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2007

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Basel Accord and Financial Intermediation: The Impact of Policy ¹

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May 2008

¹This work was initiated while both authors were visiting the Bank of Canada and benefited from a lot of initial stimulus from Mingwei Yuan, as well as from discussions with Scott Hendry, Césaire Meh, Kevin Moran, Vincenzo Quadrini and seminar participants at the Universities of Alabama, Connecticut, Florida International, Montréal, Boston College, the Dallas Fed, the NBER Summer Institute and the Midwest Macro Meetings at the Chicago Fed. The views expressed in this paper are those of the authors. No responsibility for them should be attributed to the Bank of Canada. Any errors or omissions are those of the authors.

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Abstract

This paper studies loan activity in a context where banks have to follow Basel Accord type rules and need to find financing with the households. Loan activity typically decreases when investment returns of entrepreneurs decline, and we study which type of policy could revigorate an economy in a trough. We find that active monetary policy increases loan volume even when the economy is in a good shape, while introducing active capital requirement policy can be effective as well if it implies tightening of regulation in bad times. This is performed with a heterogeneous agent economy with occupational choice, financial intermediation and aggregate shocks to the distribution of entrepreneurial returns.

Keywords: Bank Capital Channel, Capital Requirements, Basel Accord, Occupational Choice, Bankruptcy, Credit Crunch.

JEL Classification: E44, E22, G28, E58

1 Introduction

Traditionally, the literature on financial intermediation and credit channels, especially credit crunches, emphasized the relation between banks and entrepreneurs requiring credit, neglecting the funding of banks. With this paper, we want to be much more precise in this respect and study the impact of funding on credit. Indeed, regulation that has become world wide with the Basel Accord puts limits on the amount of loans banks can give, limits that are determined by the level of bank equity. Crucially, the amount of equity banks can issue depends in our model on the supply of equity by households (who also purchase deposits).

In our model economy, households have heterogenous asset holdings because of different labor histories and because only some of them get a draw allowing them to apply for credit as entrepreneurs (among those, the return on investment is stochastic). Non-entrepreneur households invest in bank deposits and bank equity, and banks maximize profits while following regulations. A central bank conducts the monetary policy and regulates the banks.

Therefore, when banks need to reduce their loan portfolio, the displaced entrepreneurs also become new equity holders, thereby acting as “automatic stabilizers”. However, banks typically cut loans as a consequence of their loan portfolio becoming too risky, and households may then want to hold less equity in banks that are now more risky. Whether banks have to tighten credit a lot or not now depends very much on the distribution of assets across households and their equity decisions.

We solve this very rich model using numerical methods, in particular for the transitional dynamics that may lead an economy into a possible credit crunch. We then look for policies that may help the economy out of a trough or prevent it. We find that the endogenous distribution of assets has strong implications that should not be neglected in future research. Also, monetary policy can only have positive real effects if the central bank is able to commit to act in certain ways.

We find some evidence in our model that a credit crunch can arise in the presence of capital requirements, as documented in the data by Bernanke and Lown (1991). The numerical simulations show that the size of the crunch is relatively small. We then investigate the potential role of flexible capital requirements. One would first think that loosening those requirements in a trough would expand the loan mass. It appears that, on the contrary, tighter capital requirements increase the demand for equity, and thus facilitate the financing of banks sufficiently to offset the reduction of allowable loans for given equity. Again, this highlights the importance of household savings decisions. This result is particularly important in the light of the new Basel Accord, whose more flexible requirements essentially tighten the equity requirements when the economy passes through a rough patch, as highlighted by Catarineu-Rabell, Jackson and Tsomocos (2003). This procyclicality of capital requirements was previously thought to have a negative impact on credit, we show it is the opposite once bank funding is taken into account. The conservative lending behavior implied by such a policy in the face of increased aggregate uncertainty has been observed in the data, for example by Baum, Caglayan and Ozkan (2002).

We are not the first to highlight the real impact of monetary policy through lending.

Bernanke and Gertler (1995) highlight two channels. In the balance sheet channel, Fed policy affects the financial position of borrowers and hence their ability to post collateral or self-finance. In the bank lending channel, Fed policy shifts the supply of bank credit, in particular loans. They argue the importance of the latter channel has declined with deregulation, as this channel relies on reserves. Van de Heuvel (2001) identifies another channel stemming specifically from Basel Accord like rules. The “bank capital channel” arises from maturity transformation through banks: higher short term interest rates depress profits, and consequently equity and capital adequacy. This model has a very detailed banking structure, but neglects the problems of households and firms. Our model has a simpler banking structure but emphasizes the source of financing (households) and the demand for loans (entrepreneurs) by modeling occupational choice, savings and bankruptcy.¹

Chami and Cosimano (2001) identify a similar channel, called “bank-balance sheet channel”, using the concept of increasing marginal cost of external financing. As Van den Heuvel, they need market power in the banking industry to obtain the result. Our model has fully competitive banks. Furthermore, they summarize the demands for loans with a reduced form while we try to come closer to a general equilibrium framework. Bolton and Freixas (2001) find that capital requirements can be the origin of a credit crunch. Their model is very detailed on the lending market and asymmetric information. Our model puts more emphasis on the financing side and does not explicitly require asymmetric information. In a model where banks as well as entrepreneurs face moral hazard (hence the existence of bank capital and net worth), Meh and Moran (2004) show that responses to monetary and technology shocks are dampened but more persistent. Bank capital/asset ratio in their model is countercyclical like in the data, but the authors do not explore the behaviour of credit².

The structure of this paper is as follows: section 2.2 analyzes the heterogeneous behavior of households, sections 2.3 and 2.4 analyze the (homogeneous) financial sector and the central bank, section 2.6 defines and analyzes the equilibrium and section 3 presents the calibration of the model. Section 4 analyzes bank lending and optimal monetary policy behavior following negative shocks. Section 5 concludes. Appendices give additional details about various aspects of the model and the solution strategy.

2 Model

2.1 Overview

There are three types of agents in the economy: households, banks, and a central bank. Households in a productive stage of their lives aim to become entrepreneurs, but a shortage of internal financing forces them to apply for external funds. Successful applicants become entrepreneurs

¹The heterogeneity of firms we obtain is endogenous. Bernanke, Gertler and Gilchrist (1998) also have heterogeneous firms, but they exogenously fix a share of firms to have easy access to credit.

²Regulations in many countries limit or prevent banks from investing equity (capital) in their borrowers’ business, arguably to limit their risk exposure. However, contribution of the model in Meh and Moran (2004) is based on the assumption which implies that banks invest share of their capital into borrowers’ business.

and others become workers. Each worker faces an idiosyncratic shock of becoming unemployed while the entrepreneurs face risky returns on their investment. All households in a productive stage of life (entrepreneurs, employed and unemployed workers) face a risk of becoming permanently retired, and all retirees face a risk of dying. New households are born to replace the deceased ones.

When households make their consumption–saving decision, they decide optimally on allocation of their savings between bank deposits and bank equity. Banks collect deposits and equity, provide loans to entrepreneurs and purchase risk-free government bonds in order to maximize their profits. Banks screen loan applications and accept them according to the level of each household’s net worth. Banks also have to purchase deposit insurance and are subject to a capital adequacy requirement imposed by the central bank. The central bank controls the government bond rate.

We now go through the model in more detail. The economy is subject to aggregate shocks and can thus be represented by an aggregate state vector including the current shock and the current distribution of assets and occupations that we ignore in the following to simplify notation.

2.2 Households

In the model economy, there is a continuum of measure one of households, each maximizing their expected discounted lifetime utility by choosing an optimal consumption–savings path. A household can either be productive or retired, and the probability of a productive household retiring τ is exogenous³.

Each productive household i is endowed with one investment project of size x^i , which is always greater than the household’s net worth m^i . We assume that the total investment is a fixed multiple of household’s net worth: $x^i = \phi m^i$ where $\phi > 1$. The project is indivisible, and so $(\phi - 1)m^i$ has to be funded by the bank in order for a project to be undertaken⁴. If a household receives a loan it becomes an entrepreneur and invests into a project, receiving a return r^i drawn from a trinomial distribution. The distribution of returns is such that households always prefer investing into projects and becoming entrepreneurs to becoming workers. We study an equilibrium in which this participation constraint is satisfied in all cases for households that receive loans. The returns are drawn independently across households (i.e. projects) and time. The lowest of the returns is sufficiently negative with a positive probability to lead to bankruptcy, in which case a household is guaranteed a minimal amount of consumption c_{min} and starts next period with no assets.

When the bank rejects a loan application, the household enters the work force and faces exogenous probabilities $1-u$ of becoming employed and u of becoming unemployed. Workers inelastically supply their labor and receive an after tax wage income y . Unemployed workers receive unemployment benefits θy where θ is the replacement ratio.

³Once retired, household cannot become productive again.

⁴Therefore at a household level, demand for loans is uniquely determined by the net worth and so by the history of consumption–savings decisions and luck.

Labor supply is inelastic at an individual level. At the aggregate level, labor supply is determined by moves between the pools of workers, entrepreneurs, unemployed and retirees. This further strengthens the role asset accumulation plays in the economy. We use aggregate labor input data on the average hours per worker to calibrate the labor demand. Therefore, the labor market clears implicitly at the level of the utility function. Because of the inelastic labor supply, we need to assume exogenous wages for the calibrated parameter values.

After retirement, the household earns income from its savings and pension (which equals unemployment benefit payments). Retirees face a probability δ of dying. They are then replaced by agents with no assets and any remaining assets are lost (no bequests).

