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CENTRALIZED VS DECENTRALIZED BANKING SYSTEMS

Abstract:

In this research, we develop a theoretical model to compare centralized and decentralized banking structures in the context of lending policy. The problem faced by banks in both systems is that, to choose a level of loans without having complete knowledge of the state of the entire and the local economy i.e., signals. Observing and appraising hard local signals which are based on verifiable information of the local economies is the benefit of the centralized banking system, whereas considering unverifiable information of the local economies so-called soft signals is the important asset of the decentralized banking system. To compare two banking systems, we use the risk-return trade-off method on systemic risk measure and Expected Return (ER). In terms of the expected social welfare, we address conditions which type of banking system might have better performance. The findings show that the optimal banking structure is dependent on the correlation of the system as well as the state of the entire economy. Furthermore, we investigate the efficient hybrid of these two types of banking systems which leads to decreasing systemic risk, therefore, maximizing expected social welfare.

Keywords:

Banking structures, hard and soft information, Relationship Lending, systemic risk

JEL Classification: D02, G21, G32