The role of bank capital in the propagation of shocks

A presentation prepared for the BIS CCA Conference on “Systemic risk, bank behaviour and regulation over the business cycle”

Buenos Aires, 18–19 March 2010

Authors*: Césaire A Meh and Kevin Moran
Affiliation: Bank of Canada and Université Laval
Email: cmeh@bankofcanada.ca, kmoran@ecn.ulaval.ca

* This presentation reflects the views of the authors and not necessarily those of the BIS or of central banks participating in the meeting.
The Role of Bank Capital in the Propagation of Shocks

Césaire A. Meh       Kevin Moran
Bank of Canada       Université Laval


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In the last decade, there has been progress in building quantitative DSGE models with financial frictions that tend to fit aggregate data.

In practice, however, these models abstract from the state of the balance sheets of banks and interaction with real economy.

- **Implication:** Supply of funds of banks unaffected by their balance sheet.

The current crisis has reminded us that the state of the balance sheet of banks plays an important role in economic fluctuations.
We build a quantitative macroeconomic model in which bank capital matters because it mitigates an agency problem between a bank and its creditors.

We use the model to study how the presence of bank capital affects the transmission of shocks.
The bank capital channel greatly amplifies and propagates the effects of technology shocks, but plays a lesser role for monetary policy shocks.

When the bank capital channel is active, an economy with more bank capital is better able to absorb technology shocks than an economy with less bank capital.

A sudden scarcity of banking capital depresses bank lending and economic activity.

- No bank capital


- Market-determined capital adequacy ratio and/or not quantitative


- Bank Capital needed for exogenous regulatory requirements
Sketch of the model

a. New Keynesian DSGE model based on CEE
b. Financial Intermediation and bank capital (HT, QJE 1997)

Findings

Conclusion
MODEL

Final Good Sector

- Competitive firms that assemble differentiate intermediate goods

\[ Y_t = \left( \int_0^1 Y_{jt} \frac{\xi_p - 1}{\xi_p} \, dj \right)^{\frac{\xi_p}{\xi_p - 1}}, \quad \xi_p > 1 \]

Intermediate Good Sector

- Monopolistic competitive firms produce differentiated intermediate goods

\[ Y_{jt} = z_t k_{jt}^\theta k h_{jt}^\theta h_{jt}^e \theta e h_{jt}^b \theta b, \quad z_t \sim AR(1) \]

- Face sticky price à la Calvo

- Full indexation to previous inflation rate if no price changes
**MODEL**

**Investment Good Sector**

- Entrepreneurs need external funds from banks to make investments
- Experience idiosyncratic productivity shock: $\tilde{R}_i_t$
- Can divert the resource and obtain a private return proportional to the size of the investment: $\tilde{b}_i_t$
- Diversion affects the probability of success of the project

**Banking Sector**

- Bankers are endowed with a monitoring technology
- Cost of monitoring for investment size $i_t$: $\mu_i_t$
- Monitoring activity is not publicly observable $\Rightarrow$ so bankers may not monitor adequately
LENDING RELATIONSHIP

Two Sources of Moral Hazard

1. Moral Hazard
   Entrepreneurs may privately choose low return projects to enjoy private benefits

   Entrepreneurial Net Worth

2. Moral Hazard
   Banks have an incentive not to monitor in order to save costs

   Bank Net Worth

Entrepreneurs → Banks → Households

Loans

Funds
INVESTMENT PROJECTS

- Three types of projects available to the entrepreneur:

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<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Private benefits</td>
<td>0</td>
<td>$bi_t$</td>
<td>$Bi_t$</td>
</tr>
<tr>
<td>Prob. of success</td>
<td>$\alpha^g$</td>
<td>$\alpha^b$</td>
<td>$\alpha^b$</td>
</tr>
</tbody>
</table>

- Good project is socially desirable

- Bank monitoring can eliminate only project with highest private returns

- The projects financed by an individual bank are perfectly correlated
Household Sector

