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BANK RISK-TAKING, CREDIT ALLOCATION, AND MONETARY POLICY TRANSMISSION: EVIDENCE FROM CHINA

XIAOMING LI, ZHENG LIU, YUCHAO PENG, AND ZHIWEI XU

ABSTRACT. Loan-level evidence shows that China’s implementation of Basel III in 2013 has reduced bank risk-taking both on average and conditional on monetary policy easing. However, banks reduce risk-taking by increasing lending to ostensibly low-risk but inefficient state-owned enterprises (SOEs), leading to credit misallocation. We establish these empirical results using a difference-in-difference identification, exploiting cross-sectional differences in lending behaviors between high-risk and low-risk bank branches before and after the new regulations. To understand how changes in capital regulations may affect monetary policy transmission, we construct a two-sector general equilibrium model featuring bank portfolio choices and capital adequacy ratio (CAR) constraints. The model highlights a risk-weighting channel, through which expansionary monetary policy shifts bank lending toward inefficient SOEs, consistent with empirical evidence. Under government guarantees of SOE loans, such a shift in lending reduces the portfolio risks for individual lenders, but it also reduces aggregate productivity and raises the average risk of bank insolvency.

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1. INTRODUCTION

In response to the 2008-09 Global Financial Crisis and the recent COVID-19 pandemic, central banks have aggressively eased monetary policy to mitigate recessions. Such policy interventions, however, have raised concerns about financial stability. If the policy interest rate remains persistently low, it might fuel asset price booms, leading to excessive leverage and risk taking by financial institutions (Stein, 2013; Bernanke, 2020).

Does monetary policy easing encourage bank risk-taking? In theory, the link between monetary policy and bank risk-taking can be ambiguous. For example, the standard portfolio choice models suggest that monetary policy tightening that raises the returns on safe assets should induce banks to increase holdings of safe securities and thus reducing risk-taking. In contrast, the risk-shifting models have the opposite predictions. In those models, asymmetric information between banks and borrowers and limited liabilities of banks create an agency problem (Stiglitz and Weiss, 1981). An increase in deposit interest rates following monetary policy tightening can exacerbate the agency problem. Banks respond to the increase in funding costs by raising the share of lending to riskier borrowers to boost expected returns. In the data, both the portfolio choice considerations and the risk-shifting effects can be present, making it challenging to identify the link between monetary policy and bank risk-taking. In general, bank risk-taking can depend on its leverage (Dell’Ariccia et al., 2014). Under limited liabilities, a more leveraged bank has a greater incentive for risk-taking when it faces an increase in funding costs. Thus, changes in banking regulations that affect bank leverage can also affect risk-taking and its responses to monetary policy shocks.

In this paper, we examine the empirical link between monetary policy and bank risk-taking using Chinese data, exploiting cross-sectional differences in banks’ responses to regulation changes for identification. In China, bank lending is the primary source of financing for firms. Thus, changes in banking regulations can have important implications for the transmission of monetary policy to the real economy. A prominent change in bank regulations is China’s implementation of the Basel III capital regulations in 2013, which raised the minimum capital adequacy ratio (CAR) for all commercial banks and also introduced a new Internal Ratings Based (IRB) approach, under which a bank’s CAR is assessed based on risk-weighted assets, with risk weights depending on credit risks of bank loans.

We designed our empirical methods with guidance from a simple theoretical model, which features bank portfolio choices subject to CAR constraints. In the model, the effective risk of a loan portfolio is the product of two components: a project-specific risk that the bank can optimally select and an idiosyncratic bank-specific risk that the bank

cannot select. The bank-specific risks may reflect the location of a bank (or a branch) or the industries (or firms) to which the bank concentrates its lending (Zentefis, 2020).

The model predicts that, in response to a regulation that raises the sensitivity of risk-weighted assets to loan risks (i.e., risk-weighting sensitivity), banks choose to reduce risk-taking; and those banks facing higher idiosyncratic risks reduce risk-taking more aggressively. The model also predicts that an expansionary monetary policy shock raises bank leverage, forcing banks to reduce risk-taking under binding CAR constraints. Increasing the sensitivity to risk weighting amplifies the reduction in bank risk-taking in response to monetary policy easing, and the amplification effect is stronger for those banks facing higher idiosyncratic risks.

For our empirical investigation, we use confidential loan-level data from one of the “Big Five” commercial banks in China, merged with firm-level data from China’s Annual Survey of Industrial Firms (ASIF). We use the merged data, with about 400,000 unique firm-loan pairs for the periods from 2008 to 2017, to estimate the empirical relation between bank risk-taking and monetary policy shocks. Guided by the theory, we use a difference-in-difference approach to identifying the effects of the Basel III regulations on bank risk-taking—both on average and conditional on monetary policy shocks—by exploiting the cross-sectional differences in lender-specific risks, before and after the implementation of the new regulation.

We measure bank risk-taking by a dummy indicator that equals one if the loan is extended to an SOE firm. The prevailing government policy offers SOEs preferential credit access (Song et al., 2011), such that SOE firms are perceived as ex ante low-risk borrowers.¹ An increase in the share of SOE lending would thus imply a reduction in risk-taking. The main independent variables of interest include (1) an interaction term between a dummy variable indicating the periods after the new Basel III regulations were put in place in 2013 and an indicator of whether a branch has had a history of high NPL share before the new regulation (i.e., risk history); and (2) a triple interaction term between the post-regulation dummy, the risk history indicator, and our measure of monetary policy shocks. We control for the year-quarter fixed effects, branch fixed effects, and firm-year fixed effects. According to our theory, a bank with a higher NPL share in the past (i.e., high-risk branches) should be more likely to reduce risk-taking under the new regulations, both on average and conditional on monetary policy easing. Thus, we should expect the coefficients on both interaction terms to be positive.

¹As we show in Section 4.1.2, all else being equal, loans to SOEs receive higher credit ratings than those to non-SOE firms, reflecting government guarantees of SOE loans.

Consistent with theory, we find that, after the Basel III regulations were implemented, high-risk branches indeed reduced risk-taking relative to low-risk branches by increasing the share of lending to SOE firms; and the decline in risk-taking is observed both on average and conditional on monetary policy expansions. The estimated declines in bank risk-taking are statistically significant and economically important. Our baseline estimation suggests that a one standard deviation positive shock to M2 growth raises the probability of SOE lending by 6.3% under the new regulations.² These empirical findings are robust when we control for loan demand factors or when we include additional control variables. Furthermore, the effects of the banking regulation changes are different from those of other policy changes that have taken place since 2013, such as interest-rate liberalization, the anti-corruption campaign, and the deleveraging policy.

The risk-weighting mechanism that is present at the micro-level has important implications for the transmission of monetary policy to the macroeconomy. Raising the risk-weighting sensitivity reduces bank risk-taking following an expansionary monetary policy. However, banks reduce risk-taking by increasing the share of lending to SOEs. Since SOEs have lower productivity on average than private firms (Hsieh and Klenow, 2009), an increase in the share of lending to SOEs would reduce aggregate productivity. Furthermore, since SOEs in China enjoy preferential credit access under government guarantees of their loans, they have lower marginal product of capital than private firms (Song et al., 2011; Chang et al., 2016). Increased lending to SOEs can exacerbate the over-investment problem, further reducing allocative efficiency (Liu et al., 2021).

To further understand the aggregate implications of capital regulations for the relation between bank risk-taking and monetary policy, we extend the simple static model to a two-sector dynamic general equilibrium model featuring bank portfolio choices and CAR constraints. In line with the Basel III regulations, the risk weights on bank loans used for calculating the effective CAR in our model depend on the overall riskiness of bank's loan portfolio. Since SOE loans have lower risks and lower expected returns than private-firm loans, the risk weights decrease in the SOE loan share. We calibrate the model to match Chinese data, and in particular, to moments in our firm- and loan-level data.

The quantitative results show that an expansionary monetary policy shock raises bank leverage, and the bank reduces its risk weights by raising the share of SOE lending. Moreover, since SOEs are less productive than private firms (i.e., POEs), raising SOE lending

²A lending unit in our data is a bank branch. In practice, the bank headquarter determines the level of capital and sets guidelines on risk-weighted assets for provincial branches, which are then trickled down to lower level branches. Our results are robust when we use a sample with bank-level data from 17 Chinese banks instead of the loan-level data from a single large bank (see Section S.2 for details).

also leads to a persistent decline in total factor productivity (TFP). To examine the importance of the risk-weighting mechanism, we compare our baseline model's impulse responses to a monetary policy shock with a counterfactual, in which the share of SOE loans is held fixed at the steady state level. We find that allowing banks to adjust the risk weights (i.e., the share of SOE lending) significantly amplifies the responses of bank leverage, although it also reduces TFP, partly dampening the expansionary effects of monetary policy. The endogenous risk-weighting channel helps reduce the bank's risk-taking. However, since the risk-weighting mechanism amplifies the response of leverage to the monetary policy easing, the bank's insolvency probability becomes larger. In this sense, the micro-prudential policy such as the CAR regulation reduces the allocative efficiency and leads to opposing effects on the bank's credit risks and insolvency risks. Overall, the risk-weighting mechanism and the resulting credit misallocation lead to a modest welfare loss conditional on an expansionary monetary policy shock.

2. RELATED LITERATURE

Our work contributes to the literature on the bank risk-taking channel of monetary policy transmission. A reduction in the short-term interest rate can boost bank profits and net worth and thus increase the risk-taking capacity (Adrian and Shin, 2010). Monetary policy shocks can also affect the perception and the price of risks and thus change financial institutions' risk-taking behaviors (Borio and Zhu, 2012). Empirical literature has documented some evidence of the risk-taking channel. Examples include Maddaloni and Peydró (2011), Bruno and Shin (2015), Delis et al. (2017), and Bonfim and Soares (2018). In a recent study, Caglio et al. (2021) use firm-bank matched data in the United States to show that a monetary policy expansion raises credit demand of small and medium-sized firms (SMEs). Consistent with our empirical results, Caglio et al. (2021) also find that highly levered banks reduce lending to risky private firms and SMEs during monetary policy expansions. While they focus on a credit demand channel of monetary policy transmission, the empirical component of our study complements theirs by focusing on a credit supply channel. Our work also makes a theoretical contribution by constructing a two-sector general equilibrium model that highlights an important risk-weighting channel, through which expansionary monetary policy shocks induce increased bank lending to inefficient SOE firms. While such shifts in lending reduces portfolio risks for individual lenders, it also reduces aggregate productivity and raises the average risk of bank insolvency.

Our model with bank portfolio choices is closely related to the model of bank liquidity management by Bianchi and Bigio (2017). In their model, banks face liquidity risks on

the liability side (e.g., unexpected deposit withdrawals) and they have a precautionary motive of holding liquid assets such as reserves and government securities. Under binding capital requirements, a monetary policy shock leads to a tradeoff for banks between profiting from more lending and incurring greater liquidity risks on the liability side. They highlight the importance of interbank market frictions for monetary policy transmission. In our model, if one interprets the low-risk, low-return lending to SOEs as a rough counterpart to the liquid assets in their model, then banks under CAR constraints also face a tradeoff between profitable lending and increasing default risks on the asset side. That said, our focus differs from theirs. We study the implications of banking regulations (in particular, risk-weighting of assets under CAR constraints) for bank risk-taking using loan-level and firm-level data. We use the simple portfolio-choice model as a theoretical guidance for our empirical specifications.

