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Banks as patient fixed-income investors

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Abstract

We examine the business model of traditional commercial banks when they compete with shadow banks. While both types of intermediaries create safe “money-like” claims, they go about this in different ways. Traditional banks create money-like claims by holding illiquid fixed-income assets to maturity, and they rely on deposit insurance and costly equity capital to support this strategy. This strategy allows bank depositors to remain “sleepy”: they do not have to pay attention to transient fluctuations in the market value of bank assets. In contrast, shadow banks create money-like claims by giving their investors an early exit option requiring the rapid liquidation of assets. Thus, traditional banks have a stable source of funding, while shadow banks are subject to runs and fire-sale losses. In equilibrium, traditional banks have a comparative advantage at holding fixed-income assets that have only modest fundamental risk but are illiquid and have substantial transitory price volatility, whereas shadow banks tend to hold relatively liquid assets.

JEL classification

G01; G21; G23

Keywords

Commercial banking; Shadow banking; Safe money-like claims

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