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 politi**cs

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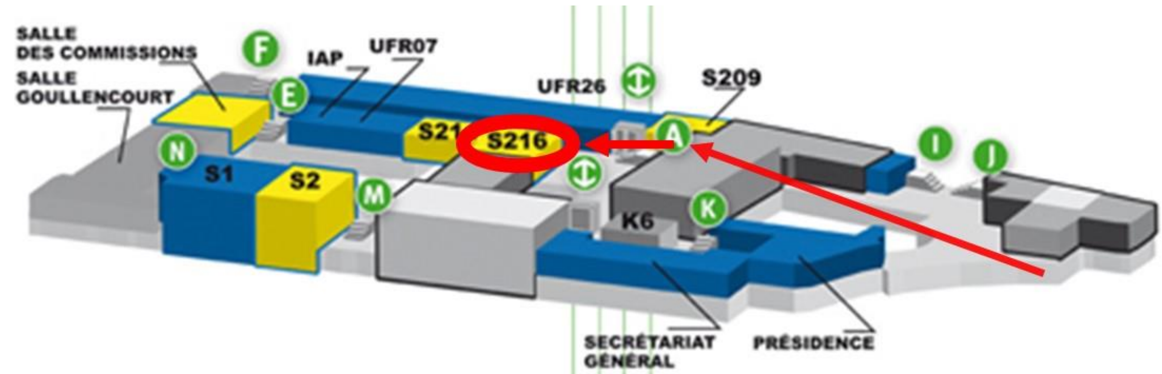

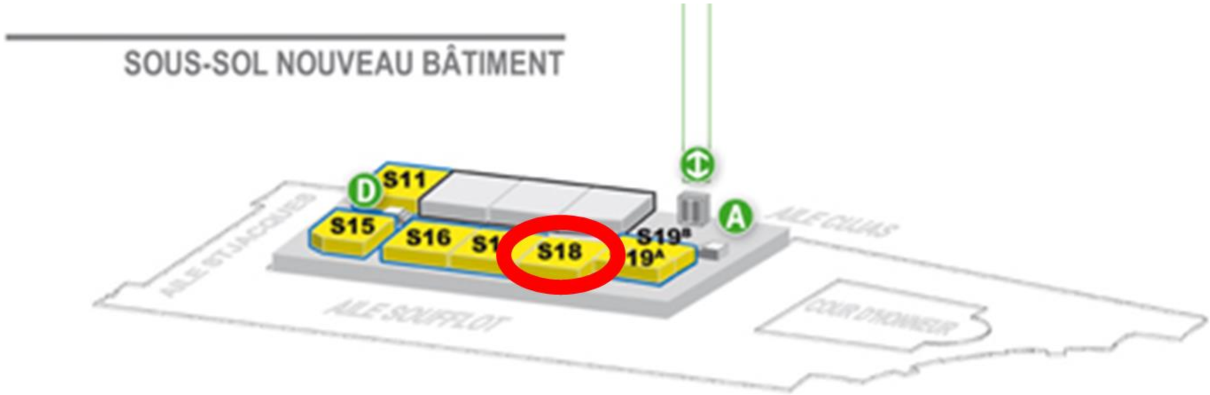

Detailed Syllabus and bibliography below (presentation will focus on * papers)

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.

<u>April 3 Morning: The liability structure of unprotected banks in theory (45 minutes)</u>

Douglas Diamond and Philip Dybvig (1983), Bank runs, deposit insurance, and liquidity, *Journal of Political Economy*.

Douglas Diamond (1984), Financial intermediation and delegated monitoring, *Review of Economic Studies.*

* Charles Calomiris and Charles Kahn (1991), The role of demandable debt in structuring optimal banking arrangements, *American Economic Review*.

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

Bengt Holmstrom and Jean Tirole (1997), Financial intermediation, loanable funds, and the real sector, *Quarterly Journal of Economics*.

Charles Calomiris, Florian Heider and Marie Hoerova (2017), A theory of bank liquidity requirements, Working Paper.

Jason Donaldson and Giorgia Piacentino (2019), Money Runs, Working Paper.

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

* Charles Calomiris and Mark Carlson (2016), Corporate governance and risk management at unprotected banks: National banks in the 1890s, *Journal of Financial Economics*.

Charles Calomiris and Mark Carlson (2017), Rediscovering macro-prudential regulation: The National Banking Era from the perspective of 2015. In *Financial Systems and Economic Growth: Credit, Crises, and Regulation from the 19th Century to the Present,* edited by Peter Rousseau and Paul Wachtel.

* Charles Calomiris and Berry Wilson (2004), Bank capital and portfolio management: The 1930s ‘capital crunch’ and scramble to shed risk, *Journal of Business*.

Charles Calomiris and Andrew Powell (2001), Can emerging market bank regulators establish credible discipline? The case of Argentina, 1992-1999. *In Prudential Supervision: What Works and What Doesn't,* edited by Frederic Mishkin.

Sole Martinez Peria and Sergio Schmukler (2001), Do depositors punish banks for bad behavior? Market discipline, deposit insurance, and banking crises, *Journal of Finance*.

