Bank failure and credit spreads*

Jorge Abad
CEMFI

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Abstract

This paper develops a macroeconomic model in which banks intermediate funds between households and firms, and are subject to failure risk. Using the model, it is possible to decompose credit spreads faced by bank borrowers in two components. First, a scarcity premium arises when banks' constraints tighten and bank equity becomes relatively scarce at the aggregate level. Second, a failure risk premium arises when bank risk is high and the deposit spreads faced by banks increase. This decomposition is important for the optimal policy response to a banking crisis. When the scarcity premium is the dominant force driving credit spreads, a reduction in capital requirements (akin to a release of countercyclical capital buffers) can effectively reduce funding costs of bank borrowers. If, instead, the failure risk component dominates, a reduction in capital requirements can have the opposite effect, leading to an increase in bank leverage and higher funding costs for banks, which translate into higher borrowing costs for non-financial borrowers with adverse consequences for aggregate activity.

Keywords: financial crises, credit spreads, macroprudential policy, capital regulation.

JEL codes: E44, G01, G21, G28.

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