Prof. Dr. Falko Fecht

Financial Intermediation, Crises & Regulation (Bundesbank Lecture)

This lecture deals with the economic role of financial intermediaries, in particular banks, in the financial system, the extent to which they are fragile and the need for government intervention to mitigate excessive fragility.

Based on a thorough analysis of financial market inefficiencies the lecture shows how financial intermediaries help mitigating these inefficiencies. In order to improve efficiency banks are necessarily to some extent fragile. However, due to financial contagion and other negative externalities of bank failures the fragility is likely to be excessive. This calls for government intervention in the banking sector and provides an economic rational for bail-outs and capital requirements. But these interventions might generate themselves misincentives and increase fragility even further.

I. Introduction (Block I)

II. Hidden information and adverse selection (Block II)

- Overinvestment Problem
- Underinvestment Problem
- Collateralization
- Equilibirum Credit Rationing

1. Tirole, J. (2006) The Theory of Corporate Finance, Princeton University Press, chapters 6.
2. Stiglitz, J. E., & Weiss, A. (1981). Credit Rationing in Markets with Imperfect Information. American Economic Review, 71(3), 393–410.
3. Bester, H. (1985). Screening vs. rationing in credit markets with imperfect information. American Economic Review, 75(4), 850–855.

III. Hidden action and moral hazard (Block III)

- Borrowing Capacity
- Collateralization
- Market monitoring

1. Tirole, J. (2006) The Theory of Corporate Finance, Princeton University Press, chapters 3&4.
2. Milgrom, P., & Stokey, N. (1982). Information, Trade and Common Knowledge. Journal of Economic Theory, 21, 11–21.
3. Grossman, S. J., & Stiglitz, J. E. (1980). On the Impossibilityof Informationally Efficient Markets. American Economic Review, 70(3), 393–408.

IV. The role of banks in mitigating moral hazard (Block IV+V)

- Economic Role of Investment Banking

- Banks as monitors
- Economies of scope in monitoring and risk transformation

1. Morrison, Al. and Wilhelm, W. (2007) Investment Banking: Institutions, Politics, and Law. Oxford University Press.
2. Holmstrom, B., & Tirole, J. (1997). Financial Intermediation, Loanable Funds, and the Real Sector. Quarterly Journal of Economics, CXII(August).
3. Diamond, D. W. (1984). Financial Intermediation and Delegated Monitoring. Review of Economic Studies, 51(3), 393.

V. Competition in corporate lending and financial stability (Block VI+VII)

- Relationship lending
- Banking competition and lending standards
- Competition stability trade-off

1. Rajan, R. G. (1992). Insiders and Outsiders : The Choice between Informed and Arm ' s-Length Debt. Journal of Finance, 47(4), 1367–1400.
2. Dell'Ariccia, G., & Marquez, R. (2006). Lending booms and lending standards. Journal of Finance, 61(5), 2511–2546.
3. Allen, F., & Gale, D. (2004). Competition and Financial Stability. Journal of Money, Credit, and Banking, 36(3b), 453–480.

VI. Banks as Liquidity Providers (Block VIII)

- Liquidity transformation as an efficient insurance
- Liqudiity transformation as a commitment device

1. Diamond, D. W., & Dybvig, P. H. (1983). Bank Runs, Deposit Insurance, and Liquidity. Journal of Political Economy, 91(3), 401–419.
2. Diamond, D. W., & Rajan, R. G. (2001). Liquidity risk, liquidity creation and financial fragility: A theory of banking. Journal of Political Economy, 109(2), 287–327.

VII. Financial Fragility and Contagion (Block IX)

- Interbanks credit risk exposure
- Fire-sales

1. Allen, F., & Gale, D. (2000). Financial Contagion. Journal of Political Economy, 108(1), 1.
2. Fecht, F. (2004). On the stability of different financial systems. Journal of the European Economic Association, 2(6), 969–1014.

VIII. Financial Regulations and Bail-out Policies (Block X)

- Costs of financial crises
- Capital regulation
- Optimal bail-out policy

1. Dellariccia, G., Detragiache, E., & Rajan, R. (2008). The real effect of banking crises. Journal of Financial Intermediation, 17(1), 89–112.
2. Perotti, E., & Suarez, J. (2002). Last bank standing: What do I gain if you fail? European Economic Review, 46(9), 1599–1622.
3. Acharya, V. V., & Yorulmazer, T. (2007). Too many to fail—An analysis of time-inconsistency in bank closure policies. Journal of Financial Intermediation, 16(1), 1–31.