Our paper is closely related to the empirical literature that highlights the role of bank capitalization for the risk-taking channel of monetary policy. [Jiménez et al. \(2014\)](#) use Spanish loan-level data to show that, following a decline in short-term interest rates, more thinly capitalized banks are more likely to increase lending to ex ante risky borrowers, reflecting a search-for-yield effect. [Dell’Ariccia et al. \(2017\)](#) use U.S. loan-level data and document evidence that lower short-term interest rates are associated with more risk-taking in bank lending; and this negative relation is stronger for better capitalized banks, reflecting the risk-shifting effect.

We contribute to this empirical literature by highlighting a new channel—a risk-weighting channel—through which monetary policy shocks can influence bank risk-taking. Under the Basel III regime, a bank with any given capitalization can boost its effective CAR by shifting lending to low-risk borrowers. Our baseline estimation suggests that the implementation of Basel III regulations has significantly reduced bank risk-taking in China, both on average and conditional on an expansionary monetary policy shock. This result, however, is not driven by adjustments in capitalization, but by changes in risk-weighting of bank assets. When we control for the level of capitalization, the reduction in risk-taking following a positive monetary policy shock becomes more pronounced.

The risk-weighting channel has important implications for capital allocations and productivity in the macroeconomy. Since SOEs are less productive than private firms, increased lending to SOEs reduces aggregate productivity. Thus, our is also related to the literature that studies the reallocation channel in the presence of credit market distortions. For example, [Gao et al. \(2019\)](#) examine the effects of the 2009 bank entry deregulation in China using loan-level and firm-level data. They document evidence that,

following the deregulation, most loans originated from new entrant banks went to SOEs, which had explicit or implicit government guarantees and are thus considered “safe” borrowers. [Cong et al. \(2019\)](#) examine loan-level data and find that the credit expansion during China’s large-scale fiscal stimulus period in 2009-2010 disproportionately favored SOEs despite their lower average product of capital.³

We contribute to the literature on the reallocation effects of macroeconomic policies by documenting micro evidence of the risk-taking channel and examining the macroeconomic implications of credit misallocation stemming from changes in bank lending behaviors induced by changes in capital regulations.

We focus on the unintended credit misallocation effects of capital regulations. However, other forms of banking regulations—such as liquidity regulations—can also create unintended consequences. In a complementary study, [Hachem and Song \(2021\)](#) show that, in the presence of imperfect competition in the interbank markets and shadow banking, tightening liquidity regulations can lead to an unintended credit boom through a shadow banking channel. The shadow-banking channel can also hamper the transmission of monetary policy shocks, as shown by [Chen et al. \(2018\)](#), who present empirical evidence that China’s contractionary monetary policy after the global financial crisis was not effective in reining in aggregate credit growth because it was accompanied by a rapid expansion in shadow banking activities.

3. A SIMPLE MODEL OF BANK RISK-TAKING

This section presents a static, partial equilibrium model to illustrate how bank capital regulations affect the responses of bank risk-taking and its responses to monetary policy shocks.

The economy has a competitive banking sector, with a continuum, risk-neutral banks. Each bank has an endowment of net worth $e > 0$ units of consumption goods. A bank takes deposits d from households at the risk-free interest rate r . The bank can lend (i.e., invest) up to $k = e + d$ units of goods in a risky project. The project return R is a random variable drawn from a uniform distribution with the cumulative density function (CDF) $\mathbf{F}(R)$.

³A partial list of the recent studies that highlights the reallocation effects of macroeconomic policies includes [Song et al. \(2011\)](#), [Reis \(2013\)](#), [Hsieh and Song \(2015\)](#), [Chang et al. \(2016\)](#), [Bleck and Liu \(2018\)](#), [Chang et al. \(2019\)](#), [Liu et al. \(2021\)](#), [Chen et al. \(2020\)](#), [Huang et al. \(2020\)](#), and [Liu et al. \(2021\)](#).

For simplicity, we parameterize the distribution of R such that the mean and the variance are respectively given by

$$\mathbf{E}[R] = (\phi_1 - \phi_2\sigma)\sigma, \quad \mathbf{Var}[R] = \frac{1}{12}(\sigma\Delta)^2, \quad (1)$$

where $\phi_1, \phi_2 > 0$ are parameters. The effective project risk consists of two components: a selectable component $\sigma > 1$ and a fixed component $\Delta \geq 1$. Each individual bank can choose a specific project indexed by σ from a set of feasible projects. The fixed component Δ of the project risk is bank-specific (and not selectable), reflecting cross-sectional differences in project risks stemming from geographical locations of the banks or the customers (industries or firms) to whom a bank concentrates its lending (Zentefis, 2020).

Our parameterization implies that the lower bound $\underline{R}(\sigma, \Delta)$ and the upper bound $\bar{R}(\sigma, \Delta)$ of the uniform distribution $\mathbf{F}(R)$ are respectively given by

$$\underline{R}(\sigma, \Delta) = \left(\phi_1 - \phi_2\sigma - \frac{1}{2}\Delta\right)\sigma, \quad \bar{R}(\sigma, \Delta) = \left(\phi_1 - \phi_2\sigma + \frac{1}{2}\Delta\right)\sigma. \quad (2)$$

The cumulative density function is then given by

$$\mathbf{F}(R) = \frac{R - \underline{R}(\sigma, \Delta)}{\bar{R}(\sigma, \Delta) - \underline{R}(\sigma, \Delta)} = \frac{R - \underline{R}(\sigma, \Delta)}{\sigma\Delta}. \quad (3)$$

Under our assumptions of the distribution function, the project risk depends on both σ and Δ , whereas the expected return depends only on σ , but not on Δ . In this sense, an increase in Δ represents a mean-preserving spread of the project returns.

The distribution function implies the existence of an interior level of project risk, denoted by $\sigma^* = \frac{\phi_1}{2\phi_2}$, that maximizes the expected return. If $\sigma < \sigma^*$, the expected return $\mathbf{E}[R]$ monotonically increases with the risk parameter σ , implying a risk-return tradeoff, i.e., a higher risk is associated with a higher return. If $\sigma > \sigma^*$, then a higher risk is associated with a lower return. In this case, the project is socially inefficient. We focus on an equilibrium with the risk-return tradeoff.

Each bank has limited liabilities, such that it would exit the market if the realized profit falls below zero. Under deposit insurance, the households receive risk-free returns on their deposits at the interest rate r . A bank of type Δ takes as given the risk-free interest rate r and the stochastic project return $R(\sigma, \Delta)$, and chooses σ and d to solve the profit maximizing problem

$$V = \max_{\{\sigma, d\}} \int_{\underline{R}(\sigma, \Delta)}^{\bar{R}(\sigma, \Delta)} \max\{Rk - rd, 0\} d\mathbf{F}(R), \quad (4)$$

subject to the flow-of-funds constraint

$$k = e + d, \quad (5)$$

and the capital adequacy ratio (CAR) constraint

$$\frac{e}{\xi(\sigma\Delta)k} \geq \tilde{\psi}. \quad (6)$$

Under the CAR constraint (6), the bank is required to maintain a CAR above the minimum level of $\tilde{\psi}$. Consistent with the Basel III regulations, the bank's CAR is measured by the ratio of bank capital e to the risk-weighted assets $\xi(\sigma\Delta)k$, where $\xi(\sigma\Delta)$ denotes the risk weighting function.⁴

The CAR constraint (6) is equivalent to a leverage constraint. Denote by $\lambda = \frac{k}{e}$ the leverage. Then the CAR constraint can be rewritten as

$$\lambda \leq \frac{1}{\tilde{\psi}\xi(\sigma\Delta)}. \quad (7)$$

Thus, tightening the CAR constraint (i.e., raising $\tilde{\psi}$) reduces the bank's borrowing capacity.

We parameterize the risk-weighting function such that $\xi(\sigma\Delta) = \mu(\sigma\Delta)^\rho$, where $\mu > 0$ and $\rho \in (0, 1)$.⁵

Under limited liability, there exists a break-even level of project return $R^*(\sigma, \Delta)$ such that the bank remains solvent if and only if the realized return $R \geq R^*(\sigma, \Delta)$. It is straightforward to show that the break-even level of project return is given by

$$R^*(\sigma, \Delta) = r[1 - \psi(\sigma\Delta)^\rho], \quad (8)$$

where $\psi \equiv \tilde{\psi}\mu$. Under the assumption that $r\psi < \frac{1}{2}$, a sufficient condition to ensure $R^*(\sigma, \Delta) > \underline{R}(\sigma, \Delta)$ is given by

$$\psi\bar{\sigma}^\rho < 1 - \frac{(\phi_1 - \frac{1}{2})^2}{4\phi_2 r}. \quad (9)$$

where $\bar{\sigma} \equiv \arg \max_{\sigma} \underline{R}(\sigma, 1) = \frac{\phi_1 - \frac{1}{2}}{2\phi_2}$.

⁴The risk weight $\xi(\sigma\Delta)$ is a function of the effective project risk, which depends on both σ and Δ . To the extent that loan default risks and the potential default costs are increasing with the effective project risk, our assumption on the risk-weighting function is consistent with the Internal Ratings Based (IRB) approach under Basel III.

⁵To differentiate the capitalization effect and risk-weighting effect of CAR regulations, we introduce two parameters, $\tilde{\psi}$ and ρ . The parameter $\tilde{\psi}$ captures the regulations on the level of capitalization. The parameter ρ measures the risk-weighting sensitivity and captures the regulations on risk-weighting. Under our parameterization, the nonlinearity of the risk-weighting function implies a greater penalty to riskier loans in the bank's portfolio, such that each asset is assigned a unique risk weight, capturing—in reduced-form—the essence of the IRB approach in Basel III.

Assuming that the CAR constraint (6) is binding, we can rewrite the bank's objective function in Eq. (4) as

$$\begin{aligned} V &= \max_{\{\sigma\}} \frac{e}{\psi(\sigma\Delta)^\rho} \int_{R^*(\sigma,\Delta)}^{\bar{R}(\sigma,\Delta)} [R - R^*(\sigma,\Delta)] d\mathbf{F}(R) \\ &= \max_{\{\sigma\}} \frac{e}{2\psi(\sigma\Delta)^{\rho+1}} [\bar{R}(\sigma,\Delta) - R^*(\sigma,\Delta)]^2, \end{aligned} \quad (10)$$

where we have used the flow-of-funds constraint (5) and the binding CAR constraint to substitute out k and d and we have also imposed the relation $d\mathbf{F}(R) = \frac{1}{\sigma\Delta}dR$. Thus, the bank profit increases with both the leverage ratio ($\lambda = \frac{1}{\psi(\sigma\Delta)^\rho}$) and the interest income ($\bar{R}(\sigma,\Delta) - R^*(\sigma,\Delta)$).

We focus an interior solution to the bank portfolio choice problem and project risk parameter such that $\sigma \in (0, \bar{\sigma})$.

The first-order condition for the optimizing choice of σ implies that

$$\frac{1+\rho}{2\sigma} [\bar{R}(\sigma,\Delta) - R^*(\sigma,\Delta)] = \frac{\partial [\bar{R}(\sigma,\Delta) - R^*(\sigma,\Delta)]}{\partial \sigma}. \quad (11)$$

The right-hand side of the equation measures the marginal benefit of increasing the risk σ through increasing the interest income, which increases bank profits. Holding the leverage ratio constant, a higher risk raises the upper-tail of the return and reduces the break-even point $R^*(\sigma,\Delta)$. That is, $\frac{\partial [\bar{R}(\sigma,\Delta) - R^*(\sigma,\Delta)]}{\partial \sigma} > 0$. The left-hand side of the equation is the marginal cost of increasing the risk through reducing the leverage ratio, which reduces bank profits. The optimal risk-taking equates the marginal benefit to the marginal cost.

