Available online at www.sciencedirect.com

SciVerse ScienceDirect

Journal of Economic Theory 149 (2014) 43–64

JOURNAL OF Economic Theory

www.elsevier.com/locate/jet

Looting and risk shifting in banking crises [☆]

John H. Boyd [a], Hendrik Hakenes [b,c,*]

[a] *University of Minnesota, Finance Department, 3-273 Carlson School of Management, 321 19th Avenue South, Minneapolis, MN 55455, United States*

[b] *Finance Department, University of Bonn, Adenauerallee 24-42, 53113 Bonn, Germany*

[c] *Max Planck Institute, Bonn, Germany*

Received 25 February 2011; final version received 25 August 2012; accepted 28 August 2012

Available online 29 October 2012

Abstract

We construct a model of the banking firm with inside and outside equity and use it to study bank behavior and regulatory policy during crises. In our model, a bank can increase the risk of its asset portfolio ("risk shift"), convert bank assets to the personal benefit of the bank manager ("loot"), or do both. A regulator has three policy tools: it can restrict the bank's investment choices; it can make looting more costly; and it can force banks to hold more equity. Capital regulation may increase looting, and in extreme cases even risk shifting. Looting penalties reduce both looting and risk-shifting.

© 2012 Elsevier Inc. All rights reserved.

JEL classification: G21; G28; D82

Keywords: Looting; Stealing; Tunneling; Risk shifting; Asset substitution; Gambling

1. Introduction

There is a large theoretical literature on banking crises and how banks respond when they are close to or in bankruptcy. Most of this work has focused on "risk shifting," also sometimes known in the literature as "gambling for resurrection." The idea is that in a crisis and with its

☆ We thank Martin Hellwig, Andrew Hertzberg, Ross Levine, Paul Povel, Isabel Schnabel, Karl Shell (the editor), Andy Winton, an associate editor and a referee, seminar participants in Bonn, Frankfurt, and conference participants at the ESSFM in Gerzensee, the Wisconsin Money and Banking conference in Madison, the SAET on Kos, and the EEA in Milan for discussion.

* Corresponding author at: Finance Department, University of Bonn, Adenauerallee 24-42, 53113 Bonn, Germany.
E-mail addresses: jboyd@csom.umn.edu (J.H. Boyd), hakenes@uni-bonn.de (H. Hakenes).

0022-0531/$ – see front matter © 2012 Elsevier Inc. All rights reserved.
http://dx.doi.org/10.1016/j.jet.2012.10.001

equity depleted, a bank may willingly take on large risks even if these risks are associated with low expected returns. If these low probability, high return gambles pay off, the bank may survive; if they do not, the bank was broke anyway. Thus, from the bank's perspective there may be little downside risk to such gambles. In the literature, such risk-shifting behavior is usually studied as an off-shoot of a more general moral hazard problem induced by deposit insurance or the discount window. The literature on that topic is large, beginning with the seminal work of Kareken and Wallace [18].[1]

An interesting and probably under-appreciated study by Akerlof and Romer [1] argues that much of the theoretical work on banking crises has essentially missed the mark. They argue that bank managers in crises are frequently interested in personally taking as much from the bank as they can (hereafter "looting"), and their risk-shifting actions are primarily intended to facilitate such looting. In such circumstances, there is often a fine line between activities that raise eyebrows, and those that are criminal. An example may help to clarify. Consider a savings and loan association in a crisis, which issues a large volume of fixed rate mortgages financed with short maturity liabilities having a much lower rate of interest. This action produces an extreme maturity mismatch, is inherently risky, and might be interpreted as the risk-shifting action predicted by standard theory. Akerlof and Romer observe, however, that this portfolio allocation also substantially increases short run profits which allows bank managers to pay themselves large salaries and bonuses, consume perks, and so on, without violating regulation or attracting shareholder attention.

In essence, the Akerlof–Romer argument is that risk-shifting need not be an end to itself, but rather may be a device to facilitate looting. Their study puts a new perspective on a large literature; however, it stops short of providing a fully-specified model of banks' actions when risk-shifting and looting are both possible. Nor could we find such a model elsewhere in the literature, and that led to our writing the present study. Next, we briefly discuss some case-study evidence on banks' behavior during crises.

Evidence. In the recent crisis in the United States, we saw much evidence of looting reflected in large salaries, bonuses, etc. to top managers on their way out.[2] It is harder to know if failing banks took large risks at the last minute. In a crisis environment, there is limited useful information about portfolio strategies of such firms. It does seem clear that the large banks, or at least some of them, went into the crisis with extremely risky portfolio allocations. We base this assessment on the amount of financial backing some of them (Fannie May, Freddie Mac, AIG) have already received from the government. This would be consistent with the expected effect of moral hazard distortions. Recent research argues persuasively that a new form of risk shifting has emerged, relating to bank sales of troubled assets (Diamond and Rajan [9]). Their argument, greatly simplified, is that troubled banks have no incentive to sell troubled assets, even if they are correctly priced by the market. For them, holding such assets is a "gambling for resurrection strategy." The assets will pay handsomely in good future states of the world, whereas in bad states the troubled banks will not be in existence anyway.

[1] See Gorton and Winton [13, Section V] for a literature review.

[2] This behavior gained wide coverage in the press, see e.g. the New York Times on March 10, 2009 ("The Looting of America's Coffers") or the Economist on January 29, 2009 ("Looting Stars").

متن کامل مقاله ← دریافت فوری

ISIArticles
مرجع مقالات تخصصی ایران

- ✓ امکان دانلود نسخه تمام متن مقالات انگلیسی
- ✓ امکان دانلود نسخه ترجمه شده مقالات
- ✓ پذیرش سفارش ترجمه تخصصی
- ✓ امکان جستجو در آرشیو جامعی از صدها موضوع و هزاران مقاله
- ✓ امکان دانلود رایگان ۲ صفحه اول هر مقاله
- ✓ امکان پرداخت اینترنتی با کلیه کارت های عضو شتاب
- ✓ دانلود فوری مقاله پس از پرداخت آنلاین
- ✓ پشتیبانی کامل خرید با بهره مندی از سیستم هوشمند رهگیری سفارشات