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The Effect of Bank Capital on Lending: Does Liquidity Matter?

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Abstract

This paper uses a sample of quarterly observations of insured US commercial banks to examine whether the effect of bank capital on lending differs depending upon the level of bank liquidity. We find that the effect on credit growth of an increase in bank capital, defined as growth rate of net loans and unused commitments, is positively associated with the level of bank liquidity only for large banks and that this positive relationship has been more substantial during the recent financial crisis period. This result suggests that bank capital exerts a significantly positive effect on lending only after large banks retain sufficient liquid assets.

JEL classification: G01, G21

Keywords: Bank capital, Bank liquidity, Lending behavior, Financial crisis, Basel III