A Quantitative Model of Bank Merger Dynamics

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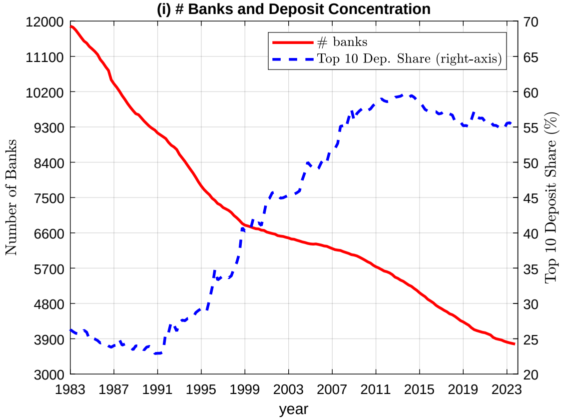
November 13, 2025

*The views expressed in this paper do not necessarily reflect those of the Federal Reserve Bank of Philadelphia or the Federal Reserve System.

†Charles Smith gratefully acknowledges support from the National Science Foundation Graduate Research Fellowship Program under Grant No. 2137424. Any opinions, findings, and conclusions or recommendations expressed in this material are those of the author(s) and do not necessarily reflect the views of the National Science Foundation.

Question



- What are the effects of banking industry consolidation due to Riegle-Neal on lending, markups, financial stability, and allocative efficiency?

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   - Dominant-Fringe Merger model following the framework of Gowrisankaran and Holmes (2004)

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4. Conduct policy counterfactuals:
   - What would have happened absent Riegle-Neal?
   - How have mergers affected the transmission of monetary policy?
   - What is optimal dynamic merger regulation?

Data Summary

1. Increase in deposit market concentration and decline in the number of banks post-Riegle-Neal is driven by mergers. ▸ Deposit Market

2. Increase in markups on bank loans. ▸ Loan Markups

3. Acquirers are substantially larger than targets. ▸ Acquirer vs. Target

4. Marginal propensity to lend (MPL) regressions demonstrate that the MPL declines in bank size. ▸ Bank Marginal Propensity to Lend

5. Granular regressions for the banking industry (Gabaix (2011)) demonstrate that deposit shocks to the largest banks have a substantial effect on aggregate bank lending. ▸ Bank Granularity

Mapping a Simple Model to the Data

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- Financial (in)stability $\rightarrow$ entry/exit creating an endogenous size distribution of banks.

Model Essentials

- 2 types of bank $i \in \{d, f\}$
- Each period begins with:
  - A measure γ of ex-ante identical fringe banks, each with D_f deposits
  - A dominant bank, with deposits D_d
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- Second, loan market competition, a la Cournot, occurs.
  - Banks chose between loans and securities, with securities offering a risk free rate $r_A > r_D$.
  - Borrowers decide whether to fund their project, and then make a discrete choice between bank B and nonbank N loans.

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- Following the loan stage:
  - Banks with positive profits pay dividends. Banks with negative profits choose to exit or inject costly equity.
  - New fringe banks can enter at cost K_f.
  - The next period begins with $(\gamma = \Gamma - \gamma_x + \gamma_e, D'_d, \theta')$

Merger Stage

- Starting in state $s = (\gamma, D_d, \theta)$:
- The dominant bank makes a TOLI offer to a measure $\gamma - \Gamma$ of fringe banks.
- Let $p(s, \Gamma)$ be the price of a unit of deposits. Then, the dominant bank solves the following problem:

$$v_d(s) = \max_{\Gamma \in [0,\gamma]} -p(\Gamma, s)(\gamma - \Gamma)D_f - H(\Gamma, s) + w_d(\Gamma, D'_d, \theta) \tag{1}$$

subject to

$$p(\Gamma, s)D_f \geq w_f(S) \tag{2}$$

- where $H(\Gamma, s)$ are regulatory costs, w_d is the value of the dominant bank at the loan stage, and $S = (\Gamma, D'_d, \theta)$
- If the dominant bank chooses to not acquire any fringe banks, then $\Gamma^*(s) = \gamma$