We first show that, for any given idiosyncratic risk Δ , raising the required level of capitalization (ψ) or increasing the sensitivity of risk-weighting (ρ) would reduce bank risk-taking. Furthermore, the optimal level of risk σ increases with the bank-specific risk Δ . These results are formally stated in Proposition 1 below.

Proposition 1. Under the condition (9), there exists a unique $\sigma \in (0, \bar{\sigma})$ that maximizes the bank's expected profit. The optimal σ satisfies

$$\frac{\partial \sigma}{\partial \psi} < 0, \quad \frac{\partial \sigma}{\partial \rho} < 0. \quad (12)$$

Furthermore, we have

$$\frac{\partial \sigma}{\partial \Delta} > 0. \quad (13)$$

Thus, the optimal project risk decreases with both the level of required capitalization (ψ) and the sensitivity of risk-weighting to portfolio risks (ρ), whereas it increases with bank-specific risks (Δ).

Proof. See Supplemental Appendix S.1. $\square$

Given the CAR constraint, an expansionary monetary policy (i.e., a decline in r) induces the bank to increase its leverage but reduce risk exposures σ . A decline in r lowers the break-even rate of return $R^*(\sigma, \Delta) = r[1 - \psi(\sigma\Delta)^\rho]$ and boosts the interest income for any given leverage. Thus, the bank chooses to increase leverage. However, under the binding CAR constraint, increasing leverage requires reducing the risk. This result is formally stated in the Proposition 2.⁶

Proposition 2. The optimal leverage ratio $\lambda = \frac{k}{e}$ decreases with the risk-free interest rate, whereas the optimal level of risk σ increases with the interest rate. That is,

$$\frac{\partial \lambda}{\partial r} < 0, \quad \frac{\partial \sigma}{\partial r} > 0. \quad (14)$$

Proof. See Supplemental Appendix S.1. $\square$

Changes in CAR regulations can affect how bank risk-taking responds to monetary policy shocks. In practice, China's implementation of Basel III beginning in 2013 led to an increase in the required bank capitalization, with the minimum CAR increased to 10.5% from 8%. This can be interpreted as an increase in the parameter ψ in our model. The new regulations also allowed banks to adopt the Internal Ratings Based (IRB) approach to calculating risk-weighted assets for assessing a bank's CAR, increasing the sensitivity of risk-weighting to credit risks. This aspect of the regulatory policy change can be captured by an increase in the elasticity parameter ρ in our model.

As shown in Proposition 2, monetary policy easing raises bank leverage but reduces risk-taking under given capital regulations (parameterized by ψ and ρ). The results hold for all banks regardless of their idiosyncratic risks Δ .

In a regime with a higher ψ , a bank would have higher capitalization on average. Thus, monetary policy easing would still raise leverage and reduce risk-taking, but to a lesser extent. In a regime with a higher ρ , however, the bank's capitalization level would become more sensitive to risks. Thus, monetary policy easing would lead to a larger reduction in risk-taking. To isolate the bank-specific factor Δ , we first consider a case

⁶In our simple model here, bank decisions are static. In a more general environment with forward-looking banks, a bank would care about the value of future rents in its risk-taking decisions; that is, a charter value channel would be present (Keeley, 1990). When the deposit interest rate falls such that the interest income rises, a forward-looking bank would choose a safer portfolio to reduce the probability of project failures in future periods. In this sense, generalizing the model to incorporate the charter value channel would strengthen the relation between risk-taking and monetary policy that we establish in Proposition 2.

where banks are homogeneous with identical Δ . These results are formally stated in the proposition below.

Proposition 3. Assume that banks are homogeneous with an identical Δ , the sensitivity of bank risk-taking to monetary policy shocks measured by $\frac{\partial \sigma}{\partial r}$ decreases with the tightness of capital requirements measured by ψ , but increases with the risk-weighting sensitivity measured by ρ . In particular, we have

$$\frac{\partial^2 \sigma}{\partial r \partial \psi} < 0, \quad \frac{\partial^2 \sigma}{\partial r \partial \rho} > 0. \quad (15)$$

Proof. See Supplemental Appendix S.1. $\square$

In general, the impact of regulation changes (in particular, changes in the risk-weighting sensitivity ρ) on bank risk-taking depends on bank-specific risks Δ . All else being equal, a higher level of bank-specific risk implies a higher level of risk-weighted assets. To meet the CAR constraints, the bank would have to choose a lower-risk portfolio (i.e., a lower σ). Propositions 1 and 3 show that increasing the risk-weighting sensitivity (ρ) reduces risk-taking for all banks both on average (Eq (12)) and conditional on an expansionary monetary policy shock (Eq (15)). We now show that the effects of raising the risk-weighting sensitivity ρ on risk-taking are stronger for banks with higher levels of idiosyncratic risks Δ . These results are formally stated in the Proposition 4 below.

Proposition 4. A banks facing a greater level of idiosyncratic risks (Δ) reduces risk-taking (σ) more aggressively when regulations raise the risk-weighting sensitivity ρ . That is,

$$\frac{\partial^2 \sigma}{\partial \rho \partial \Delta} < 0. \quad (16)$$

Furthermore, under a higher level of the risk-weighting sensitivity (e.g., when ρ increases from 0 to 1), a bank facing a greater level of idiosyncratic risks reduces risk-taking more aggressively following an expansionary monetary policy shock. In particular, we have

$$\frac{\partial}{\partial \Delta} \left[\frac{\partial \sigma}{\partial r} \Big|_{\rho=1} - \frac{\partial \sigma}{\partial r} \Big|_{\rho=0} \right] > 0. \quad (17)$$

Proof. See Supplemental Appendix S.1. $\square$

4. EMPIRICAL ANALYSIS

The theoretical model predicts that increasing the sensitivity of risk-weighting reduces bank risk-taking, and risk-taking declines more for those banks facing higher idiosyncratic risks. The model also predicts that an expansionary monetary policy shock raises bank leverage, forcing banks to reduce risk-taking under binding CAR constraints. Increasing the risk-weighting sensitivity amplifies the reduction in bank risk-taking in response to

monetary policy easing, and the amplification effect is stronger for those banks facing higher idiosyncratic risks. We use these theoretical insights for our empirical identification and we have obtained evidence that supports these predictions.

4.1. The data and some stylized facts. We begin with descriptions of our micro-level data and some stylized facts in the data.

4.1.1. *The data.* We construct a unique micro data set using confidential loan-level data from one of the “Big Five” commercial banks in China, merged with firm-level data in China’s Annual Survey of Industrial Firms (ASIF).⁷ The loan-level data contain detailed information on each individual loan, including the quantity, the price, and the credit rating, among other indicators. To control for borrower characteristics in our empirical estimation, we merge the loan data with firm-level data taken from the ASIF, which covers all above-scale industrial firms from 1998 to 2013, with 3,964,478 firm-year observations.⁸ The ASIF data contain detailed information on each individual firm, including the ownership structure, employment, capital stocks, gross output, value-added, firm identification (e.g., company name), and complete information on the three major accounting statements (i.e., balance sheets, profit and loss accounts, and cash flow statements). In the absence of consistent firm identification code, we merge the loan data with the firm data using firm names. The merged dataset contains information on about 400,000 unique firm-loan pairs from 2008:Q1 to 2017:Q4, accounting for approximately half of the total amount of loans issued to manufacturing firms by the bank.

4.1.2. *Credit ratings and loan ownership.* China’s government has provided preferential credit access for SOEs (Song et al., 2011; Chang et al., 2016). Under such preferential policy, SOEs are considered safe borrowers. Our evidence shows that, all else being equal, SOE loans are more likely to receive high credit ratings.

Table 1 displays the credit rating and the share of SOE loans in each rating category. The credit rating includes 12 categories, ranging from AAA to B. For each individual loan, the bank identifies whether the borrower is an SOE or not. For each rating category, Table 1 reports the number and amount of loans and the corresponding SOE shares. The table shows that SOE loans account for the bulk of the high-quality loans. In particular, for loans rated AA or above, SOE loans account for 20-30% in terms of the number of

⁷The “Big Five” banks play a dominant role in China’s banking sector. They account for about half of China’s bank lending in our sample period.

⁸Through 2007, the ASIF covered all SOEs regardless of their sizes, and large and medium-sized non-SOEs with annual sales above five million RMB. After 2007, the Survey excluded small SOEs with annual sales below five million RMB. After 2011, the ASIF included only manufacturing firms with annual sales above 20 million RMB.

TABLE 1. Credit Ratings and Loan Ownership

Credit Rating	Number	SOE Share	Amount	SOE Share
AAA	4,426	21.5%	248,587	63%
AA+	7,213	31.6%	314,584	56%
AA	22,852	21.8%	515,173	52%
AA-	51,709	8.2%	632,094	32%
A+	52,555	4.6%	385,145	22%
A	25,927	8.6%	247,910	28%
A-	15,401	2.8%	105,009	15%
BBB+	14,264	1.8%	87,363	9%
BBB	9,825	2.3%	66,454	22%
BBB-	4,991	0.8%	35,511	2%
BB	9,573	7.3%	93,432	22%
B	59,594	1.8%	425,004	5%

Notes: AAA to B correspond to the categories of credit ratings. The column of “Amount” is the total volume of loans (million Yuans).

loans and 50-60% in terms of the amount of loans. For loans with lower credit ratings, the SOE share is substantially smaller.

The positive relation between the credit rating and the SOE share of the loans is statistically significant and is not driven by time and location fixed effects or firm characteristics, as shown in Table 2. The table shows the estimation results when we regress credit ratings on the SOE loans, with or without controlling for time and location fixed effects and (potentially time-varying) firm characteristics. The dependent variable is the credit rating, taking values from 1 to 12, corresponding to the rate categories from B to AAA. The independent variable is a dummy indicator, which is equal to 1 if the borrower is an SOE and 0 otherwise. We estimated the empirical relation using both an OLS specification and an ordered Probit model. In each case, we obtained a positive correlation between credit ratings and SOE lending, and the correlation is significant at the 99% confidence level.

