Microeconomics of Banking

Second Edition\textsuperscript{1}

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\textsuperscript{1}This second edition is dedicated to the memory of Jean-Jacques Laffont.
# Contents

1 General Introduction

1.1 What Is a Bank, and What Do Banks Do? ........................................... 19
1.2 Liquidity and Payment Services ......................................................... 21
   1.2.1 Money Changing ........................................................................... 21
   1.2.2 Payment Services ......................................................................... 22
1.3 Transforming assets ............................................................................. 23
1.4 Managing Risks ..................................................................................... 24
   1.4.1 Credit Risk ..................................................................................... 24
   1.4.2 Interest Rate and Liquidity Risks .................................................. 24
   1.4.3 Off-Balance-Sheet Operations ....................................................... 25
1.5 Monitoring and Information Processing ................................................. 26
1.6 The Role of Banks in the Resource Allocation Process .......................... 26
1.7 Banking in the Arrow-Debreu Model ..................................................... 27
   1.7.1 The Consumer ............................................................................... 28
   1.7.2 The Firm ....................................................................................... 28
   1.7.3 The Bank ...................................................................................... 28
   1.7.4 General Equilibrium ..................................................................... 29
1.8 Outline of the Book .............................................................................. 30

2 The Role of Financial Intermediaries ..................................................... 35

2.1 Transaction Costs .................................................................................. 38
2.1.1 Economies of Scope ........................................ 39
2.1.2 Economies of Scale ........................................ 40

2.2 Coalitions of Depositors and Liquidity Insurance .................. 41
2.2.1 The Model ................................................. 41
2.2.2 Characteristics of the Optimal Allocation .................... 42
2.2.3 Autarky ..................................................... 42
2.2.4 Market Economy .......................................... 43
2.2.5 Financial Intermediation .................................. 44

2.3 Coalitions of Borrowers and the Cost of Capital ................. 45
2.3.1 A Simple Model of Capital Markets with Adverse Selection .... 46
2.3.2 Signaling Through Self-Financing and the Cost of Capital .... 48
2.3.3 Coalitions of Borrowers .................................... 49
2.3.4 Suggestions for further Reading .......................... 50

2.4 Financial Intermediation as Delegated Monitoring .............. 51

2.5 The Choice Between Market Debt and Bank Debt ............... 55
2.5.1 A Simple Model of the Credit Market with Moral Hazard .... 55
2.5.2 Monitoring and Reputation (Adapted from Diamond 1991) .... 57
2.5.3 Monitoring and Capital (Adapted from Holmström and Tirole 1997) 59
2.5.4 Financial Architecture (Boot and Thakor 1997) ................ 62
2.5.5 Credit Risk and Dilution Costs (Bolton Freixas 2000) ......... 63

2.6 Liquidity Provision to Firms .................................. 67

2.7 Suggestions for further reading ................................ 68

2.8 Exercises ..................................................... 69
2.8.1 Strategic Entrepreneurs and Market Financing .............. 69
2.8.2 Market vs. Bank Finance .................................. 70

2.9 Problems .................................................... 71
2.9.1 Strategic Entrepreneurs and Market Financing .............. 71
2.9.2 Market vs. Bank Finance ........................................ 72
2.9.3 Economies of Scale in Information Production ............. 75
2.9.4 Monitoring as a Public Good and Gresham’s Law .......... 75
2.9.5 Intermediation and Search Costs (Adapted from Gehrig 1993) .. 77
2.9.6 Intertemporal Insurance ..................................... 77
2.10 Solutions ...................................................... 79
2.10.1 Economies of Scale in Information Production ............. 79
2.10.2 Monitoring as a Public Good and Gresham’s Law .......... 79
2.10.3 Intermediation and Search Costs ............................ 81
2.10.4 Intertemporal Insurance ..................................... 82

