The cost of bank regulatory capital

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March 2020

Summary

The Basel I Accord introduced a discontinuity in required capital for undrawn credit commitments. While banks had to set aside capital when they extended commitments with maturities in excess of one year, short-term commitments were not subject to a capital requirement. We use this difference to infer the price banks are willing to pay to reduce regulatory capital, and to ascertain the role capital regulation plays on the composition of credit in the economy. Our results show that following Basel I, short-term commitments increased as undrawn fees declined (relative to those of long-term commitments). These results are robust and appear to be driven by the Basel I Accord: they are more prevalent among low-capital banks and do not hold in several placebo tests. We estimate that banks are willing to pay at least $0.05 to reduce regulatory capital by one dollar. While this inferred cost might appear to be low, our results show that the relative decline in short-term commitment prices induced by Basel I triggered a large shift in quantities, underscoring the sensitivity of credit to regulatory capital regimes.