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Cover; Contents; I. Introduction; II. Relationship to the Literature; III. Model; A. Approach; B. Credit Constraints; C. Banking; D. Trading; IV. Benefits of Conglomeration; V. Time Inconsistency of Capital Allocation; A. Setup: Long-term Banking; B. The Consequences of Time Inconsistency; C. Cost of Conglomeration under Time Inconsistency; VI. Trading as Risk-Shifting; A. Setup: Risky Trading; B. Risk-Shifting; C. The Interaction of Time Inconsistency and Risk Shifting; VII. Discussion; A. Front-loaded Income in Relationship Banking; B. External Equity and Internal Capital Allocation
C. Policy Implications VIII. Conclusion; References; Figures; 1. The Timeline; 2. The Timeline with Time Inconsistency; 3. Relationship Banking Allocation R as a Function of Trading Opportunities; 4. The Volume of Banking (R) and Trading (T), and Profits ()under Conglomerated Banking; 5. The Volumes of Banking (R)and Trading (T), and Profits () with Risk-shifting; 6. Time Inconsistency Arises due to a Higher Return to Trading under Risk-shifting ("Effect 1"); 7. Risk-shifting Arises due to a Higher Volume of Trading, Driven by Time Inconsistency ("Effect 2")

Sommario/riassunto

We study the effects of a bank's engagement in trading. Traditional banking is relationship-based: not scalable, long-term oriented, with high implicit capital, and low risk (thanks to the law of large numbers). Trading is transactions-based: scalable, shortterm, capital constrained, and with the ability to generate risk from concentrated positions. When a bank engages in trading, it can use its 'spare' capital to profitability expand the scale of trading. However, there are two inefficiencies. A bank may allocate too much capital to trading ex-post, compromising the incentives to build relationships ex-ante. And a bank may use trading for risk-shifting. Financial development augments the

scalability of trading, which initially benefits conglomeration, but beyond some point inefficiencies dominate. The deepending of the financial markets in recent decades leads trading in banks to become increasingly risky, so that problems in managing and regulating trading in banks will persist for the foreseeable future. The analysis has implications for capital regulation, subsidiarization, and scope and scale restrictions in banking.
