Discussion of Jacewitz and Pogach's "Deposit Rate Advantages At the Largest Banks"

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The Paper

- Carefully documents funding advantage of large banks (> $500 million)

- Roughly 36 basis point advantage

- 30% to 70% of large banks' income from this advantage

- Is this because of TBTF?

My Discussion

- Empirical work very careful: Not much to say here
- Will address whether advantage is due to TBTF
- Question: Why are some banks big, others small?
- Or, why does the banking system have small banks at all?
- Broader issue of how regulation should be structured

Industrial Organization Framework

- Banks as technologies for transforming funds to productive investments

- Span of control

- Use k units of capital

- Produce $\theta f(k): \theta \in \{\theta_N, \theta_D\}$

- θ is productivity of bank. Varies across banks, Perfectly correlated across banks

- f concave, diminishing marginal product

Industrial Organization Framework

- q_N: Value of output in N state
- q_D: Value of output in D state
- $\bar{R}$: Opportunity cost of capital
- Banks solve

$$\max q_N(\theta_N f(k) - Rk) + q_D \max\{(\theta_D f(k) - Rk), 0\}$$

subject to

$$q_N Rk + q_D \min\{Rk, \lambda\theta_D f(k)\} \geq \bar{R}k$$

Industrial Organization Framework

- Efficient allocation (without debt constraints)

$$[q_N \theta_N + q_D \theta_D] f'(k) = \overline{R}$$

- With debt and default

$$[q_N \theta_N + q_D \lambda \theta_D] f'(k) = \overline{R}$$

- R depends on parameters

Industrial Organization Framework

- If average and marginal products proportional

- Can show
  - Proportional increases in $\theta_N, \theta_D \Rightarrow$ large and small banks pay the same face interest rate
  - If some banks are statistically less risky, they are larger. *R* is lower

What Did We Learn

- Framework which yields heterogeneity in size

- Large banks pay lower interest rates only if they are less risky

- Large banks pay same interest rates if they have same risk profiles

Thoughts on Too Big To Fail

- Wrong question
- If all banks are small, why would they adopt less risk?
- Possible failure of financial system leads to intervention
- Size not key issue
- How many big banks failed in the Great Depression?

What is the Issue?

- Short term debt
- Leads to panics
- Has benefits as well as costs
- Bailouts encourage use of short-term debt
- What kinds of assets should be funded with short-term debt?

Answer

- Not assets with close substitutes in public markets
- Not government debt in particular
- Not mortgage-backed securities
- Lots of C & I type loans
- Regulation should penalize banks with lots of short-term debt and lots of publicly traded assets
- Current regulatory regime gives points to banks which hold publicly traded securities! Completely wrong-headed