3 The Industrial Organization Approach to Banking ................. 89
3.1 A Model of a Perfect Competitive Banking Sector ............. 90
3.1.1 The Model .................................................. 90
3.1.2 The Credit Multiplier Approach ............................. 92
3.1.3 The Behavior of Individual Banks in a Competitive Banking Sector .................................. 93
3.1.4 The Competitive Equilibrium of the Banking Sector .......... 94
3.2 The Monti-Klein Model of a Monopolistic Bank ............... 97
3.2.1 The Original Model ....................................... 97
3.2.2 The Oligopolistic Version .................................. 98
3.2.3 Empirical Evidence ....................................... 99
3.3 Monopolistic Competition ..................................... 100
3.3.1 Does Free Competition Lead to the Optimal Number of Banks? 101
3.3.2 The Impact of Deposit Rate Regulation on Credit Rates .... 103
3.3.3 Bank Network Compatibility ................................ 106
3.3.4 Empirical Evidence ....................................... 107
3.4 The Scope of the Banking Firm ................................ 107
3.5 Beyond price competition ...................................... 108
4 The Lender–Borrower Relationship

4.1 Why Risk Sharing Does Not Explain All the Features of Bank Loans

4.2 Costly State Verification

4.2.1 Incentive Compatible Contracts

4.2.2 Efficient Incentive Compatible Contracts

4.2.3 Efficient Falsification-Proof Contracts

4.3 Incentives to Repay

4.3.1 Nonpecuniary cost of bankruptcy

4.3.2 Threat of Termination

4.3.3 Impact of Judicial Enforcement

4.3.4 Strategic Debt Repayment: The Case of a Sovereign Debtor

4.4 Moral Hazard

4.5 The Incomplete Contract Approach

4.5.1 Private Debtors and the Inalienability of Human Capital

4.5.2 Liquidity of Assets and Debt Capacity

4.5.3 Soft Budget Constraints and Financial Structure

4.6 Collateral as a Device for Screening Heterogenous Borrowers

4.7 Problems

4.7.1 Optimal Risk Sharing with Symmetric Information

4.7.2 Optimal Debt Contracts with Moral Hazard (Adapted from Innes 1990)

4.7.3 The Optimality of Stochastic Auditing Schemes

4.7.4 The Role of Hard Claims in Constraining Management (Adapted from Hart and Moore 1995)

4.7.5 Collateral and Rationing (Adapted from Besanko and Thakor 1987)

4.7.6 Securitization (Adapted from Greenbaum and Thakor 1987)

4.8 Solutions

4.8.1 Optimal Risk Sharing with Symmetric Information
4.8.2 Optimal Debt Contracts with Moral Hazard 184
4.8.3 The Optimality of Stochastic Auditing Schemes 185
4.8.4 The Role of Hard Claims in Constraining Management 186
4.8.5 Collateral and Rationing 187
4.8.6 Securitization 188

5 Equilibrium in the Credit Market 193
5.1 Definition of Equilibrium Credit Rationing 194
5.2 The Backward Bending Supply of Credit 195
5.3 Equilibrium Credit Rationing 197
  5.3.1 Adverse Selection 197
  5.3.2 Costly State Verification 199
  5.3.3 Moral Hazard 200
5.4 Equilibrium with a Broader Class of Contracts 202
5.5 Problems 206
  5.5.1 The Model of Mankiw (1986) 206
  5.5.2 Efficient Credit Rationing (Adapted from De Meza and Webb 1992) 207
  5.5.3 Too Much Investment (Adapted from De Meza and Webb 1987) 207
5.6 Solutions 208
  5.6.1 The Model of Mankiw (1986) 208
  5.6.2 Efficient Credit Rationing 208
  5.6.3 Too Much Investment 209

6 The Macroeconomic Consequences of Financial 215
6.1 A Short Historical Perspective 217
6.2 The Transmission Channels of Monetary Policy 218
  6.2.1 The Different Channels 220
  6.2.2 A Simple Model 221
6.2.3 Credit View versus Money View: Justification of the Assumptions and Empirical Evidence ........................ 223
6.2.4 Empirical Evidence on the Credit View .................... 225
6.3 Financial Fragility and Economic Performance .................. 226
6.4 Financial Development and Economic Growth .................... 232

