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

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Summary

max $E[\text{rent } + \text{ put}]$

risk↑ ⇔ rent↓ and put↑
value of bank

Only for a *given* level of risk $\sigma$!
Message

Capital requirements may prevent extreme risk taking

But: Is local optimum efficient?
leverage

marginal benefit of leverage

marginal cost 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)]