The households make their consumption–savings decision to maximize their expected lifetime utility. The contemporaneous utility function is a CRRA type:

$$U(c, l)_j = \frac{(l_j^\sigma c^{1-\sigma})^{1-\rho} - 1}{1 - \rho}$$

where $j \in \{W, U, E, R\}$, l denotes leisure, c consumption and ρ is a risk-aversion parameter. As mentioned above, the labor supply is inelastic and the values l_j represent market-clearing values for leisure.

Let V_j denote the value functions and m^* be the minimum net worth necessary for external financing. A worker with a net worth m ($< m^*$) faces probability $(1 - u)$ of being employed, following which he receives labor income $y = (1 - l_W)w$ and interest income $R^d m$, pays a banking fee ξ^5 , consumes a desired level and invests his remaining net worth m'^6 in a bank. If unemployed, he receives unemployment benefit payment θy and makes a similar consumption–savings decision. In the next period, depending on the level of m' , a worker may either become an entrepreneur (borrower) or remain a worker (depositor).

For an employed worker, the Bellman equation is:

$$V_W(m^i) = \max_{c^i, m^{i'}} \{U_W(l_W, c^i) + \beta[(1 - \tau)[(1 - u)V_W(m^{i'}) + uV_U(m^{i'}) + E_{r'}V_E(m^{i'}, r^{i'})] + \tau V_R(m^{i'})]\} \quad (1)$$

s.t.

$$c^i + m^{i'} = (1 + r^d)m^i + y - \xi$$

For an unemployed worker:

$$V_U(m^i) = \max_{c^i, m^{i'}} \{U_U(l_U, c^i) + \beta[(1 - \tau)[(1 - u)V_W(m^{i'}) + uV_U(m^{i'}) + E_{r'}V_E(m^{i'}, r^{i'})] + \tau V_R(m^{i'})]\} \quad (2)$$

s.t.

$$c^i + m^{i'} = (1 + r^d)m^i + \theta y - \xi$$

⁵We will justify in the calibration the use of ξ .

⁶A prime ' denotes variable values in the next period.

An entrepreneur i invests in a project of size x^i , earns a stochastic net return r^i and labor income $y = (1 - l_E)w$ and pays the borrowing cost $r^l(x^i - m^i)$, while making a consumption-savings decision to maximize his expected utility. Because the net wealth is constrained to be non-negative, significant project losses may drive the entrepreneur into bankruptcy. When bankrupt, an entrepreneur defaults on the portion of the debt he can not repay less a minimal consumption allowance c_{min} which has to be granted by the bank. Upon default, the entrepreneur starts the next period as a household with no assets and no liabilities. The returns on project r_i are drawn independently across time and individuals and follow a trinomial distribution. The lowest of the returns is sufficiently negative to lead the entrepreneur to bankruptcy. The value function of an entrepreneur is as follows:

$$V_E(m^i, r^i) = \max_{c^i, m^{i'}} \{U_E(l_E, c^i) + \beta[(1 - \tau)[(1 - u)V_W(m^{i'}) + uV_U(m^{i'}) + E_{r'}V_E(m^{i'}, r^{i'})] + \tau V_R(m^{i'})\} \quad (3)$$

s.t.

$$c^i = \max\{c_{min}, m^i + y + (1 + r^i)x^i - r^l(x^i - m^i) - \xi - m^{i'}\}$$

$$x^i = \phi m^i$$

The assumption of proportionality of the the project x^i to entrepreneur's asset holdings m^i can be justified by the collateral requirements typically observed in credit markets. The proportionality parameter ϕ can easily be calibrated from the data. To stress the effects of the supply of credit, we assume that households *ex ante* always prefer to apply for a loan. This implies a participation constraint for households in a productive stage of their lives that needs to be satisfied for all households that obtain a loan:

$$E_r V_E(m, r) \geq (1 - u)V_W(m) + uV_U(m), \quad \forall m \geq m^* \quad (4)$$

Every household faces an exogenous probability of retirement τ . Once retired, the household collects retirement income $y_R = \theta w$ and manages its assets subject to the risk of death δ .

$$V_R(m) = \max_{c^i, m^{i'}} \{U_R(1, c^i) + \beta[(1 - \delta)V_R(m^{i'})]\} \quad (5)$$

s.t.

$$c^i + m^{i'} = (1 + r^d)m + y_R - \xi.$$

Because of their risk aversion, the agents smooth their consumption over time. The presence of heterogeneous risks of unemployment and retirement as well as the heterogeneity in project returns lead to a non-degenerate distribution of assets in the economy. Intuitively, the individual risks along these dimensions substitute for the uncertainty of income which is modeled as fixed. Without these risks, there would be no reason to save other than to invest in a project, and the asset distribution would unrealistically collapse along $m = 0$ and $m = m^*$. This would not allow for financial intermediation because of lack of funds (no depositors). Also, without heterogeneity, there would be no bankruptcy, as pointed out by Chatterjee, Corbae, Nakajima and Ríos-Rull (2002). All equilibria we study in this bimodal distribution are

very unstable because all entrepreneurs can drift to zero assets following a shock. The distribution of assets plays a crucial role in determining the dynamics of the aggregate variables.

The decision to allocate savings between bank equity and bank deposits is obtained by maximizing a risk-adjusted return on portfolio r_i^{port} across agent types i , $i \in \{W, U, R\}$:

$$\max_{\omega_{ri}} r_i^{port} - \frac{1}{2} \lambda_i \sigma_{port}^2$$

where $r_i^{port} = r^e \frac{E_i}{M_i} + r^d \frac{D_i}{M_i} = \omega_{ri} r^e + (1 - \omega_{ri}) r^d$, $\omega_{ri} \equiv E_i/M_i$ is a weight on the risky (equity) investment for agent type i , λ_i is a risk-aversion parameter and σ_{port}^2 is a variance of the portfolio return. Because bank deposits carry no risk ($\sigma_d^2 = 0$), the household maximizes:

$$\max_{\omega_{ri}} \omega_{ri} r^e + (1 - \omega_{ri}) r^d - \frac{1}{2} \lambda_i \omega_{ri}^2 \sigma_e^2$$

which yields the optimal share of equity $\omega_{ri}^* = \frac{r^e - r^d}{\lambda_i \sigma_e^2}$. This in turn defines the demand for equity (and implicitly for deposits) given savings M_i for any agent group:

$$\frac{E_i}{M_i} = \frac{r^e - r^d}{\lambda_i \sigma_e^2} \quad (6)$$

Note that we have separated this portfolio problem from the intertemporal utility maximization of the household. We do this for computational reasons: given that with aggregate shocks we need to include the entire asset distribution in the state space, we need to avoid having to track for each household two separate assets to keep the state space dimensionality within computationally efficient bounds. Appendix B shows the details of making savings decisions depend on asset levels.

2.3 Financial Sector

2.3.1 Bank

The representative bank maximizes its expected profits, taking the asset distribution in the economy as given. Profits equal asset returns less the funding costs, deposit insurance payments and the expected loan losses and liquidation costs. The bank's choice variables are loans L , bonds B , equity E and deposits D . Because the bank takes the distribution of assets as well as all returns as given, the choice of loan volume is identical to choice of a threshold level of net worth m^* . Formally, the problem can be stated as:

$$\max_{L, B, D, E} r^l L + r^b B - r^d D - r^e E - \delta \left(\frac{D}{E} \right)^\gamma D - (1 + lc) \epsilon L + \xi \quad (7)$$

subject to

$$B + L = D + E = M \quad (8)$$

$$\frac{E}{L} \geq \alpha \quad (9)$$

$$D + E \geq L \quad (10)$$

where M is the total amount of loanable funds that are exogenous from the point of view of the bank⁷, δ is a per-unit deposit insurance cost parameter, ϵ is an expected share of loan losses, ϵ determines the loans facing bankruptcy losses, and lc is a liquidation cost parameter. Equation (8) is the usual balance sheet constraint, (9) is the regulatory requirement on capital adequacy and (10) is a non-negativity constraint on bond holdings. The profit function (7) is non-linear due to the inclusion of deposit insurance costs which are an increasing function of the deposit/equity ratio. Because profits increase in loans for any given asset distribution, one and only one of the constraints (9) and (10) will bind at any time⁸. The solution of the profit maximization is described in the appendix.

2.4 Central bank

The central bank in this model determines the bond interest rate r^b and elastically supplies (government) bonds at this rate. In addition, it determines the capital-to-asset ratio parameter α . Therefore α and r^b are the only monetary policy instruments it has at hand. In the simulation section 4 we show how different monetary policy actions, as represented by mean preserving changes in r^b across the aggregate states, influence the behavior of the different types of households and of the representative bank. We also do similar exercises with mean preserving changes in the capital requirements.

2.5 Market clearing

On the financial side, markets for loans, bonds, equity and deposits must clear. The bond market clears automatically because of an infinitely elastic supply of bonds⁹. The remaining market clearing conditions are:

$$D^S = D^D = \sum_{m^i < m^*} m^i (1 - \omega_r) \quad (11)$$

$$E^S = E^D = \sum_{m^i < m^*} m^i \omega_r \quad (12)$$

$$L = \sum_{m^i \geq m^*} (\phi - 1) m^i \quad (13)$$

$$M = \sum_{m^i < m^*} m^i = D + E = B + L = \sum_{m^i \geq m^*} (\phi - 1) m^i \quad (14)$$

⁷The total amount of assets flowing through the financial sector is determined by households' decisions. Half of the total "financial" assets (note that the self-financed part of entrepreneur's project does not enter financial sector) has to equal total bank liabilities=assets (see equation 14).

⁸The chances that both of them bind at the same time can be dismissed as arbitrarily low.

⁹One can think of banks depositing their non-loanable investments at the central bank which also sets the deposit rate in this model.