- Utility function: \( u(\cdot) = \log(c_t^h - \gamma c_{t-1}^h) + \psi \log(1 - l_{it}^h) + \zeta \log(M_t^c / P_t) \)
- Habit formation in consumption
- Monopolistic supplier of specialized labor input
- Sticky wage à la Calvo
- Variable capital utilization
- Ultimate suppliers of funds to entrepreneurs via banks

Central Bank

- Set monetary policy according to a Taylor Rule

\[
r_t^d = \rho_r \hat{r}_{t-1}^d + (1 - \rho_r) [\rho_\pi (\pi_t - \bar{\pi}) + \rho_y \hat{y}_t] + \epsilon_t^{mp}
\]
One optimal contract will have the following structure:

- the entrepreneur invests all his net worth
- if success, $R$ is distributed among the entrepreneur, the banker and the households: $R = R^e_t + R^b_t + R^h_t$
- if failure, neither party is paid anything

Objective of the financial contract:

- Choose project size and payment shares to maximize expected payoff to entrepreneurs subject to five constraints
• Incentive constraint of bankers: \( q_t \alpha^g R_t^b i_t - \mu i_t \geq q_t \alpha^b R_t^b i_t \)

• Incentive constraint of entrepreneurs: \( q_t \alpha^g R_t^e i_t \geq q_t \alpha^b R_t^e i_t + q_t bi_t \)

• Participation constraint of bankers: \( q_t \alpha^g R_t^b i_t \geq (1 + r_t^a) a_t \)

• Participation constraint of households: \( q_t \alpha^g R_t^h i_t \geq (1 + r_t^d) d_t \)

• Resource constraint: \( a_t + d_t - \mu i_t \geq i_t - n_t \)
• Incentive constraint of bankers: \( q_t \alpha^g R^b_i t - \mu i_t \geq q_t \alpha^b R^b_i t \)

• Incentive constraint of entrepreneurs: \( q_t \alpha^g R^e_i t \geq q_t \alpha^b R^e_i t + q_t b i_t \)

• Participation constraint of bankers: \( q_t \alpha^g R^b_i t \geq (1 + r^a_t) a_t \)

• Participation constraint of households: \( q_t \alpha^g R^h_i t \geq (1 + r^d_t) d_t \)

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• Participation constraint of bankers: $q_t \alpha^g R^b_t i_t \geq (1 + r^a_t) a_t$

• Participation constraint of households: $q_t \alpha^g R^h_t i_t \geq (1 + r^d_t) d_t$

• Resource constraint: $a_t + d_t - \mu i_t \geq i_t - n_t$
UPSHOT OF THE OPTIMAL CONTRACT

- **Payments:**

\[
R_t^e = \frac{b}{\Delta \alpha}; \quad R_t^b = \frac{\mu}{q_t \Delta \alpha}; \quad R_t^h = R - \frac{b}{\Delta \alpha} - \frac{\mu}{q_t \Delta \alpha}
\]

where \( \Delta \alpha \equiv \alpha^g - \alpha^b > 0 \)

- **Investment Size:**

\[
i_t = \left(\frac{1}{G_t}\right) \times\left( a_t + n_t \right) \\
\text{‘entrepreneurial leverage’} \quad \text{internal funds}
\]

where

\[
G_t \equiv 1 + \mu - \frac{q_t \alpha^g}{1 + r^d_t} \left( R - \frac{b}{\Delta \alpha} - \frac{\mu}{\Delta \alpha q_t} \right)
\]

**NOTE:** \( \mu, b \uparrow \Rightarrow i_t \downarrow, \quad r^d_t \uparrow \Rightarrow i_t \downarrow, \quad q_t \uparrow \Rightarrow i_t \uparrow \)
• The capital adequacy ratio is market determined:

\[ CAR_t = \frac{\mu}{\mu + q_t \Delta \alpha \left( \frac{1+r_t^a}{1+r_t^d} \right) \left( R - \frac{b}{\Delta \alpha} - \frac{\mu}{\Delta \alpha q_t} \right)} \]

