Financing Choices of Banks: The Role of Non-Binding Capital Requirements

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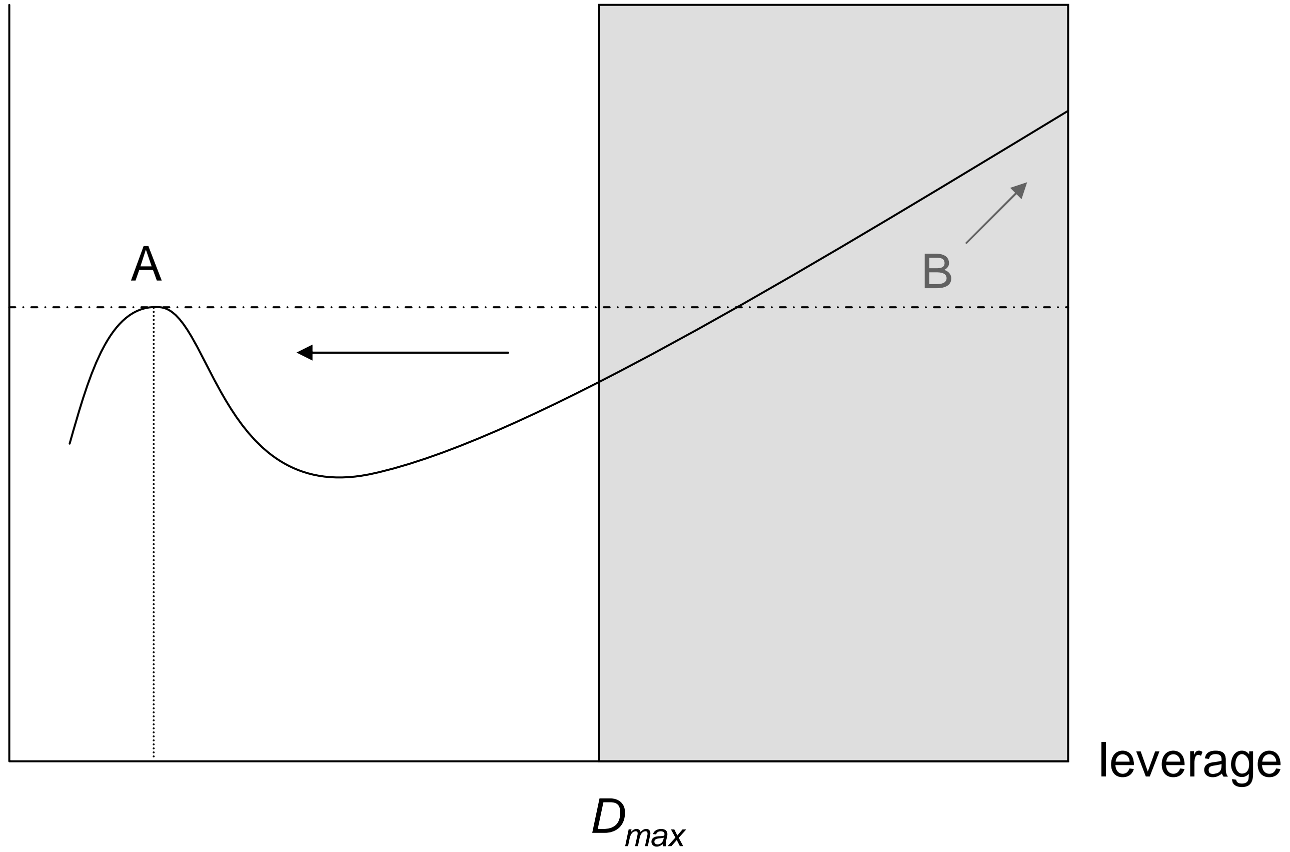
Summary

max E[rent + put]