4.1.3. *Changes in banking regulations and bank risk-taking.* The Basel III regulations implemented in 2013 raised the minimum CAR from 8% to 10.5%. It has also introduced

TABLE 2. Credit Ratings and SOE Loans

	(1)	(2)	(3)	(4)
Credit Rating	OLS	Ordered Probit	Ordered Probit	Ordered Probit
SOE loan	1.361*** (0.028)	0.884*** (0.008)	0.374*** (0.011)	0.509*** (0.012)
Branch FE	yes	no	no	yes
Year-quarter FE	yes	no	yes	yes
Initial Controls $\times$ year FE	yes	no	yes	yes
R ²	0.262	—	—	—
Observations	241,688	264,213	241,688	241,688

Notes: Column (1) reports the results in OLS estimation. Columns (2)-(4) report results in ordered Probit estimation. “Initial Controls” includes the average firm characteristics (including size, age, leverage, and ROA) in the years before 2013. The numbers in the parentheses are robust standard errors. The statistical significance are denoted by asterisks: *** for $p < 0.01$, ** for $p < 0.05$, and * for $p < 0.1$.

the IRB approach for weighting bank asset risks based on loan default probabilities and default exposures.⁹

Our theory in Section 3 predicts that the increased sensitivity to risk weighting under the new Basel III regulations should reduce bank risk-taking. Figure 1 presents some

⁹The CBRC formally approved the “Big Five” commercial banks’ applications for adopting the Internal Ratings Based approach to assess risk-weighted assets in April 2014. However, the banks have prepared for the implementation of the IRB approach well before the formal approval. For instance, in the 2012 annual report of the Industrial and Commercial Bank of China (ICBC), the bank explicitly stated in the section of *Preparation for the implementation of capital regulation* that “In respect of credit risk, the Bank further ,..., reinforced the group management of the *internal rating of credit risks*. It pushed forward the optimization of the internal rating system and model and constantly improved the business verification system of internal rating business. Besides, the Bank continuously promoted the application of *internal rating* results in credit approval, risk monitoring and early warning, risk limit setting, economic capital measurement and performance appraisal.” In the 2013 annual report, the ICBC stated in the section of *Credit Risks* that “The Bank also continuously advanced the application of *internal rating* results, and accelerated the construction of credit risk monitoring and analysis center to enhance the whole process monitoring and supervision of credit risk. As a result, credit risk management of the Bank was fully strengthened.” See the Appendix for additional details of changes in China’s bank regulation policy.

suggestive evidence that banks have reduced risk weights on their assets by shifting lending to low-risk borrowers in the post-2013 period. The figure shows that the share of high-quality loans (i.e., those loans rated AAA or AA+) declined steadily from 2008 to 2012, but it has been increasing since 2013. Formal tests of structural breaks (such as the Bai-Perron test) identifies a structural break in the share of loans rated AA+ or AAA in the first quarter of 2013, suggesting that the changes in capital regulations have contributed to changes in bank risk-taking.¹⁰ Furthermore, since SOE loans are correlated with high credit ratings (see Section 4.1.2), we should expect banks to increase the share of SOE lending (relative to trends) after 2013. Indeed, Figure 1 shows that the share of lending to SOEs has been declining before 2013, reflecting the underlying trend declines in the SOE sector in the economy.¹¹ After 2013, however, the share of SOE loans has stabilized, indicating that banks increased lending to SOEs relative to the long-term trend under the new capital regulations.

4.2. The empirical model and the estimation approach. We now examine formally how changes in capital regulations affect the responses of bank risk-taking following a monetary policy shock. For this purpose, we estimate the triple-difference empirical specification

$$\begin{aligned} SOE_{ijt} = & \alpha \times RiskH_j \times Post_y + \beta \times RiskH_j \times Post_y \times MP_t \\ & + \gamma \times RiskH_j \times MP_t + \theta \times X_i \times \mu_y + \eta_j + \mu_t + \epsilon_{ijt}. \end{aligned} \quad (18)$$

In this specification, the dependent variable SOE_{ijt} is a dummy variable that takes a value of one if the individual bank loan (indexed by i) is extended to an SOE firm by the city-level branch (indexed by j) in quarter t , and zero otherwise.

We interpret the implementation of Basel III regulations, and in particular, the changes in risk-weighting methods (from RW to IRB) as an exogenous event for bank branches.¹² We use the dummy variable $Post_y$ to indicate the post-2013 periods under the new regulations: it equals one if the year is 2013 or after, and zero otherwise.

¹⁰In practice, the CAR constraints are not always binding. However, as we show in the Appendix (see Figure A.1), the Big Five Chinese commercial banks responded to the implementation of the Basel III regulations that raised the minimum CAR by increasing their effective CAR. Our theory suggests that, to the extent that banks would like to maintain a buffer between their effective CAR and the regulatory minimum, changes in capital regulations should have impact on banks risk-taking behaviors.

¹¹Chang et al. (2016) document evidence that the share of SOE output in China's industrial revenue has declined steadily from about 50% in 2000 to about 30% in 2010, and further to about 20% in 2016.

¹²According to an internal document issued in 2012 by the bank from which we obtained the loan level data, the bank branches were required to implement the IRB risk-weighting approach, strengthen risk assessment, and improve controls of loan risks.

Notes: This figure shows the time series of the share of SOE loans to the total amount of loans (the blue line) and the share of high quality loans (i.e., those with credit ratings AA+ or AAA) in total loans (the gray line). The unit is percentage points. The dashed lines are linear fitted trend for the time series before or after 2013. The Bai-Perron test detects a significant structural break in 2013:Q1 in the trend of the share of high quality loans, although it does not detect a significant structural break in the share of SOE loans.

Our theoretical model suggests that the impact of changing the sensitivity to risk-weighting on bank risk-taking—both on average and conditional on monetary policy shocks—can vary across bank branches, depending on their idiosyncratic risks (see Proposition 4). In particular, high-risk bank branches should be more sensitive to regulation changes than low-risk branches. Based on this theoretical implication, we implement a difference-in-difference identification approach, exploiting the differential responses to regulation changes between the high-risk and the low-risk branches to identify the impact of regulation changes on risk-taking. We use the bank branches with a high average share of non-performing loans (NPLs) prior to 2013 as the treatment group and the other branches as the control group. Specifically, we define the dummy variable $RiskH_j$, which equals one if the branch j 's average share of NPL in the periods 2008-2012 is above the median, and zero otherwise. This classification of risk groups based on past NPL ratios is consistent with our theoretical model. Our theory suggests that a bank branch with a higher level of idiosyncratic risks would take more risks in lending (see Proposition 1), resulting in a higher share of non-performing loans. In our empirical specification (18), we include the interaction term $RiskH_j \times Post_y$ to capture the relative responses of the

TABLE 3. Parallel trend test

	(1)	(2)	(3)	(4)	(5)
Variables	Low-risk group	High-risk group	Mean difference	<i>t</i> -statistic	<i>p</i> -value
SOE loan share	0.316	0.349	-0.033	-0.9256	0.355
AAA&AA+ loan share	0.097	0.068	0.028	1.3638	0.174
Small firm loan share	0.236	0.209	0.028	1.212	0.226
Averaged loan rate (%)	6.357	6.403	-0.046	-1.1523	0.250
log(Interest Income)	17.299	17.308	-0.009	-0.0589	0.953
log(loan amount)	20.057	20.049	0.008	0.0533	0.958
Loan-to-firm asset ratio	0.142	0.130	0.012	0.5455	0.586

Notes: Columns (1) and (2) report the average characteristics before 2013 of the low-risk group (i.e., bank branches with low NPL ratios) and the high-risk group (i.e., branches with high NPL ratios), respectively. Column (3) shows the differences in the average characteristics between these two groups. Column (3) shows the difference between Columns (1) and (2). Columns (4) and (5) report the *t*-statistics and *p*-values from the *t*-test of the difference reported in Column (3). A branch is classified in the high-risk group if its average share of non-performing loans in 2008-2012 exceeds the median. Otherwise, it is in the low-risk group. The loan amount, interest income, SOE loan share, AAA& AA+ loan share, and the small firm loan share are calculated for each bank branch and averaged across time and across branches within each group. The average loan rate is the volume-weighted average loan interest rates across branches within each group. The ratio of loan amount to firm's total asset is calculated for each loan deal, averaged across time for each branch, and then averaged across branches within each group.

high-risk branches to changes in the regulations. The theory suggests that the coefficient on this interaction term should be positive (i.e., $\alpha > 0$).

To ensure the validity of our identification approach, we conduct a mean test for the pre-2013 period to see whether the behaviors of the treated group differed systematically from the control group before the new regulations were implemented. Table 3 compares several indicators of the lending behaviors between the control group (i.e., the low-risk branches with NPL shares at or below the median) and the treatment group (i.e., the high risk branches with NPL shares above the median). The table shows that the average differences in the behaviors of these two groups prior to 2013 are small and statistically insignificant, as indicated by the *t* statistics and the *p*-values.

To examine how changes in banking regulations could affect the responses of risk-taking behaviors following monetary policy shocks, we construct a measure of monetary policy shock (i.e., the term MP_t in Eq. (18)), which is the exogenous component of

China's M2 growth, a quarterly time series estimated from the money growth rule using the regime-switching approach of [Chen et al. \(2018\)](#). Our theory predicts that, under given CAR regulations, monetary policy easing reduces bank risk-taking (Proposition 2); raising the sensitivity to risk weighting amplifies the reduction in risk-taking following a monetary policy expansion (Proposition 3); and furthermore, the reductions in risk-taking following an expansionary monetary policy shock should be more pronounced for high-risk branches (Proposition 4). To capture these effects, we include the triple interaction term $RiskH_j \times Post_y \times MP_t$ in our empirical specification. The theory predicts that the coefficient on this triple interaction term should be positive (i.e., $\beta > 0$).

The variable X_i in Eq. (18) is a vector of control variables for the initial conditions facing firm i (i.e., the borrower of loan i). It includes firm characteristics such as the size (measured by the log of total assets), the age, the leverage, and the returns on assets (ROA). We do not have data on these firm characteristics after 2013, since the ASIF sample covers the period from 1998 to 2013. To capture potential time variations of firm characteristics, we follow [Barrot \(2016\)](#) and include interactions between the initial conditions X_i with the year fixed effect μ_y .¹³ The set of independent variables also include city (or equivalently, branch) fixed effect η_j and time (quarters) fixed effect μ_t . Finally, the term ϵ_{ijt} denotes the regression residual.¹⁴ The parameter γ in Eq. 18 measures the average response of bank risk allocations to monetary policy shocks in the full sample. Our theory predicts that, under the new regulations with risk weighting (i.e., in the post-2013 periods), an expansionary monetary policy should raise bank leverage and reduce risk taking (see Proposition 2). However, before the introduction of the IRB approach in 2013, banks could not choose the risk weights on their assets based on credit risks. Thus, our theory has no clear predictions for the sign of γ .

Table 4 displays the summary statistics for the variables of interest in our analysis. The mean probability of SOE lending (the *SOE* dummy) is 5.9%, with a standard deviation of about 0.24. The average share of high-risk branches (the *RiskH* dummy) before 2013 is about 51.4%, with a standard deviation of 0.5. The monetary policy shock (the term *MP*) has a mean of zero and a standard deviation of 0.007.

4.3. Empirical results.

We now discuss the empirical estimation results.

¹³One advantage of this approach is that the interaction term is exogenous to changes in banking regulations after 2013.

¹⁴In the empirical specification (18), the effects of the linear term $RiskH_j$ are captured by the branch fixed effect η_j and the effects of the terms MP_t , $Post_y$, and $MP_t \times Post_y$ are captured by the time (year-quarter) fixed effect μ_t . We do not include a firm fixed effect because the ownership structure of firms is fixed in our sample: SOEs remains state owned and private firms remain private.

TABLE 4. Summary statistics

Variables	Obs.	Mean	Sta. Dev.	Min	Median	Max
<i>SOE</i>	333,500	0.059	0.235	0.000	0.000	1.000
<i>RiskH</i>	333,500	0.514	0.500	0.000	1.000	1.000
<i>MP</i>	333,500	0.000	0.007	-0.017	0.001	0.027

4.3.1. *Baseline estimation results.* We use our micro-level data to estimate the baseline empirical model in Eq. (18). Table 5 reports the estimation results. We firstly use high credit rating as dependent variable to show the risk taking channel. In Column (2), the positive value of α suggests that, after implementing Basel III that increased the risk-weighting sensitivity, bank branches (especially those with risky balance sheets in the past) reduced their risk exposures. The positive value of β implies that an expansionary monetary policy shock increases high rating loans after the implementation of the new regulations, but not before.

