Global Banking: Endogenous Competition and Risk Taking

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Discussion by

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Motivation

- Is global banking good or bad for financial stability?
  - Contributed to propagation of risk in the crisis (Rajan, 2005)
  - "Bricks and mortar" business model can promote local competition, thus reducing risk-taking (IMF, 2015)
- Recent evidence shows benefit of global banking
  - Foreign banks reduce costs of credit and risk taking, the more so when low entry barriers and wide scope for competition (e.g., Claessens et al., 2001; Giannetti and Ongena, 2012)
- Faia et al. (2016): foreign expansion through bricks and mortar reduces bank idiosyncratic and systemic risks

The model in a nutshell

- Dynamic entry model in open economy
- Banks can decide to operate in different countries
  - Segmented markets: deposits and loans in each country
  - Fixed entry cost (for headquarter and each subsidiary)
  - Deposits are fully insured against a fee
  - Firms undertake risky projects with risk/return tradeoff
  - Banks monitor loans - higher cost in foreign country
  - Banks face Cournot competition in deposit and loan markets
    - Households and firms have no market power
    - Banks can extract rents from spread (loan-deposit rate)

Main insights

- Banks enter in foreign markets if future discounted profits (charter value) exceed entry and set up costs
- Determinants of banks' charter value
  - ***Predatory banking***: because of additional monitoring costs, banks accept lower loan-deposit spread in foreign markets, especially when they have small market share
  - ***Endogenous risk taking***: Entry affects intensity of competition, and thus loan rates and risk – higher rates, more risk
    - ***Deposit rate channel:*** entry leads to more deposits and higher rates
    - ***Loan rate channel***: entry leads to more loans and lower rates
    - ***Charter value channel***: lower loan-deposit spread decrease banks' profits and charter value

Main insights (cont.)

- Dynamic entry process triggered by predatory banking
- Final effect on loan rates and thus risk depend on functional forms
  - In "most common" cases, entry compresses loan-deposit spread
  - Endogenous competition induce banks to make firms behave more prudently, despite deposit insurance
- Two scenarios
  - Deterministic "long-term" scenario with invariant project risk/return trade-off
  - Stochastic "short run" scenario with productivity shocks affecting project risk/return trade-off

Main insights (cont.)

- Global banks reduce risk taking by promoting local competition and reducing loan rate
- Effect is stronger with
  - Perfectly correlated loan risk
  - Exogenous exit
  - Horizontal expansion

General comments

- Very interesting paper, combining trade and (macro) banking
  - Novel and under-studied research question
  - Important to build models that can explain recent evidence
- Very rich framework
  - Do you need all these ingredients and effects?
  - Can you streamline the analysis a little bit?
- Some (micro) comments
  - On the model
  - Going forward

Comment 1 – competition

- Competition in loan and deposit markets
  - Normally, only competition in one market is considered (e.g., Allen and Gale, 2000; Martinez-Miera and Repullo, 2010)
  - Why?
    - It simplifies the analysis
    - It avoids timing issues across the two markets (Yannelle, 1998)
  - Banks maximize profits in the two markets independently of each other in the paper
  - What happens with more interaction across markets?

Comment 2 - risk taking and failure

- Banks set loan and deposit rates and firms choose risk
- Lower rates, as due to greater competition, imply lower risk, as in Boyd and De Nicolò (2006)
- Firm projects fail with probability 1-p
- **But** banks firms fail at an exogenous rate ϱ (even if project returns are perfectly correlated) - bank exit is **not** related to risk, as typical in more micro models
- Is this important?
  - Endogenous risk is considered in one extension, but still not linked to loan risk

Comment 3 – deposit insurance

- Deposits are fully insured
- Banks pay insurance cost
  - Independent of risk and deposit quantity
- How important are these assumptions?
- Banks have no capital
  - What would happen with capital?
  - Is capital really equivalent to banks paying (fixed) deposit premium?

Comment 4 – going forward

- Predatory banking is important - dumpling in trade
  - Is there evidence of this in global banking?
- Banks operate in a "bricks and mortar" model
  - Is this optimal for them?
- No attention to the structure of banks
  - Branch versus subsidiary
  - Can it matter, e.g., for monitoring cost, firm selection, etc?

Conclusions

- Very interesting and novel analysis
- Room to streamline it a little
- Room to micro found (or at least explain) some assumptions in more details and extend it further (in future work!)