Bank Profit

- Following the loan stage, loan defaults (θ') and chargeoffs (λ) are realized. The profit of bank $i \in \{d, f\}$ is given by:

$$\pi_i(L_i; S, \theta', \lambda_i') = [\theta' r_B^L - (1-\theta')\lambda_i']L_i + r^A(D_i - L_i) - r^D(D_i) - C_i(L_i). \quad (3)$$

where $C_i(L_i)$ is the cost of loan monitoring. We assume $C_i(L_i)$ takes the following form:

$$C_i(L_i) = \kappa_i + C_{1i}L_i + C_{2i}L_i^2 \quad (4)$$

Further, we denote dividends by:

$$\mathscr{D}_i(L_i; S, \theta', \lambda_i') = \pi_i(L_i; S, \theta', \lambda_i') - \mathbf{1}_{\{\pi_i(\cdot)<0\}}\psi_i(|\pi_i(L_i; S, \theta', \lambda_i')|). \quad (5)$$

where ψ_i captures the costs of equity issuance.

Dominant Bank Loan Problem

The dynamic programming problem of the dominant bank can then be written as:

$$w_d(S, r_N^L) = \max_{L_d \leq D'_d} \mathbb{E}_{\theta'|\theta}\Big[\max_{x'_d \in \{0,1\}} (1 - x'_d)\big(\mathscr{D}_d(L_d; S, \theta', \lambda'_d) + \beta v_d(s')\big)\Big], \quad (6)$$

subject to

$$\begin{aligned} L_d + \Gamma L_f^*(L_d, S, r_N^L) &= L_B(r_B^L, r_N^L), & (7)\\ \gamma' &= F(L_d, S, \theta'). & (8) \end{aligned}$$

where $s' = (\gamma', D'_d, \theta')$ and the function $F(L_d, S, \theta')$ captures the transition of the measure of fringe banks.

- Equation (7) illustrates both loan market clearing and that the dominant bank takes into account both how their loan decision affects the fringe loan decision, L_f, and the bank interest rate, r_B^L.
- Equation (8) ensures that the dominant bank internalizes its impact on market structure in the future.

Fringe Bank Loan Problem

- Given the stackelberg game in the loan market, taking the interest rates r_B^L and r_N^L as given, the problem of the fringe bank solves:

$$w_f(L_d, S, r_N^L) = \max_{\ell_f \leq D_f} \mathbb{E}_{\theta', \lambda'_f|\theta} \Big[\max_{\chi'_f \in \{0,1\}} (1 - \chi'_f) \big(\mathscr{D}_f(\ell_f; L_d, S, \theta', \lambda'_f) + \beta v_f(s') \big) \Big]$$

- The entry decision satisfies:

$$v_i^e(L_d, S, r_{\mathcal{N}}^L, \theta'; \gamma^e(x'_d, e'_d)) = \max_{e'_i \in \{0,1\}} (1 - e'_i) \{-K_i + v_i(s')\}, \tag{9}$$

- The evolution of the mass of fringe banks then is given by:

$$\gamma' = F(L_d, S, \theta') = \Gamma - \gamma^x(L_d, S, \theta') + \gamma^e(L_d, S, \theta'). \tag{10}$$

Markov Perfect Equilibrium

- Taking r^A and r^D as given, a **Markov Perfect Merger Equilibrium** is a set of bank value functions $\{v_i, w_i\}$ and policy functions $\{\Gamma, L_i, \ell_f, x'_i, \chi'_f, e'_i\}$ for $i \in \{d, f\}$, ℓ_N, prices $\{p, r^L_B, r^L_N\}$, and transition functions for $\{\gamma', D'_d\}$ such that:
  1. The pre-merger value function v_d solves (1). The merger quantity Γ maximizes (1).
  2. The merger pricing function p satisfies (2).
  3. The post-merger value functions w_d and w_f solve (6) and (9). The loan supply policy functions (L_d, ℓ_f) and exit decision rules (x'_d,χ'_f) maximize (6) and (9).
  4. Consistency requires $\ell_f = L_f$ and $\chi'_f = x'_f$.
  5. r^L_B clears the loan market (7). Demand For Loans
  6. r^L_N satisfies the nonbank first order condition (21). Nonbank Loan Problem
  7. The mass of entrants γ^e solves the entry problem (9)
  8. Transition functions are consistent with mergers, entry, and exit (10)

