Discussion of
Jacewitz and Pogach’s
“Deposit Rate Advantages
At the Largest Banks”

V. V. Chari
University of Minnesota and
Federal Reserve Bank of Minneapolis
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 $\theta f(k) : \theta \in \{\theta_N, \theta_D\}$
- $\theta$ 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)

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

- With debt and default

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

- \( R \) 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