Modelling Risky Financial Institutions

David Martinez-Miera

The main objective of this course is to understand the key mechanisms underlying the risk taking behavior of banks and their consequences for the real economy. The course present different setups that allow the participant to better understand:

1. The relevance of imperfect information in the credit market

2. The role of financial institutions in the economy

3. Banks' risk strategies and their impact on the overall allocation of capital in the economy

4. The role of banks and other agents in determining the inherent instability of the economy

5. The logic and possible unintended consequences underlying banking regulation

Chapters

1. Financial Intermediation and information frictions
2. Bank monitoring and the role of net wealth
3. Bank risk taking and competition
4. Liquidity and runs
5. Banking Regulation: Capital Regulation
6. Banks and Non-Banks
7. Banks in General Equilibrium

A useful reference for most of the course is the textbook of Xavier Freixas and Jean-Charles Rochet, Microeconomics of Banking, 2nd Edition, Cambridge, MA: MIT Press, 2008.

In brackets is the estimated length in weeks of the chapter. This might be subject to change

Exhaustive Reading list

1. Financial Intermediation and information frictions

   De Meza, D., & Webb, D. C. (1987). Too Much Investment: A Problem of Asymmetric Information. The Quarterly Journal of Economics, 102(2), 281–292.

   Stiglitz, J. E., and A. Weiss (1981), “Credit Rationing in Markets with Imperfect Information,” American Economic Review, 71, 393-410.

2. Bank monitoring and the role of net wealth

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Diamond, D. (1991), “Monitoring and Reputation: The Choice between Bank Loans and Directly Placed Debt,” Journal of Political Economy, 99, 689-721.

Holmstrom, B., and J. Tirole (1997), “Financial Intermediation, Loanable Funds, and the Real Sector,” Quarterly Journal of Economics, 112, 663-691.

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3. Bank risk taking and competition

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Bhattacharya, S., A. Boot, and A. Thakor, A (1998), “The Economics of Bank Regulation,” Journal of Money, Credit and Banking, 30, 745-770.

Boyd, J., and G. De Nicolò (2005), “The Theory of Bank Risk-Taking and Competition Revisited,” Journal of Finance, 60, 1329-1343.

Farhi, E., and J. Tirole (2012), “Collective Moral Hazard, Maturity Mismatch and Systemic Bailouts,” American Economic Review, 102, 60-93.

Hellmann, T. F., K. C. Murdock, and J. Stiglitz (2000), “Liberalization, Moral Hazard in Banking, and Prudential Regulation: Are Capital Requirements Enough?,” American Economic Review, 90, 147-165.

Keeley, M. C. (1990), “Deposit Insurance, Risk, and Market Power in Banking,” American Economic Review, 80, 1183-1200.

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4. Liquidity and runs

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Bhattacharya S., and D. Gale (1987), “Preference Shocks, Liquidity and Central Bank Policy,” in W. Barnett and K. Singleton (eds.), New Approaches to Monetary Economics, Cambridge: Cambridge University Press, 69-88.

Bryant, J. (1980), "A Model of Reserves, Bank Runs, and Deposit Insurance," Journal of Banking and Finance, 4, 335-344.

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5. Banking Regulation: Capital Regulation

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6. Banks and Non-Banks

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He, Z., and A. Krishnamurthy (2012), “A Model of Capital and Crises,” Review of Economic Studies 79, 735-777.

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