• When \( \mu = 0 \) \( \Rightarrow \) \( CAR_t = 0 \) (bank capital Not needed)
  - \( \mu \uparrow \Leftrightarrow \) \( CAR_t \uparrow \)
  - \( q_t \downarrow \) (recession) \( \Rightarrow \) \( CAR_t \uparrow \)
  - \( r_t^a \uparrow \) (scarcity of bank capital) \( \Rightarrow \) \( CAR_t \downarrow \)
Law of motion of bank capital & entrepreneurial net worth

- Bank Capital (Bank equity or Bank net worth)
  - Build bank capital mainly from retained earnings

\[
A_{t+1} = \left[ r_{t+1} + q_{t+1}(1 - \delta) \right] \tau^{b} \alpha^{g} R^{b} \left( \frac{A_{t} + N_{t}}{G_{t}} \right) + w_{t+1}^{b} \eta^{b}
\]

- Entrepreneurial Net Worth

\[
N_{t+1} = \left[ r_{t+1} + q_{t+1}(1 - \delta) \right] \tau^{e} \alpha^{g} R^{e} \left( \frac{A_{t} + N_{t}}{G_{t}} \right) + w_{t+1}^{e} \eta^{e}
\]
# Table 1: Baseline Parameter Calibration

<table>
<thead>
<tr>
<th>Household Preferences and Wage Setting</th>
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<tr>
<td>(\gamma)</td>
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<td>4.0</td>
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<td>0.64</td>
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<tr>
<td>(\zeta)</td>
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<tr>
<td>(\psi)</td>
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<td>(\beta)</td>
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<tr>
<td>(\xi_w)</td>
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<tr>
<td>(\phi_w)</td>
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<thead>
<tr>
<th>Capital Good Production and Financing</th>
<th>(\mu)</th>
<th>(\alpha^g)</th>
<th>(\alpha^b)</th>
<th>(R)</th>
<th>(b)</th>
<th>(\tau_e)</th>
<th>(\tau_b)</th>
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<tr>
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<td>0.025</td>
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<td>1.21</td>
<td>0.16</td>
<td>0.78</td>
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<table>
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<tr>
<th>Resulting Steady-State Characteristics</th>
<th>(CAR)</th>
<th>(I/N)</th>
<th>(BOC)</th>
<th>(ROE)</th>
<th>(I/Y)</th>
<th>(K/Y)</th>
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<tbody>
<tr>
<td></td>
<td>14%</td>
<td>2.0</td>
<td>5%</td>
<td>15%</td>
<td>0.198</td>
<td>11.8</td>
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</table>
PREVIEW OF FINDINGS

1. Technology shock

2. Technology shock with more bank capital

3. Bank capital shock
1. Response to Negative Technology Shock
One Standard Deviation Adverse Technology Shock

Césaire A. Meh, Kevin Moran
Bank of Canada
Université Laval

The Role of Bank Capital in the Propagation of Shocks

Bank of Canada/BIS Joint Conference 22/25
2. Response to Technology Shock with More Bank Capital
Negative Technology Shock: Eco. with More Bank Capital

Césaire A. Meh, Kevin Moran
Bank of Canada

The Role of Bank Capital in the Propagation of Shocks

Baseline Economy

Economy with More Bank Capital
3. Response to Bank Capital Shock
Negative Shock to Bank Capital

Césaire A. Meh, Kevin Moran
Bank of Canada          Université Laval
The Role of Bank Capital in the Propagation of Shocks
Central Bank of Argentina/BIS Joint Conference 26/25
We presented a DSGE model in which bank capital mitigates an agency problem between banks and their creditors.

The cyclical features of the bank capital-asset ratio generated by the model are broadly consistent with those observed in data.

The bank capital channel amplifies and propagates the effects of technology shocks, but plays a lesser role for monetary policy shocks.