7 Individual Bank Runs and Systemic Risk 243

7.1 Banking Deposits and Liquidity Insurance ........................ 244
  7.1.1 A Model of Liquidity Insurance .............................. 245
  7.1.2 Autarky ................................................. 245
  7.1.3 The Allocation... ........................................ 246
  7.1.4 The Optimal (Symmetric) Allocation ......................... 246
  7.1.5 A Fractional Reserve Banking System ....................... 247
7.2 The Stability of the Fractional Reserve System... ............... 248
  7.2.1 The Causes of Instability ................................. 248
  7.2.2 A First Remedy to Instability: Narrow Banking ................ 249
  7.2.3 Regulatory Responses: Suspension... ........................ 251
  7.2.4 Jacklin’s Proposal: Equity versus Deposits .................. 252
7.3 Bank Runs and Renegotiation ..................................... 254
7.4 Efficient Bank Runs .............................................. 258
7.5 Interbank Markets and the Management... .......................... 260
  7.5.1 The Model of Bhattacharya and Gale (1987) .................. 261
  7.5.2 The Role of the Interbank Market ............................ 261
  7.5.3 The Case of Unobservable Liquidity Shocks .................. 262
7.6 Systemic risk and contagion ...................................... 263
  7.6.1 Aggregate liquidity and banking crises ....................... 264
  7.6.2 Payment systems and OTC operations ......................... 266
  7.6.3 Contagion through interbank claims .......................... 267
7.7 The Lender of Last Resort:

7.7.1 Four Views on the LLR Role

7.7.2 Liquidity and solvency: a coordination game

7.7.3 The practice of LLR assistance

7.7.4 The Effect of LLR and Other Partial Arrangements

7.8 Problems

7.8.1 Bank Runs and Moral Hazard

7.8.2 Bank runs

7.8.3 Information-Based Bank Runs

7.8.4 Banks’ Suspension of Convertibility

7.8.5 Aggregate Liquidity Shocks (adapted from Hellwig (1994))

7.8.6 Charter Value

7.9 Solutions

7.9.1 Banks Runs and Moral Hazard

7.9.2 Bank runs

7.9.3 Information-Based Bank Runs

7.9.4 Banks’ Suspension of Convertibility

7.9.5 Aggregated Liquidity Shocks

7.9.6 Charter Value

8 Managing Risks in the Banking Firm

8.1 Credit Risk

8.1.1 Institutional Context

8.1.2 Evaluating the Cost of Credit Risk

8.1.3 Regulatory Response to Credit Risk

8.2 Liquidity Risk

8.2.1 Reserve Management

8.2.2 Introducing Liquidity Risk in the Monti-Klein Model
<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>8.2.3</td>
<td>The Bank as a Market Maker</td>
<td>308</td>
</tr>
<tr>
<td>8.3</td>
<td>Interest Rate Risk</td>
<td>311</td>
</tr>
<tr>
<td>8.3.1</td>
<td>The Term Structure of Interest Rates</td>
<td>312</td>
</tr>
<tr>
<td>8.3.2</td>
<td>Measuring Interest Rate Risk Exposure</td>
<td>314</td>
</tr>
<tr>
<td>8.3.3</td>
<td>Applications to Asset Liability Management</td>
<td>315</td>
</tr>
<tr>
<td>8.4</td>
<td>Market Risk</td>
<td>317</td>
</tr>
<tr>
<td>8.4.1</td>
<td>Portfolio Theory: The Capital Asset Pricing Model</td>
<td>317</td>
</tr>
<tr>
<td>8.4.3</td>
<td>An Application of the Portfolio Model: The Impact of Capital Requirements</td>
<td>322</td>
</tr>
<tr>
<td>8.5</td>
<td>Problems</td>
<td>327</td>
</tr>
<tr>
<td>8.5.1</td>
<td>The Model of Prisman, Slovin, and Sushka (1986)</td>
<td>327</td>
</tr>
<tr>
<td>8.5.2</td>
<td>The Risk Structure of Interest Rates (Adapted from Merton 1974)</td>
<td>328</td>
</tr>
<tr>
<td>8.5.3</td>
<td>Using the CAPM for Loan Pricing</td>
<td>329</td>
</tr>
<tr>
<td>8.6</td>
<td>Solutions</td>
<td>330</td>
</tr>
<tr>
<td>8.6.1</td>
<td>The Model of Prisman, Slovin, and Sushka</td>
<td>330</td>
</tr>
<tr>
<td>8.6.2</td>
<td>The Risk Structure of Interest Rates</td>
<td>331</td>
</tr>
<tr>
<td>8.6.3</td>
<td>Using the CAPM for Loan Pricing</td>
<td>332</td>
</tr>
</tbody>
</table>