Subsequently, Column (3) shows the OLS result for baseline estimations. Consistent with our theory, the estimated values of both α and β are both positive and statistically significant.¹⁵ The positive value of α suggests that, after implementing Basel III that increased the risk-weighting sensitivity, bank branches (especially those with risky balance sheets in the past) reduced their risk exposures by raising the share of SOE loans, which are considered safe lending because of their high credit ratings under government guarantees. The positive value of β implies that an expansionary monetary policy shock increases bank lending to SOEs after the implementation of the new regulations, but not before. Indeed, the estimated value of γ is statistically insignificant, indicating that a monetary policy shock by itself did not have a significant impact on bank risk-taking on average. We obtain similar results when we estimate a Probit model instead of an OLS model (see Column (2) of the table).¹⁶

The point estimate of $\beta = 0.535$ implies that, for those bank branches with a high NPL ratio in the past, a one standard deviation increase in monetary policy shock (0.7%) would raise the probability of lending to SOEs by $0.535 \times 0.7\% = 0.37\%$. Since the sample average of the number of loans extended to SOEs is 5.9%, a one standard

¹⁵We report robust standard errors in the baseline regressions. Clustering the standard errors by firms or by bank branches does not affect the main results, as we discuss in Supplementary Appendix S.2.

¹⁶The variables used in our estimation are not demeaned. Thus, in general, the estimated coefficient α for the interaction term $RiskH_j \times Post_y$ may not capture the average effect but the effect for periods when $MP_t = 0$. This concern, however, is not important in practice because the monetary policy shock MP_t has a mean of zero (see Table 4).

TABLE 5. Effects of Regulations on Bank's Risk-Taking

	(1)	(2)	(3)	(4)	(5)	(6)
	$HR_{i,j,t}$	$HR_{i,j,t}$	$SOE_{i,j,t}$	$SOE_{i,j,t}$	$SOE_{i,j,t}$	$SOE_{i,j,t}$
	OLS	Probit	OLS	Probit	OLS	Probit
$RiskH_j \times MP_t \times Post_y$	0.833*** (0.290)	0.621*** (0.230)	0.535** (0.215)	0.452** (0.184)	1.221*** (0.354)	0.929*** (0.293)
$RiskH_j \times Post_y$	-0.00303 (0.00195)	0.00782*** (0.00168)	0.00712*** (0.00149)	0.0058*** (0.0014)	0.00411* (0.00213)	0.0025 (0.0021)
$RiskH_j \times MP_t$	-0.514** (0.251)	-0.525 (0.160)	-0.0185 (0.172)	-0.0598 (0.125)	6.137** (2.415)	4.245* (2.287)
$RiskH_j \times MP_t \times CAR_{y-1}$					-0.487** (0.192)	-0.339* (0.179)
$RiskH_j \times CAR_{y-1}$					0.00192* (0.00108)	0.0021** (0.0011)
Branch FE	yes	yes	yes	yes	yes	yes
Year-quarter FE	yes	yes	yes	yes	yes	yes
Initial controls $\times$ year FE	yes	yes	yes	yes	yes	yes
R ²	0.356		0.353		0.353	
Observations	186,734	186,734	333,500	315,382	333,500	315,382

Notes: Columns (1) and (2) report the estimation results for the credit rating. $HR_{i,j,t}$ is equal to 1 if and only if the rating of the loan is AA+ or AAA. Columns (3) and (4) report the estimation results in the baseline model, using OLS and the Probit, respectively. The monetary policy shock is constructed using the approach in [Chen et al. \(2018\)](#). The CAR for the pre-2013 periods is measured using the traditional RW approach, but for the post-2013 periods, it is measured using the new Internal Ratings Based (IRB) approach that increased the sensitivity of risk-weighted assets to loan risks. Both models include controls for the branch fixed effects, the year-quarter fixed effects, and the average firm characteristics (including size, age, leverage, and ROA) in the years before 2013 interacted with the year fixed effects. The numbers in the parentheses indicate robust standard errors. The levels of statistical significance are denoted by the asterisks: *** for $p < 0.01$, ** for $p < 0.05$, and * for $p < 0.1$. The data sample ranges from 2008:Q1 to 2017:Q4.

deviation increase in the monetary policy shock would thus raise the probability of SOE lending by $0.37/5.9 = 6.3\%$ relative to the mean. In this sense, our estimated effects of monetary policy shocks on bank risk-taking under the new capital regulations are not just statistically significant, but also economically important.

4.3.2. *Capitalization or risk weighting?* The literature shows that the relation between bank risk-taking and monetary policy depends on the level of capitalization (Jiménez et al., 2014; Dell’Ariccia et al., 2017). Our theory suggests that changes in sensitivity to risk-weighting of bank assets can also affect risk-taking conditional on monetary policy shocks (Propositions 3 and 4).

The implementation of Basel III in 2013 raised the required CAR from 8% to 10.5%. It also introduced the new IRB approach for calculating risk-weighted assets, increasing the sensitivity of risk weighting to credit risks. To isolate the effects of changes in risk weighting sensitivity on the risk-taking channel of monetary policy shocks, we need to control for the effects of changes in bank capitalization. For this purpose, we augment our baseline empirical specification (18) by including two additional controls that capture the effects of capitalization—the effective annual CAR of the bank (CAR_{y-1}) and the interactions between the effective CAR and monetary policy shocks ($MP_t \times CAR_{y-1}$)—both interacted with the $RiskH_j$ term. Since the CAR calculation methods changed in 2013, we construct a measure of the effective CAR based on the RW approach for the pre-2013 periods, and then splice it with the CAR calculated based on the new IRB approach for the post-2013 periods.

Table 5 reports the estimation results when the effects of capitalization are controlled for (Columns (3) and (4)). In both the OLS and the Probit regressions, the estimates of the coefficient on $RiskH_j \times MP_t \times CAR_{y-1}$ are significantly negative, implying that better capitalization leads to more risk-taking following an expansionary monetary policy shock. This result is consistent with that obtained by Dell’Ariccia et al. (2017) using U.S. data.

After controlling for the effects of capitalization, the estimated coefficient on $RiskH_j \times MP_t \times Post_y$ remains significantly positive, with a magnitude about twice as large as that in baseline regression. For example, under the OLS specification (Column (3)), the point estimate rises from the baseline value of 0.535 to 1.221.¹⁷ The point estimate (1.221) implies that a one standard deviation monetary policy shock would increase the probability of SOE lending by about 14% (relative to the mean). We obtained similar results when we estimate the Probit model (see Column (4)).¹⁸ Thus, consistent with our theory, the declines in bank risk-taking following a monetary policy expansion were

¹⁷The effective CAR is endogenous and can be correlated with the $Post_y$ dummy. This correlation, however, does not change the consistency of the point estimates of the coefficients on $RiskH_j \times Post_y$ and $RiskH_j \times MP_t \times Post_y$, although it might affect the standard errors.

¹⁸We have also estimated the same model by replacing the CAR measure with the deviations of the effective CAR from the required CAR (i.e., a CAR gap), or by including both the effective CAR and the CAR gap. The results are similar.

Notes: The figure shows the estimated coefficients α and β for the years 2011, 2013, and after 2013 from the empirical model in Eq. (19). The dots indicate the point estimates, and the shaded gray areas indicate the 95% confidence bands. The treatment group is the high-risk bank branches with average NPL ratios above the median in the pre-2013 period. The control group is the low-risk branches with pre-2013 average NPL ratios below the median. The coefficient α_τ measures the difference in the share of SOE lending between the treatment group and the control group in year τ . The coefficient β_τ measures the difference in SOE lending between these two groups conditional on monetary policy shocks. We use 2012 as a reference year.

primarily driven by changes in risk-weighting in the post-2013 period under the new regulations.

4.3.3. *Parallel trends.* Our difference-in-difference identification assumes that the risk-taking behaviors of the treatment group (i.e., the high-risk branches) and the control group (i.e., the low-risk branches) followed parallel trends in the pre-2013 periods, but diverged after the new regulations were put in place.

To examine the validity of our parallel trends identification assumption, we estimate the empirical model

$$\begin{aligned} SOE_{i,j,t} = & \sum_{\tau} \alpha_{\tau} \times RiskH_j \times \delta_{\tau} + \sum_{\tau} \beta_{\tau} \times RiskH_j \times \delta_{\tau} \times MP_t \\ & + \gamma \times RiskH_j \times MP_t + \theta \times X_i \times \mu_y + \eta_j + \mu_t + \epsilon_{i,j,t}, \end{aligned} \quad (19)$$

where $\tau \in \{2011, 2013, > 2013\}$ denotes the year, δ_{τ} is a dummy variable, which is equal to one in year τ and zero otherwise. The other variables have the same definitions as in the baseline model specified in Eq. (18), except that MP_t is demeaned by year. The parameter α_{τ} measures the relative risk-taking behavior of the treatment group in year τ , and the parameter β_{τ} measures the relative response of risk-taking to a monetary policy shock for the treatment group in year τ . Implicitly, the reference year is 2012. We consider the periods before the new regulations (2011), the year when the regulation was implemented (2013), and the years after the regulation shock.¹⁹

Figure 2 shows the point estimates of α_{τ} and β_{τ} along with the 95% confidence bands. Since 2012 is the reference year, we normalize the values of both parameters to zero in that year. The figure shows that, in the pre-2013 periods, the estimated values of α and β are insignificantly different from zero, implying that the risk-taking behaviors of the treatment group—both on average and conditional on monetary policy shocks—were not significantly different from the control group. The figure also shows that, since the regulation was implemented (2013 and after), the estimated values of α and β have both turned positive and statistically significant at the 95% confidence level, implying significant reductions in risk-taking by the high-risk branches (relative to the low-risk branches). These results suggest that the shock (i.e., the implementation of Basel III) triggered changes in the behaviors of the treatment group relative to the control group, validating our identification assumption.

4.3.4. *Robustness.* In Online Appendix S.2, we have done a battery of robustness tests including controlling for loan demand factors, the effects of other events such as the interest rate liberalization, the anti-corruption campaign, and the deleveraging policy, using data from multiple banks, and adding more controls. The results show that our baseline estimation results are robust to alternative measurements, model specifications, and additional controls.

¹⁹For a similar approach to testing the validity of the parallel trends assumption, see Barrot (2016).

5. AGGREGATE IMPLICATION OF RISK-WEIGHTING MECHANISM: A TWO-SECTOR GENERAL EQUILIBRIUM MODEL

We have presented micro evidence that the tightened capital regulations in China have reduced bank risk-taking, both on average and conditional on an expansionary monetary policy shock. Our evidence suggests that banks reduce loan risks by raising the share of lending to SOEs, lowering aggregate productivity. Is this risk-taking channel of monetary policy important in the aggregate economy?

To answer this question requires a general equilibrium framework that allows us to examine how changes in banking regulations affect the portfolio choices in bank lending decisions, and how bank lending affects capital allocations among firms in different sectors, particularly following a monetary policy shock. We now present such a two-sector dynamic general equilibrium model.

5.1. The dynamic model. The economy features a competitive banking sector, in which the representative bank takes deposits from households and lends to two types of intermediate goods producers: SOEs and POEs. Each firm faces idiosyncratic productivity shocks, such that the bank receives stochastic returns from lending. Consistent with empirical evidence, we assume that SOE projects yield lower expected returns but also bear lower risks than POE projects.²⁰ Under a CAR constraint, banks need to maintain a minimum ratio of net worth to risk-weighted assets, where the risk weights depend on the share of safe loans (i.e., SOE lending). The household consumes a final good produced using intermediate goods as inputs and deposit at the banks. The stochastic return on the banks' asset causes a risk of bankruptcy. When banks are insolvent, the government intervenes and bails out banks, resulting in a risk-free households deposit. Intermediate goods are produced using labor and capital as inputs. Retail prices are sticky, such that monetary policy has real effects. In light of the empirical study of [Chen et al. \(2018\)](#), we assume that the central bank follows a money supply rule, under which the money growth rate is adjusted to stabilize deviations of inflation and output growth from their respective targets.