Calibration

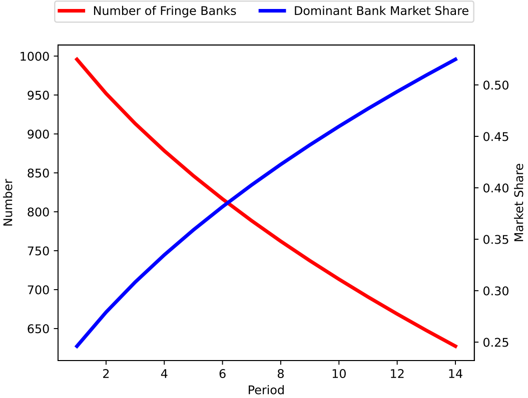
- We estimate most model parameters using Simulated Method of Moments to match the banking industry data pre-Riegle-Neal (1984-1993).
Parameters and Targets

- Broadly we targets moments related to:
  - Loan outcomes: Loan default frequency and charge-off rates
  - Bank costs: Net marginal expenses and fixed costs
  - Bank profitability: Dividend issuance, equity issuance

- The calibrated parameters: Calibration

- We recalibrate bank fixed costs and the nonbank marginal cost change to match banking industry data post-Dodd-Frank. Recalibrated Parameters

Validation: Untargeted Transition Path



- We present the evolution of the endogenous state variables in the 14 years post-Riegle-Neal.
- We capture the decline in the number of banks and the growth of dominant bank quite accurately as in Figure 1.

Price and Market Share Changes: Transition Path

Figure: Evolution of Market Prices

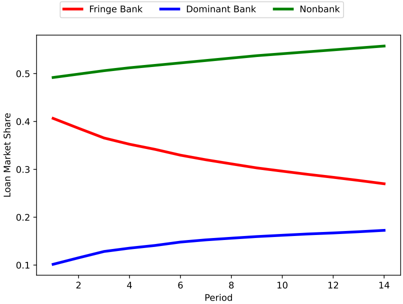


Figure: Evolution of Loan Market

- Bank mergers increase the price of loans and the value of fringe banks.
- The growth of the nonbanking sector is partially due to bank mergers.

Counterfactual: No Riegle-Neal

Name	Calc	Pre	Post	Post - No Mergers
Deposit Market Share Top 10	$\frac{D_d}{D_d+\gamma D_f}$	24.60%	55.26%	27.00%
Loan Market Share Top 10	$\frac{L_d}{L_d+\gamma L_f}$	21.51%	40.68%	22.19%
Bank Loans to Total Loans Ratio	$\frac{L_d+\gamma L_f}{L_n+L_d+\gamma L_f}$	51.51%	39.70%	44.92%
Interest Rate	r_B^L	4.93%	5.49%	4.96%
Bank Failure Rate Fringe	$\frac{\gamma_x}{\Gamma}$	0.03%	0.44%	1.24%
Loan Markup Top 10	$\frac{\theta r^L}{r_D+c'(L_d)}$	218.16%	258.73%	180.46%
Loan Markup Fringe	$\frac{\theta r^L}{r_D+c'(L_f)}$	204.25%	135.03%	128.60%
Tobin's Q (Dominant)	$\frac{V_d}{D_d}$	27.08%	34.04%	30.85%
Tobin's Q (Fringe)	$\frac{V_f}{D_f}$	23.40%	6.42%	2.15%

- Absent mergers, the dominant bank has a much lower market share.
- Increased competition leads to a lower interest rate and lower markups.
- However, bank value declines and there are more bank failures.

