Summer Research Paper:

Bank Regulation in a Dynamic Model of Banking*

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This paper investigates the trade-off between restricting growth by setting high capital requirements and frequent crises by imposing low requirements in a simplified version of the dynamic model of banks by De Nicolò et al. (2014). In the model banks that are exposed to credit risk finance their investment in long-term risky assets (loans) by deposits and equity. Banks' deposits are guaranteed by the government which provides a role for regulatory capital requirements. The model reveals that capital requirements increase lending and social welfare, with an inverted U-shaped relation implying moderate capital requirements. Further, regulatory capital ratios reduce banks' default rate, however, to that end higher capital ratios might be necessary.

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