Banking and Trading

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Abstract

We study the effects of a bank's engagement in trading. Traditional banking is relationship-based: not scalable, long-term oriented, with high implicit capital, and low risk (thanks to the law of large numbers). Trading is transactions-based: scalable, short-term, capital constrained, and with the ability to generate extreme risk from concentrated positions. When a bank engages in trading, it can use its `spare' capital to profitably expand the scale of trading. However there are two inefficiencies. A bank may allocate too much capital to trading ex-post, compromising the incentives to build relationships ex-ante. And a bank may use trading for risk-shifting. Financial development augments the scalability of trading, which initially benefits conglomeration, but beyond some point inefficiencies dominate. The deepening of financial markets in recent decades leads trading in banks to become increasingly risky, so that problems in managing and regulating trading in banks will persist for the foreseeable future. The analysis has implications for capital regulation, subsidiarization, and scope and scale restrictions in banking.