Discussion of:

Competition and Stability in Banking: A New World for Banking Policy?

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The views expressed are my own and do not reflect those of the FRBNY or the Federal Reserve System.

The Question

- How does competition affect stability of the banking system?

  - timely question with important implications

- What are the mechanisms at work?

  - paper goes through theory and evidence

- What are the implications for banking regulation ...

  - in normal times?

  - during a crisis?

- Paper provides an excellent overview and synthesis of the literature

- Examines two channels through which competition can affect stability

  - liability side: makes a bank more susceptible to a run

  - asset side: affects bank's investment decisions

- I will focus my comments on the liability side

  - illustrate the argument in a simple model

  - then comment on implications

Competition and Bank Runs

- A simple model based on Diamond & Dybvig (1983)

- 2 periods, $t = 1, 2$

- Depositors' preferences:

$$\left\{ \begin{array}{c} u\left(c_1\right) \\ u\left(c_1 + c_2\right) \end{array} \right\} \quad \text{if} \quad \left\{ \begin{array}{c} \text{impatient} \\ \text{patient} \end{array} \right\}$$

  - type is revealed at $t = 1$; fraction π will be impatient

- Two assets:

	Return at $t = 1$	Return at $t = 2$
liquid	1	1
illiquid	$1 - \tau$	$R > 1$

- Banks offer demand deposit contracts

  - depositors receive c_1 if they withdraw early, c_2 if they wait

- Imperfect competition:

