

Discussion of

**The Foreign Liability Channel
of Bank Capital Requirements**

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Banking Crisis Management Conference

June 9-10, 2026

Introduction

- What are the (stability) effects of capital requirements?
 - Taking into account the existence of foreign bank liabilities
- Macro-finance setup: Stability vs growth trade-off + open economy
 - Banks invest and are subject to capital requirements
 - Banks funded by insured national and **uninsured** foreign
 - Foreign trade (intermediate and final goods)
- Main message
 - **Higher capital → safer banks → more reliant on foreign debt**
 - Differences between capital and foreign prudential policies

My personal view

- Paper analyses a relevant underexplored issue
 - National vs foreign debt
 - Capital regulation vs other foreign stability policies
- Paper with relevant policy implications
 - Capital requirements are not a panacea!
 - Some (international) risks might call for other instruments
- Some ideas that came to my head – Could we learn more?
 - Foreign or uninsured?
 - Optimal policy mix?
 - Exogenous dry up foreign risk?

Bank capital regulation and its effects

- Banks capital regulation is a key tool to reduce bank default
 - Ex-ante perspective (incentives): reduces risk taking assets
 - **Ex-post perspective (buffer): higher loss absorption capacity**
- However, bank capital can also have costs
 - Can reduce production: bank capital is costly
 - **Can expose banks to other sources of risks**
 - **Foreign liability channel (new)**
- Implications for optimal capital regulation
 - And for the role of other policies (new risks)

Building block 1: Production – stability

- Banks are funded with equity and debt
 - Equity is costly (w.r.t debt)
- Banks invest in (risky) productive capital
 - More bank investment → higher production
- Bank capital regulation
 - $\text{equity} > k \text{ bank investment}$
 - **Higher k (cap req) reduces investment and output**
- Bank investment is risky
 - **Higher k makes bank less prone not to be able to repay debt**
 - 100% equity bank would never **default**

National vs foreign bank liability

- Banks are funded with National and Foreign debt
 - National debt is **insured** → risk is not priced
 - Foreign debt is **uninsured** → risk is priced
 - **Lower bank risk reduces the relative cost of foreign debt**
- **Anything that reduces risk of bank → increases foreign debt**
- Foreign debt has some exogenous limit $\underline{d}$
 - State dependent exogenous limit to foreign bank debt
- Foreign debt is denominated in foreign currency
 - Exchange rates matter for their pricing

Building block 2: Small open economy

- International goods are used in the production function
 - Final goods are sold also in the international market
 - Exchange rate matters
- Foreign debt is in foreign currency
 - Exchange rate matters
- Central bank can intervene in the exchange rates
 - But at a cost
- International flows (exchange rates) affect production (welfare)
 - Some scope for interventions

Risk 1: (Exogenous) bank risk –buffer-

- **Banks returns are (exogenously) risky**
 - Shock to bank profits
 - Independent of any policy, choice or regulation
- The higher the amount of bank equity
 - The less probable is that a return shock leads to bank failure
 - Bank failure has social costs, bankruptcy costs
 - **Higher equity → higher default buffer → safer banks**
- Main result: Foreign liability channel
 - **Higher bank capital → safer bank → more foreign funding**
 - Recall foreign funding prices risk and national does not

Risk 2: (Exogenous) foreign debt dry up

- Foreign debt can (exogenously) dry up $\rightarrow \underline{d}' < \underline{d}$
 - $\rightarrow$ This affects production as banks can not fund so cheaply
 - $\rightarrow$ Also exchange rates
- **Relevance of this dry up depends on the amount of foreign debt**
 - $\rightarrow$ only relevant if $d^* > \underline{d}'$
 - $\rightarrow$ **Higher equity $\rightarrow$ higher foreign debt $\rightarrow$ more exposure**
- Main result
 - $\rightarrow$ **Higher bank capital $\rightarrow$ more exposed to foreign dry up**
 - $\rightarrow$ Recall this is an exogenous dry up (not due to fundamentals)

Can bank capital address both risks?

- **No**

- Higher bank capital can reduce total bank risk
- But it increases the exposure to foreign dry up risk
 - As higher capital increases foreign debt funding
 - Relative relevance of this channel increases
 - Foreign dry up consequences are not only bank default

- You have two sources of risk - two policies

- Bank risk tackled with capital requirements
- Foreign flow (exchange rates) with FX interventions or tax

C.1 Insured vs Uninsured

- Foreign debt is uninsured vs national debt is uninsured
- How realistic is this?
 - Isn't a part of national debt also uninsured?
- When a bank becomes safer national uninsured also increase
 - They also value safety
- The issue: who is more elastic national or foreign uninsured?
 - If elasticity of national $>$ elasticity of international
 - Foreign liability channel of capital would reverse
- Foreign liability channel = uninsured liability channel in disguise?

C.1 Insured vs Uninsured

- Foreign liability channel = uninsured liability channel
- Closed economy
 - Insured and uninsured depositors (maybe segmented)
 - Higher capital req → safer banks → higher uninsured
 - Makes banks more exposed to uninsured shocks (runs...)
- Then one can think of the small open economy as an application
 - In which extra exchange rate results appear
 - Allowing to analyze the usefulness of different policies

C.2 Welfare of combined policies

- Results on combined policies are based on IRF
 - It might make sense to undergo welfare analysis
- Would a combination of both policies increase optimal cap req?
 - The existence of FX effects makes optimal cap req lower
 - Conjecture:
 - If we “control” the FX channel cap req might be higher
- Currently just comment you can control FX with other policies
 - eg tax on international flows
 - But this is probably not welfare optimal (production cost).

C.3 Exogenous shocks

- Both of the risk shocks are exogenous
 - Profit shock is independent of bank capital
 - Foreign liability dry up is exogenous to country fundamentals
- Do not have **any** knowledge of international finance but...
 - Why is the “dry up” an upper limit and not a fraction?
 - $\underline{d}' < \underline{d}$ vs τd^*
 - Upper limit: the more you have the nearer to be affected
 - Fraction: having more or less does not directly impact
 - Is it true that dry ups are exogenous to country fundamentals
 - E.g. safe productive country = unsafe low productive?

Conclusion

- Nice paper on effects of capital req on bank foreign debt
 - Maybe on uninsured debt?
 - Interaction of optimal policies