Allocative Efficiency

- We use the following decomposition of weighted average bank-level cost, as proposed by Olley and Pakes (1996).

$$\hat{c} \equiv \sum_{i \in \{D,F\}} C_i(L_i)\omega(L_i) = \bar{c} + Cov(C_i(L_i), \omega(L_i)) \tag{11}$$

Moment	Pre Riegle-Neal	Post Dodd-Frank	No Merger Regulation $h = 0$
Avg. (loan-weighted) cost $\hat{c}$	0.0293	0.0403	0.0352
Avg. cost $\bar{c}$	0.0300	0.0479	0.0479
$Cov(c, \omega)$	-0.0006	-0.0076	-0.0128
Total Bank Loans $L_d + \Gamma L_f$	1.2000	0.9174	0.7594

- Allocative efficiency, as measured by $Cov(c, w)$, increases as dominant banks can exploit increasing returns to scale.
- Absent merger regulation, allocative efficiency is even higher, as more mergers allow banks to further exploit increasing returns to scale.

Conclusion

- We document evidence on banking mergers, granularity, and the marginal propensity to lend.
- We develop a model based on the dominant-fringe framework of Gowrisankaran and Holmes (2004), to study the effects of bank mergers.
- We use the model to conduct counterfactuals
- Maintaining pre-Riegle-Neal merger restrictions would create more competition, leading to lower interest rates, but a less valuable bank sector with more frequent bank failures
- Allowing more mergers improves allocative efficiency, but decreases total bank lending.

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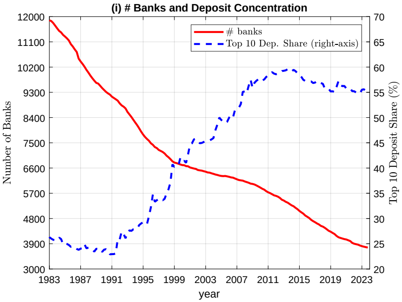
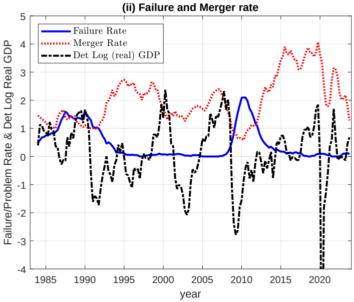
Appendix

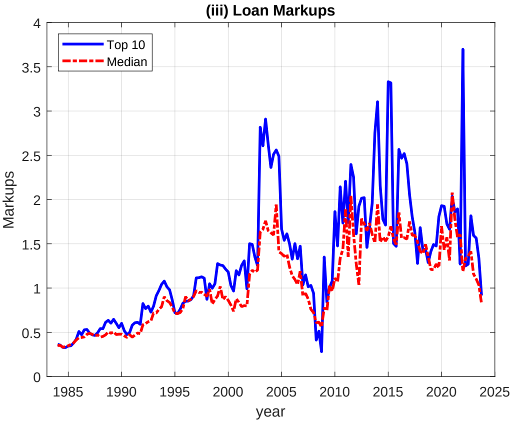
Deposit Market Concentration





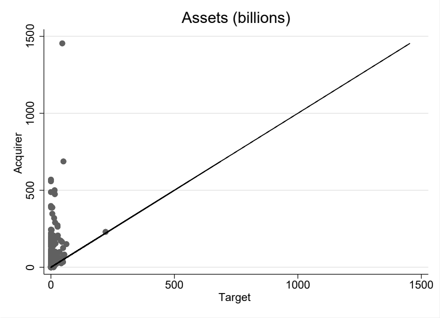
- Rise in top 10 bank share and decline in the number of fringe banks is driven by merger activity. Back

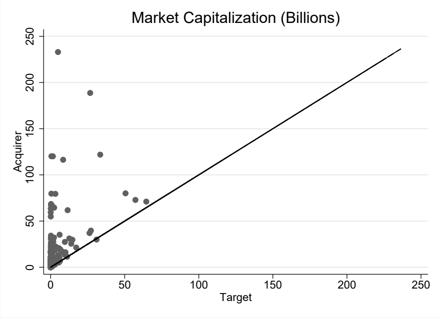
Bank Loan Markups



- Rise in top 10 bank share and declining number of fringe banks coincides with a rise in markups. Back