  - a bank's depositors have outside option $\overline{u}$

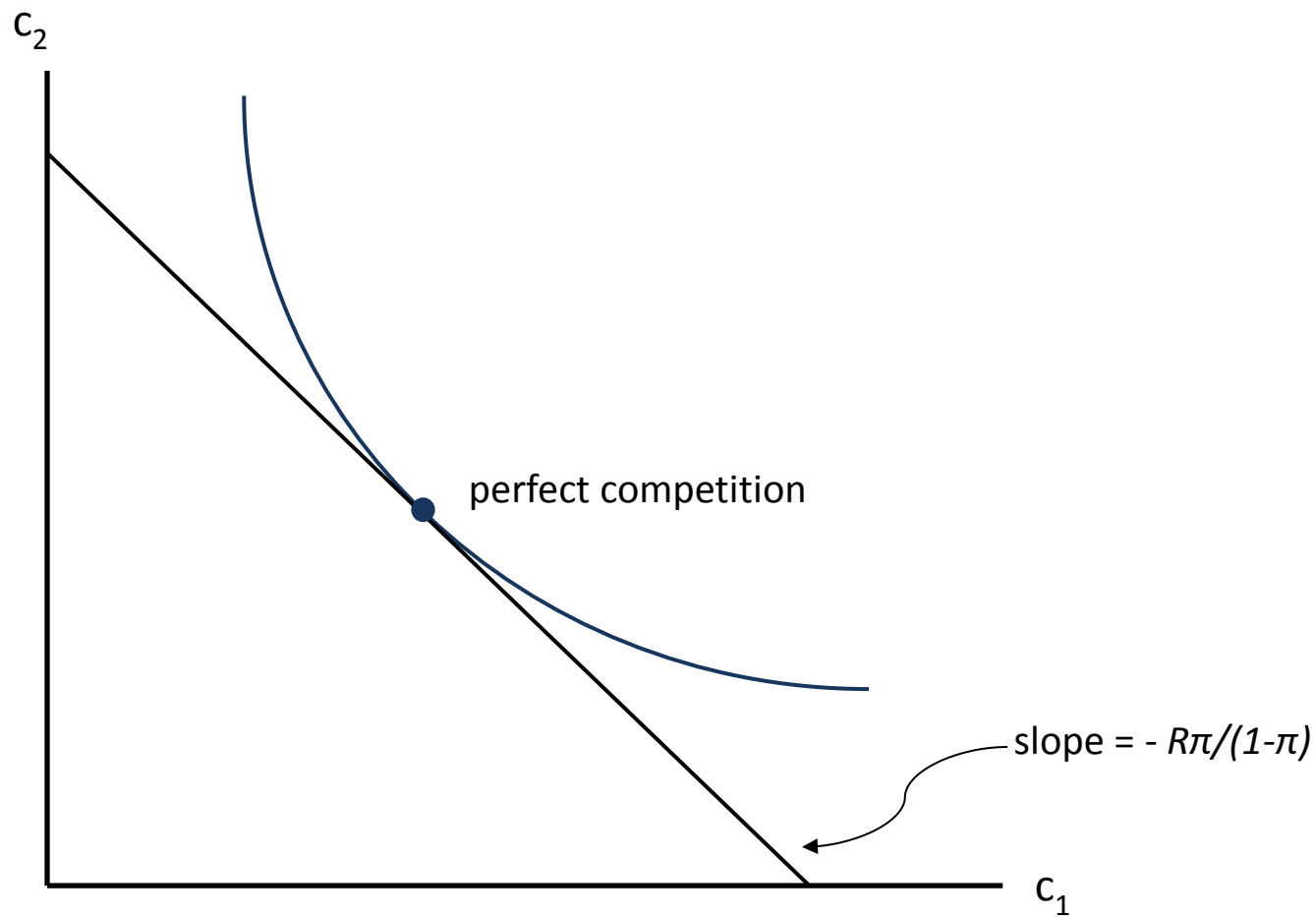 - higher $\overline{u} \approx$ more competition
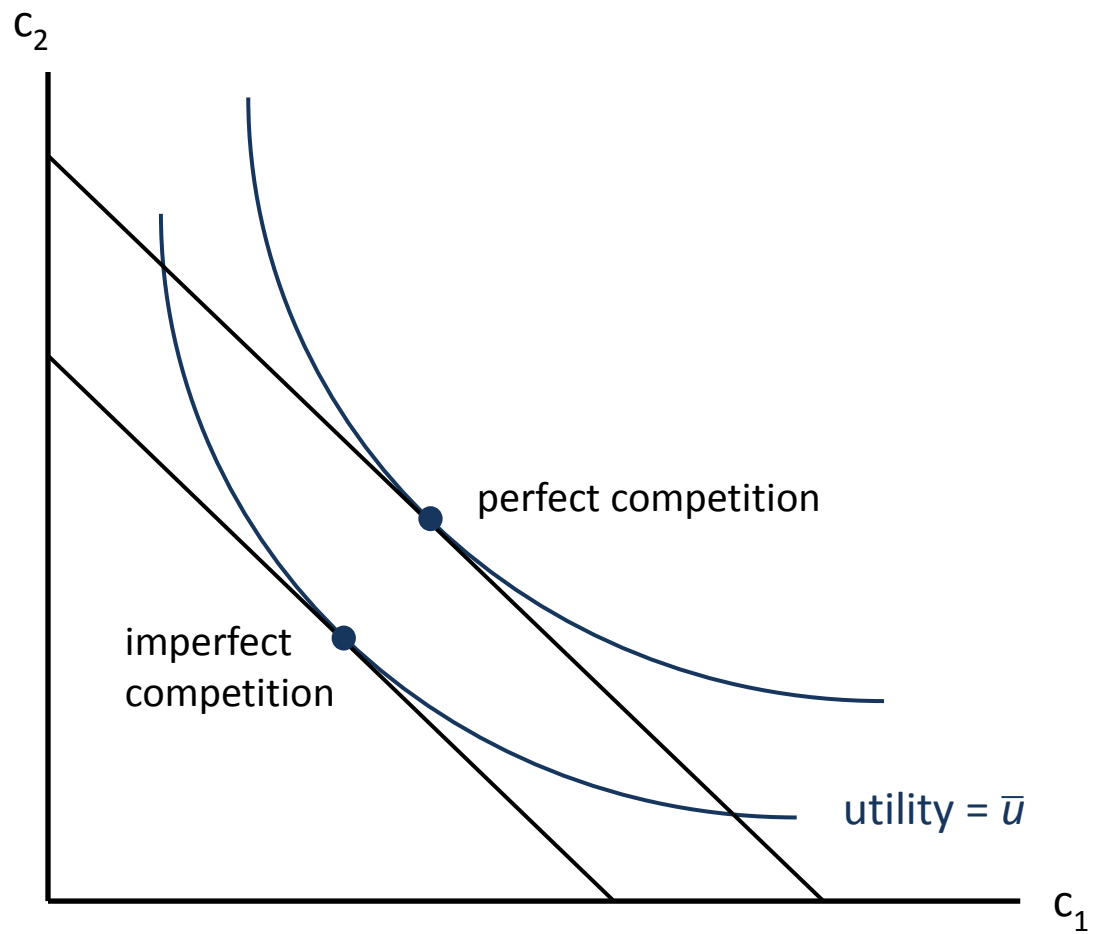
- Bank's profit