Also, expected losses of the bank must in equilibrium equal the realized loan losses:

$$\epsilon = \sum_{m^i \geq m^*} \max\left\{0, (1 + \mu) \left[r^l (\phi - 1) m^i - \phi m^i (1 + r^i) \right] + c_{min} \right\}$$

where μ are auditing costs. The market clearing equations (11) – (14) connect the new homogeneous part with the original heterogeneous part of the model. The sum of individual demands for deposits, equity and loans on the right-hand sides must equal the supply levels decided on an aggregate level.

Equity market clearing implicitly defines the return on equity r^e as a function of all other returns. In the case of an *interior* solution, equations (21) and (6) imply:

$$\frac{1}{\delta} (r^e - r^d)^3 - \left[\frac{1}{\alpha \delta} (r^l - r^d - (1 + l_c) \epsilon) + 1 \right] (r^e - r^d)^2 + 2\lambda \sigma_e^2 (r^e - r^d) - \lambda^2 \sigma_e^4 = 0 \quad (15)$$

In the case of a *corner* solution, equations (24) and (6) imply:

$$\begin{aligned} r^{e3} - r^{e2} \left[2r^d + r^l - (1 + l_c) \epsilon + 1 \right] - r^e \left[r^{d2} + 2r^d (r^l - (1 + l_c) \epsilon + 1) + 2\lambda \sigma_e^2 \right] \\ - \left[r^{d2} (r^l - (1 + l_c) \epsilon + 1) + 2\lambda \sigma_e^2 r^d + \delta \lambda^2 \sigma_e^4 \right] = 0 \end{aligned} \quad (16)$$

To illustrate the functioning of the equity market, it is useful to undergo a following thought experiment. Consider a case of an increase in the lending interest rate r^l , possibly because of an increase in the demand for loans. As long as the ratio of expected losses as a proportion of loans ϵ rises less than r^l , the bank's profit margin on each new loan goes up, which prompts the bank to lend more. To do so, bank has to raise more equity (it starts without any excess of it: $E = \alpha L$), which is why the equity supply equation (21) is increasing in the loan profit margin. The demand for equity (6) is unaffected by the return on loans, and so to raise more of equity, the bank's offered r^e has to increase. Note that because the government bond rate is exogenous and it determines the deposit rate in an interior solution (which is the norm), and because the bank can not choose the size of its balance sheet M , r^e plays an important role in the bank's liability management. Its increase will lead to a rise in the total amount of equity raised and to a more-than-proportional increase in the E/D ratio for any size of the balance sheet M ¹⁰.

It is therefore easy to see that when the bank increases the share of loans in its portfolio, it has to fund the higher equity holdings at an ever-increasing price. Eventually, the original profit margin disappears and a new optimal loan level is achieved. Two cases can occur. First, the total amount of new loans is less than the new balance sheet level, loan market clearing conditions are satisfied and constitute a potential equilibrium. Secondly, the total amount of new loans may exceed the new balance sheet volume M , which is what we defined earlier as a *corner solution*. In the latter case the loan market does not clear and the banks ration some of the eligible loan applicants. Because there is no asymmetric information problem in this model (hence no adverse selection), an increase in the price of loans does not affect its quality and a higher r^l is needed to clear the market. Therefore we have a choice of focusing on

¹⁰This follows from the fact that $\frac{E}{D} = \frac{\omega_r}{1 - \omega_r}$ and ω_r increases in r^e .

market-clearing equilibria which rule out corner solutions and equity "hoarding", or allowing credit rationing when multiple equilibria may arise and excess equity is kept as a backup in case the total amount of loanable funds M increases. For simplicity, we only focus on the market-clearing equilibria, and only equation (15) becomes relevant. One of the implications of this is that we will never observe the bank holding excess equity in equilibrium, and so regulatory changes in capital adequacy ratio ρ will have a direct effect on the loan volume.

The above market clearing condition (15) defines a return on equity as function of all other returns and some parameters: $r^e = r^e(r^l, r^d, \sigma_e^2, \lambda, \alpha)$. The above cubic equations can be solved analytically but does not determine the r^e uniquely. Depending on the parameter values, two of the three roots may be complex, which we disregard.

Now we have a recursive system. Conditional on M , equation (21) determines the optimal level of equity E , equation (23) determines the optimal level of deposits D , equation (14) determines the optimal level of bonds B and equation (22) determines the optimal level of loans L . We therefore have $\{r^e, r^d, E, D, L, B\}$ as a function of $\{r^l, M\}$ and exogenous variables.

2.6 Equilibrium

A recursive equilibrium in this model economy are four value functions $V_j(m, s)$, where s represents the aggregate state (current shock, distribution of m), for $j \in \{E, W, U, R\}$, decision rules $\{g_j^m(m, s), g_M^d(s), g_M^e(s), g_B^{m*}(s), g_B^{r^l}(s)\}$, government policies $\{\alpha(s), r^b(s)\}$, prices $\{r^d(s), r^{port}(s), r^e(s)\}$, aggregate asset levels $\{L, D, B, E\}$, and a function $\Psi(\mu)$ such that:

1. decision rules $g_j^m(m, s)$ solve each household's problem with the associated value functions $V_j(m, s)$.
2. decision rules $g_M^d(s)$ and $g_M^e(s)$ solve portfolio problem of the household.
3. decision rules $g_B^{m*}(s)$ and $g_B^{r^l}(s)$ solve the banks' problems.
4. loan, equity and deposit markets clear:

$$L(s) = \sum_{m \geq m^*} (\phi - 1)m\mu(m, s) \quad (17)$$

$$E(s) = \frac{r^e - r^d}{\gamma\sigma_e^2} \sum_{m < m^*} m\mu(m, s) \quad (18)$$

$$D(s) = \left(1 - \frac{r^e - r^d}{\gamma\sigma_e^2}\right) \sum_{m < m^*} m\mu(m, s) \quad (19)$$

5. the distribution of households is the fixed point of the law of motion Φ :

$$\mu'(m, s) = \Psi(m, s)$$

3 Parametrization

To simulate the economy and obtain numerical results, we parametrize the model to the Canadian economy in the years of 1988 to 1992, in accordance with the available data on project return distributions. Indeed, these are the only years for which Statistics Canada published such data.

First we calibrate the household sector. Several parameters are set in accordance with the literature: $\rho = 2.5$, $\beta = 0.96$ and $\sigma = 0.67$. In accordance with the models that include explicit leisure specification, $l_E = l_W = l_U = 0.55$ while $l_R=1$, as a result of which the labor input of entrepreneurs and workers, and the search effort of unemployed are set to 0.45. Wages are exogenous and while they completely characterize the labor income of entrepreneurs and workers, the incomes of unemployed and retired are determined by the ratio of unemployment insurance benefits to wages $\theta = 0.3$ ¹¹.

The probability of unemployment is set equal to the average Canadian unemployment rate for the considered period: $u = 0.0924$. The probability of retirement τ and the mortality rate δ are set at 0.05 and 0.1, so that the number of expected periods while worker and retiree are 20 and 10, respectively. Longer expected lifetime horizon allows us to utilize the effect of savings over time more fully than in the usual 2-period models (e.g. Williamson (1987) and Bernanke and Gertler (1989)).

Now we turn to the financial side. Following the calibration in Yuan and Zimmermann (1999), we set the real bond rate r^b at 1%, such that the deposit rate r^d is about 0.9%, which corresponds to an average of savings rates and guaranteed investment certificate rates. The parameter α of the capital adequacy constraint is taken to represent the tier-1 capital requirements imposed by the Basel Accord (1988) and set to $\alpha = 0.08$. The deposit insurance parameter δ is calibrated using the premium rates of the Canadian Deposit Insurance Corporation for banks in 2000/2001 (0.0417% of insured deposits). This per-unit rate corresponds to $\delta = 0.0000417$ for an average D/E ratio of 10. The loan administration cost l_c is assumed to equal 0. The account flat fee ξ is set at 0.0003 by trial and error in order to get the banks to break even. The parameters of the equity market that need to be calibrated are λ and σ_E^2 . The variance of returns on equity of the banks is calculated from the TSE (Toronto Stock Exchange) monthly series on financial enterprises' returns on equity from September 1978 until December 2000, which are deflated by the CPI. Therefore, $\sigma_E^2 = 0.24$. The risk-aversion parameter of the portfolio optimization problem λ is calibrated from the market clearing condition (15) using the observed average real deposit, lending and ROE rates. This implies $\lambda = 16$.

The distribution of returns follows a two-state Markov process calibrated such that the high state occurs 75% of the time. Specifically, a high state has a 75% chance of reoccurring the next period, while a low state can repeat itself with a 25% chance. The distributions of project returns in both aggregate states are calibrated from firms' return on equity data. Statistics Canada (1994) reports the distribution of return on equity by non-financial enterprises from the fourth quarter of 1988 until the fourth quarter of 1992. Average returns in each quarter are reported for the top, middle and bottom tertile. Assuming the underlying distribution is

¹¹This measure is based on the effective replacement rate of Hornstein and Yuan (1999).

normal, we find the returns and associated probabilities for trinomial distributions such that a) average returns are replicated, b) we have two extreme returns, one implying bankruptcy. We compute two such distributions, one for the high aggregate state, corresponding to the average of the 75% best quarters in the sample period, and the other for the low state. The returns and the associated distributions are the following:

$$\text{High: } \begin{pmatrix} -50\% & 5.2\% & 60\% \\ 0.71\% & 98.48\% & 0.81\% \end{pmatrix} \text{Low: } \begin{pmatrix} -50\% & 2.57\% & 60\% \\ 1.79\% & 97.42\% & 0.79\% \end{pmatrix}$$

The ratio of investment to net worth ($\phi - 1$) is calibrated to equal the average debt-equity ratio during the reference period, and so $\phi = 2.2$. With a minimum return on investment of -50%, we have occasional bankruptcies.

