

## Bank Competition, Risk, and Subordinated Debt

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**Abstract** This paper studies a dynamic model of banking in which banks compete for insured deposits, issue subordinated debt, and invest in either a prudent or a gambling asset. The model allows banks to choose their level of risk after the interest rate on subordinated debt is contracted. We show that requiring banks to issue a small amount of subordinated debt can reduce their gambling incentives. Moreover, when equity capital is more expensive than subordinated debt, adding a subordinated debt requirement to a policy regime that only uses equity capital requirements is Pareto improving.

**Keywords** Bank regulation · subordinated debt · risk taking · imperfect competition · franchise value

As banks grow in size and complexity, regulators find it increasingly difficult to monitor and control their risk-taking behavior. Accordingly, regulators are searching for new ways to refrain banks from taking excessive risk. A consensus emerging from this search is that market discipline should be given a more prominent role. Indeed, the Basel Committee on Banking Supervision has designated market discipline as one of the three pillars underpinning prudential regulation (Basel Committee on Banking Supervision 2006).<sup>1</sup>

Economists have formulated a number of proposals to enhance market discipline; the most popular ones would require banks to issue a minimum amount of subordinated debt.<sup>2</sup> The proponents argue that subordinated debt can enhance market

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<sup>1</sup>The other two pillars are minimum capital requirements and supervisory review process. For an excellent exposition on various aspects of market discipline, see Flannery (2001).

<sup>2</sup>For a careful review of these proposals, see Basel Committee on Banking Supervision (2003) or Board and Treasury (2000).

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