Optimal Debt Maturity

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Preliminary and Incomplete

Abstract

It is not clear why banks use so much short-term financing. One possible explanation is that the threat of early liquidation may force bankers to select their investments more carefully.

The paper explores the validity of this disciplining argument in a model inspired of Huberman and Repullo (2011). Bankers can secretely influence the probability of success of their investments and receive private benefits of control. Investors observe a signal on the payoff of the investment project at the interim date. If this signal is too bad, they liquidate the bank and fire the manager. We determine the optimal mix of short-term and long-term debts as a function of the characteristics of the investment.

We find that short-term debt is only useful when the investment is barely profitable. Moreover, the gains from short-term financing are typically small.

1 Introduction

This paper develops a variant of Huberman and Repullo (2011) that allows the quantification of optimal debt maturity.

Compared to Huberman and Repullo (2011), we make the following changes:

- The return in case of success is constant (R)
- There is a private benefit of control B that the banker loses if the bank is liquidated early.

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