Capital composition and investor-driven risk-taking in banking

Mami Kobayashi
Ritsumeikan University

Banking regulation recognizes debt-like hybrid claims as capital partly because its subordination in payments promote the market discipline raised by the vigilance of its investors. We counter this argument to show that agency problems arising from the duality of investors who search for yield as capital providers but also receive predetermined fixed payments as creditors promote their bank to take risk.

By modeling the investors who can influence the bank's choice of the investing assets through deciding the interest rate, we derive the conditions under which they gain more from the bank's risk-taking by achieving the large repayment that offsets an increase of the bank's default risk. In particular, low credit spreads among assets promote the investor-driven risk-taking, which suggest the requirement on the stringent restriction on hybrid-claim capitalization during accommodative monetary conditions.

When applied to non-financial firms, our results suggest that increased issuance of subordinated debt during the Corona disaster will encourage corporate risk-taking, and that the government's policy of purchasing CP and highly-rated corporate bonds will facilitate this.