4 Capital requirements, bank lending and monetary policy

In this section, we want to understand the behavior of the model economy. This is no easy task, as the model is quite complex. The rich aggregate state space implies that many different histories of shocks can be studied. We focus here on one particular history which we believe is empirically relevant from the business cycle perspective. The model economy has been hit by a long sequence of High aggregate shocks, thus the distribution of assets has converged to a High steady state. Given the way the shock process has been calibrated, the economy spends on average 50% of time in the initial state of this experiment, a state that we will sometimes refer to as “normal times.” Our experiment then starts with a succession of five Low shocks and then five High shocks. Thus, the model economy wanders through a whole cycle, bottoming out in the middle. Note that this a particular history of shocks among many others, and that this history is not anticipated.

Figure 1 shows the behavior of various indicators in a benchmark economy, i.e., one with no policy intervention from the central bank on the interest rate for bonds nor the capital requirements. When the initial bad shock hits the economy, the lending rate jumps up, essentially to cover against higher expected loan losses. As the bad news (negative shocks) accumulate, the lending rate decreases as m^* increases and the households adapt their asset levels. Banks ration more and more loans as bad shocks accumulate but revert to “normal” behavior as soon as good news come in. From peak to trough, the amount of loans decreases by 3.0%, and 3.6% of all entrepreneurs are driven out. The consequence is that the size of an average loan increases by 0.6%, corresponding to the empirically documented phenomenon that small businesses are hurt more when credit conditions worsen.

Do the results of the benchmark calibration imply a credit crunch? Despite the fact that banks can increase the interest rate on loans to compensate for higher rates, they have to decrease the total loan mass. The reason is the following. Facing increased risk, more entrepreneurs are forced to become workers due to a higher bankruptcy rate. With more agents that save, the volume of assets increases. However, a smaller share of those assets are channeled to bank equity because its return is too low given its risk. The banks are then squeezed

by the capital requirement and have to ration credit and invest more into “unproductive” government bonds. Without the capital requirement, banks could give more loans, in principle, by charging even higher loan rates, and entrepreneurs would still be ready to pay these rates. Although all agents behave optimally, we have a situation that can be described as a credit crunch, where marginal return and marginal costs of loans are not equal.

Capital requirements imply that changes in the composition of banks’ liabilities affect the amount of credit in the economy. An adverse productivity shock increases the number of depositors and lowers the number of borrowers. Yet risk averse depositors shy away from the highly risky bank equity which leads to a further credit decline (due to the capital requirements). However, the movements described above are relatively small.

4.1 Countercyclical monetary policy

The following experiments will help us understand what are the consequences of various policy actions. The first policy experiment, described in Figure 2, involves a 25 basis point reduction of the bond rate in the worst aggregate state (current shock Low, long history of Low shocks).¹² Thus, the central bank reacts only after a prolonged decline in the economy. Note that the decisions of the banks are changed only in this specific state: m^* and the lending rate are unaffected when the central bank does not move, but when it does banks reduce the lending rate by the same margin and, more importantly, significantly relax their loan threshold m^* . Thus the situation for entrepreneurs should improve noticeably: easier access to credit at better conditions. Loan activity is negatively affected, however, and equity is reduced compared to the benchmark. This is because workers decide to save slightly less (interest rates are lower) and put a smaller proportion into equity (return is lower). Note that household decisions are affected even when the central bank has left the bond rate untouched, in anticipation of possible changes. Ultimately, the same number of entrepreneurs get loans and the average loan is now smaller.

A one-time drop in the interest rate therefore does not appear to be an effective policy. What now if the interest rate is gradually reduced by 5 points after each bad shock, and goes back to normal whenever a good shock comes by? This policy should take into account better the anticipations the households formulate. In Figure 3, we see that the outcome is quite different. Banks become much more generous to entrepreneurs in bad times, both in terms of lower lending rates in bad times (but higher in good ones) and quite significantly in terms of m^* . In all aggregate states, there are more entrepreneurs, loans, deposits and equity. While the average loan is larger in normal times compared to the benchmark, it is smaller in almost any other. This means that asset accumulation has increased for households: entrepreneurship is more interesting as monetary policy counterbalances the increased risk in bad times. Indeed, while firms face lower average returns and higher bankruptcy rates, monetary policy forces banks to offer better conditions. This has an impact on asset accumulation even in good times. We conclude that an active countercyclical monetary policy can have a significant positive impact. Note, however, that it cannot remove the cyclical nature of loans.

¹²Note that all experiments are designed such that the average r^b or m^* stay at the same level.

4.2 Procyclical monetary policy

If a policy of lower interest rates may have negative consequences under some circumstances, one may naturally ask whether an interest rate increase can do some good. Indeed, higher bond rates mean higher returns on savings and potentially more equity to satisfy the loan needs in the presence of capital requirements.

In Figure 4, we find that the model economy does not behave in a symmetric way, as compared to Figure 2. While the lending rate increases as expected, m^* stays essentially put rather than shoot up. Consequently, loan activity does not change much as households barely change their decisions compared to the benchmark. The sum of all tiny changes results, however, in a noticeable decrease in the average loan size, but not as strong as in the opposite policy.

Comparing Figures 3 and 5, it appears that the same kind of asymmetry exists for a gradual policy. A gradual increase of the bond rate has a negative, but much smaller impact on the various assets.

An explanation for this asymmetry is as follows. Procyclical monetary policy induces a drop in m^* , leading to an increase in the loan volume as more smaller agents can become entrepreneurs. Moreover, a lower m^* induces workers to save more (consumption drops) at any given deposit rate because entrepreneurship is more likely to be attained (this move is slightly offset by the distributional movements as there are fewer workers and more entrepreneurs). Because of this boom in banks' liabilities, the asset side of banks' balance sheets expand which reinforces the initial loan volume increase.

On the other hand, a countercyclical monetary policy induces a small rise in m^* . This is a strong saving disincentive for workers who want to become entrepreneurs, and leads to a drop in the volume of deposits and equity. Such drop is partly offset by an increase of the pool of depositors and a rise in the deposit interest rate. These offsetting moves are behind the relatively small changes in the volume and the composition of banks' balance sheets.

The asymmetry is compounded by the fact that the distribution of agents is skewed in the neighborhood of m^* . Households have little reason to attain an asset level just below m^* , as the lot of an entrepreneur is better, in expected terms, than that of a worker. Thus, an increase in m^* has stronger consequences on loans than a decrease.

Banks' decision to change m^* in an asymmetric way is just a reflection of the equilibrium nature of the problem. With procyclical monetary policy, banks' desire to give more loans requires a rise in their equity funding (capital requirements bind). Yet equity is more risky in bad states and households channel their savings away from equity and into deposits. Therefore, in order to expand their loans, banks must make the vision of entrepreneurship (a motivation for saving) highly desirable to get sufficient equity - hence a sharp drop in m^* . On the contrary, a countercyclical monetary policy motivates a loan volume drop which is achieved by an increase in m^* . Such increase can be small because for any amount of savings, risk-averse households prefer deposits in bad times anyway.

The heterogenous agent setup of this model highlights the effects of the changes in distribution of assets and bank financing on loan activity. In particular, it shows the asymmetric

propagation of monetary policy.

4.3 Countercyclical capital requirements

The interest rate is one of two instruments the central bank can use. The other is to modify the capital requirements, which in the benchmark economy are set at a 8% equity/loan ratio, as in the Basle Accord. As it appears capital requirements have an impact on the model economy, one may want to establish whether it can be used for cyclical purposes as well. In the first experiment, Figure 6, the equity/loan ratio is allowed to be reduced to 7% in the worst aggregate state only. While the banks can now offer more generous conditions, in this state only, households observe higher bank risk and shift from equity to deposits sufficiently to counterbalance and decrease the loan mass. As for a bond rate reduction, the average loan size decreases as the number of entrepreneurs barely changes compared to the benchmark economy.

The next experiment involves a gradual decline of the capital requirements during the bad shocks, Figure 7. One would expect that the regulator allowing the banks to take more risks during a downturn may generate more loans. To the contrary, equity declines even more, resulting in a smaller loan mass. Interestingly, loans are lower even when the regulator does not intervene and has in fact slightly more stringent capital requirements to maintain the same average as in the benchmark. The reasons are the same as previously: households shy away from banks when they take on more risk.

4.4 Procyclical capital requirements

If countercyclical capital requirements have adverse effects, maybe procyclical ones have a positive impact on lending ability. Figure 8 looks at the punctual policy, Figure 9 at the gradual one. Both policies have positive effects, locally and small for the first one, globally and massively for the second one. Thus it appears that tightening capital requirements is good for loan activity because it improves the financing of the banks. In this case the arguments are symmetric to the countercyclical policies.

Note that we have no informational problem in the model economy that would actually require the imposition of capital requirements. One can easily imagine that if the model would include this feature, it would only reinforce the result: the presence of more entrepreneurial risk leads to a higher impact of asymmetric information and risk, thus furthering the need for regulation.

4.5 Credit crunch? What exactly happens in the model?

A negative aggregate shock lowers the expected project returns and increases their volatility. This affects the loan volume and the lending rate in four ways. *First*, both these effects decrease the expected value of risk-averse entrepreneurs ($E_r V_E$) while the value functions of non-entrepreneurial households do not change.¹³ Therefore the incentive to accumulate assets

¹³There is only a second order effect coming from expectations to be an entrepreneur in the future.

in order to be eligible for a loan declines. This lowers the demand for credit because fewer agents save enough to pass the m^* cutoff. *Second*, the risk-neutral banks only care about the expected return of projects. The relative net payoff of bonds versus loans rises and induces a substitution from loans to bonds. The loan supply drops and the lending rate r^L increases to compensate for higher loan losses. This is the credit supply effect (i.e. the "crunch"). *Third*, an increase in r^L further discourages loan applicants because their net return on investment declines, and the equilibrium credit level drops further. Therefore the post-shock equilibrium exhibits a higher lending rate and a lower level of loans which further propagates the shock. Note that the decline in the market-clearing volume of credit is partly demand-driven, and cannot be only attributed to the credit crunch behavior of the banks. *Fourth*, the household perceives more risk in the bank when entrepreneurial risk increases. It then shifts from equity to insured deposits, thus making it harder for banks to meet the capital requirements. They further reduce the supply of loans.

