

“CAPITAL REGULATION AND SHADOW FINANCE: A QUANTITATIVE ANALYSIS” by Radoslaw Paluszynski, University of Houston

**Abstract:**

This paper studies the effects of higher bank capital requirements. Using new firm-lender matched credit data from South Korea, we document that Basel III coincided with a 25% decline in credit from regulated banks, and an increase of similar magnitude from nonbank (shadow) lenders. We use our data to estimate the effect of capital requirements on bank credit, and the spillover effect of the reform on non-bank lending. We then build a general equilibrium model with heterogeneous banks and firms that replicates these micro estimates. We find that Basel III can account for most of the observed decrease in regulated bank lending, and about three quarters of the increase in shadow lending. The latter is driven exclusively by general equilibrium effects of the reform. A counterfactual experiment using the model shows that suppressing the rise of shadow lenders would significantly increase the firms' borrowing costs.