The Funding of Subsidiaries Equity, “Double Leverage,” and the Risk of BHCs

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European Stability Mechanism

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1 The views expressed hereafter are those of the authors and do not necessarily reflect the views of the ESM.
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- provides an extensive discussion on “double leverage”
- follows a rigorous econometric analysis based on a number of different specification/estimation strategies
- does not content itself with correlations but tries to uncover some degrees of causality (e.g. Granger causality, IV, etc.)
Key results

- A higher DLR $\frac{x E(S)}{E(HC)}$ is associated with/causes more volatile stock returns.
- This relationship is non-linear, mostly driven by holding companies with a large $DLR \geq 100\%$.
- Capital ratios and the global financial crisis could influence the market effect of DLR.
- The type of subsidiaries matters: stock returns are more volatile when holding companies invest in bank subsidiaries.
Main comments - specifications

Apart from the effect of the DLR, the specification and identification strategies condition some interesting results:

The impact of regulatory capital and the crisis on the marginal effect of DLR: Capital dampens the marginal effect of DLR in OLS but reinforces it in the panel regression.

Panel regression: static? any serial correlation concerns?

Potential collinearity issue: DLR and size might be highly correlated. Useful to provide a correlation matrix of independent variables.

The impact of the crisis deserves further exploration.

Potential reverse causality? Banks (double) leverage up in the upturn because risks were compressed. Capital requirements (based on a VaR calculation) allow more leverage.

Is there a change of behaviour before and after the crisis?
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Dependent variable (stdev): a measure of risks or risk-taking?

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Stock returns also capture market volatility

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- Basel III (and Basel II) requires BHC to deduct from their own equity significant holdings of other financial intermediaries
- Recent banking regulations (CRR) in Europe are even tougher
  - Articles 36 and 43-49
  - Double leverage *de facto* impossible
Minor comments

- Useful to provide additional information on the sample
  - How many BHCs? How many subsidiaries on average?
- Some suggestions on the structure of the paper (to make the main story/results more salient)
  - Section 2, which is useful for readers to understand the key concepts, is a bit too long
  - Focus on one baseline regression + one or two most relevant alternatives