4.6 Does the equity market worsen or soften the credit decline?

The existence of equity market can either amplify or reduce the impact of a negative shock on a volume of credit. Only the second and fourth of the above mentioned four effects is directly affected by the existence of an equity market. The equilibrium condition (15) shows that only changes in r^L and ϵ affect credit behavior through the equity channel, and they do so in an offsetting manner. An increase in ϵ (higher loan losses) increases the return on equity r^E , while an increase in r^L lowers it. We therefore distinguish two cases. (A) If $d(r^L - (1 + l_c)\epsilon) < 0$, then a rise in r^E increases the cost of funds to the bank which squeezes the profit margin further and leads to an additional substitution from loans to bonds (L drops) as well as an increase in r^L . At the same time the portfolio return r^{PORT} increases, making borrowing relatively less attractive (demand for credit drops). In this case, the presence of the equity market worsens the credit decline: a higher r^E is only compatible with a lower amount of equity E on the market, as households are risk averse while banks are risk neutral, which in turn requires an additional drop in loans due to a binding capital adequacy constraint (see equation (22)). Case (B) when $d(r^L - (1 + l_c)\epsilon) > 0$ has the opposite implication – it softens the effects of financial accelerator.

According to the simulations (comparing peak and trough states), $d(r^L - (1 + l_c)\epsilon) = 0.0002$ and we can conclude that the presence of the equity market softens the credit crunch.

5 Conclusion

We used a complex model to study the interaction of household saving decisions, project returns, Basel Accord type banking regulation and credit activity. We find that the Basel Accord has a noticeable impact on loans when project returns decline through the cycle. Active monetary policy through interest rate reductions in bad times is able to put loan activity at a higher level, but without removing its cyclical nature.

A relaxation of the Basel Accord capital requirements in bad times obtains negative results, as households shy away from the equity banks need to make loans. As in models with informational problems, of which there are none explicitly here, a tightening is in order. This calls therefore for regulatory policy to be active through the cycle, instead of the immutable policies currently in place. This policy can be achieved with the proposed amendment to the Basel Accord (Basel II), if banks adopt a risk evaluation method à la Merton, as pointed out by Catarineu-Rabell, Jackson and Tsomocos (2003).

Our results also emphasized that it is important to take into account the financing of banks. Given capital requirements, banks are limited in their lending by the bank equity households are willing to hold. As this decision is influenced by interest rates, this gives rise to another channel of monetary policy. This channel has also been identified by Chami and Cosimano (2001) and van der Heuvel (2001). Unlike these papers, we do not require explicit asymmetric information, market power in the banking industry or increasing marginal cost of financing.

A Appendix: Solving the banks' problem

Due to the inequality constraints, we have to use a Kuhn-Tucker approach and be careful about the corner solutions. The Lagrangean for this problem is:

$$\begin{aligned} \mathcal{L} = & r^l L + r^b B - r^r D - r^e E - \delta \left(\frac{D}{E} \right)^\gamma D - (1 + l_c) \epsilon L \\ & + \lambda_1 (D + E - B - L) + \lambda_2 (E/L - \alpha) + \lambda_3 (D + E - L) \end{aligned}$$

Then the first order conditions are:

$$\begin{aligned} r^l - \lambda_1 - \lambda_2 E/L^2 - \lambda_3 - \epsilon(1 + l_c) &= 0 \\ r^b - \lambda_1 &= 0 \\ -r^d - \delta(\gamma - 1) \left(\frac{D}{E} \right)^\gamma + \lambda_1 + \lambda_3 &= 0 \\ -r^e + \delta\gamma \left(\frac{D}{E} \right)^{\gamma+1} + \lambda_1 + \lambda_2/L + \lambda_3 &= 0 \end{aligned}$$

As noted above, there are two possibilities: either constraint (9) or constraint (10) bind. In terms of the Lagrangean we therefore need to consider two cases. The one where $\lambda_2 > 0$ and $\lambda_3 = 0$ (i.e. (9) binds while (10) does not) will be referred to as an "interior solution" because not all loanable funds are invested into loans. The opposite case where $\lambda_3 > 0$ and $\lambda_2 = 0$ will be referred to as a "corner solution". For simplicity, in what follows we assume $\gamma = 1$.

Interior solution

This is the case when bank holds just enough equity to satisfy the capital adequacy requirement ($E/L = \alpha$ and therefore $D + E > L$). The above first order conditions can be combined into:

$$r^d = r^b - 2\delta \frac{D}{E} \tag{20}$$

$$\frac{M}{E} = 1 + \left[\frac{1}{\delta}(r^e - r^d) - \frac{1}{\alpha\delta}(r^l - r^d - (1 + l_c)\epsilon) \right]^{\frac{1}{2}} \quad (21)$$

$$L = \frac{1}{\alpha}E \quad (22)$$

$$D = M - E \quad (23)$$

where (21) is an equity (or implicitly deposit) supply equation. Conditional on particular values of M and all levels of prices, equations (20) to (23) form a recursive system which uniquely determines all quantities.

Corner solution

In a corner solution, bank holds more equity than required by the capital adequacy requirement ($D + E = L$ and therefore $E/L > \alpha$). Now, $r^b > r^d$ ¹⁴, and the above first order conditions can be combined into:

$$\frac{M}{E} = 1 + \left[\frac{r^e - r^l + (1 + l_c)\epsilon}{\delta} \right]^{\frac{1}{2}} \quad (24)$$

$$L = M \quad (25)$$

$$D = M - E \quad (26)$$

$$r^l - r^b - (1 + l_c)\epsilon = r^b - r^d \quad (27)$$

where (24) is again an equity supply equation. Note that now loans and equity supply decisions are disconnected. Equation (27) shows a wedge between the bond and deposit rates. The bond "premium" on the right hand side equals the profit differential between net returns on loans and bonds that would equal zero in an interior solution.

B Appendix: Portfolio optimization

The Euler equation for equity is:

$$MU_t = \beta E_t[MU_{t+1}R_{t+1}^e]$$

$$MU_t = \beta E_t[MU_{t+1}]E_t[R_{t+1}^e] + cov_t(MU_{t+1}, R_{t+1}^e)$$

Because returns on equity are uncertain, the covariance between expected gross return and expected marginal utility at $t + 1$ affects consumption decisions of households in equilibrium. The intuition is easy to see if we think of starting from certain returns on equity and then allow for uncertainty with $cov > 0$ – returns on equity tend to be high when MU of consumption is high. Such change makes allocations under certainty suboptimal because $MU_t < PV(E_t MU_{t+1})$. An inter-temporal re-allocation by shifting consumption from today to the future period increases MU_t and lowers MU_{t+1} which brings Euler equation into balance. So when comovement between MU and R^e is positive – an empirical regularity, see

¹⁴A lower demand for bank's financing by deposits (relative to equity) depresses their price.

Duffee (2005) – households save more through equity than through deposits with the same return (R^d is certain). A non-zero covariance justifies existence of two assets in equilibrium.

This implies differences in saving patterns across heterogeneous agents arising from differences in their expected income (and consumption) levels. On average, entrepreneurs earn most, workers less, and unemployed and retirees least of all. With increasing and concave utility $MU^{worker} < MU^{retired} < MU^{unemployed}$ ¹⁵. If $\text{cov}(MU, R^e)$ were a constant wedge, the last Euler equation above implies that covariance between R^e and C will be least important for agents with highest average MU (unemployed) and most important for workers because of their low MU . Then, workers will save most through the equity while unemployed will save least via equity, because the comovement of risky returns is relatively less important when MU is high.

To implement this idea in the scope of the current model, we introduce three mutual funds for each of the three types of depositors: workers, unemployed and retirees. Equation (6) show that choices of workers, unemployed and retirees of share of risky equity in their portfolio saving depends on their risk aversion parameter λ_i . Guided by the above discussion and standard micro theory we calibrate λ_i as proportional to the distance X_i between utility of mean consumption $U(\bar{C}_i)$ and average of utilities $U(\bar{C}_i - T)$ and $U(\bar{C}_i + T)$ where T is chosen to clear equity market ($E_W + E_U + E_R = E$). Specifically for workers (and similarly for unemployed and retired), $\lambda_W = \frac{M_W + M_U \frac{X_W}{X_U} + M_R \frac{X_U}{X_R}}{M/\lambda}$ where λ is the aggregate lambda implied by the overall market's equity holdings (the homogeneous part of the model), M_i is overall asset holding of agent type i .

C Appendix: The solution procedure

Heterogeneous agents models with aggregate shocks are difficult to solve because the distribution of agents is not invariant and becomes a highly dimensional state variable. The two main strategies to solve this problem is to either find a good way to summarize the distribution with very few variables, as Krusell and Smith (1998) demonstrate, or to work with linearization, as Cooley and Quadrini (1999) do. Unfortunately, neither is possible here due to some highly non-linear phenomena that are crucial in our model. For example, decision rules change abruptly in the vicinity of m^* . Finally, second degree effects appear to be quite important, and they are likely to vanish with linearization.

Our strategy uses the realization that aggregate shocks in a two-state Markov process lead to transitional states somewhere between two steady-states corresponding to repeated identical shocks. We therefore choose a sufficient number of aggregate states to represent a large proportion of actual aggregate states.

