

# Contents

Preface to the Third Edition	xiii
<b>1 Introduction</b>	<b>1</b>
1.1 What Is a Bank, and What Do Banks Do?	1
1.2 Liquidity and Payment Services	2
1.2.1 What Came First: Money or Credit?	2
1.2.2 Money Is Memory	3
1.2.3 Money as a Bubble	5
1.2.4 The Three Functions of Money	5
1.2.5 Money Changing	6
1.2.6 Payment Services	6
1.3 Managing Financial Risks	7
1.3.1 Transformation Risk	7
1.3.2 Credit Risk	8
1.3.3 Financial Markets Risk	8
1.4 Alleviating Asymmetric Information Problems	9
1.4.1 Ex Ante Asymmetric Information	9
1.4.2 Interim Asymmetric Information	9
1.4.3 Ex Post Asymmetric Information	9
1.5 Banking in a World without Frictions	9
1.5.1 The Consumer	10
1.5.2 The Firm	11
1.5.3 The Bank	11
1.5.4 The Competitive Equilibrium	11
1.6 Outline of the Book	12
1.7 Problem	13
1.8 Solution	14
Notes	14
References	15

<b>2</b>	<b>Banks and Informational Frictions</b>	17
2.1	Introduction	17
2.2	Maturity Transformation and Liquidity Insurance	18
2.2.1	The Diamond-Dybvig Model	19
2.2.2	The Symmetric Pareto Optimal Allocation	19
2.2.3	Autarky	20
2.2.4	Financial Markets	21
2.2.5	Bank Deposit Contracts	22
2.3	Financial Intermediation as Delegated Monitoring	23
2.4	Moral Hazard and the Monitoring Role of Banks	24
2.5	Credit Risk and Dilution Costs	28
2.5.1	The Model	28
2.5.2	Bond Financing	28
2.5.3	Equity Issue	29
2.5.4	Bank Loan	29
2.6	Further Reading	30
2.7	Problems	31
2.7.1	Market versus Bank Finance	31
2.7.2	Banks and Moral Hazard	32
2.8	Solutions	32
2.8.1	Market versus Bank Finance	32
2.8.2	Banks and Moral Hazard	33
	Note	34
	References	34
<b>3</b>	<b>The Industrial Organization Approach to Banking</b>	37
3.1	The Old Approach to Monetary Policy: Money and Credit Multipliers	38
3.2	Perfectly Competitive Banking	39
3.2.1	The Model	39
3.2.2	How Do Interest Rates Influence the Volumes of Deposits and Loans?	40
3.2.3	The Competitive Equilibrium	40
3.3	Imperfect Competition	41
3.3.1	The Monti-Klein Model of a Monopoly Bank	42
3.3.2	The Oligopoly Version	43
3.3.3	Product Differentiation	44
3.3.4	Empirical Evidence	47

3.4	Is There a Trade-off between Competition and Financial Stability?	47
3.4.1	The Fragility View	47
3.4.2	The Stability View	48
3.4.3	The Impact of Capital Requirements	48
3.4.4	Empirical Evidence	49
3.5	Competition and Lending Standards	50
3.5.1	The Screening Externality	50
3.5.2	Lending Standards through the Business Cycle	51
3.5.3	Empirical Evidence	51
3.6	Relationship Banking	52
3.6.1	A Simple Model	52
3.6.2	Public and Private Information about Borrowers	53
3.6.3	Empirical Evidence	53
3.7	Platform Competition and Two-Sided Markets	55
3.7.1	A Model of the Payment Card Industry	56
3.7.2	Card Use	57
3.7.3	Monopoly Network	57
3.7.4	Competing Networks	58
3.7.5	Welfare Analysis	59
3.7.6	Bigtechs	59
3.8	Further Reading	60
3.9	Problems	62
3.9.1	Double Bertrand Competition	62
3.9.2	Deposit Rate Regulation	63
3.10	Solutions	63
3.10.1	Double Bertrand Competition	63
3.10.2	Deposit Rate Regulation	64
	Notes	65
	References	65
<b>4</b>	<b>The Lender-Borrower Relationship</b>	<b>69</b>
4.1	The Complete Information Benchmark	70
4.2	Costly State Verification	72
4.2.1	Incentive-Compatible Contracts	72
4.2.2	Efficient Incentive-Compatible Contracts	73
4.3	Debt as the Least Information-Sensitive Security	74
4.4	Incentives to Repay	75
4.4.1	Promise to Lend Again	75
4.4.2	The Impact of Judicial Enforcement	76

