UNIVERSITY OF AMSTERDAM

Incentives and Regulation in Banking
N. Martynova

This thesis includes three essays on banking. The first two focus on the problem of bank asset opacity in the banking regulatory design. The third essay focuses on the regulatory arbitrage.

The first essay "Convertible Bonds and Bank Risk-Taking" (joint with Enrico Perotti) studies the effect of going concern contingent capital (convertible bonds, or CoCos) on ex ante bank risk-taking incentives. CoCos are debt instruments that convert into equity when bank is doing poorly. Optimal conversion ahead of default forces deleveraging in highly levered states, when risk incentives are worse. The equity infusion reduces endogenous risk shifting by diluting returns in high states. Interestingly, contingent capital may be less risky in equilibrium than traditional debt, as its lower priority is compensated by reduced endogenous risk.

The second paper "Internal Asset Transfers and Risk-Taking in Financial Conglomerates" studies the effect of securitization in financial conglomerates on their risk choice, and compares it with the choice of standalone banks. Loan sales in conglomerates avoid information asymmetry, which enables conglomerate banks to shift worse loan risk to the deposit insurance by selling their best loans to the affiliates. However, such a value transfer induces a better asset monitoring by conglomerates enhancing their asset value. As a result, under low capital requirements, conglomerate banks may be safer than standalone banks due to stronger monitoring incentives.

The third paper "Franchise Value and Risk-Taking in Modern Banks" (joint with Lev Ratnovski and Razvan Vlahu) studies the effect of bank franchise value on bank incentives to take risk. We consider a setup where a bank takes risk by levering up, to invest in risky market-based instruments. High franchise value allows the bank to borrow more, so it can take risk on a larger scale. This offsets lower incentives to take risk of given size. As a result, a bank with a higher franchise value may have higher risk-taking incentives. The proposed effect is stronger when a bank can expand the balance sheet using inexpensive senior funding (such as repos), and when it can achieve high leverage thanks to better institutional environment (with more protection of creditor rights).