

Accepted Manuscript

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PII: S0378-4266(16)30152-2
DOI: [10.1016/j.jbankfin.2016.09.003](https://doi.org/10.1016/j.jbankfin.2016.09.003)
Reference: JBF 5010

To appear in: *Journal of Banking and Finance*

Received date: 17 October 2014
Revised date: 21 July 2016
Accepted date: 10 September 2016

Please cite this article as: Jing Li, Accounting for Banks, Capital regulation and Risk-taking, *Journal of Banking and Finance* (2016), doi: [10.1016/j.jbankfin.2016.09.003](https://doi.org/10.1016/j.jbankfin.2016.09.003)



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Accounting for Banks, Capital Regulation and Risk-Taking*

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Abstract

This paper examines risk-taking incentives in banks under different accounting regimes in presence of capital regulation. In the model the bank jointly determines the capital issuance and investment policy. Given an exogenous minimum capital requirement, lower-of-cost-or-market accounting is the most effective regime that induces the bank to issue more excess equity capital above the minimum required level and implement less risky investment policy. However, the disciplining role of lower-of-cost-or-market accounting may discourage the bank from exerting project discovery effort ex-ante. From the regulator's perspective, the accounting regime that maximizes the social welfare is determined by a tradeoff between the social cost of capital regulation and the efficiency of the bank's project discovery efforts. When the former effect dominates, the regulator prefers lower-of-cost-or-market accounting; when the latter effect dominates, the regulator may prefer other regimes.

*This paper is based on the second part of my dissertation at Columbia University. I am especially grateful for the support and guidance of my advisor Tim Baldenius. I have also benefited a lot from members of my dissertation committee: Patrick Bolton, Hui Chen, Bjorn Jorgensen, and Nahum Melumad. I would also like to thank Jon Glover, Thomas Hemmer (2009 AAA session discussant), Mike Kirschenheiter (2010 FARS session discussant), Pierre Liang, Robert McDonald (Discussant at Cleveland Federal Reserve conference), Xiaojing Meng, Gil Sadka and seminar participants at Columbia University and Cleveland Federal Reserve Conference on Countercyclical Capital Requirement (2010) for their helpful comments and suggestions. Any errors are my own.

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