5.1.1. The banking sector. The banking sector is populated by a continuum of banks with measure one. To simplify the analysis, we follow [Coimbra and Rey \(2017\)](#) and assume banks live for two periods. In the first period, the representative bank makes

²⁰As we have discussed, under the prevailing government policies, SOEs receive preferential credit treatments and their loans are mostly guaranteed by the government, despite their low productivity relative to POEs. Our model captures this feature in China by assuming that SOE projects have lower risks and lower expected returns than POE projects.

loan (i.e., investment) decisions; in the second period, the bank obtains payoffs from the loans. Each bank entering the market in period t is endowed with equity e_t . It takes deposits d_t from households at the competitive real deposit rate R_t^d . The equities and deposits are both measured in final good units. The total funds available to the bank is therefore $e_t + d_t$.

The bank lends out its available funds to intermediate-good producers. The firms use the loans to finance purchases of capital k_{t+1} from capital producers at the competitive price Q_t . The value of loans (i.e., the bank asset value) is thus $Q_t k_{t+1}$. The bank faces the flow-of-funds constraint

$$Q_t k_{t+1} = e_t + d_t. \quad (20)$$

The bank chooses to allocate a fraction ω_t of the loans $Q_t k_{t+1}$ to SOE projects and remaining $1 - \omega_t$ fraction to POE projects. Firms in sector $j \in \{s, p\}$ face the idiosyncratic productivity $\tilde{z}_j$, where s and p denote the SOE sector and POE sector, respectively. We assume that $\tilde{z}_j$ follows the log-normal distribution $\mathbf{F}_j(\tilde{z}_j)$, with a mean of $\tilde{\mu}_j$ and a standard deviation of $\tilde{\sigma}_j$. The SOE projects yield lower returns and bear lower risks than the POE projects. That is, $\tilde{\mu}_s < \tilde{\mu}_p$ and $\tilde{\sigma}_s^2 < \tilde{\sigma}_p^2$.

In period $t + 1$, a firm of type $j \in \{s, p\}$ produces a homogeneous intermediate good using the capital k_{jt+1} and labor l_{jt+1} as inputs, with the Cobb-Douglas production function

$$y_{jt+1} = (\tilde{z}_j k_{jt+1})^\alpha l_{jt+1}^{1-\alpha}, \quad (21)$$

where $\alpha \in (0, 1)$ is the output elasticity of effective capital.

Profit maximizing implies that the capital return of a type j project is given by

$$r_{t+1} \tilde{z}_j k_{jt+1} = \max_{l_{jt+1}} p_{t+1}^m (\tilde{z}_j k_{jt+1})^\alpha l_{jt+1}^{1-\alpha} - W_{t+1} l_{jt+1}, \quad (22)$$

where r_{t+1} denotes the marginal product of capital, W_t denotes the real wage rate, and p_t^m denotes the relative price of intermediate goods. The optimal choice of labor input implies that the marginal product of effective capital is given by

$$r_{t+1} = \alpha p_{t+1}^m \left(\frac{1 - \alpha}{W_{t+1}/p_{t+1}^m} \right)^{\frac{1-\alpha}{\alpha}}, \quad (23)$$

which depends on aggregate states only.

At the end of period $t + 1$, the firms sell the capital $(1 - \delta)k_{jt+1}$ after depreciation at the rate $\delta \in (0, 1)$, at the capital price Q_{t+1} as a part of loan repayments to the bank. Thus, the investment income from a type j project is $r_{t+1} \tilde{z}_j k_{jt+1} + (1 - \delta) Q_{t+1} k_{jt+1}$.

The investment efficiency of the bank loan portfolio is a weighted average of the two types of projects given by $z_t = \tilde{\mathbf{z}} \Omega_t$, where $\Omega_t = [\omega_t, 1 - \omega_t]'$ and $\tilde{\mathbf{z}} = [\tilde{z}_s, \tilde{z}_p]$. Denote by $f(z_t; \omega_t)$ the probability density function (PDF) of z_t , with the mean $\mu_{zt} = \omega_t \tilde{\mu}_s +$

$(1 - \omega_t) \tilde{\mu}_p$ and the variance $\sigma_{zt}^2 = \omega_t^2 \tilde{\sigma}_s^2 + (1 - \omega_t)^2 \tilde{\sigma}_p^2$. The standard deviation σ_{zt} captures the riskiness of the bank loan portfolio, and it decreases with the share of SOE loans ω_t .²¹

The bank faces the CAR constraint that requires its capital adequacy ratio (denoted by ψ_t) to exceed a minimum level $\tilde{\psi}$. Under the Basel III regulations, the bank's effective CAR is measured by the ratio of its equity to its risk-weighted assets. Specifically, the CAR constraint is given by

$$\psi_t = \frac{e_t}{h_t Q_t k_{t+1}} \geq \tilde{\psi}, \quad (24)$$

where h_t denotes a risk-weighting function. Consistent with the IRB approach implemented in China under the Basel III regulations, we assume that h_t increases with the riskiness of the bank loan portfolio or decreases with the share of safe loans, which in our model, corresponds to the share of SOE loans (ω_t). In particular, we assume that the risk-weighting function takes the same form as that in the static model

$$h_t = h(\omega_t) = \xi [\sigma_{zt}(\omega_t)]^\rho, \quad (25)$$

where $\xi > 0$ and $\rho > 0$.

As in the static model of Section 3, the CAR constraint is equivalent to the leverage constraint

$$\lambda_t \leq \frac{1}{\tilde{\psi} h(\omega_t)}, \quad (26)$$

where $\lambda_t \equiv \frac{Q_t k_{t+1}}{e_t}$ is the leverage ratio.²²

The bank maximizes the profit $r_{t+1} z_t k_{t+1} + (1 - \delta) Q_{t+1} k_{t+1} - R_t^d d_t$, subject to the flow-of-funds constraint (20) and the CAR constraint (24). When the bank is insolvent, i.e., the profit is negative due to the low realization of z_t , the government bailouts by taking the bank's revenue and pays deposit insurance to the households. The government's bailout cost is proportional to the bank's gross return in the insolvency status. We will provide more details regarding this issue when describing the fiscal authority. As a result, the bank in our model has a limited liability. The bank's optimizing problem can be

²¹Since z_t is a weighted average of two independently distributed log-normal random variables ($\tilde{z}_s$ and $\tilde{z}_p$) with endogenous weights (ω_t), the distribution of z_t can be highly complex, presenting computational challenges for solving the model. To keep our analysis tractable, we follow [Pratesi et al. \(2006\)](#) and use a log-normal distribution to approximate $f(z_t; \omega_t)$. See Appendix S.3 for details.

²²Our specification of the financial constraints facing banks is different from the financial accelerator models in the literature ([Bernanke et al., 1999](#); [Gertler and Kiyotaki, 2010](#)). In our model, changes in bank leverage is partly driven by risk weighting of bank assets, rather than the agency problem between the lender and the borrower.

written as

$$V_{t+1} = \max_{k_{t+1}, d_t, \omega_t} \int \max \{ r_{t+1} z k_{t+1} + (1 - \delta) Q_{t+1} k_{t+1} - R_t^d d_t, 0 \} f(z; \omega_t) dz, \quad (27)$$

subject to the flow-of-funds constraint (20) and the leverage constraint (26) (or equivalently, the CAR constraint (24)). Limited liability implies that there exists a cutoff level of investment efficiency, denoted by z_t^* , such that banks earn zero profit if and only if $z \leq z_t^*$. The cutoff point is given by

$$z_t^* \equiv \frac{R_t^d Q_t \left(1 - \frac{1}{\lambda_t}\right) - (1 - \delta) Q_{t+1}}{r_{t+1}}. \quad (28)$$

The last equation indicates that the cutoff of insolvency z_t^* strictly decreases with the interest rate R_t^d and increases with the leverage λ_t .

Using the flow-of-funds constraint (20) and the definition of the leverage ratio, the bank's optimization problem can be simplified to

$$V_{t+1} = \max_{\{\lambda_t, \omega_t\}} \frac{r_{t+1}}{Q_t} \lambda_t e_t \int_{z > z_t^*} (z - z_t^*) f(z; \omega_t) dz, \quad (29)$$

subject to (26).

Assuming that the leverage constraint (26) is binding. Then, the optimizing decision with respect to ω_t implies that

$$-\frac{h'(\omega_t)}{h(\omega_t)} \int_{z > z_t^*} (z - z_t^*) f(z; \omega_t) dz = - \int_{z > z_t^*} (z - z_t^*) \frac{\partial f(z; \omega_t)}{\partial \omega_t} dz + \frac{\partial z_t^*}{\partial \omega_t} \int_{z > z_t^*} f(z; \omega_t) dz, \quad (30)$$

where

$$\frac{\partial z_t^*}{\partial \omega_t} = -\tilde{\psi} h'(\omega_t) Q_t \frac{R_t^d}{r_{t+1}} > 0. \quad (31)$$

Eq. (30) shows the risk-return tradeoff of loan allocations between SOEs and POEs. The left side of Eq. (30) indicates the marginal benefit of increasing the share of SOE lending. Since SOE loans are less risky, increasing ω_t reduces the risk weight $h(\omega_t)$ on bank assets, relaxing the CAR constraint and allowing the bank to raise the leverage ratio. This helps increase the bank's investment returns. The right side of Eq. (30) shows the marginal cost of increasing the share of SOE lending. It consists of two terms. A change in the SOE loan share (ω_t) shifts the distribution of the portfolio returns, and this effect is captured by the first term on the right side of Eq. (30). An increase in ω_t reduces the expected return on the portfolio, although the overall impact on the distribution function $f(z; \omega_t)$ of the loan portfolio can be ambiguous, depending on the initial value of ω_t . The SOE loan share also affects the cutoff point for insolvency z_t^* , as reflected by the second term. An increase in ω_t reduces the risk weight $h(\omega_t)$ on bank assets, allowing the bank to increase the leverage ratio. As the balance sheet expands, the probability

of insolvency increases (i.e., the break-even point z_t^* becomes larger). This further leads to a higher cost for the government to bail out banks. The above analysis indicates that implementation of Basel III may reduce the risks of a bank's asset portfolio, but may raise the systemic risks that are captured by the insolvency probability in the banking sector. Eq. (31) implies that the cutoff z_t^* does not respond to the share of SOE loans ω_t , when the risk weight $h(\omega)$ is a constant. In this case, the leverage effect of monetary policy is muted.

In our model, a bank lives for two periods. At the end of the second period of its life, the bank distributes dividends V_t to the representative household. The household then transfers a fraction $\kappa \in [0, 1]$ of the dividends to new banks. A new bank's equity endowment e_t evolves according to the law of motion

$$e_t = \rho_e e_{t-1} + (1 - \rho_e) \kappa V_t, \quad (32)$$

where $\rho_e \in (0, 1)$ measures the persistence of the bank net worth e_t .

5.1.2. The fiscal authority. The fiscal authority collects a lump-sum income tax T_t from households and provides them deposit insurance. In the event that a bank becomes insolvent, the fiscal authority bails it out. We assume that the bailout cost is ζ fraction of the bank's gross return, i.e.,

$$\Psi_t = \zeta \int_{z < z_{t-1}^*} [r_t z + (1 - \delta) Q_t] k_t f(z; \omega_{t-1}) dz. \quad (33)$$

Ψ_t reflects a dead weight loss which strictly increases with the cutoff of the bank insolvency z_{t-1}^* .