Acquirers vs. Targets





- Acquirers are larger than targets, whether measured by assets or market capitalization.
- The median acquirer is seven times larger than median target. Back

Bank Marginal Propensity to Lend

- We are interested in estimating the following relationship:

$$\Delta L_{it} = \beta_{k(i)} \Delta D_{it} + \zeta_{it} \tag{12}$$

- Following the MPC literature, the deposit shock process is given by:

$$\begin{aligned} \log(D_{it}) &= \xi_k X_{it} + z_{it} + \varepsilon_{it} \quad \text{where} \quad z_{it} = z_{it-1} + \eta_{it} \\ \Rightarrow \Delta D_{it} &= \xi_k \Delta X_{it} + \underbrace{\eta_{it} + \Delta\varepsilon_{it}}_{=\nu_{it}} \end{aligned} \tag{13}$$

Then the deposit process in (13) implies that equation (12) can then be written as

$$\Delta L_{it} = \beta_k \xi_k \Delta X_{it} + \beta_k \nu_{it} + \zeta_{it}. \tag{14}$$

so that the idiosyncratic shocks ν_{it} help identify the MPL.

Bank MPL Regression

	Dependent Variable $\Delta\log(L_{it})$					
ν_{it}	0.515***	0.514***	0.520***	0.519***	0.456***	0.455***
	(0.00103)	(0.00103)	(0.00170)	(0.00170)	(0.00256)	(0.00256)
$\nu_{it} \times I_{t10}$		0.358***		0.345***		0.305***
		(0.0221)		(0.0453)		(0.0633)
Bank FE	✓	✓	✓	✓	✓	✓
Time FE	✓	✓	✓	✓	✓	✓
Bank Controls	✓	✓	✓	✓	✓	✓
Period	1984-2019		1984-1993		2011-2019	
N	946299	946299	353150	353150	169536	169536
R-sq	0.362	0.362	0.398	0.398	0.287	0.287
adj. R-sq	0.348	0.349	0.371	0.371	0.260	0.260

- Results suggest the average MPL out of deposits is 0.51, with the largest banks having a higher MPL of 0.86. Back

Bank Granularity Regressions

- We implement Gabaix (2011) granularity results in the banking industry.
- Let the granular residual be:

$$\Gamma_t^d \quad = \quad \sum_{i=1}^{K} \omega_{it} \nu_{it} \tag{15}$$

- K denotes the number of "granular" banks, $\omega_{it} = \frac{L_{i,t-1}}{L_{t-1}}$ is the loan market share of bank i, $L_{t-1} = \sum_{i=1}^{N} L_{i,t-1}$ is aggregate lending.
- We then estimate the model:

$$\Delta L_t = \beta_\Gamma \Gamma_t^d + \epsilon_t^\Gamma \tag{16}$$

- We compute the R^2 from the estimated equation (16) given by

$$R^2 = \frac{\beta_\Gamma^2 Var(\Gamma_t^d)}{Var(\Delta L_t)}. \tag{17}$$

Bank Granularity Regressions and MPL

- Equation (16) can be rewritten as:

$$\Delta L_t \approx \sum_{i=1}^{N} \omega_{it} \Delta L_{it} = \beta_d \underbrace{\sum_{i=1}^{K} \omega_{it} \nu_{it}}_{\Gamma_t^d} + \underbrace{\beta_f \sum_{i=K+1}^{N} \omega_{it} \nu_{it} + \sum_{i=1}^{N} \omega_{it} (\beta_k \xi_k X_{it} + \zeta_{it})}_{=\epsilon_t^{\Gamma}}$$

- Under this approximation, $\beta_\Gamma = \beta_d$.
- Our estimate of β_d is biased downward if there is business stealing/mergers.

