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An Analysis of the Impact of 'Substantially Heightened' Capital Requirements on Large Financial Institutions

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Abstract

We examine the impact of "substantially heightened" capital requirements on large financial institutions, and on their customers. Our analysis yields three main conclusions. First, the frictions associated with raising new external equity finance are likely to be greater than the ongoing costs of holding equity on the balance sheet, implying that the new requirements should be phased in gradually. Second, the long-run steady-state impact on loan rates is likely to be modest, in the range of 25 to 45 basis points for a ten percentage-point increase in the capital requirement. Third, due to the unique nature of competition in financial services, even these modest effects raise significant concerns about migration of credit-creation activity to the shadow-banking sector, and the potential for increased fragility of the overall financial system that this might bring. Thus to avoid tilting the playing field in such a way as to generate a variety of damaging unintended consequences, increased regulation of the shadowbanking sector should be seen as an important complement to the reforms that are contemplated for banks and other large financial institutions.

Keywords: Financial Institutions; Governing Rules, Regulations, and Reforms; Capital; Equity; Financing and Loans; Credit;

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