The aggregate state space is assumed two-dimensional: one dimension is the current shock, High or Low, the other is a counter of how far from the the High steady-state the economy is. Specifically, this counter is incremented by one each time a Low shocks occurred in the

¹⁵Retirees have a lot of free time.

previous period, or decreased by one if a High shock occurred. The minimum counter value is one, the maximum is chosen such that this state occurs infrequently. We choose a maximum of 5, implying with the transition probabilities of the Markov process that the economy will in any of the aggregate states $S_{sc}\%$ of the time, where

$$S = \begin{pmatrix} 50.2 & 16.7 & 5.6 & 1.9 & 0.6 \\ 16.7 & 5.6 & 1.9 & 0.6 & 0.2 \end{pmatrix}.$$

We then solve this model economy with the standard tools for heterogeneous agent economies, that is value function iterations followed by iterations on the invariant distribution (defined over the aggregate states as well). The equilibrium is reached by finding the set of lending rates r^l and loan eligibility rules m^* that balance all markets and satisfy all constraints in all aggregate states.

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D Figures

Figure 1: Benchmark economy as it cycles through all possible aggregate states

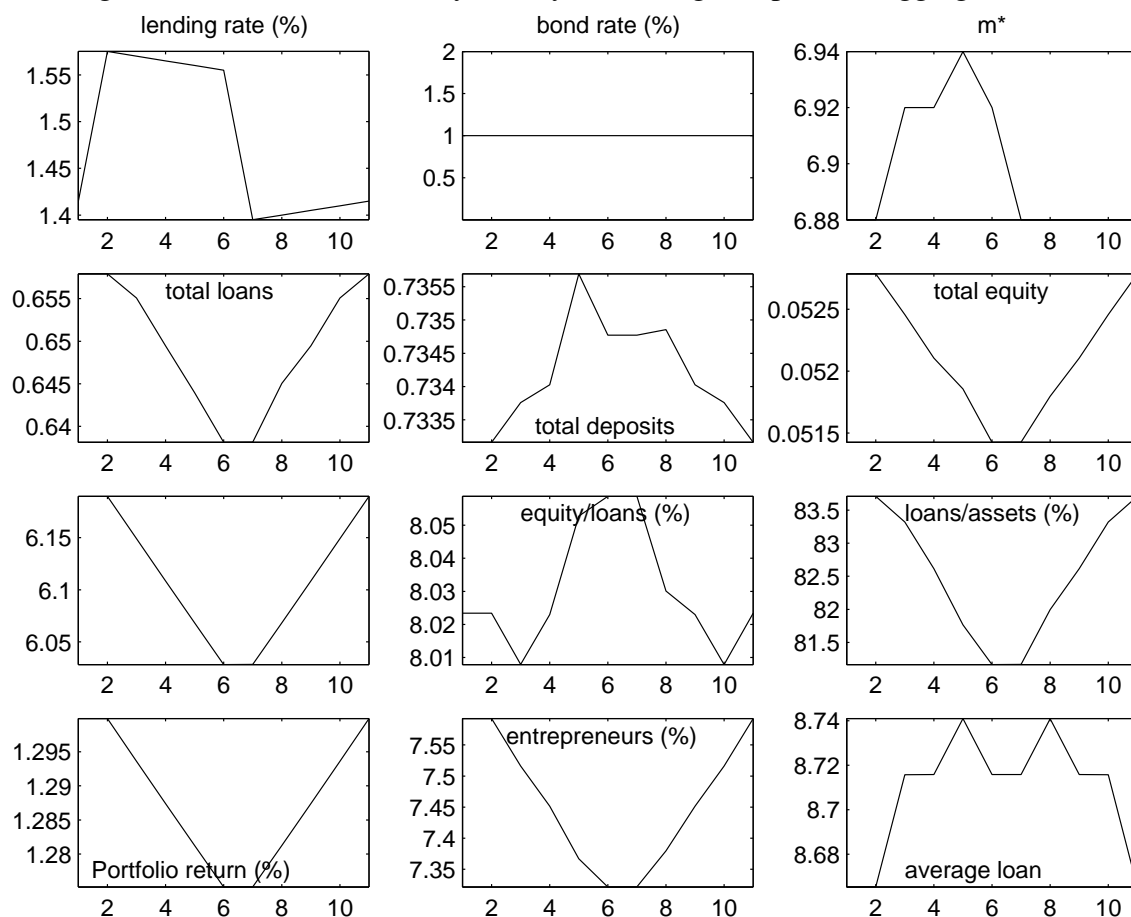


Figure 2: Benchmark and policy with interest rate reduction in worst case only

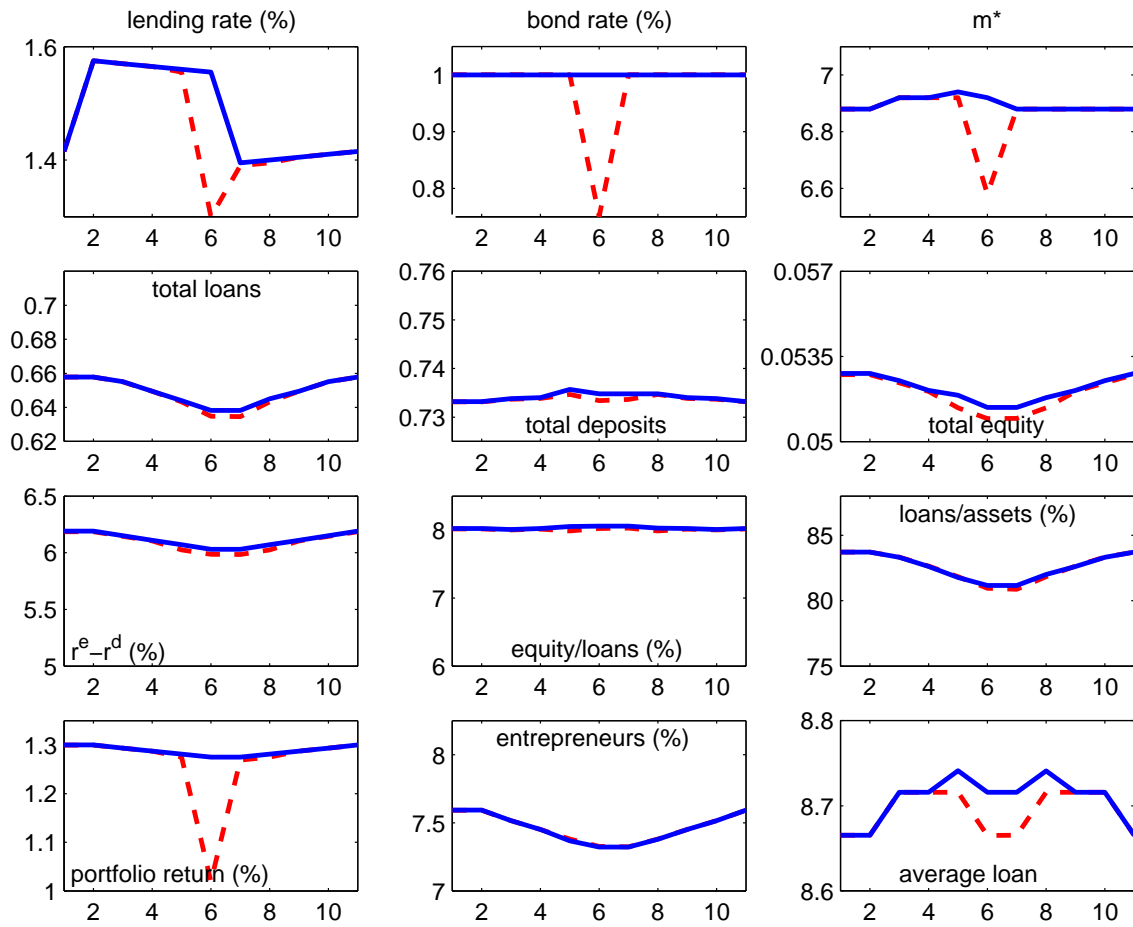


Figure 3: Benchmark and policy with gradual interest rate reduction in bad return situations