$$R\left(1 - \pi c_1\right) - \left(1 - \pi\right) c_2$$

- Bank maximizes profit subject to

$$\pi u\left(c_1\right) + \left(1 - \pi\right) u\left(c_2\right) \geq \overline{u}$$

Graphically:

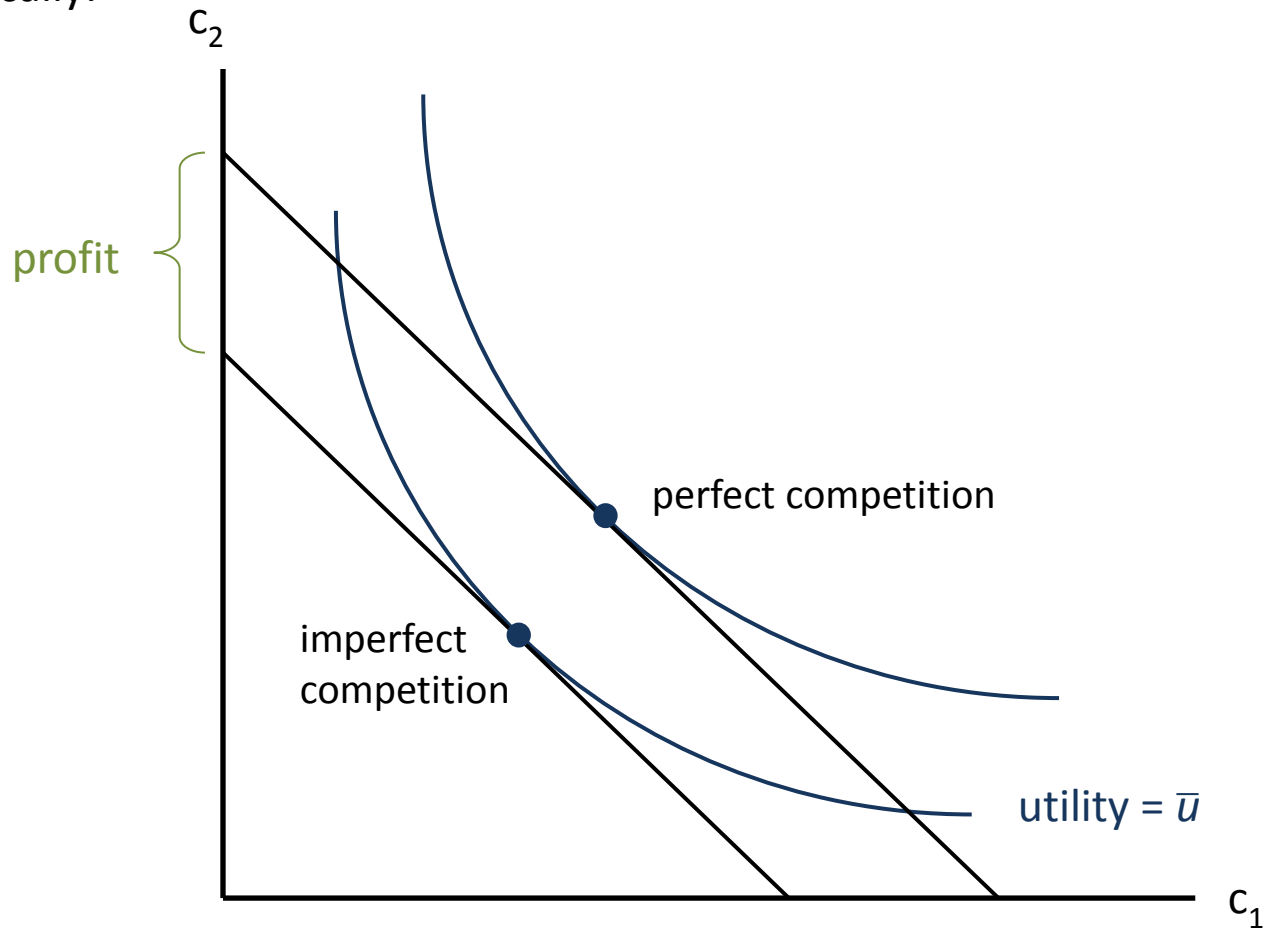
c_2

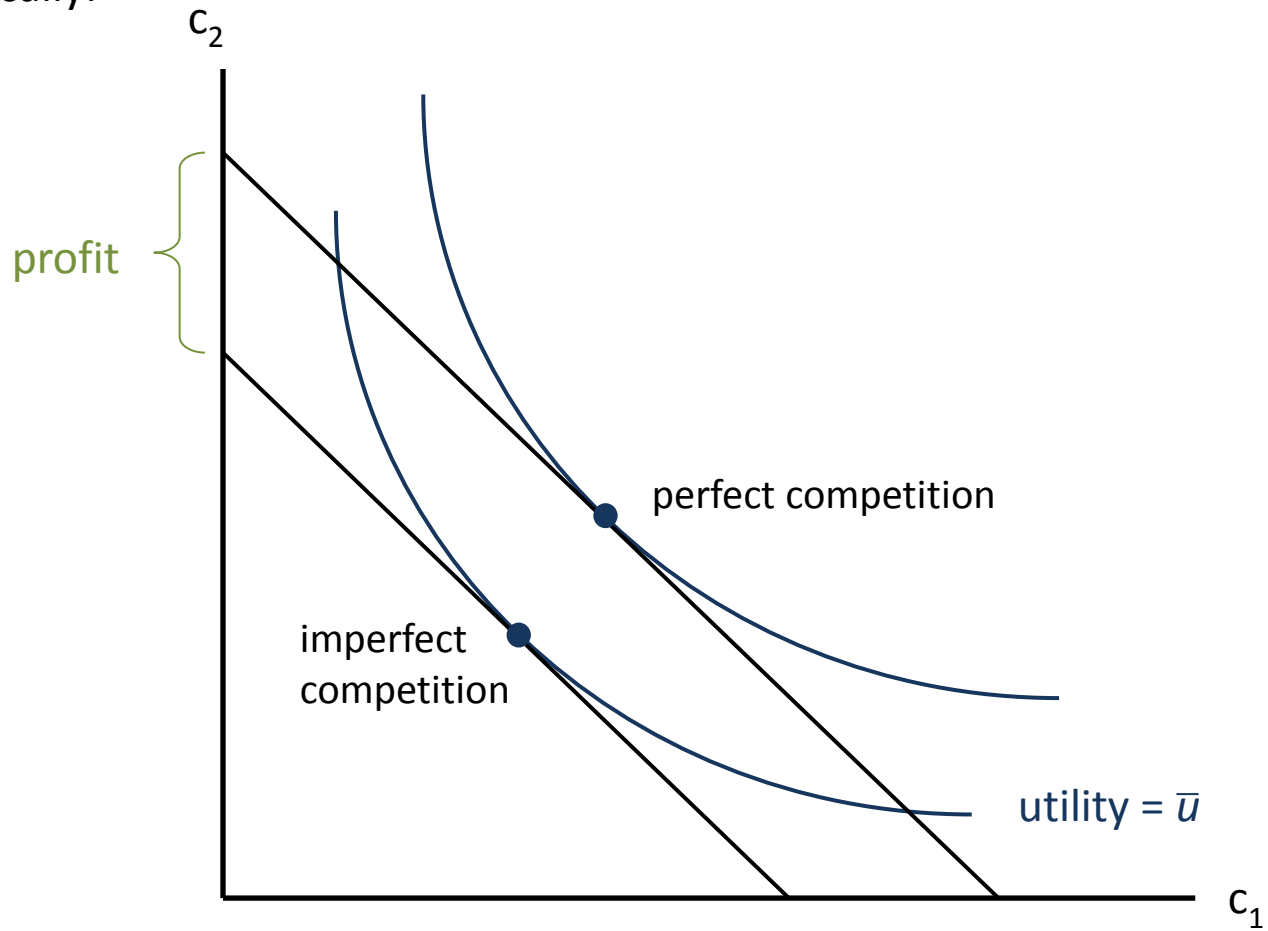perfect competition

slope $= -R\pi/(1-\pi)$

c_1

Graphically:

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Less competition $\rightarrow$ lower c_1 and c_2, higher profit

- The bank is susceptible to a self-fulfilling run if

$$c_1 > \pi c_1 + (1 - \tau)(1 - \pi c_1)$$

or

$$1 > \pi + (1 - \tau)\left(\frac{1}{c_1} - \pi\right)$$

- RHS is strictly decreasing in c_1

  $\Rightarrow$ increased competition makes this more likely to be satisfied

- Intuition: profits are a buffer against unexpected withdrawals

  - competition shrinks this buffer; leaves bank more vulnerable

  - note: profit and bank capital are equivalent here

What should a regulator do?

- Deposit insurance can (usually) prevent runs, but …
    - exacerbates moral hazard problem on the asset side

In principle:

- Use risk-sensitive deposit insurance
    - design to offset moral-hazard effects

- Combine with risk-based capital requirements
    - offset externalities caused by systemic effects

In other words:

- Appropriate (risk-sensitive) regulation can remove the tradeoff between competition and stability

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In practice:

- Risk-sensitive regulation requires regulators to assess and *codify* risk

- Codification opens the door to regulatory arbitrage

  - people care independently about the asset's rating (think of "AAA" assets)

- If risk-sensitive regulation is imperfect, limiting competition may be a (partial) substitute

    - a blunt instrument to be sure, but perhaps useful nonetheless

    - might want some risk-sensitive regulation, some limits to competition

- Interesting point; potentially quite important

- Arguing against competition makes me uncomfortable, but …

    - now is certainly a time for thinking broadly

Comments

1) How broadly should we think of this analysis as applying?

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1) How broadly should we think of this analysis as applying?

- Only commercial banks? all financial intermediaries?

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2) Should not underestimate the benefits of competition

- Danger following a crisis is sometimes too much reaction rather than too little

- Dynamic efficiency and innovation is important

    - compare online banking with cable TV service

3) How are banks different from General Motors?

- Some of the arguments above would apply to GM as well

  - less competition would have increased (short-term) profits

  - possible coordination failure among customers

  - large social cost of (disorderly) failure, etc.

- Good test for any argument that banks are special

  - paper partially addresses this issue; could do more

4) Time-consistency is a serious issue

- Paper discusses how policy has changed during the crisis

  - allowing mergers that previously would have been rejected, etc.

  - market participants anticipate these reactions to some degree

  - need to incorporate these effects into our models

- See recent work on the Diamond-Dybvig model with limited commitment by policy makers

  - Ennis and Keister (2009)

  - shows how public intervention can be a *source* of instability