4.5	Sovereign Debt	78
4.5.1	The Eaton-Gersovitz Paradigm	78
4.5.2	Critiques of the Eaton-Gersovitz Paradigm	79
4.5.3	The Political Economy Approach	80
4.6	Complements	81
4.6.1	Moral Hazard	81
4.6.2	Incomplete Contracts	82
4.6.3	Soft Budget Constraints	83
4.7	Further Reading	85
4.8	Problems	86
4.8.1	Optimal Risk Sharing with Symmetric Information	86
4.8.2	Optimal Debt Contracts with Moral Hazard	86
4.8.3	The Pareto Frontier in the Townsend Model	87
4.8.4	The Optimality of Stochastic Auditing Schemes	87
4.9	Solutions	88
4.9.1	Optimal Risk Sharing with Symmetric Information	88
4.9.2	Optimal Loan Contracts with Moral Hazard	88
4.9.3	The Pareto Frontier in the Townsend Model	89
4.9.4	The Optimality of Stochastic Auditing Schemes	89
	Notes	90
	References	91
<b>5</b>	<b>The Macroeconomic Consequences of Financial Imperfections</b>	<b>93</b>
5.1	A Short Historical Perspective	94
5.2	Transmission Channels of Monetary Policy	95
5.2.1	The Money View and the Interest Rate Channel	95
5.2.2	The Credit View and the Lending Channel	96
5.2.3	Credit View versus Money View: Comparing the Underlying Assumptions	98
5.2.4	Empirical Evidence	100
5.2.5	Nonconventional Monetary Policy	102
5.3	Financial Fragility and Economic Performance	102
5.3.1	First Best Allocation (Perfect Information)	103
5.3.2	Credit Constraints and Limited Liability	104
5.3.3	Macroeconomic Implications	106
5.4	Credit Cycles	107
5.4.1	The Financial Accelerator	107
5.4.2	Changing Credit Standards	108
5.4.3	Collateral-Driven Credit Cycles	109

5.5	Aggregate Credit Rationing	110
5.5.1	The Backward-Bending Supply of Credit	111
5.5.2	Adverse Selection	111
5.5.3	Cash Flow Diversion	113
5.5.4	Moral Hazard	114
5.6	Financial Development and Economic Growth	115
5.7	Further Reading	118
5.8	Problems	120
5.8.1	Adverse Selection and Aggregate Credit Rationing	120
5.8.2	Too Much Investment	120
5.9	Solutions	121
5.9.1	Adverse Selection and Aggregate Credit Rationing	121
5.9.2	Too Much Investment	121
	Notes	122
	References	123
<b>6</b>	<b>Bank Runs, Bank Panics, and the Lender of Last Resort</b>	<b>129</b>
6.1	The Fractional Reserve System	130
6.1.1	The Bryant-Diamond-Dybvig Model	130
6.1.2	Implementing the Optimal Allocation	130
6.1.3	Multiple Equilibria	131
6.1.4	Speculative Bank Runs	132
6.1.5	Fundamental Bank Runs	133
6.2	How to Remedy Banks Fragility	134
6.2.1	Narrow Banking: From the Chicago Plan to Stablecoins	134
6.2.2	Deposit Insurance and Prudential Regulation	134
6.2.3	Equity Financed Banks	135
6.3	Interbank Markets	136
6.3.1	Insuring Liquidity Shocks	137
6.3.2	Adverse Selection	137
6.3.3	Liquidity Hoarding	138
6.4	The Lender of Last Resort (LLR)	138
6.4.1	Bagehot's Doctrine	138
6.4.2	The Practice of LLR Assistance	139
6.4.3	Criticisms of the LLR Policy and the Modern Form of Bank Runs	140
6.5	Further Reading	142
6.6	Problems	143
6.6.1	Nominal Bank Runs	143
6.6.2	Aggregated Liquidity Shocks	144

