

12F008

6 ECTS

Banking Theory

Overview and Objectives

The objective of this course is

- 1) to understand the role imperfect information and the role of financial institutions in the economy
- 2) to explore how modeling imperfect information can lead to interesting policy recommendations
- 3) to grasp some understanding of financial market institutions.

Course Outline

Textbook

Freixas, X. and Rochet, J.C., Microeconomic theory of banking. MIT Press, second edition. 2008
Bhattacharya, S., A. Boot and A. Thakor (BBT) Credit Intermediation and the Macroeconomy, OUP, 2004

Gorton, Gary and Andrew Winton. "Financial Intermediation". Chapter 8 in G.M. Constantinides & M. Harris & R. M. Stulz (ed.), 2003. "Handbook of the Economics of Finance," Handbook of the Economics of Finance, Elsevier, volume 1, number 1, March.

2. Why Do Financial Intermediaries Exist?

FR, pages 1-24, 30-49

BBT, Part I: Discussion

References:

Allen and Gale. "Intertemporal insurance"

Bolton, P., and X. Freixas, "Equity, Bonds and Bank Debt: Capital Structure and Financial Market Equilibrium under Asymmetric Information" *Journal of Political Economy*, April 2000, 2, 108, 324-51

Boot A.W., Thakor A.V., "Financial System Architecture", *Review of Financial Studies*, 1997; vol. 10; 3: 693-733 (BBT, 21).

Holmstrom, B., and J. Tirole, "Financial Intermediation, Loanable Funds, and the Real Sector", *Quarterly Journal of Economics*, 1997 (BBT, 23).

3. The Industrial Organization Approach

FR, Chapter 3

BBT, Part V: Discussion p.569

References:

Tullio Jappelli, Marco Pagano and Magda Bianco. "Courts and Banks: Effects of Judicial Enforcement on Credit Markets". *Journal of Money, Credit, and Banking*. Vol. 37, n° 2. April 2005

Hauswald, R. and R. Marquez. 2005. "Competition and strategic information acquisition in credit markets." *Review of Finance Studies* 19:967-1000.

Giovanni Dell'Ariccia and Robert Marquez. "Information and bank credit allocation". *Journal of Financial Economics*. 72 (2004) 185-214

Shaffer, S. 1998. "The winner's curse in banking." *Journal of Financial Intermediation* 7(4): 359-392.

Sharpe, S., "Asymmetric Information, Bank Lending and Implicit Contracts: A Stylized

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Model of Customer Relationships", *Journal of Finance*, 1990; vol. 45; 4: 1069-87.
Matutes, C., and Vives X., "Imperfect Competition, Risk Taking, and Regulation in Banking", *European Economic Review*
Ruckes. Martin "Bank Competition and Credit Standards". *The Review of Financial Studies*. Vol. 17, n° 4. 2004
Parlour, Christine A. and Guillaume Plantin. "Loan Sales and Relationship Banking". *The Journal of Finance*. Vol. LXIII, n° 3. June 2008
Giovanni Dell'Ariccia and Robert Marquez. "Lending Booms and Lending Standards".
Yoshiaki Ogura. "Learning from a rival bank and lending boom". *Journal of Financial Economics*, 15 (2006)

4. The Borrower-Lender Contract in Asymmetric Information

FR, pages 127-43 and 146-57

References:

Winton, A. "Competition among Financial Intermediaries when Diversification Matters", *Journal of Financial Intermediation*, 6, 1997, pp. 307-346 (BBT, 18)

5. Equilibrium and Rationing in the Credit Market

FR, pages 171-85

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References:

Stiglitz, J., and A. Weiss, "Credit Rationing in Markets with Imperfect Information", *American Economic Review*, 1981; vol. 71;3: 393-410.
Williamson, S., "Costly Monitoring, Loan Contracts, and Equilibrium Credit Rationing", *Quarterly Journal of Economics*, 1987; vol. 102; 1: 135-45.

