COMMENTS TO HUANG AND RATNOVSKY: "THE RISKS OF BANK WHOLESALE FUNDING"

at Joint BCBS-JFI workshop

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*Views and conclusions are those of the discussant and cannot be attributed to Norges Bank

BRIEF OUTLINE OF THE PAPER

Main topics of the paper:

- The incentives of wholesale financiers (always assumed sophisticated) to monitor whether a bank has good or bad assets.

- Early liquidation of a bank by these sophisticated wholesale financiers.

The Bright side of wholesale funding (à la Calomiris and Kahn 1991).

- Wholesale financiers have a costly monitoring technology that with a certain probability gives precise information on bank quality, or no information.

- On bank liquidation, sophisticated wholesale financiers have seniority over passive depositors (in practice through first come first served constraint).

- This gives the wholesale financiers incentive to provide a socially optimal amount of monitoring the bank, because

- if they discover the bank has bad assets, they can rescue their own funds by withdrawing and forcing the bank into early liquidation.

- These early liquidations are socially optimal.

The Dark side of wholesale funding, the contribution of this paper.

- If monitoring by wholesale financiers do not give information on the bank's quality, wholesale financiers may instead follow a noisy, publicly and freely available signal of the bank's quality.

- Wholesale financiers may either:

  1. disregard the noisy signal and passively roll over the funding

  2. follow the noisy signal and make early withdrawal and hence liquidation if the noisy signal indicates bad assets at the bank.

- The noisy freely available signal triggers socially a too low threshold for early bank liquidation both:
  - when the bank is only funded with wholesale deposits
  - and in mix with ordinary passive deposits where the wholesale deposits have some seniority.

- The noisy signal also causes wholesale financiers to do less monitoring than socially optimal when the only source of funding.

- In mix with ordinary deposits there is an interior optimal degree of seniority for wholesale funds that yields the socially optimal amount of monitoring.

COMMENTS

- A timely and important issue, the role of wholesale financiers and early bank liquidation.

- Paper is well written, although interesting parts of it are still TBC

Main critical comment

- How is R, the payment to financiers (depositors) when the bank is successful determined?
  Does the paper implicitly assume a monopolistic bank?

Some key variables and parameters

$X =$ the value of bank assets at date 2 if succesful

$L =$ the value of bank assets if early liquidated at date 1

$R =$ the payment to financiers (depositors) if the bank is successful

$W =$ wholesale financiers' initial or fair share of bank liability

$s =$ wholesale financiers' share of bank assets if liquidated

$\theta =$ precision parameter of noisy signal

$1 < L < X$

The determination of R not explained in the paper.

- Paper seems to assume $R < X$.
  - The bank is left with positive expected profits.
  - A monopolistic bank?

- Instead assume Bertrand competition for funding among at least 2 banks:
  $R = X$, s.t. participation constraint for financiers (always met since $X > 1$)

Implications of Bertrand competition $R = X$ and freely available noisy signal

- When banks are only funded by wholesale financiers:
  - the threshold for early bank liquidations becomes socially optimal
  - the amount of monitoring by the financiers becomes socially optimal.
- When banks are funded with a mix of wholesale funds and passive depositors:
  - Still socially too low threshold for early bank liquidations as long as wholesale financiers have seniority over depositors at early liquidations, i.e., $s > W$.

– Socially too low monitoring, but not due to seniority, only because wholesale financiers share benefits of monitoring with passive depositors.

SUMMARY AND POLICY IMPLICATIONS, IDEAS FOR FURTHER WORK

- Unclear why the bank earns expected positive profits unless it is a monopoly bank.

- Some results not robust to allowing for Bertrand competition among banks.

- However, the main result of too high tendency of early bank liquidations due to seniority, remains. This result is novel compared to for instance Calomiris and Kahn (1991).

- Can we eliminate wholesale financiers' seniority over ordinary depositors at early liquidations?
  - Probably not.

- Can some LLR policy prevent early wholesale withdrawals turning into inefficient liquidations? Maybe more interesting to study than the effect of deposit insurance in this model.

SOME OTHER COMMENTS

- Would introduction of some noise in the information obtained from wholesale financiers' monitoring change the results?

- The probability distribution of the bank's assets and the probability distribution of the noisy signal about its quality is set the same. Seems natural. Would different probabilities for the assets and the noisy signal (e.g. the noisy signal is more pessimistic) change results?

- Consider introduction of outside equity?

- How will the use of unstable short term wholesale funding influence banks' decisions about their asset side? Will banks relying on such funding be more careful about high growth in illiquid loans?