

Liquidity: Concepts and Risks

Munich, 17-18 October 2008

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**Discussion of “The Dark Side of Bank Wholesale Funding”
by Lev Ratnovski and Rocco Huang**

Comments on “The Dark Side of Bank Wholesale Funding”, by Huang & Ratnovski, 2008

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Outline

Summary of the Paper

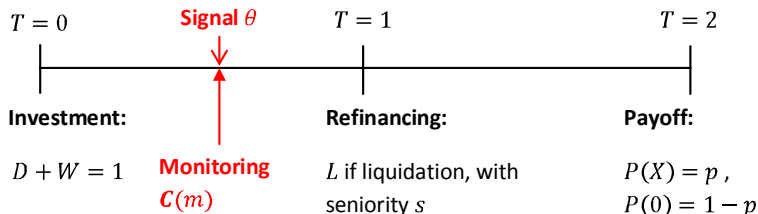
- Two faces of wholesale funding
- Model structure
- Main insights

Comments and Discussions

Mechanism: Noisy signal and seniority

- ▶ Uncertainty on the project's quality, Calomiris and Kahn (1991)
 - ▶ Incentive for monitoring, and efficient liquidation;
 - ▶ Seniority maximizes monitoring, first best & bright side.
- ▶ However, when there's a noisy signal on the project's quality
 - ▶ Lower incentive to monitor;
 - ▶ Seniority → Excess incentives to liquidate. Dark side!

Model structure



- ▶ Key components: Noisy signal with precision θ ; seniority in liquidation.
- ▶ Now the trade-off:
 - ▶ Invest $C(m)$ to avoid inefficient liquidation;
 - ▶ Liquidate to get back more senior debt.

Robust results?

- ▶ This paper: Financiers in Bertrand competition for banks, zero profit
 - ▶ Monitoring effort m affected indirectly through R ;
 - ▶ $s \uparrow \Rightarrow R \downarrow \Rightarrow m \downarrow$, less interested in long-term value and more inefficient liquidation.
- ▶ Alternative (more often in market?): Banks in Bertrand competition for financiers.
 - ▶ With insurance, R directly determined by long-term value;
 - ▶ Financiers' interest in line with the banks (even with higher seniority). More monitoring effort m ;
 - ▶ Will the outcome be different?

General equilibrium?

- ▶ This paper: Partial equilibrium with silent depositors.
 - ▶ Seniority as parachute for wholesale financiers, leaving depositors with poor expected return;
 - ▶ Depositors participate as long as $d_0 \geq 1$.
- ▶ Alternative: Endogenize the decision of becoming a depositor / financier.
 - ▶ Financiers still have the seniority of liquidation, but R is lower;
 - ▶ Will the outcome be different? s may have less impact on R , hence on m .

Conclusion

- ▶ Simple, compact, beautiful partial equilibrium model;
- ▶ Very timely paper, mechanism that people long neglected. Great help for understanding the current financial turmoil;
- ▶ Very flexible framework for extensions:
 - ▶ Alternative settings in the competition structure?
 - ▶ General equilibrium?
 - ▶ And so on.