

The Emergence of a Parallel World: The Misperception Problem for Bank Balance Sheet Risk and Lending Behavior

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We examine the reason that there have coexisted the two opposing views on distressed banks' lending behavior in Japan's post-bubble period: the one is the stagnant lending in a capital crunch and the other is the forbearance lending to low-quality borrowers. To this end, we address the measurement problem for bank balance sheet risk. We define the credit supply and allocation effects of bank capital in the bank loan equation specified at loan-level units, thereby finding that the parallel world, or the above two opposing views, would emerge if the regulatory capital does not reflect the actual condition of increased risk on bank balance sheet, while the fair value of capital signals it. In the real world of Japan's post-bubble period, banks with low market-evaluated capital decreased the supply of credit, engaging in window dressing of the regulatory or book capital. The parallel world can emerge whenever banks are allowed to evaluate portfolio risk with their discretion.