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Capital Regulation and Tail Risk

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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[Suggested Citation](#) >[Show Contact Information](#) >[Download This Paper \(Delivery.cfm/SSRN_ID1951899_code1723649.pdf?abstractid=1951899&mirid=1\)](#)[Open PDF in Browser \(Delivery.cfm/SSRN_ID1951899_code1723649.pdf?abstractid=1951899&mirid=1&type=2\)](#)

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