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Capital Regulation and Tail Risk

De Nederlandsche Bank Working Paper No. 307

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Abstract


The paper studies risk mitigation associated with capital regulation, in a context where banks may choose tail risk assets. We show that this undermines the traditional result that higher capital reduces excess risk-taking driven by limited liability. Moreover, higher capital may have an unintended effect of enabling banks to take more tail risk without the fear of breaching the minimal capital ratio in non-tail risky project realizations. The results are consistent with stylized facts about pre-crisis bank behavior, and suggest implications for the optimal design of capital regulation.

Keywords: Banking, Capital regulation, Risk-taking, Tail risk, Systemic risk

JEL Classification: G21, G28

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