“Lax Lending Standards and Capital Requirements”

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Summary of the paper (i)

- Fashionable approach: banking in a macro setting
- A theory of lax lending standards (Hachem (2012)):
  - Assumption 1: each bank has every period only a unit of effort to divide between finding and screening borrowers
  - Hence, bank without a borrower *today* faces a worse pool of borrowers *tomorrow*
  - Assumption 2: banks too small to internalize impact of their lending decisions on the future pool of borrowers (e.g. Landier (2006), Gerling, Kowalik and Schumacher (2012))
  - Inefficiency: banks screen “too little” (lax lending standards)

Summary of the paper (ii)

- Results:
  - Banks provide too much uninformed credit
  - They become overexposed to negative economic shocks
  - Lax lending standards amplify economic shocks and increase volatility of credit

- Policy implications:
  - Capital regulation works because capital is more costly than alternative financing
  - Counter-cyclical capital requirements:
    - high when interest rates are low and aggregate productivity is high, and vice versa

Overview of Discussion

- A comment on the relevance of the proposed mechanism
- Comments on model setup
  - Capital
  - Interbank market
  - Implications
- Conclusion

Comment on the relevance of the mechanism

- The paper assumes:
  - A trade-off between matching and screening
  - More competition => less interest in the future borrowers' pool
- Some (stylized) facts about lending technology and market structure:

Type of banks	Lending technology (Berger et al. (2005))	Market structure
Community banks	Informationally opaque borrowers	Close to monopolistic
Large banks	Relatively transparent borrowers	Competitive

- Is banking in the model the banking we know?
  - Community banks: screening important, but they may internalize their decisions
  - Large banks: they may not internalize their decisions, but screening unimportant, because they make their lending decision on hard information

Comments on model setup: capital (i)

- Assumption 1: each bank's capital is constant over the period
  - Book value of capital? Regulatory forbearance between stage 1b and 2a?
  - Because capital=retained earnings, this assumption ignores the fact that capital for lending at stage 2=bank's profits at stage 1b
- Assumption 2: after loan returns are realized capital plus interest on it has to be repaid; only then bank stays solvent
  - Capital as debt-like instrument?
  - Usually return on equity=the residual payment to the bank shareholders

Comments on model setup: capital (ii)

- Assumption 3: capital is more costly than debt
  - Used to get binding credit requirements when the bank can choose its capital
  - Cost of capital=cost of issuance or opportunity cost of investing in the bank
    - In the model no issuance (capital=retained earnings) and opportunity cost is i_b
  - Important to understand this cost, because crucial for results
  - Capital has its cost: limit on the amount of loans the bank can generate
- Assumption 4: the bank issuing a loan at stage 1b does not take into account that this loan also generates revenue at stage 2 if retained (equations (2) and (4))
  - No clear reason for such an assumption
  - Without this assumption capital as buffer to protect lending opportunity at stage 2 => potential for non-binding capital requirements
  - Elizalde and Repullo (2007), Martinez-Miera and Repullo (2010)

Comments on model setup: capital (iii)

Proposal:

- get rid of cost of capital,
- assume capital is not constant and take into account residual nature of capital
- consequence: banks have incentive to accumulate capital and screen more

Purpose: assess at what level of γ capital requirements become relevant

Comments on model setup: interbank market

- The information structure on the interbank market is not clear
  - From (2) and (4): symmetric information? (each borrowing bank pays $1+i_b$)

- Are interbank market loans insured? Not clear
  - They are not (or fair deposit insurance fees in place)? Each borrowing bank pays $1+i_b$, hence no put option coming from deposit insurance
  - They are? The fact that the unmatched bank's capital is at risk is not taken into account:
    - No lending: loss of return but for sure the bank has capital to lend tomorrow,
    - Lending: in case of default no chance to lend tomorrow
    - Screening reduces risk of interbank loan => threat of not getting a loan, possibility that the borrowing bank's is not granted the loan might increase incentive to screen

- Modeling of interbank market matters for the main results

Comments on policy implications (i)

- Result 1:
  - More screening when interest rates/bank funding costs are high

- Discuss robustness of this result:
  - Matching vs. screening ≈ standard risk shifting
    - less screening => lower expected value and higher expected default probability
  - Small change in the model (mispriced deposit insurance or asymmetric information on the interbank market):
    - higher i_b => risk taking or less screening

Comments on policy implications (ii)

- Result 2 (follows from Result 1):
  - Capital regulation is good because it increases cost of financing by increasing the share of costly capital

- Usually capital lowers the incentive for risk shifting, because it increases the share of pie the bank gets (“skin in the game”)

- This effect should be present in the model too

- Natural way to motivate the capital regulation

Conclusion

- A novel approach to banking
- Very interested in the interaction between the aggregate productivity shocks and interest rate and its implications for the counter-cyclical capital requirements
- Looking forward to the version with welfare analysis (similar issues: Repullo and Suarez (2012), Martinez-Miera and Suarez (2012), Hachem (2012))