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ABSTRACT

The regulation of bank capital as a means of smoothing the credit cycle is a central element of forthcoming macro-prudential regimes internationally. For such regulation to be effective in controlling the aggregate supply of credit it must be the case that: (i) changes in capital requirements affect loan supply by regulated banks, and (ii) unregulated substitute sources of credit are unable to offset changes in credit supply by affected banks. This paper examines micro evidence—lacking to date—on both questions, using a unique dataset. In the UK, regulators have imposed time-varying, bank-specific minimum capital requirements since Basel I. It is found that regulated banks (UK-owned banks and resident foreign subsidiaries) reduce lending in response to tighter capital requirements. But unregulated banks (resident foreign branches) increase lending in response to tighter capital requirements on a relevant reference group of regulated banks. This “leakage” is substantial, amounting to about one-third of the initial impulse from the regulatory change.

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