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Deposit Rate-Setting, Risk Aversion, and the Theory of Depository Financial Intermediaries

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IT IS WIDELY RECOGNIZED that the theory of the depository financial intermediary is not well developed.[1] There are at least two areas, however, where a thorough understanding of intermediary behavior is essential. First, financial intermediaries are among the most heavily regulated firms in the economy. The effectiveness of this regulation is largely dependent on an understanding of the behavioral characteristics of these intermediaries. Second, the new view of money supply determination, which is gaining renewed interest in the literature, emphasizes the role of intermediary decisions in determining the money supply. According to this view, an understanding of intermediary behavior is essential to understanding money supply movements.

Two divergent approaches have been employed in the literature to model the depository financial intermediary. A number of writers e.g., Hart and Jaffee [6], Hyman [9], Kane and Malkiel [11], Parkin [18], and Pyle [24], have adopted the Markowitz-Tobin portfolio theory as their analytical apparatus. The principal advantage of this approch is the explicit treatment of uncertainty which has long played a prominent role in discussions of intermediary behavior. This approach, however, omits two key aspects of the behavior of depository financial intermediaries. First, it is assumed that asset and deposit markets are perfectly competitive so that quantity-setting is the relevant behavioral mode in both markets. This assumption is not applicable to deposit markets since such markets are virtually always highly concentrated where intermediaries set rates and face random deposit levels. The effect of deposit quantity-setting behavior is that liquidity considerations, which have also played a prominent role in discussions of intermediary behavior, are ignored.[2] Second, the approach ignores the resource costs incurred in intermediary operations.

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