Deposit insurance and specialization in commercial bank lending

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Abstract

Recent literature focuses on liquidity provision as a unique service provided by financial intermediaries. In this paper, we address why commercial banks dominate the provision of these services. Liquidity provision in lending is reflected in offering loan commitments. We argue that commercial banks have a unique advantage in providing this form of liquidity. This unique advantage derives from their access to deposit insurance, and perhaps to a lesser degree, their access to the discount window of the Federal Reserve System. We empirically examine business loans offered by commercial banks, investment banks, and insurance companies. We show that commercial banks have a comparative advantage in offering loan commitments with fixed-formula floating interest rates. Other major financial intermediaries such as investment banks favor bridge loans for corporate restructuring, and insurance companies favor longer term fixed interest rate spot loans. These results are consistent with commercial banks’ unique corporate lending role (that of liquidity provision) deriving from their access to fixed-price deposit insurance.

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1. Introduction

Traditionally, a commercial bank is defined as an institution that simultaneously engages in two activities: deposit taking and commercial lending. However, in recent years, many insurance companies and investment banks also make commercial loans and collect deposits. This has again led to debates on...
what is unique about commercial banks versus other financial intermediaries. The differences in services provided by banks and other financial intermediaries are important for policy debates on bank regulation and the role of banks in monetary policy. In this paper, we argue that the bundle of liquidity services (loan commitments and demandable deposits) that commercial banks offer make them unique, and that access to deposit insurance assures them a comparative advantage in providing these activities.

A number of studies have focused on the environment that might motivate a combination of deposit services and lending activities within a single intermediary. A recent paper by Kashyap, Rajan, and Stein (2002) provides a convincing economic rationale for combining the provision of liquidity services related to lending and deposit taking in a single intermediary. What they do not address is why these services should be housed in a commercial bank. In this paper, we provide a complementary explanation for the merging of these two services in one intermediary and why this intermediary should be a commercial bank. Our focus is quite different though complementary to the synergies described by Kashyap et al. In their model, synergies arise naturally because shocks to liquidity from the lending and deposit sides of the balance sheet are not perfectly correlated. The intermediary can economize on the amount of assets they hold for liquidity purposes, and as a result, lower the cost of providing these services.

To focus on the unique aspects of commercial banks, we consider the type of lending that financial intermediaries undertake. We argue that the lending product that distinguishes commercial banks from other intermediaries such as investment banks and insurance companies is loan commitment or credit lines (we use the two terms interchangeably thereafter). The loan commitment contract is the primary instrument most commercial banks offer in their corporate lending (see Avery & Berger, 1991). The central feature of a loan commitment is that the borrower has the option to draw down and repay the loan at any time during the life of the contract. In our analysis, we note that virtually all loan commitments have a fixed price component at the time the loan is made. This component is usually in the form of fixed default spread relative to a floating index (prime or LIBOR). This desirable feature (from the borrower’s perspective) often leads to potential adverse selection problem for the bank offering the contract. In a period of volatile interest rates, commercial banks will likely face an increase in the proportion of high-risk borrowers choosing to draw down the loans. This means that borrowing under this kind of agreements may take on a nonrandom pattern. This adverse selection risk associated with offering loan commitments is very unattractive from the bankers’ perspective. It is exactly this type of risk, we argue, that fixed-price deposit insurance can reduce. The deposit insurance is serving as a hedge against some of the risks associated with contracts with less than complete contingent pricing. For commercial banks, the adverse selection costs are partially offset by the inefficient deposit insurance pricing schedule offered by the FDIC. Since only commercial banks have access to deposit insurance, they have an advantage in this type of lending relative to other types of financial intermediaries. They also have an additional advantage in offering loan commitments because of their access to the discount window at the Federal Reserve.

The analysis thus far suggests an important prediction about financial intermediaries’ lending patterns. While we expect to see all major intermediaries providing funds to businesses, we should see

1 These include Calomiris and Kahn (1991), Diamond and Rajan (2001), Flannery (1994), and Qi (1998) among others.

2 This argument however ignores that commercial finance companies also specialize in lending through loan commitments (see Carey, Post, & Sharpe, 1998). The findings of their study suggest that regulation on risk taking imposed on insured commercial banks may leave open a segment of the high-risk loan commitment market for commercial finance companies.
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