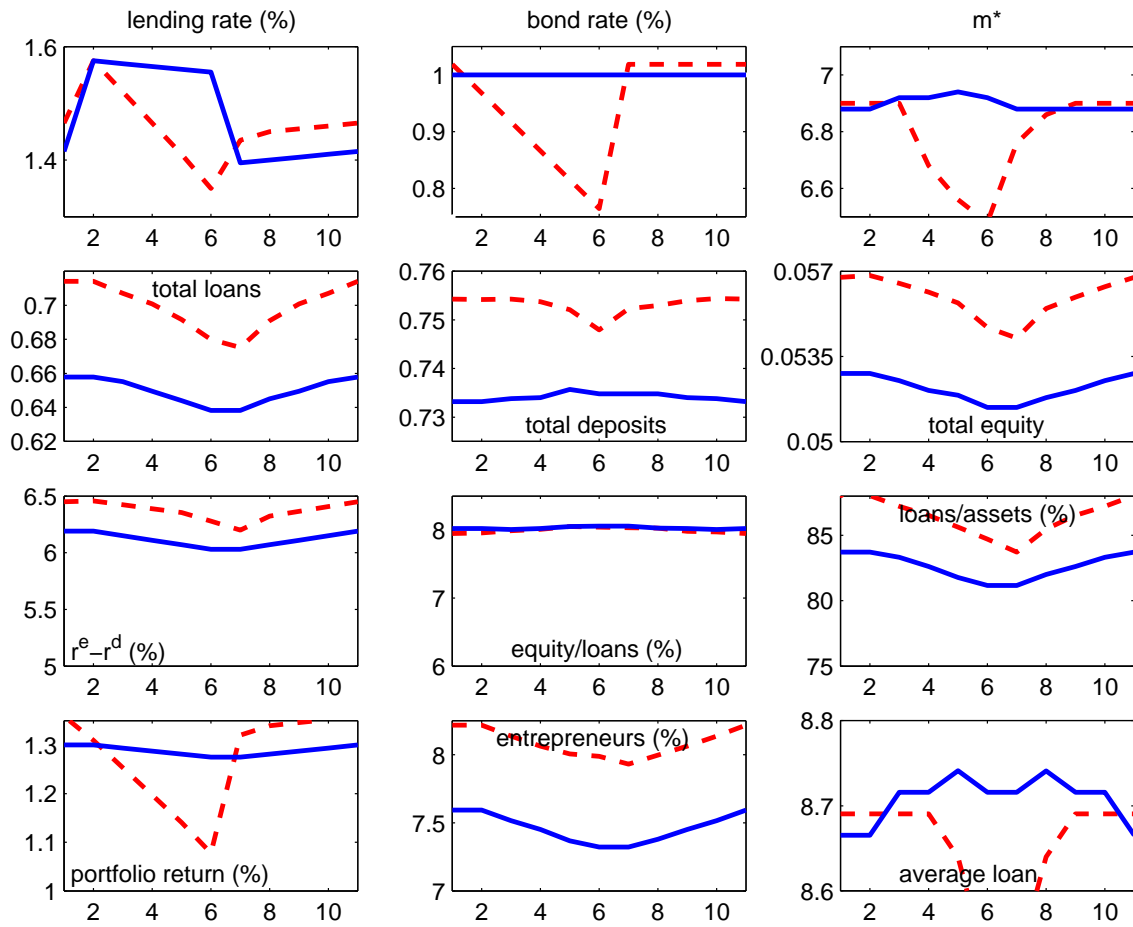


Figure 4: Benchmark and policy with interest rate increase in worst case only

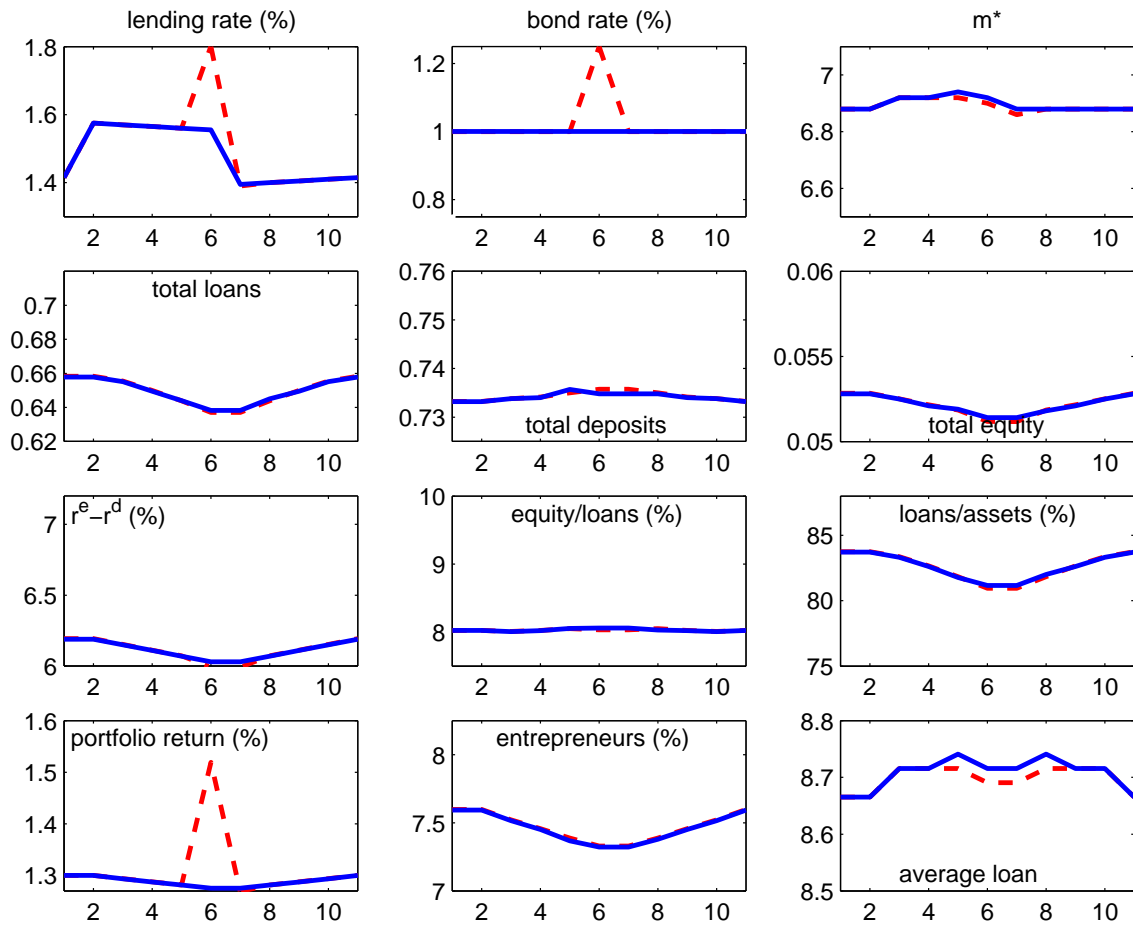


Figure 5: Benchmark and policy with gradual interest rate increase as aggregate states worsen

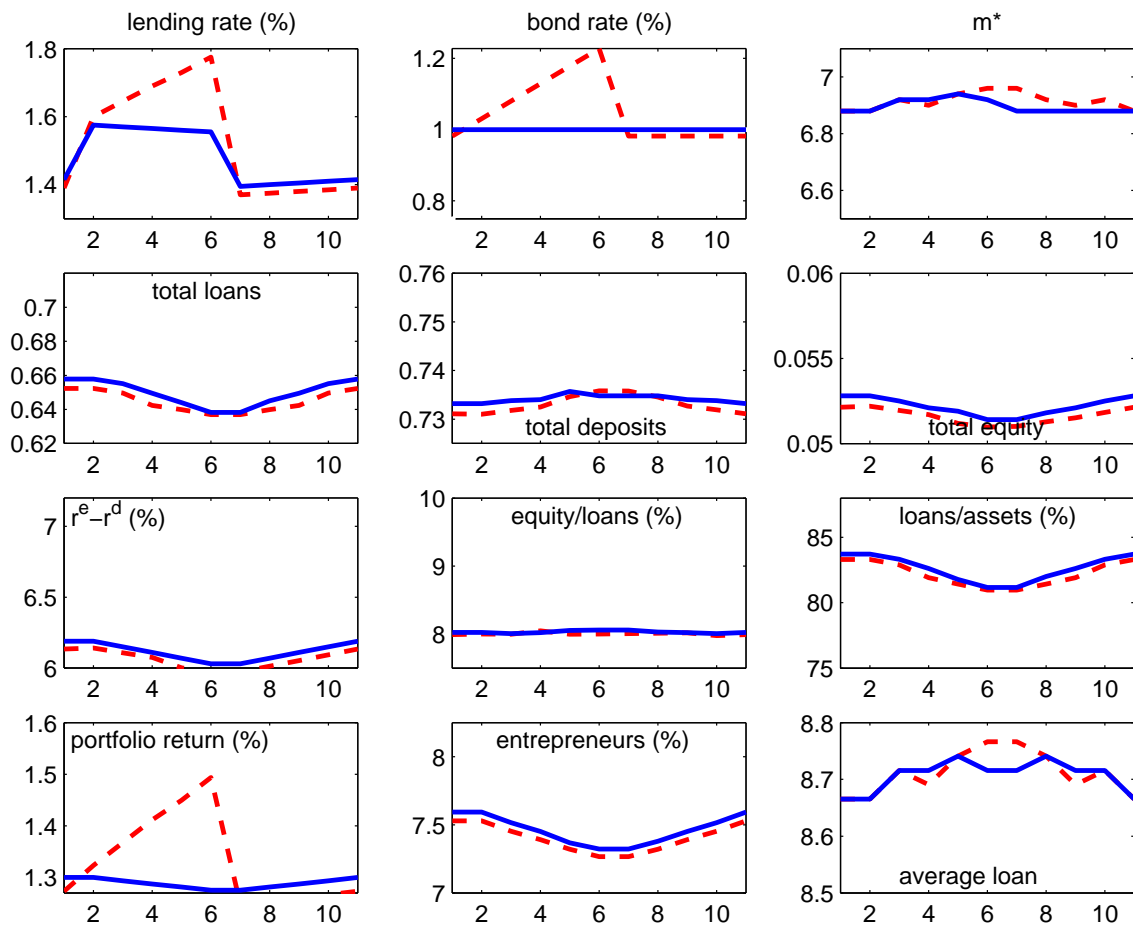


Figure 6: Benchmark and policy with relaxing of capital requirements in worst case only

