Week 14
Irregularities, continued

We stopped in the middle of the circular city model, and this is where we start. The model does not provide many new insights, but it is a convenient way of studying some particular problems related to competition, as shown by the brief application to contracts where loans are only given to depositors, a restriction in competition which turns out to be welfare improving.

Section 3.3 on “evergreening” explains why banks may want to keep bad and nonperforming loans in their portfolio. Writing off the losses immediately may result in insolvency of the bank which then will be closed by the authorities, whereas renewing the loans which will never be paid back makes it possible to go on, since eventually the losses can be covered by gains from other loans. It may even be rational to run the bank in this way, namely if the cost of monitoring the loans so as to prevent failures is sufficiently high. The model in the notes (which is the original model presented by the author) might be somewhat simpler for our purpose; the important thing is that there are at least two types of contracts, long and short, and that banks can hide failures in some short contracts by pretending that they are long and therefore not yet finalized.

We conclude with a treatment of money laundering in Section 4. In general, money laundering transforms money obtained through illegal activities to money which has the appearance of being perfectly legal. Banks may be involved in this process, and therefore banks are required to report on cases which may cause suspicion of money laundering. The final section 4.3 deals with some possible side effects. The model is not quite straightforward, and you need only read it superficially, hopefully catching the intuition behind the results.

Following this, we turn to operational risk, which is an important, but complex area, since it covers risk arising from the very process of running the bank. It can be seen from the text also that there is no simple and obvious approach to operational risk. We skip the initial sections except for some overall comments (which means that this is not in the curriculum) and begin with Section 4 on the Basel II rules, which again, as with credit risk, are subdivided into three different approaches, so that the bank may choose the one which fits it best.