risk$\uparrow$ $\Rightarrow$ rent$\downarrow$ and put$\uparrow$

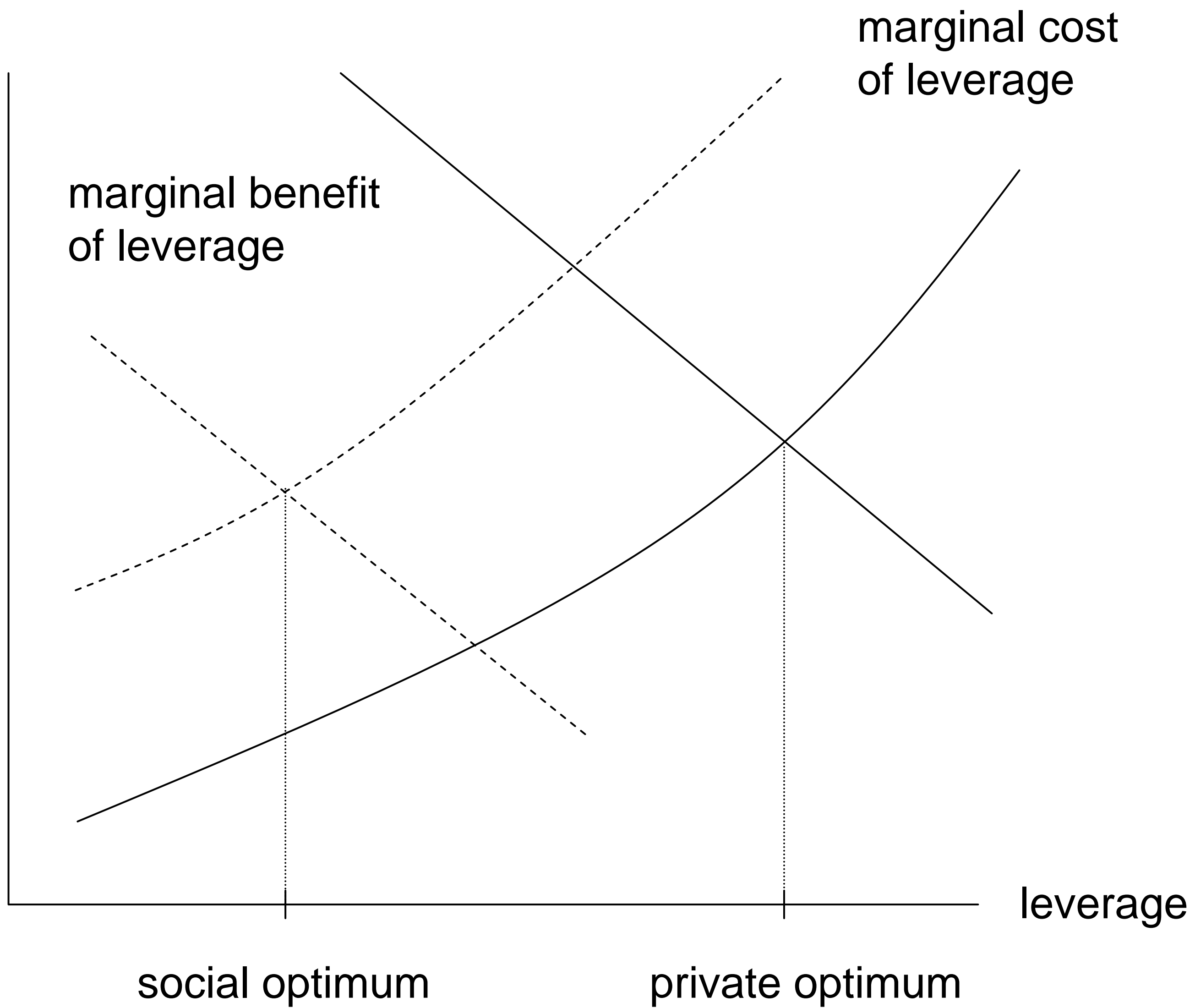


Only for a *given* level of risk σ!

Message

Capital requirements may prevent **extreme** risk taking

But: Is local optimum efficient?


marginal cost
of leverage
marginal benefit
of leverage
leverage
social optimum
private optimum

⇨ Local optimum is inefficient

Role of capital regulation?

Why are capital requirements not binding?

- Minimum capital is *not* a buffer
- Adjustment costs

⇨ hold excess capital as a buffer

[e.g., Lindquist (2004), Bichsel and Blum (2004)]