Bank Granularity Regression Results

	Dep. Var. $\Delta \log(L_t)$					
	Top 10 Banks		Top 35 Banks		Top 100 Banks	
(intercept)	0.00774***	0.00772***	0.00788***	0.00794***	0.00775***	0.00779***
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
Γ_t^x	0.220***	0.219***	0.328***	0.326***	0.381***	0.376***
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
Γ_{t-1}^x	-0.0221	-0.0225	-0.0363	-0.0365	-0.0335	-0.0314
	(0.567)	(0.562)	(0.420)	(0.419)	(0.466)	(0.495)
Γ_{t-2}^x		0.0118		0.0391		0.0464
		(0.761)		(0.388)		(0.315)
N	191	190	191	190	191	190
R^2	0.149	0.149	0.224	0.227	0.273	0.277
Adjusted R^2	0.140	0.136	0.215	0.214	0.265	0.265

- R^2 of 0.149 suggests that shocks to largest 10 banks have a substantial impact on aggregate lending.
- Implied MPL is much lower (0.220), likely due to business stealing/mergers.

Back

Demand for Loans

- Demand for loans comes from ex-ante identical borrowers who demand one-period loans to fund a risky project.
- Every period, given r^L_B, r^L_N, and shock ω, borrowers decide whether to invest ($\iota = 1$) or not ($\iota = 0$).

$$\max_{\{\iota\}}(1-\iota)\cdot\omega + \iota\cdot E_{\boldsymbol{\delta}}[\Pi_E(\theta, r^L_B, r^L_N, \boldsymbol{\delta})] \tag{18}$$

- Conditional on choosing $\iota = 1$, entrepreneurs observe $\boldsymbol{\delta} = \{\delta_B, \delta_N\}$ and then choose which type of lender $k \in \{B, N\}$ to borrow from to solve:

$$\Pi_E(\theta, r^L_B, r^L_N, \delta) = \max_{k\in\{B,N\}} \alpha E_{\theta'|\theta}[\pi(r^L_k, \theta)] + \delta_k \tag{19}$$

where

$$\pi_E(r^L_k, \theta') = \begin{cases} \max\{0, R - r^L_k\} & \text{with prob } \theta' \\ \max\{0, -(\lambda' + r^L_k)\} & \text{with prob } 1-\theta' \end{cases}.$$

Back

Nonbank Loan Problem

- The profit of the representative nonbank is given by:

$$\pi_N(\ell_N, S, \theta', \lambda') = [\theta' r_N^L - (1-\theta')\lambda' - c_N]\ell_N \tag{20}$$

- The first order condition of the non-bank with respect to ℓ_N is given by

$$r^D = E_{\theta'|\theta}\left[\theta' r_N^L - (1-\theta')\lambda'\right] - c_N. \tag{21}$$

Back

Parameters and Targets

Parameter		Value	Target
Deposit Interest Rate (%)	$\bar{r} = r^D$	0.0014	Avg Interest Expense Deposits
Bank Discount Factor	β	0.998	$(1 + r^D)^{-1}$
Return on Securities	r_A^+	0.0180	Return on Net Securities
Default Frequency (Good Times)	θ_G	0.969	Mean Default Frequency (Non-Crisis)
Default Frequence (Bad Times)	θ_B	0.80	Mean Default Frequency (Financial Crisis)
Loan Loss Rate	$\bar{\lambda}$	0.31	Average Charge-off rate
Standard Dev Loan Loss rate f	σ_λ	0.15	Std dev charge off rates f
Standard Dev Loan Loss rate d	σ_λ	0.15	Std dev charge off rates d
Number of Borrowers	N	8.5	Deposit to Output
Return on investing	R	0.20	Net Interest Margin
Price coefficient	α	42.0	Elasticity of Loan Demand
Lower bound demand shock	$\underline{\omega}$	0.693	Normalization
Upper bound demand shock	$\bar{\omega}$	1.193	Dividend Issuance d and f
Mean size of Fringe Bank f	D_f	0.001	Relative Size Fringe to Top 10
Linear Cost Loans d	C_d^1	0.010	Net Marginal Expenses Top 10
Quadratic Cost Loans d	C_d^2	0.001	Elasticity Net Marginal Expenses Top 10
Fixed cost d	κ_d	0.0028	Fixed cost over loans Top 10
Mean Dist Cost Loans f	C_f^1	0.010	Net Marginal Expenses Fringe
Quadratic Cost Loans f	C_f^2	0.001	Elasticity Net Marginal Expenses Fringe
Fixed cost f	κ_f	$0.012 \times D_f$	Fixed cost over loans Fringe
External finance param. d	ψ_d^1	0.05	Avg. equity issuance to loan ratio Fringe
External finance param. f	ψ_f^1	0.50	Avg. equity issuance to loan ratio Fringe
Entry Cost f	K_f	$0.55 \times D_f$	Entry Rate
Regulatory Merger Cost	h	0.001	Post-Dodd-Frank Bank Market Share Top 10
Marginal Cost Nonbank	c_N	0.375	Bank Loan to Total Loans