The fiscal authority can recover the remaining $1 - \zeta$ fraction of bank's revenue and pays deposit insurance to the households, such that households as depositors do not suffer losses. Denote by G_t the deposit insurance payments. Then, we have

$$G_t = R_{t-1}^d d_{t-1} \int_{z < z_{t-1}^*} f(z; \omega_{t-1}) dz - (1 - \zeta) k_t \int_{z < z_{t-1}^*} [r_t z + (1 - \delta) Q_t] f(z; \omega_{t-1}) dz. \quad (34)$$

Under the deposit insurance, the household receives the competitive deposit rate R_t^d on their savings in the banks. The fiscal balance implies

$$T_t = G_t. \quad (35)$$

5.1.3. The households. The representative household has the utility function

$$\sum_{t=0}^{\infty} \beta^t \left[\log C_t - \tau_l \frac{L_t^{1+\eta}}{1+\eta} + \tau_m \log \frac{M_t}{P_t} \right], \quad (36)$$

where C_t denotes consumption, L_t denotes hours worked, and M_t/P_t denotes the real money balance. The parameter $\beta \in (0, 1)$ is a subjective discount factor, τ_l and τ_m measure the relative utility weights on leisure and money balances, respectively, and η is the inverse Frisch elasticity of labor supply.

The household maximizes the utility function (36), subject to the sequence of budget constraints

$$C_t + D_t + \frac{M_t}{P_t} = W_t L_t + R_{t-1}^d D_{t-1} + \frac{M_{t-1}}{P_t} + \Pi_t - T_t, \quad (37)$$

where D_t denotes the savings at the banks and Π_t is the sum of dividend distributions from the banks and firms, and T_t is lump-sum taxes levied by the government.

5.1.4. *The capital producers.* There is a continuum of competitive capital producers with measure one. The representative capital producer has access to an investment technology that can transform one unit of final consumption good into one unit of capital, subject to investment adjustment costs in the spirit of [Christiano et al. \(2005\)](#). The capital producer sells the capital to intermediate good producers at the relative price Q_t . The capital producer chooses investment I_t to solve the problem

$$\max \sum_{t=0}^{\infty} \beta^t \frac{\Lambda_t}{\Lambda_0} \left\{ Q_t I_t - \left[1 + \frac{\Omega}{2} \left(\frac{I_t}{I_{t-1}} - 1 \right)^2 \right] I_t \right\}, \quad (38)$$

where Λ_t denotes the marginal utility of income for the household (who owns the capital producers) and the parameter Ω measures the scale of the investment adjustment costs.

The optimizing investment decisions imply that

$$Q_t = 1 + \frac{\Omega}{2} \left(\frac{I_t}{I_{t-1}} - 1 \right)^2 + \Omega \left(\frac{I_t}{I_{t-1}} - 1 \right) \frac{I_t}{I_{t-1}} - \beta \frac{\Lambda_{t+1}}{\Lambda_t} \Omega \left(\frac{I_{t+1}}{I_t} - 1 \right) \left(\frac{I_{t+1}}{I_t} \right)^2. \quad (39)$$

Absent adjustment costs (i.e., $\Omega = 0$), the relative price of capital (i.e., Tobin's q) would be constant at $Q_t = 1$.

5.1.5. *The retail goods producers and price-setting decisions.* There is a continuum of retailers producing differentiated retail products indexed by $i \in [0, 1]$ using the homogeneous intermediate good as the only input. One unit of retail product can be produced using one unit of intermediate good purchased from the firms (SOEs or POEs) at the competitive price P_t^m . The retailers face monopolistic competition in the product markets and perfect competition in the input markets. Each retailer takes as given the price level and the demand schedule for its product, and adjusts its own price subject to quadratic price adjustment costs in the spirit of [Rotemberg \(1982\)](#).

Final good Y_t is a Dixit-Stiglitz composite of retail products $Y_t(i)$ for $i \in [0, 1]$. Specifically,

$$Y_t = \left[\int_0^1 Y_t(i)^{(\epsilon-1)/\epsilon} di \right]^{\epsilon/(\epsilon-1)}, \quad (40)$$

where $\epsilon > 1$ is the elasticity of substitution between differentiated products. The retail producer i faces the downward-sloping demand schedule $Y_t^d(i) = \left[\frac{P_t(i)}{P_t} \right]^{-\epsilon} Y_t$, where $Y_t^d(i)$ denotes the quantity, $P_t(i)$ the price of the retail product, and $P_t = \left[\int_0^1 P_t(i)^{1-\epsilon} di \right]^{1/(1-\epsilon)}$ is the price index.

Each retailer i sets a price for its own product. Price adjustments incur the resource cost $\frac{\Omega_p}{2} \left[\frac{P_t(i)}{\pi P_{t-1}(i)} - 1 \right]^2 Y_t$, where Ω_p measures the scale of price adjustment cost and π is the steady-state inflation rate. The retailer i chooses $P_{t+\tau}(i)$ to maximize the present value

$$\sum_{\tau=0}^{\infty} \beta^\tau \frac{\Lambda_{t+\tau}}{\Lambda_t} \left\{ \left(\frac{P_{t+\tau}(i)}{P_{t+\tau}} - p_{t+\tau}^m \right) \left(\frac{P_{t+\tau}(i)}{P_{t+\tau}} \right)^{-\epsilon} Y_{t+\tau} - \frac{\Omega_p}{2} \left[\frac{P_{t+\tau}(i)}{\pi P_{t+\tau-1}(i)} - 1 \right]^2 Y_{t+\tau} \right\}. \quad (41)$$

In a symmetric equilibrium with $P_t(i) = P_t$ for all i , the optimal pricing decision implies that

$$p_t^m = \frac{\epsilon-1}{\epsilon} + \frac{\Omega_p}{\epsilon} \left[\left(\frac{\pi_t}{\pi} - 1 \right) \frac{\pi_t}{\pi} - \beta \frac{\Lambda_{t+1}}{\Lambda_t} \left(\frac{\pi_{t+1}}{\pi} - 1 \right) \frac{\pi_{t+1}}{\pi} \right]. \quad (42)$$

Absent price adjustment costs (i.e., $\Omega_p = 0$), the optimal retail price would be a constant markup over the marginal cost, such that the relative price of the intermediate goods is equal to the inverse of the markup (i.e., $p_t^m = \frac{\epsilon-1}{\epsilon}$).

5.1.6. Monetary Policy. The monetary authority adjusts the money supply growth to target inflation and output growth. In particular, we consider the money supply rule

$$g_{mt} = \gamma_m g_{mt-1} + \gamma_\pi (\hat{\pi}_{t-1} - \pi^*) + \gamma_{yt} (g_{yt-1} - g_y) + \varepsilon_{mt}, \quad (43)$$

where $g_{mt} = \frac{M_t}{M_{t-1}} - 1$ denotes the growth rate of money supply, $\hat{\pi}_{t-1} = \pi_{t-1} - 1$ denotes the lagged inflation rate, $g_{y,t-1} = \frac{Y_{t-1}}{Y_{t-2}} - 1$ denotes the lagged output growth rate, and we normalize both the inflation and growth targets to zero such that $\pi^* = 0$ and $g_y = 0$.

Chen et al. (2018) present empirical evidence that China's monetary policy follows an asymmetric, pro-growth money supply rule. In line with their evidence, we allow the policy coefficient γ_{yt} of the growth gap in the money supply rule to be time varying and state-dependent. In particular, we assume that

$$\gamma_{yt} = \begin{cases} \gamma_y^+ > 0, & \text{if } g_{y,t-1} \geq 0 \\ \gamma_y^- < 0, & \text{if } g_{y,t-1} < 0, \end{cases} \quad (44)$$

where $\gamma_y^+ > 0$, $\gamma_y^- < 0$, and $\gamma_y^+ < |\gamma_y^-|$. Under this policy rule, the money growth rate accelerates in the short-fall state with below-target output growth more aggressively than in the above-target state (i.e., $\gamma_y^+ < |\gamma_y^-|$), consistent with China's pro-growth and state-dependent money supply rule documented by [Chen et al. \(2018\)](#).

5.1.7. *Aggregation, market clearing, and equilibrium.* In an equilibrium, the labor market, the capital market, the loanable funds market, and final goods market all clear.

The market clearing conditions for labor and capital imply that

$$L_t = \sum_{j \in \{s,p\}} \int l_{jt} d\mathbf{F}_j(\tilde{z}_j), \quad K_t = \sum_{j \in \{s,p\}} \int k_{jt} d\mathbf{F}_j(\tilde{z}_j). \quad (45)$$

Under constant returns, we can derive the aggregate production function

$$Y_t = \tilde{K}_t^\alpha L_t^{1-\alpha}, \quad (46)$$

where $\tilde{K}_t$ is the aggregate effective units of capital given by

$$\tilde{K}_t = \mu_{zt-1} K_t, \quad (47)$$

where $\mu_{zt} = \omega_t \tilde{\mu}_s + (1 - \omega_t) \tilde{\mu}_p$ measures the mean of the capital productivity z_t .

The aggregate capital stock follows the law of motion

$$K_{t+1} = (1 - \delta)K_t + I_t. \quad (48)$$

Loanable funds market clearing implies that

$$D_t = d_t. \quad (49)$$

Final good market clearing implies the aggregate resource constraint

$$C_t + \left[1 + \frac{\Omega}{2} \left(\frac{I_t}{I_{t-1}} - 1 \right)^2 \right] I_t + \Psi_t = Y_t. \quad (50)$$

Under the government policies, an equilibrium in this economy consists of the prices and the allocations such that: (1) taking all prices as given, the allocations solve the optimizing problems for the household, the bank, and intermediate good producers in both sectors; (2) taking all prices but its own as given, the price for each retail product and the allocations solve the retailer's optimizing problems; and (3) the markets for labor, capital, loanable funds, and final good all clear.

TABLE 6. Calibrated Parameter Values

β	Discounting factor	0.96
α	Capital share	0.5
Ω	Investment adjustment cost	6.23
η	Frisch inverse elasticity	2
δ	Capital depreciation rate	0.10
ϵ	Elasticity of substitution in CES	11
Ω_p	Price adjustment parameter	60
κ	Fraction of profit endowed to new banks	0.25
ρ_e	Persistence of endowment process	0.95
ζ	Insolvency cost parameter	0.12
μ_s	SOE-specific TFP	0.55
μ_p	POE-specific TFP (normalized)	1
σ_s	SOE productivity dispersion	1.42
σ_p	POE productivity dispersion	1.70
$\tilde{\psi}$	Capital adequacy ratio	0.12
ρ	Parameter in risk-adjusted weight	0.7395
ξ	Parameter in risk-adjusted weight	0.7126
γ_m	parameter in money growth rule	0.391
γ_π	parameter in money growth rule	-0.397
γ_y^+	parameter in money growth rule	0.183
γ_y^-	parameter in money growth rule	-1.299

5.2. Parameter calibration. We solve the model's steady state equilibrium and the transition dynamics following a monetary policy shock based on calibrated parameters. Table 6 shows our calibration.

A period in the model corresponds to one year. We set the subjective discount factor to $\beta = 0.96$, implying a steady-state real interest rate of 4 percent. We set the capital depreciation rate to $\delta = 0.1$. We set the capital income share to $\alpha = 0.5$, in line with the empirical evidence in [Zhu \(2012\)](#). Following [Chang et al. \(2015\)](#), we set the scale of price adjustment costs to $\Omega_p = 60$ and the elasticity of substitution between differentiated retail products to $\epsilon = 11$. We set the investment adjustment cost parameter to $\Omega = 6.23$, in line with the estimation in the DSGE literature ([Smets and Wouters, 2007](#)). We set $\kappa = 0.75$ such that 25% of the bank profits are allocated to entering banks as start-up funds. We assume that $\rho_e = 0.95$ in our baseline calibration. We set $\tilde{\psi} = 0.12$, in light with the CAR requirements for systemically important banks in China. The bailout cost

in our model is essentially a bankruptcy cost, therefore we set the parameter to $\zeta = 0.12$, in line with [Bernanke et al. \(1999\)](#).