9 The Regulation of Banks 337

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>9.1</td>
<td>The Justification of Banking Regulations</td>
<td>338</td>
</tr>
<tr>
<td>9.1.1</td>
<td>The General Setting</td>
<td>339</td>
</tr>
<tr>
<td>9.1.2</td>
<td>The Fragility of Banks</td>
<td>340</td>
</tr>
<tr>
<td>9.1.3</td>
<td>The Protection of Depositors and Customers Confidence</td>
<td>341</td>
</tr>
<tr>
<td>9.1.4</td>
<td>The Cost of Bank Failures</td>
<td>343</td>
</tr>
<tr>
<td>9.2</td>
<td>A Framework for Regulatory Analysis</td>
<td>344</td>
</tr>
<tr>
<td>9.3</td>
<td>Deposit Insurance</td>
<td>346</td>
</tr>
<tr>
<td>Section</td>
<td>Page</td>
<td></td>
</tr>
<tr>
<td>------------------------------------------------------------------------</td>
<td>------</td>
<td></td>
</tr>
<tr>
<td>9.3.1 The Moral Hazard Issue</td>
<td>347</td>
<td></td>
</tr>
<tr>
<td>9.3.2 Risk-Related Insurance Premiums</td>
<td>348</td>
<td></td>
</tr>
<tr>
<td>9.3.3 Is Fairly Priced Deposit Insurance Possible?</td>
<td>350</td>
<td></td>
</tr>
<tr>
<td>9.3.4 The Effects of Deposit Insurance on the Banking Industry</td>
<td>351</td>
<td></td>
</tr>
<tr>
<td>9.4 Solvency Regulations</td>
<td>353</td>
<td></td>
</tr>
<tr>
<td>9.4.1 The Portfolio Approach</td>
<td>353</td>
<td></td>
</tr>
<tr>
<td>9.4.2 Cost of Bank Capital and Deposit Rate Regulation</td>
<td>354</td>
<td></td>
</tr>
<tr>
<td>9.4.3 The Incentive Approach</td>
<td>356</td>
<td></td>
</tr>
<tr>
<td>9.4.4 The Incomplete Contract Approach</td>
<td>358</td>
<td></td>
</tr>
<tr>
<td>9.4.5 The 3 Pillars of Basel 2</td>
<td>362</td>
<td></td>
</tr>
<tr>
<td>9.5 The Resolution of Bank Failures</td>
<td>362</td>
<td></td>
</tr>
<tr>
<td>9.5.1 Resolving Banks’ Distress: Instruments and Policies</td>
<td>363</td>
<td></td>
</tr>
<tr>
<td>9.5.2 Information Revelation and Managers Incentives</td>
<td>364</td>
<td></td>
</tr>
<tr>
<td>9.5.3 Who Should Decide on Banks’ Closure?</td>
<td>366</td>
<td></td>
</tr>
<tr>
<td>9.6 Market Discipline</td>
<td>369</td>
<td></td>
</tr>
<tr>
<td>9.7 Further Readings</td>
<td>372</td>
<td></td>
</tr>
<tr>
<td>9.8 Problems</td>
<td>374</td>
<td></td>
</tr>
<tr>
<td>9.8.1 Moral hazard and capital regulation</td>
<td>374</td>
<td></td>
</tr>
<tr>
<td>9.9 SOLUTION</td>
<td>375</td>
<td></td>
</tr>
<tr>
<td>9.9.1 Moral hazard and capital regulation</td>
<td>375</td>
<td></td>
</tr>
</tbody>
</table>
A la mémoire de Jean-Jacques Laffont
Preface