6.7	Solutions	145
6.7.1	Nominal Bank Runs	145
6.7.2	Aggregated Liquidity Shocks	145
	Notes	146
	References	146
<b>7</b>	<b>Liquidity</b>	<b>149</b>
7.1	Introduction	149
7.2	Different Forms of Liquidity	150
7.2.1	Defining Liquidity	150
7.2.2	Public and Private Liquidity	151
7.2.3	Funding Liquidity and Market Liquidity	151
7.3	The Supply of Private Money	152
7.3.1	Do Banks Issue Too Much Money?	152
7.3.2	Shadow Banking	154
7.4	Private and Public Supply of Liquidity	156
7.4.1	The Model	156
7.4.2	Symmetric Information	156
7.4.3	Moral Hazard	157
7.4.4	Aggregate Shocks	158
7.5	Bubbles: When Asset Prices Diverge from Fundamentals	158
7.5.1	Bubbles as Sources of Liquidity	158
7.5.2	Cash in the Market Pricing	159
7.5.3	Liquidity Spirals	159
7.6	Liquidity Dry-Ups	160
7.7	Liquidity and Collateral Prices	160
7.7.1	Informational Sensitivity of Securities	161
7.7.2	Implications	161
7.8	Further Reading	162
7.9	Problem	163
7.10	Solution	164
	Notes	165
	References	165
<b>8</b>	<b>Banking Regulation: The Microprudential Approach</b>	<b>169</b>
8.1	Introduction: Why Are Banks Regulated?	169
8.2	Deposit Insurance and Moral Hazard	170
8.2.1	The Moral Hazard Issue	171
8.2.2	Risk-Related Insurance Premiums	172

8.3	Capital Regulation 1: The Theory	173
8.3.1	The Value at Risk Approach	173
8.3.2	Risk-Weighted Capital Regulation	174
8.3.3	Portfolio Distortions	175
8.3.4	What Level for Banks' Capital?	176
8.4	Capital Requirements 2: The Practice	176
8.4.1	The Costs of Capital Regulation	176
8.4.2	Empirical Evidence	177
8.4.3	Regulatory Competition	178
8.4.4	Accounting Rules and the Supplementary Leverage Ratio	178
8.4.5	Supervisors' Information and Managers' Incentives	179
8.4.6	Market Discipline	180
8.5	Further Reading	182
8.5.1	Banks' Portfolio and Bankruptcy Risk	182
8.5.2	Liquidity Regulation	183
8.5.3	Disclosure and Market Discipline	183
8.6	Problems	184
8.6.1	Capital Regulation and Speculative Activities	184
8.6.2	Capital Requirements and Business Cycles	185
8.7	Solutions	185
8.7.1	Capital Regulation and Speculative Activities	185
8.7.2	Capital Requirements and Business Cycles	186
	Notes	186
	References	186
<b>9</b>	<b>Systemic Risk and Macroprudential Regulation</b>	<b>191</b>
9.1	Introduction	191
9.2	Systemic Risk	191
9.2.1	The Determinants of Systemic Risk	192
9.2.2	Shadow Banks and Systemic Risk	193
9.2.3	Measuring Systemic Risk	194
9.3	Ex Post Policies: Bank Restructuring and Resolution	195
9.3.1	A Bargaining Game between Bankers and Regulators	195
9.3.2	Bank Resolution and Managers' Incentives	196
9.3.3	Optimal Bailout Mechanisms	196
9.3.4	Debt Overhang after a Banking Crisis	199
9.3.5	How to Restart a Frozen Market?	199
9.3.6	Bail-Ins and CoCo Bonds	200

9.4	Externalities and Macroprudential Policy	200
9.4.1	Nonpecuniary Externalities	201
9.4.2	Fire-Sale Externalities	202
9.4.3	Procyclical Leverage and Credit Cycles	203
9.5	Further Reading	207
	Notes	207
	References	208
	Index	211