Financial Synergies and Systemic Risk in the Organization of Bank Affiliates

Elisa Luciano, Clas Wihlborg

PII: S0378-4266(17)30281-9
DOI: 10.1016/j.jbankfin.2017.11.011
Reference: JBF 5256

To appear in: *Journal of Banking and Finance*

Received date: 14 September 2016
Revised date: 18 September 2017
Accepted date: 16 November 2017

Please cite this article as: Elisa Luciano, Clas Wihlborg, Financial Synergies and Systemic Risk in the Organization of Bank Affiliates, *Journal of Banking and Finance* (2017), doi: 10.1016/j.jbankfin.2017.11.011

Financial Synergies and Systemic Risk in the Organization of Bank Affiliates*

Elisa Luciano
University of Torino and Collegio Carlo Alberto, Italy

Clas Wihlborg
Chapman University, USA

September 13, 2017

Abstract

We analyze theoretically banks' choice of organizational structures in branches, subsidiaries or stand-alone banks, in the presence of public bailouts and default costs. These structures are characterized by different arrangements for internal rescue of affiliates against default. The cost of debt and leverage are endogenous. For moderate bailout probabilities, subsidiary structures, wherein the two entities provide mutual internal rescue under limited liability, have the highest group value, but also the highest risk taking as measured by leverage and expected loss. We explore the effect of constraints on leverage and policy implications. The conflict of interests between regulators, who minimize systemic risk, and banks, who maximize their own value, is mitigated when capital requirements are effective.

KEYWORDS: bank organization, bank risk, financial synergies, endogenous leverage in banking, default costs, bailouts

JEL classification numbers: G210, G32, G33

*A preliminary version of the paper was circulated under the title "Financial synergies and the Organization of Bank Affiliates; A Theoretical Perspective on Risk and Efficiency". The Authors thank the late Ted Eisenberg and Geoffrey Miller for clarifying the legal scholars' point of view. They thank Michael Brennan, Jean Edouard Colliard, Giovanni Dell'Ariccia, Charles Goodhart for helpful comments; they are grateful to conference participants at the FEBS 2013 Conference, Paris, the IRMC 2013, Copenhagen, the FBM-Luiss 2013 Conference, Rome, the VII Swiss Conference on Financial Intermediation, Lenzerheide, 2014, the 2015 GRETA Conference, Venice, 2015, to seminar participants at the Banque de France, Bank of Italy, INSEAD, Roma Tor Vergata. They thank Flavia Barsotti, Riccardo Giacomelli and Luca Regis for computational assistance. The usual disclaimers apply. Funding from the Europlace Institute of Finance, Bachelier grant, is gratefully acknowledged.