Discussion of: "Banking and Trading" Arnoud Boot and Lev Ratnovski

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Goal of Paper

- Analyze the interaction of trading and banking in a universal bank.

Main Results: First Best

- Main constraint is: A - D$>$bA.
- If the bank can commit to banking, then conglomeration enables using “excess capital” to trade. The bank exhausts banking opportunities before allocating any assets to trading.

The Friction

- Assume the bank cannot commit to banking
- And part of the return comes through “credit line fees” received before actual lending.
- These lead to a time inconsistency problem at the bank. The bank might not find it optimal to follow through its promises after collecting the fees.

Main Result under the Friction

- Under some conditions on the parameters, we see a contraction of banking.
- Nevertheless Banking coexists with trading.
- Under other parameters, only some trading exists and banking implodes.

What is a Bank?

- Has franchise value R_0 (implicit equity).
- Bank borrows at rate 0 and lends or trades.
- Subject to the constraint that A - D$>$bA.

How is (First Best) Banking Modeled?

- Mass $\bar{R}$ of customers.
- Bank lends to R of them and earns return $1 + r$ on each.
- Bank chooses R.
- At maximum lending, there is spare borrowing capacity in banking: $R_0 + r\bar{R} > b\bar{R}$.

Banking Friction

- There are two periods: period 0 and period 1.
- Assume now that only $\rho < r$ can be collected in period 1. $(r - \rho)$ is collected as a “credit line” fee at period 0.
- Bank might not find it optimal in period 1 to follow up on its ”credit line” promises.

How is Trading modeled?

- For T units invested, net returns tT if $T \leq S$ and 0 if $T > S$.
- Trading is less profitable than banking $t < r$.
- Standalone trading is not possible $(1 + t)T - T < bT$.

Discussion's Contribution

- PLEASE change the notation! R for amount borrowed?!!
- Some things that need more explanation.
- Modeling concerns.
- Some advice.

Things that needs more explanation

- Period 0 is called ex-ante, and period 1 ex-post. But there is no uncertainty here.
- S is called the scalability of trading. There is no clear explanation of what scalability means. Is it just the decreasing of scale aspect of the return to trading?
- Both S and $\bar{R}$ look as if they are limits on what the bank can do profitably though.

Modeling Concerns

- Banking and Trading differ in their scale and returns.
- But basically the friction is what drives the result. Is this friction important?
- Is not most of banking just lending and not the uncommitted promise to lend?
- In the paper, credit line lending is a friction. In reality, banks choose optimally to lend this way. Huge difference.

Some Advice

- Write the maximization problem of customers.
- Rethink what the crucial difference between banking and trading is.
- Get the model to a stage to handle policy questions of the “Volcker Rule” costs and benefits (No safety net etc).
- The English of the paper is way ahead of its math.
- Overall, this is a working paper that has the potential to address a very important topic.