During the last three decades, the economic theory of banking has entered a process of change that has overturned economists’ traditional vision of the banking sector. Before that, banking courses of most doctoral programs in Economics, Business, or Finance focused either on management aspects (with a special emphasis on risk) or on monetary aspects and their macroeconomic consequences. Thirty years ago, there was no such thing as a “Microeconomic Theory of Banking,” for the simple reason that the Arrow-Debreu general equilibrium model (the standard reference for Microeconomics at that time) was unable to explain the role of banks in the economy.\footnote{This disappointing property of the Arrow-Debreu model is explained in Chapter 1.}

Since then, a new paradigm has emerged (the “asymmetric information paradigm”), centered around the assumption that different economic agents possess different pieces of information on relevant economic variables, and that agents will use this information for their own profit. This paradigm has proved extremely powerful in many areas of economic analysis. Regarding banking theory, it has been useful in both explaining the role of banks in the economy and pointing out the structural weaknesses of the banking sector (exposition to runs and panics, persistence of rationing on the credit market, recurrent solvency problems) that may justify public intervention.

This book provides a guide to this new microeconomic theory of banking. Rather than seek exhaustivity, we have focused on the main issues, providing the necessary tools to understand how they have been modeled. We have selected contributions that we found to be both important and accessible to second-year doctoral students in Economics, Business, or Finance.

What is new in the second edition.

Since the publication of the first edition of this book, the development of academic research on microeconomics of banking has been spectacular. This second edition attempts to cover most of the articles that we view as representative of these new developments. Three topics are worth mentioning.

First, the analysis of competition between banks has been refined by paying more attention to “non-price competition”, namely competition through other strategic variables than interest rates (or service fees). For example banks compete on the level of asset risk they take or the intensity of the monitoring of borrowers. These dimensions are crucial to shed light on two critical issues: the competition-stability trade-off and the impact of entry of new banks, both issues of concern for prudential regulation.

Second, the literature on the macroeconomic impact of the financial structure of firms
has made significant progress on at least two questions: the transmission of monetary policy and the effect of capital requirements for banks on the functioning of the credit market.

Finally, the theoretical foundations of banking regulation have been clarified, even though the recent developments in risk modeling (due in particular to the new Basel accords on banks solvency regulation) have not yet led to a significant parallel development of economic modeling.

Prerequisites

This book focuses on the theoretical aspects of banking. A preliminary knowledge of the institutional aspects of banking, taught for instance in undergraduate courses on Money and Banking, is therefore useful. Good references are the textbooks of Mishkin (1993) or Garber and Weisbrod (1992). An excellent transition between these textbooks and the theoretical material developed here can be found in Greenbaum and Thakor (1995).

A good knowledge of microeconomic theory (at the level of a first-year graduate course) is also needed: decision theory, general equilibrium theory and its extensions to uncertainty (complete contingent markets) and dynamic contexts, game theory, incentives theory. An excellent reference that covers substantially more material than is needed here is Mas Colell, Whinston, and Green (1995). More specialized knowledge on contract theory (Salanié 1996, Laffont and Martimort 2002, Bolton and Dewatripont 2006) or game theory (Fudenberg and Tirole 1991, Gibbons 1992, Kreps 1990, or Myerson 1991) is not needed but can be useful. Similarly, a good knowledge of the basic concepts of modern finance (Capital Asset Pricing Model [CAPM], Option Pricing) is recommended (see, for instance, Huang and Litzenberger 1988 or Ingersoll 1987). An excellent complement to this book is the corporate finance treatise of Tirole (2006). Finally, the mathematical tools needed in this book are to be found in undergraduate courses in differential calculus and probability theory. Some knowledge of diffusion processes (in connection with Black-Scholes’s option pricing formula) is also useful.

