocation of large deposits from stronger to weaker banks**
- I**ncreasing credit supply by ex-ante weaker banks to riskier firms in the crisis** (measured with ex-ante risk or ex-post loan defaults)
- Consistently, **banks that gained most deposits under increasing insurance are themselves more likely to fail, particularly ex-ante weaker banks**
  - Fully consistent with the solvency view/results of Correia-Luck-Verner