Banking and Trading
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General motivation

- The recent crisis has reopened the debate on bank scope
- Combination of commercial banking with market-based activities
  - Relationship banking versus trading
- What is trading?
  - Short term, scalable arm's length activities of banks
  - Examples: proprietary trading, carry trade, positions in debt instruments (securitized credit), originating standardized loans based on hard information (mortgages)
- Why is this important?
  - Significant change in the nature of arm's length finance over the last decades, with significant increase in risk

This paper

- Focus on the relationship between banking and trading (as opposed to lending and underwriting)
- Main result: Trading may undermine the relationship banking franchise through two channels:
  - Different horizon (short term versus long term) leads to a misallocation of capital from banking towards trading
  - Different risk (risky trading versus safer banking) leads to the use of trading for risk shifting
- Banks' overexposure to trading is inefficient
  - It is even more so with deeper financial markets and less profitable traditional banking

The mechanism in more detail

- Relationship banking generates franchise value because of information-based rents but it is not scalable
- Trading is scalable but capital constrained, so it benefits from the implicit capital available in the bank
  - The "spare" capital from banking is used for trading, thus generating liability synergies
- However, there are two inefficiencies
  - Banking entails a time inconsistency problem, which leads to too much ex post trading and too little ex ante banking
  - Trading can be used more easily to boost risk and benefit shareholders and residual claimants because it is scalable

Structure of my comments

- Very timely and important research question
  - It provides an explanation as to why trading (and risk) has increased so much in the last decades
- Comments
  - What is trading?
  - Types of banks and “strength” of the argument
  - Time inconsistency problem with banking
  - A few words on the model

What is trading?

- *Short-term*, *scalable arm's length* activities of banks versus long-term, information intensive relationship banking
  - Proprietary trading, carry trade, positions in debt instruments (securitized credit), originating standardized loans based on hard information (mortgages), any marketable activities
  - What is the origination of "information-sensitive" claims?
  - What is (short term) interbank lending?
- What does scalable mean?
  - Sellable? Trading is mark-to-market, and not subject to market illiquidity in times of crises
  - Capital requirements for trading activities?

Types of banks and argument

- What types of banks do we have in mind?
  - Presumably larger? Dealing with larger companies?
  - How "information intensive" is their lending? Literature on hard and soft information in lending
  - Are these loans risky? Idiosyncratic versus aggregate
  - What is the franchise value? Lack of competition? Information franchise?
- Useful to provide more discussion/stylized facts on banks' balance sheets, losses/profits on trading and banking
  - Possibly very different across countries, depending also on industry structure

Time inconsistency in banking

- Banks lend (mostly) through credit lines
  - Upfront fees lead to front-loaded income for banks
  - Banks have discretion in honouring lending commitments
- Is it “true”?
  - How much are these fees? Just enough to open a credit line? Proportional to the size?
  - How much discretion do banks have? Credit lines are often considered binding commitments on the side of the banks!
- More “evidence” would be very useful
- Other ways to generate capital shifting from banking to trading? A simpler risk shifting argument?

A few words about the model

- Some more explanation would be helpful
  - Credit constraint $\Pi \geq bA$ - what are these terms exactly?
  - Franchise value R_0 versus borrowing R to cover borrowers' liquidity needs $\overline{R}$
  - Short term trading: returns do not depend on ex ante investments
  - Trading produces date 2 returns of tT for $T \leq S$ and 0 for $T > S$ with $t < r$ and $t < b$, i.e., it is less profitable and credit constrained
  - ...
- Is this the "best" framework for what is certainly a very interesting and important question?