Acknowledgments

Our main debt is the intellectual influence of the principal contributors to the Microeconomic Theory of Banking, especially Benjamin Bernanke, Patrick Bolton, Doug Diamond, Douglas Gale, Martin Hellwig, David Pyle, Joe Stiglitz, Jean Tirole, Robert Townsend, and several of their co-authors. We were also influenced by the ideas of Franklin Allen, Ernst
Baltensperger, Sudipto Bhattacharya, Arnoud Boot, John Boyd, Pierre André Chiappori, Mathias Dewatripont, Phil Dybvig, Gérard Gennette, Charles Goodhart, Gary Gorton, Ed Green, Stuart Greenbaum, André Grimaud, Oliver Hart, Bengt Holmström, Jack Kareken, Nobu Kiyotaki, Hayne Leland, Carmen Matutes, Robert Merton, Loretta Mester, John Moore, Rafael Repullo, Tony Santomero, Elu Von Thadden, Anjan Thakor, Xavier Vives, Neil Wallace, David Webb, Oved Yosha, and Marie-Odile Yannelle. Some of them have been very helpful through their remarks and encouragement. We are also grateful to Franklin Allen, Arnoud Boot, Vittoria Cerasi, Gabriella Chiesa, Gerhard Clemenz, Hans Degryse, Antoine Faure-Grimaud, Denis Gromb, Loretta Mester, Bruno Parigi, François Salanié, Elu Von Thadden, and Jean Tirole, who carefully read preliminary versions of this book and helped us with criticism and advice.

The material of this book has been repeatedly taught in Paris (ENSAE), Toulouse (Master “Marchés et Intermédiaires Financiers”), Barcelona (Universitat Pompeu Fabra), Philadelphia (Wharton School) and Wuhan University. We benefited a lot from the remarks of our students. The encouragement and intellectual support of our colleagues in Toulouse (especially Bruno Biais, André Grimaud, Jean-Jacques Laffont, François Salanié, and Jean Tirole) and Barcelona (Thierry Foucault and José Marin) have also been very useful. Finally, we are extremely indebted to Claudine Moisan and Marie-Pierre Boé, who competently typed the (too many) different versions of this book without ever complaining about the sometimes contradictory instructions of the two co-authors.

Outline of the Book

Because of the discouraging fact that banks are useless in the Arrow-Debreu world (see Section 1.2 for a formal proof), our first objective (after providing a general introduction in Chapter 1) will be to understand why financial intermediaries exist. In other words, what are the important features of reality that are overlooked in the Arrow-Debreu model of complete contingent markets? In Chapter 2, we explore the different theories of financial intermediation: transaction costs, liquidity insurance, coalitions of borrowers, and delegated monitoring.

The second important aspect that is neglected in the complete contingent market approach is the notion that banks provide costly services to the public (essentially management of loans and deposits), which makes them compete in a context of product differentiation. This is the basis of the Industrial Organization approach to banking, studied in Chapter 3.

Chapter 4 is dedicated to optimal contracting between a lender and a borrower. In
Chapter 5 we study the equilibrium of the credit market, with particular attention to the possibility of rationing at equilibrium, a phenomenon that has provoked important discussions among economists.

Chapter 6 is concerned with the macroeconomic consequences of financial imperfections. In Chapter 7 we study individual bank runs and systemic risk, and Chapter 8 is dedicated to the management of risks inside the banking firm. Finally, Chapter 9 is concerned with bank regulation and its economic justifications.

Teaching the Book

According to our experience, the most convenient way to teach the material contained in this book is to split it into two nine-week courses. The first of these courses covers the most accessible material of Chapters 1 through 5. The second course is more advanced and covers Chapters 6 through 9. At the end of most chapters we have provided a set of problems, together with their solutions. These problems not only will allow the students to test their understanding of the material contained in each chapter, but also will introduce students to some advanced material recently published in academic journals.

References


