Bank capital, liquid reserves, and insolvency risk

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PII: S0304-405X(17)30097-1
DOI: 10.1016/j.jfineco.2017.05.006
Reference: FINEC 2770


Received date: 13 June 2016
Revised date: 11 August 2016
Accepted date: 24 August 2016

Please cite this article as: Julien Hugonnier, Erwan Morellec, Bank capital, liquid reserves, and insolvency risk, Journal of Financial Economics (2017), doi: 10.1016/j.jfineco.2017.05.006

This is a PDF file of an unedited manuscript that has been accepted for publication. As a service to our customers we are providing this early version of the manuscript. The manuscript will undergo copyediting, typesetting, and review of the resulting proof before it is published in its final form. Please note that during the production process errors may be discovered which could affect the content, and all legal disclaimers that apply to the journal pertain.
We develop a dynamic model of banking to assess the effects of liquidity and leverage requirements on banks’ financing decisions and insolvency risk. In this model, banks face taxation, issuance costs of securities, and default costs and maximize shareholder value by choosing their debt-to-asset ratio, deposits-to-debt ratio, liquid asset holdings, equity issuance and default policies in response to these frictions as well as regulatory requirements. Our analytic characterization of the bank policy choices shows that imposing liquidity requirements leads to lower bank losses in default at the cost of an increased likelihood of default. Combining liquidity and leverage requirements reduces both the likelihood of default and the magnitude of bank losses in default.

Keywords: banks; liquidity buffers; capital structure; insolvency risk; regulation

JEL Classification Numbers: G21, G28, G32, G33.
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