* Charles Calomiris and Joseph Mason (2003), Consequences of U.S. bank distress during the Depression, *American Economic Review*.

* Shekhar Aiyar, Charles Calomiris and Tomasy Wieladek (2014), Does Macro-Pru Leak? Evidence from a UK Policy Experiment, *Journal of Money Credit and Banking*.

Shekhar Aiyar, Charles Calomiris, John Hooley,Yevgeniya Korniyenko (2014), The International Transmission of Bank Capital Requirements: Evidence from the UK, *Journal of Financial Economics*.

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

Charles Calomiris and Gary Gorton (1991), The origins of banking panics: Models, facts, and bank regulation. In *Financial Markets and Financial Crises*, edited by R. Glenn Hubbard.

* Charles Calomiris and Mark Carlson (2017), Interbank networks in the National Banking Era: Their purpose and their role in the panic of 1893, *Journal of Financial Economics*.

Matthew Jaremski (2017), The (dis)advantages of clearinghouses before the Fed, *Journal of Financial Economics*.

Haelim Anderson, Charles Calomiris, Matthew Jaremski and Gary Richardson (2018), Liquidity risk, bank networks, and the value of joining the Fed, *Journal of Money Credit and Banking*.

Mark Carlson, Kris Mitchener and Gary Richardson (2014), Arresting bank panics: Federal Reserve liquidity provision and the forgotten panic of 1929, *Journal of Political Economy*.

* Charles Calomiris and Joseph Mason (1997), Contagion and bank failures during the Depression: The June 1932 Chicago banking crisis, *American Economic Review*.

Charles Calomiris and Joseph Mason (2003), Fundamentals, panics and bank distress during the Great Depression, *American Economic Review*.

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

Charles Calomiris, Matthew Jaremski, and David Wheelock (2019), Interbank Connections, Contagion and Bank Distress in the Great Depression, Working Paper.

Charles Calomiris, Joseph Mason, Marc Weidenmier and Katherine Bobroff (2013), The effects of Reconstruction Finance Corporation assistance on Michigan banks' survival in the 1930s, *Explorations in Economic History*.

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

<u>April 3 Afternoon (Cont'd): Deposit insurance, systemic risk, and politics (45 minutes)</u>

Asli Demirgüç-Kunt and Enrica Detragiache (2002), Does deposit insurance increase banking system stability? *Journal of Monetary Economics*.

Asli Demirgüç-Kunt, Edward Kane, and Luc Laeven (2008), Determinants of deposit insurance adoption and design, *Journal of Financial Intermediation*.

* Charles Calomiris and Matthew Jaremksi (2017), Stealing deposits: Deposit insurance, risk taking, and the removal of market discipline in early 20^{th} century banks, *Journal of Finance*, forthcoming.

* Charles Calomiris and Sophia Chen (2019), The Spread of Deposit Insurance and the Global Rise in Banking Risk since the 1970s, SSRN Working paper.

Charles Calomiris and Matthew Jaremski (2016), Deposit insurance: Theories and facts, *Annual Review of Financial Economics*.

Òscar Jordà, , Moritz Schularick, and Alan Taylor (2015), The great mortgaging: Housing finance, crises, and business cycles, NBER Working Paper No. 20501.

Òscar Jordà, , Moritz Schularick, and Alan Taylor (2015). Leveraged bubbles, *Journal of Monetary Economics*.

<u>April 3 Afternoon (Cont'd):. Other emergency assistance to banks (45 minutes)</u>

Viral Acharya and Anjan Thakor (2016), The dark side of liquidity creation: Leverage and systemic risk, *Journal of Financial Intermediation*.

* Charles Calomiris, Marc Flandreau and Luc Laeven (2016), Political foundations of the lender of last resort: A global historical narrative, *Journal of Financial Intermediation*.

Carlos Garcia-de-Andoain, Florian Heider, Marie Hoerova, and Simone Manganelli (2016), Lending-of-last-resort is as lending-of-last-resort does, *Journal of Financial Intermediation*.

Viral Acharya, Itamar Dreschler and Philipp Schnabl (2014), A Pyrrhic victory? Bank bailouts and sovereign credit risk, *Journal of Finance*.

Thomas Dreschel, Itamar Dreschler, David Marquez-Ibazez, and Philipp Schnabl (2016), Who borrows from the lender of last resort? *Journal of Finance*.

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*.

Raluca Roman, Allen Berger, and John Sedunov (2016). Do bank bailouts reduce or increase systemic risk? The effects of TARP on financial system stability, Federal Reserve Bank of Kansas City, Working Paper no. 16-08.

Charles Calomiris and Urooj Khan (2015), An assessment of TARP assistance to financial institutions, *Journal of Economic Perspectives*.

Ralph De Haas, Yevgeniya Korniyenko, Alexander Pivovarsky, and Teodora Tsankova (2015), Taming the herd? Foreign banks, the Vienna Initiative and crisis transmission, *Journal of Financial Intermediation*.

Charles Calomiris (2011), An incentive-robust programme for financial reform, *The Manchester School*.

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.*