Discussion of “Credit risk transfer in banking markets with hard and soft information” by Hakenes & Schnabel

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Contribution of the paper

- Cost and benefit of buying insurance against loan default
  - allows to fund more profitable but risky projects
  - insurer cannot observe loan quality so it sets average price → bank has incentive to insure very low quality loans
- Bank use profits from high quality loans to subsidize lower quality loans
  - competition erodes profits from high quality loans
The mechanics of the model

- Bank assets (loan portfolio) are risky

\[
p_M l_G(R_G)(R_G - r) + l_M(R_M)(R_M - r) - l_M X \pi_M
\]

\[
1 - p_M \geq 0
\]

- Competitive insurers position

\[
p_M l_M X \pi_M
\]

\[
1 - p_M < \pi_M = \frac{1 - p_M}{p_M} < \pi_B = \frac{1 - p_B}{p_B}
\]
Some observations

- Two-point support: debt or equity?
- “Soft” vs “hard” information or “complete” vs “incomplete” information?
  - insurer knows/doesn’t know the quality of the loan
- Can insurer screen loan quality?
  - asking for collateral, different probability of obtaining insurance, partial insurance
- Insurer is not constrained to not default
  - in practice risk was less distributed than it was assumed → who can bear long-term risk?
- More competition leads to more bad loans
  - but more competition reduces adverse selection insurance premium → market break down less likely
A comment on modeling asymmetric info about risk

- Project qualities are ordered by First-Order Stochastic Dominance
  - distribution $F$ dominates $G$ if $F(x) \leq G(X)$

$\Rightarrow$ Any investor chooses $F$ over $G$ independent of her attitude to risk
How constrained are banks? They hold a lot of equity

Sample: top 100 US and top 100 EU publicly traded banks 1991-2004
(Gropp & Heider, 2007)
Riskier banks hold more equity (to expand capacity?)

Controls: size, profits, market to book, collateral, dividends, year & country FE