One-day research course

Financial Instability and Banking Models: Disciplining or Protecting Banks? by Prof. Charles Calomiris, Columbia Business School

Wednesday, 3 April, Centre Panthéon, Université Paris 1 Panthéon - Sorbonne

9:15 – 10:00 Session 1, room 18: The liability structure of unprotected banks in theory

10:00 – 10:15 Coffee break

10:15 – 12:30 Session 2, room 18: The liability structure of unprotected banks in history and its real consequences

12:30 – 14:30 Lunch Break

14:30 – 16:00 Session 3, room 216: What do we learn from banking crises about banking theory?

16:00 – 16:15 Coffee Break

16:15 – 17:00 Session 4, room 216: Deposit insurance, systemic risk, and politics

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Detailed Syllabus and bibliography below (presentation will focus on * papers)
Financial Instability and Banking Models: Disciplining or Protecting Banks?

Professor Charles W. Calomiris

Sorbonne, April 2009

Prior to the establishment of generous safety net protection for banks (which consists of deposit insurance, emergency lending by central banks and governments, and investments in bank equity), depositors exerted discipline on banks, implemented through depositors’ right to demand their deposits back from the bank, and the first-come, first-served rule for paying bank depositors that requested their funds. A bank that lost the confidence of depositors quickly would be forced to contract its lending and reduce its leverage, and if the loss of confidence was sufficiently severe, it could be forced to close. Depositor discipline created strong incentives for risk management by unprotected banks, which took the form of balance sheet management of cash and capital, the creation of credible supervision relationships (both private and public), the auditing and publication of bank condition reports, and the adoption of corporate governance practices to limit agency problems.

The protection of banks is justified in economic theory by concerns about the costs of systemic contractions of the banking system. Protection prevents market discipline from producing bank contractions or closures, but it also removes the incentives for banks to manage risk effectively. Regulatory discipline through minimum capital ratio and cash ratio requirements and the like can, in theory, substitute for market discipline and provide a check on bank risk taking. However, unlike market discipline, regulatory discipline is part of a political process, and therefore, may be used for purposes other than ensuring effective risk management by banks. In practice, regulation has not been reliably focused on prudent management of risk. The use of regulation as a political tool (especially to favor the interests of particular classes of borrowers, such as mortgage borrowers) has undermined the effectiveness of regulation to serve as a substitute for market discipline, and has helped to propel bank risk taking in new directions, which promote large and undesirable systemic risks (i.e., highly leveraged housing finance).

In theory, deposit insurance could be a source of increased systemic risk (through some combination of banker moral hazard, adverse selection, or political deals that purposefully shape the regulation of risk taking in a way that increases risk or reduces profitability). Alternatively, it could be a source of reduced systemic risk (through reductions in liquidity risk associated with diminished withdrawal incentives). In practice, however, deposit insurance generally has been a source of increased systemic risk.

New ideas for regulatory mechanism design in the presence of politically determined safety nets have been focusing on ways to limit the political abuse of prudential regulation by introducing market information into the regulatory process, which can serve as a source of discipline and accountability for the regulatory process. However, such reforms are difficult to
implement because political coalitions that benefit from the abuse of regulation are likely to oppose the adoption of regulatory systems that reduce the subsidies they enjoy.

This PhD-level course begins by considering the theory of bank asset and liability structure. The history bank structure, function and operation by unprotected banking is explored as a test of these theories. The peculiar history of bank instability in the U.S. is explored, and contrasted with the history of other countries in the 19th and early 20th centuries. The history and theory of the lender of last resort is examined, as well as the theory and history of deposit insurance and of emergency bank assistance via equity injections.

In the list of readings that follows, an asterisk (*) denotes a reading that will be a particular focus of the discussions. Other readings will be discussed in less detail.

**April 3 Morning: The liability structure of unprotected banks in theory (45 minutes)**


Gary Gorton and George Pennacchi (1990), Financial intermediaries and liquidity creation, *Journal of Finance*.


**April 3 Morning (Cont’d): The liability structure of unprotected banks in history and its real consequences (2 1/4 hours)**


April 3 Afternoon: What do we learn from banking crises about banking theory? (1 1/2 hours)


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Kris Mitchener and Gary Richardson (2017), Shadowy banks and the interbank amplifier during the Great Depression, Working Paper.


Charles Calomiris and Stephen Haber (2014), Fragile By Design: The Political Origins of Banking Crises and Scarce Credit, Chapters 1-9.

April 3 Afternoon (Cont’d): Deposit insurance, systemic risk, and politics (45 minutes)


April 3 Afternoon (Cont’d): Other emergency assistance to banks (45 minutes)


Markus Brunnermeier, Luis Garicano, Philip Lane, Marco Pagano, Ricardo Reis, Tano Santos, David Thesmar, Stijn Van Nieuwerburgh, and Dimitri Vayanos (2016), The Sovereign-bank diabolic loop and ESBies, American Economic Association Review Papers and Proceedings.


Charles Calomiris and Richard Herring (2013), How to design a contingent convertible debt requirement that helps solve the too-big-to-fail problem, Journal of Applied Corporate Finance.

Charles Calomiris (2017), Reforming Financial Regulation After Dodd-Frank.