

"Banks without Parachutes - Competitive Effects of Government Bail-out Policies"

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Discussion

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Issues:

- Bail Out (TBTF) effects on:
 - i) the bank that enjoys the implicit guarantee
 - ii) competitors – **spillover effects**
 - iii) welfare

- Competition and Risk taking – stability of the banking system
 - competition on the liability side and no asset transformation (monitoring/screening)

Previous literature:

- abundant with regard to **Competition and risk taking**

the issue is

risk-shifting incentives of debt, given unobservability (non-contractability) of bank risk choices – **hidden action problem**

and the role of current and expected future profits (charter value) in mitigating the agency problem

- "informal" with regard to the effects of **bail-out** policies

bail out is generally seen as paralleling unfairly priced deposit insurance:

which of course leads to excessive risk taking with respect to the *first best*

In a world of bank choices **observability**, the benchmark is the *first best* implemented by **market discipline**:

a bail out policy can only be detrimental: it reintroduces moral-hazard – shift risk on to the government

* The paper makes this point explicit.

The interesting issue is the bail-out effects in a second best environment of **hidden action** (*charter value model*)

hidden action (*charter value model*)

- bank risk choice, the return per unit invested y_i , is unobservable:

· the lower the cost of funding, the smaller the risk-shifting incentive

- bank i 's cost of funding (deposit rate) is determined knowing the bail out policy β_i :

for a given deposit-mkt clearing return $R(D)$, i 's cost of funding is $\rho_i R(D)$:

$$\left\{ p(y_i^e) + \left[1 - p(y_i^e) \right] \beta_i \right\} \rho_i R(D) = R(D)$$

repaym. prob.

$$\rho_i \equiv \frac{1}{\text{repaym. prob.}}$$

i 's expected profits are Π_i :

$$\Pi_i = \pi_i d_i$$

$$\pi_i = p(y_i) \left[\underset{\text{margin}}{y_i - \rho_i R(D)} \right]$$

i chooses d_i , y_i , so as to max Π_i given ρ_i :

as $\rho_i \downarrow$, i 's cost of funding \downarrow : $d_i \uparrow$ (i expands) , $y_i \downarrow$
(i takes **less** risk to get the increased margin with higher prob.)

(asymmetric) Bail-out Effects:

an increase in β_i leads to a lower ρ_i : i 's cost of funding
 \downarrow :

i expands and becomes safer.

Spillover effects:

$D \uparrow$ (because i expands), $R(D) \uparrow$: competitors' cost of funding increases:

competitors get riskier and shrink

Welfare implications

For $\beta_i = 1$, i 's cost of funding equals the safe-rate of interest (the opportunity cost of an unleveraged bank)

under the paper's assumption of zero d-l. of taxation

Symmetric bail-out are welfare increasing:

$\beta_i = 1$, $\forall i \implies$ First best risk choices and aggregate investment level for a perfectly competitive deposit mkt.

- **Spillover effects of Bail out**

- What does the Cournot setting allow for that a simple competitive mkt does not?

spillover effects would be there also under perfect competition

- **welfare** effects of bail out:

negative for a "transparent" banking system (no hidden action)

positive if **hidden action** (*charter value model*):

but with no d.l. of taxation