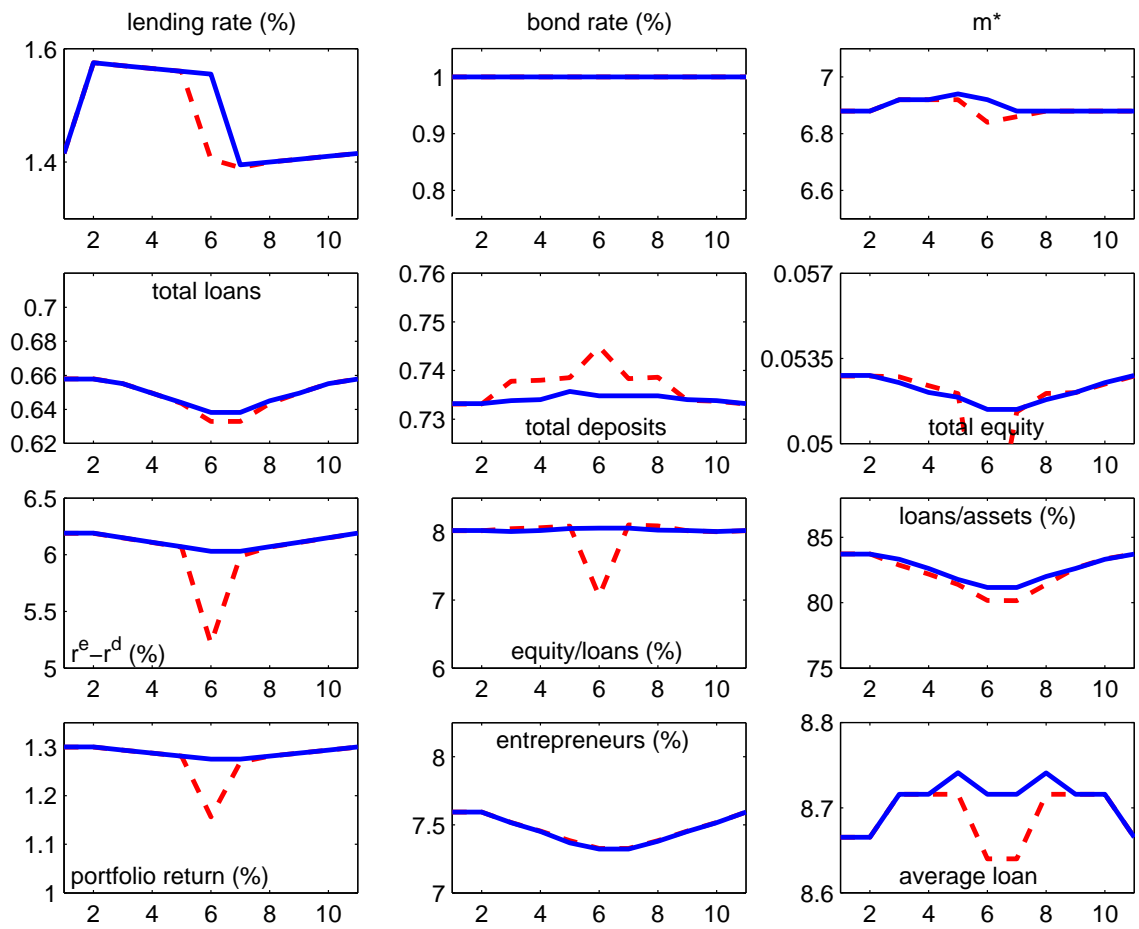


Figure 7: Benchmark and policy with gradual relaxing of capital requirements as aggregate states worsen

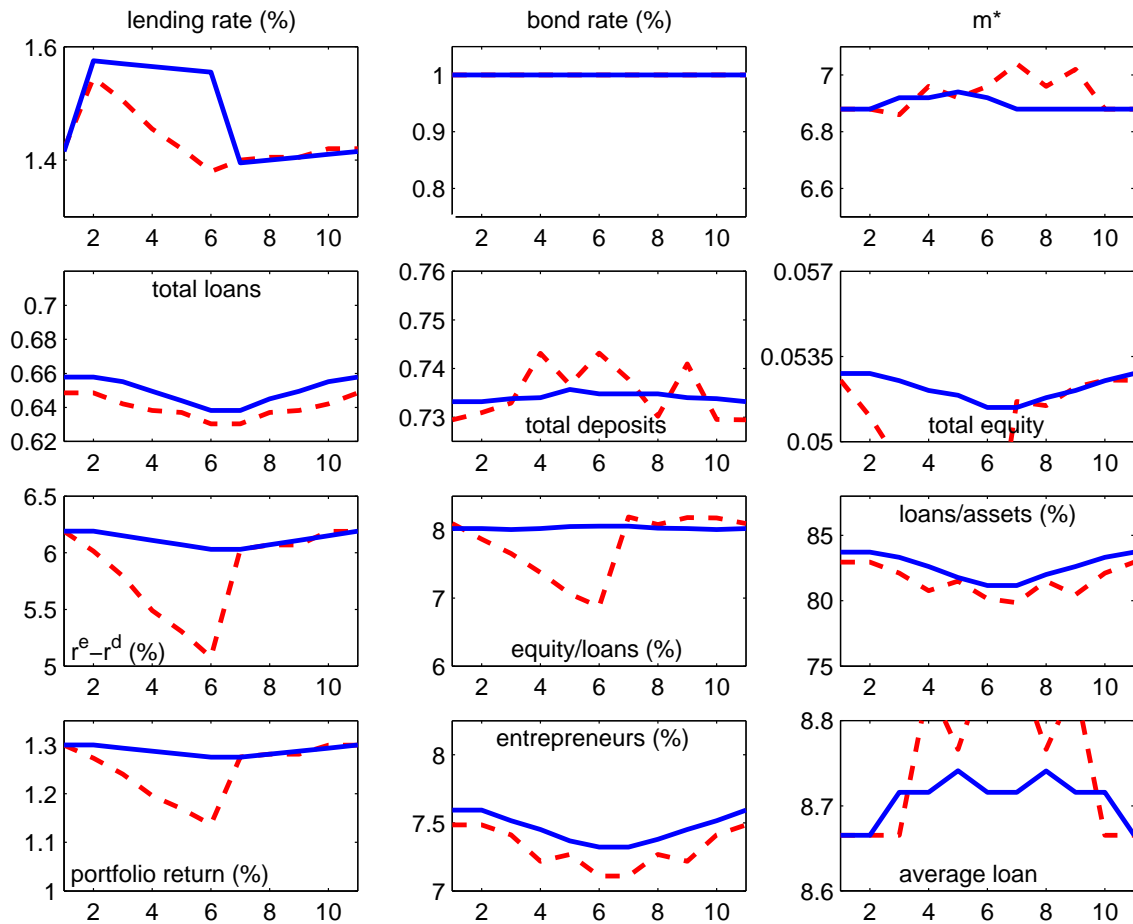


Figure 8: Benchmark and policy with tightening of capital requirements in worst case only

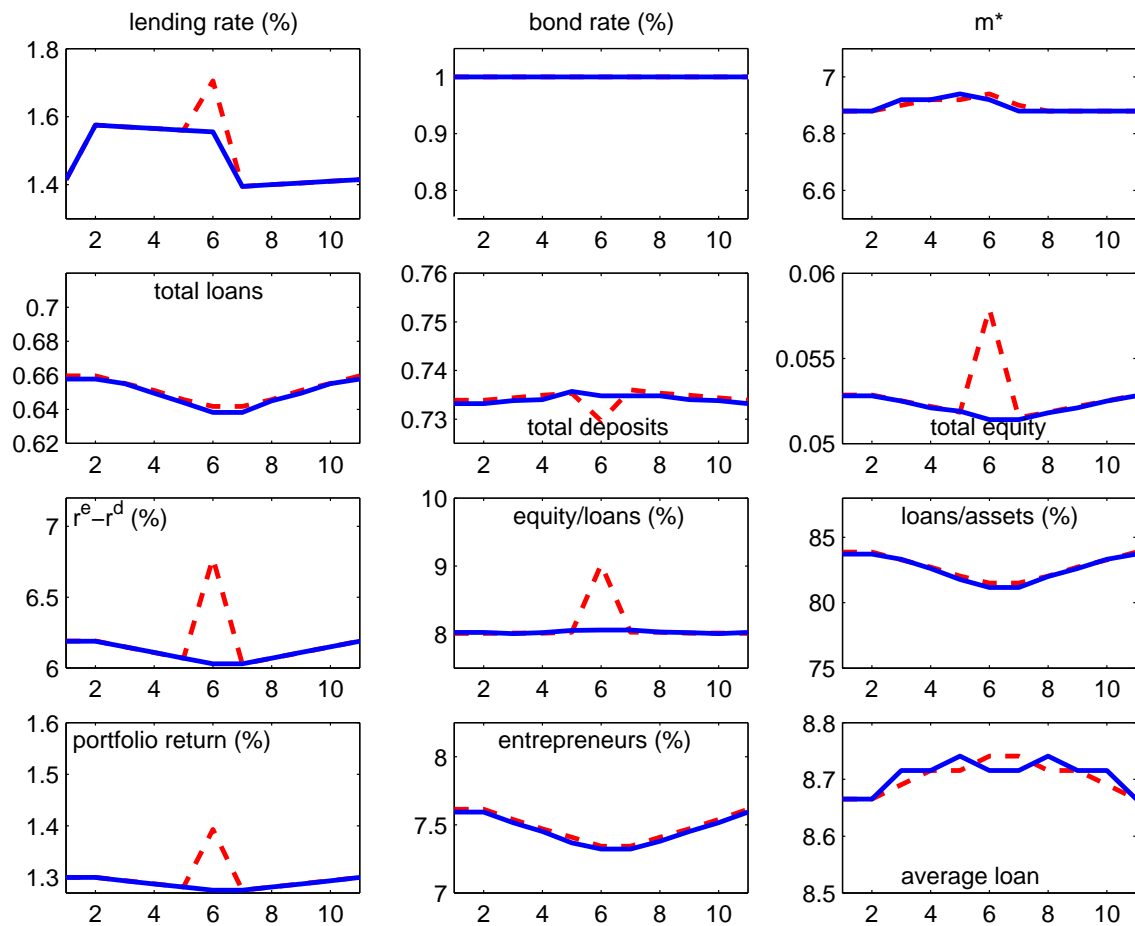


Figure 9: Benchmark and policy with gradual tightening of capital requirements as aggregate states worsen