6. Macroeconomic Consequences of the Financial Intermediation

FR, pages 193-212

BBT, Part VII, Discussion

References:

Bernake, B., and Gertler M., "Financial Fragility and Economic Performance", *Quarterly Journal of Economics*, 1990; vol. 105; 1: 87-114.
Holmström, B., and Tirole, J., "Private and Public Supply of Liquidity", *Journal of Political Economy* 1998. (BBT, 6)
Jarayne and Strahan 1996
Demirguc-Kunt and Maksimovic, 1998
Beck, Demirguc-Kunt and Maksimovic, 2005
Laeven 2004
-

7. Individual Bank Runs and Systematic Risk

FR, pages 220-21;224-48

BBT, Part II(discussion) and III (discussion)

References:

Bhattacharya, S. and D. Gale, "Preference Shocks, Liquidity and Central Bank Policy", 1987, In *New approaches in monetary economics*, edited by W. Barnett and K. Singleton. Cambridge: Cambridge University Press.

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Chari, V., R. Jagannathan, "Banking Panics, Information and Rational Expectations Equilibrium", *Journal of Finance*, 1988; vol. 43; 3: 749-61.
 Diamond, D. W, and R.H. Dybvig, "Bank Runs, Deposit Insurance, and Liquidity", *Journal of Political Economy*, 1983; vol. 91; 3: 401-19.
 Diamond, D., and R. Rajan. 2000. "A Theory of Bank Capital" *Journal of Finance* 55(5):2431-2465.
 Diamond, D., and R. Rajan. 2001. "Liquidity risk, liquidity creation and financial fragility: A theory of banking." *Journal of Political Economy* 109(2):287-327.
 Douglas W. Diamond and Raghuram G. Rajan. "A Theory of Bank Capital". *The Journal of Finance*. Vol LV. N° 6. Dec. 2000
 Diamond, D., and R. Rajan. 2005. "Liquidity shortage and banking crises." *Journal of Finance* 60(2):615-647.
 Freixas, X., B. Parigi and J.C. Rochet, "Systemic Risk, Interbank Relations and Liquidity Provision by the Central Bank" *Journal of Money Credit and Banking*, 2000
 Jacklin, C. J., "Demand Deposits, Trading Restrictions and Risk Sharing", 1987, in *Contractual arrangements for intertemporal trade*, edited by E. Prescott and N. Wallace. Minneapolis: University of Minnesota Press.
 Franklin Allen and Elena Carletti. "Interbank Market Liquidity and Central Bank Intervention". May 2008
 Rochet and Vives, 2004

8. Managing Risk in the Banking Firm

FR, pages 286-96

Default risk Institutional context Evaluating the cost of default risk Empirical evidence (credit scoring) Extensions

Portfolio risk Modern portfolio theory Application to the banking firm The impact of capital requirements Banks as market makers

References:

Rochet, J.C., "Capital Requirements and the Behaviour of Commercial Banks", *European Economic Review*, 1992; vol. 36; 5: 1137-70.

9. The Regulation of Banks

FR, pages 305-340

BBT, Part IV A discussion

References:

Morrison and White. "Is Deposit Insurance A Good Thing And, If So, Who Should Pay For It?"

George Pennacchi. "Deposit insurance, bank regulation, and system risks". *Journal of Monetary Economics*. Elsevier. Vol. 53 (1). January 2006

Aghion, P., P. Bolton and S. Fries, "Optimal Design of Bank Bailouts: The Case of Transition Economies" JITE, p.51-70 (BBT, 14)

Viral V. Acharya and Tanju Yorulmazer. "Cash-in-the-Market Pricing and Optimal Resolution of Bank Failures" Mimeo Bank of England

Bhattacharya, S., A. Boot and A. Thakor, "The Economics of Bank Regulation",

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Required Activities

TO BE DETERMINED BY PROFESSOR

Evaluation

Final Exam