Back

Parameters That Change

Parameter		Pre-Riegle-Neal	Post-Dodd-Frank
Fixed cost d	κ_d	0.0028	0.0035
Fixed cost f	κ_f	$0.012 \times D_f$	$0.028 \times D_f$
Marginal Cost nonbank	c_N	0.375	0.315

Back

Calibration

Name	Calc	Data Pre	Data Post	Model Pre	Model Post
Average Charge-off rate	$E'_{\theta}[(1-\theta')\lambda']$	0.96%	0.94%	0.96 %	0.96 %
Elasticity of Loan Demand	$-\alpha r_B^L(1-s_B)$	-1.1	-1.1	-1.00	-1.39
Deposit Share Top 10 to Fringe	$\frac{D_d}{D_d+\gamma D_f}$	24.77%	57.79%	24.60%	55.26%
Loan Share Top 10 to Fringe	$\frac{L_d}{L_d+\gamma L_f}$	28.55%	52.86%	21.51%	40.68%
Bank Loans to Total Loans Ratio	$\frac{L_d+\gamma L_f}{L_n+L_d+\gamma L_f}$	44.54%	33.28%	51.51%	39.70%
Net Interest Margin	$E_{\theta}[\theta' r_B^L - r_D]$	4.94%	4.35%	4.63%	5.18%
Net Marginal Expenses Top 10	$\frac{c(L_D)}{L_D}$	1.15%	1.35%	1.03%	1.04%
Net Marginal Expenses Fringe	$\frac{c(L_F)}{L_F}$	2.00%	1.69%	1.00%	1.00%
Elasticity Net Mg Expenses Top 10	$\frac{dC_D(L_d)}{dL_d}$	0.95%	1.03%	1.05%	1.08%
Elasticity Net Mg Expenses Fringe	$\frac{dC_f(L_f)}{dL_f}$	0.78%	0.84%	1.00%	1.00%
Fixed cost over loans Top 10	$\frac{\kappa_D}{L_D}$	0.89%	0.78%	1.02%	0.88%
Fixed cost over loans Fringe	$\frac{\kappa_F}{L_F}$	0.99%	5.83%	1.20%	2.80%
Bank Failure Rate Top 10	x_d	0.00%	0.00%	0.00%	0.00%
Bank Failure Rate Fringe	$\frac{\gamma_x}{\Gamma}$	0.76%	0.44%	0.03%	0.44%
Relative Size Dominant to Fringe	$\frac{D_f}{D_d}$	324.79	688.47	325.00	717.36
Dividends/Assets Top 10	$\mathcal{D}_d/D_d$	0.36%	0.74%	1.65%	1.99%
Dividend/Assets Fringe	$\mathcal{D}_f/D_f$	0.39%	0.66%	1.50%	0.43%
Loan Markup Top 10	$\frac{\theta r^L}{r_D+c'(L_d)}$	56.29%	205.37%	218.16%	258.73%
Loan Markup Fringe	$\frac{\theta r^L}{r_D+c'(L_f)}$	46.64%	149.73%	204.25%	135.03%
Interest Rate	r_B^L	6.69%	3.18%	4.93%	5.49%
Ratio of Loans to Deposits Top 10	$\frac{L_d}{D_d}$	83.3%	64.1%	84.18%	55.51%
Ratio of Loans to Deposits Fringe	$\frac{L_f}{D_d}$	73.3%	79.7%	99.99%	99.99%

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