We calibrate the parameters in the money growth rule following the estimation of [Chen et al. \(2018\)](#). In particular, we set $\gamma_m = 0.391$, $\gamma_\pi = -0.397$, $\gamma_y^+ = 0.183$, and $\gamma_y^- = -1.299$.

We calibrate the remaining set of parameters $\{\xi, \rho, \mu_s, \sigma_s, \sigma_p\}$ by matching the model-implied moments with their counterparts in the data. We first use the firm-level data from China's Annual Survey of Industrial Firms for the period from 1998 to 2007 to construct the firm-level TFPs. We normalize the average TFP in the POE sector to $\mu_p = 1$, and then compute the ratio of the average TFP between SOEs and POEs to pin down the value of μ_s . We use the average cross-sectional dispersion of firm-level TFPs to pin down the values of σ_j . This calibration procedure leads to $\mu_s = 0.55$, $\sigma_s = 1.42$ and $\sigma_p = 1.70$.²³

To calibrate the parameters in the risk-weighting function $h(\omega_t) = \xi [\sigma_{zt}(\omega_t)]^\rho$, we use the risk-adjusted weights on loans (denoted by h_t^{data}) and the share of safe loans (denoted by ω_t^{data}), both disclosed by China's Big Five banks. In particular, we first construct the overall riskiness of loans for each bank through the relationship $\sigma_{zt}^{\text{data}} = [(\omega_t^{\text{data}})^2 \sigma_s^2 + (1 - \omega_t^{\text{data}})^2 \sigma_p^2]^{\frac{1}{2}}$, where the parameters σ_s and σ_p are obtained from the previous calibration procedure. We then regress the log of risk-adjusted weight $\log(h_t^{\text{data}})$ on $\log(\sigma_{zt}^{\text{data}})$ to estimate the coefficients ξ and ρ . The procedure yields $\xi = 0.7126$ and $\rho = 0.7395$.²⁴

5.3. Transition dynamics following a monetary policy shock. We solve the model's transition dynamics following a monetary policy shock based on the calibrated parameters. We focus on a perfect foresight equilibrium. In period 0, the economy stays at the steady state. In period 1, an unexpected expansionary monetary policy shock hits the economy and there are no further shocks in subsequent periods.

Figure 3 displays the transition dynamics (or equivalently, impulse responses) of a few key macroeconomic variables in the benchmark model (the black solid lines) following a positive one standard deviation shock to monetary policy. The shock increases money supply, raising the bank leverage ratio. Under the CAR constraints, an increase in leverage requires the bank to reduce its credit risks (see Eq. (26)). Thus, the bank shifts lending to safe borrowers, increasing the share of SOE loans and lowering the credit risk and the insolvency risk. The credit risk, σ_{zt} , reflects the overall riskiness of bank's loan portfolio, which is decreasing in the SOE share. The insolvency risk is

²³See Supplementary Appendix B for more details.

²⁴See Supplementary Appendix B for more details.

the probability that the bank goes to insolvency, i.e., $\int_{z < z_t^*} f(z; \omega_t) dz$. However, since SOEs are less productive than POEs on average, allocating more credit to SOEs reduces aggregate TFP. The shock boosts aggregate demand, raising consumption, investment and output. While the increase in bank leverage further boosts investment, the decline in TFP partially offsets the expansionary effects.

To highlight the importance of endogenous risk-weighting of bank assets in the transmission channel of monetary policy, we consider a counterfactual economy in which the share of SOE loans ω_t is fixed at its steady state value. The transition dynamics in the counterfactual economy are shown in Figure 3 by the red dashed lines. Under the CAR constraint, bank leverage is pinned down by the SOE loan share and thus it does not respond to the shock. The constant SOE loan share also implies that the bank is unable to reallocate credit to inefficient SOEs, such that aggregate TFP does not change. Similar to the benchmark model (the black solid lines), the expansionary policy shock raises consumption, investment and output. However, the magnitude of the responses of consumption, investment and output is greater than that in the benchmark model, reflecting the two opposing effects stemming from changes in bank leverage and in aggregate TFP under endogenous risk-weighting in the benchmark model.

The constant SOE share implies that the monetary easing does not affect the bank's credit risk, $\sigma_{zt}(\omega_t)$. Compared to the dynamics in the baseline model, the expansionary monetary policy shock in the counterfactual economy leads to a larger reduction in the insolvency risk. The two models' dynamics of credit risk and insolvency risk imply that a shift in bank loans to SOEs can reduce the bank's credit risk but may not necessarily reduce insolvency risk. A reduction in credit risks leads to larger leverage because of the CAR constraint with endogenous risk-weighting. Since the SOE loans are less efficient and of lower return, larger leverage, in turn, raises the bank's insolvency risks (see Eq. (31)). Therefore, the micro-prudential policy such as the CAR regulation under a monetary easing shock faces a tradeoff between the bank's credit risks and insolvency risks.

5.4. Welfare analysis. The reallocation effect of monetary policy shocks under CAR constraints with endogenous risk-weighting reduces social welfare. To quantify the welfare effects, we measure the welfare along the transition paths following a monetary policy shock by computing the consumption equivalent for the representative household relative to the steady state (with no shocks). In particular, the welfare is the fraction of steady-state consumption required for the household to stay indifferent between an economy with the monetary policy shock and the steady-state economy. That is, we

FIGURE 3. Transition dynamics following an expansionary monetary policy

Notes: This figure shows the dynamic responses to an expansionary monetary policy shock. The vertical axes show percentage deviations from the initial steady state (e.g., 0.01 corresponds to 1%). The horizontal axes show the periods after the impact period of the shock. The solid lines denote the responses in the benchmark model; the dashed lines are those in the counterfactual case with the SOE loan share ω_t held fixed at the steady state value.

solve for the value of ϖ such that

$$\sum_{t=1}^{\infty} \beta^t \left(\log C_t - \tau_l \frac{L_t^{1+\eta}}{1+\eta} + \tau_m \log \frac{M_t}{P_t} \right) = \frac{1}{1-\beta} \left[\log(1+\varpi) C - \tau_l \frac{L^{1+\eta}}{1+\eta} + \tau_m \log \frac{M}{P} \right], \quad (51)$$

where C , L and M/P are the steady-state consumption, labor hours and real money balances, respectively.

To compute the welfare implication of monetary policy shock under the endogenous risk-weighting of bank assets, we consider a more general form of risk-weighting function with a “penalty term” (or adjustment cost) that allows for continuous variations in the magnitude of risk-weighting adjustments. In particular, the risk-weighting function takes the form of $h(\omega_t) = \xi [\sigma_{zt}(\omega_t)]^\rho + \frac{\xi_1}{2}(\omega_t - \omega)^2$, where the parameter $\xi_1 > 0$ quantifies the magnitude of risk-weighting channel. A larger value of ξ_1 indicates a weaker risk-weighting channel.

We compute the welfare along the transition path following an expansionary monetary policy shock by varying the value of ξ_1 . Each model has the same steady state equilibrium, although the transition dynamics differ. The baseline model corresponds to the case of $\xi_1 = 0$. The counterfactual model with fixed SOE share where the risk-weighting channel is completely muted corresponds to $\xi_1 = \infty$. Our calculation in Figure 4 shows that the expansionary monetary policy shock leads to a welfare gain. The magnitude increases with the value of ξ_1 , implying that the endogenous risk-weighting channel reduces the welfare gain of a monetary easing. In particular, there is a welfare gain of $\varpi = 0.27\%$ of steady-state consumption in the benchmark model where $\xi_1 = 0$. The welfare gain becomes 0.33% of steady-state consumption in the counterfactual model of fixed ω_t . Thus, the endogenous risk-weighting channel leads to a modest welfare loss of about 0.06% of consumption equivalent units.

5.5. SOE loan risks in CAR constraints. The adverse reallocation effect of monetary policy shock relies on the model’s key feature that SOE loans are considered to be safer but less efficient than POE loans. Under the CAR constraint with endogenous risk-weighting, an expansionary monetary policy leads to the bank allocating more SOE loans, resulting in a lower productivity. To highlight the effect of SOE loan risks, we specify the risk-weighting function $h(\omega_t)$ as

$$h(\omega_t) = \xi [\phi \omega_t^2 \tilde{\sigma}_s^2 + (1 - \omega_t)^2 \tilde{\sigma}_p^2]^\rho, \quad (52)$$

where the parameter $\phi > 0$ captures the bank’s evaluation of the riskiness of SOE loans when calculating the risk weight. The model with $\phi = 1$ corresponds to the baseline case. A larger $\phi > 1$ corresponds to the case where banks consider SOE loans as riskier

Notes: This figure shows the welfare implication of an expansionary monetary policy. The risk-weighting function takes the form of $h(\omega_t) = \xi [\sigma_{zt}(\omega_t)]^\rho + \frac{\xi_1}{2}(\omega_t - \omega)^2$. A larger value of ξ_1 indicates a weaker risk-weighting channel. The vertical axes show the welfare measured by the percentage of steady-state consumption. The horizontal axes show the value of parameter ξ_1 . The baseline model corresponds to the case of $\xi_1 = 0$ (yellow circle), and the counterfactual case with a constant SOE loan share corresponds to $\xi_1 = \infty$ (red dashed line).

assets when calculating the risk weight in the CAR constraint. In the latter case, the leverage may not increase as much as in the baseline model following a monetary easing, resulting in a weaker adverse reallocation effect of a monetary expansion. Figure 5 displays the aggregate dynamics in response to a favorable monetary policy shock under different levels of the bank's evaluation of SOE loan risks. When the bank considers SOE loans riskier (ϕ increases), the SOE loan share and the leverage increase less than those in the baseline model with $\phi = 1$. As a result, the aggregate productivity loss due to the credit misallocation becomes lower. Moreover, the weakened endogenous risk-weighting channel implies that the monetary policy shock causes a smaller decline in the bank's credit risks and a more considerable reduction in the insolvency risk. Since the endogenous risk-weighting channel depresses the welfare gain of a monetary easing, we expect that the welfare gain is increasing in the bank's perceived SOE loan risks in the

CAR constraint (captured by ϕ). Our quantitative exercise shows that the welfare gains are 0.029% and 0.031% of steady-state consumption in the control models with $\phi = 2.5$ and $\phi = 5$, respectively. Notice that the baseline model's welfare gain is 0.027% of steady-state consumption. Therefore, when the bank considers the SOE loans as riskier assets when calculating the risk weight in the CAR constraint, the welfare gain of an expansionary monetary policy is amplified.

6. CONCLUSION

We present robust evidence that the implementation of Basel III regulations in 2013 has significantly changed Chinese banks' risk-taking behaviors and their responses to monetary policy shocks. After the regulatory policy changes, banks reduced risk-taking by increasing the share of lending to SOEs, both on average and conditional on monetary policy expansions. The declines in bank risk-taking following a monetary policy expansion are both statistically significant and economically important. Our estimation suggests that a one standard deviation increase in the exogenous component of M2 growth raises the probability of SOE lending by up to 14% after the new regulations were put in place in 2013.

In China, banks can reduce their loan risks by shifting lending to SOEs, because SOE loans receive high credit ratings under government guarantees. However, SOEs have lower average productivity than private firms. Thus, increasing lending to SOEs reduces aggregate productivity. Our evidence supports this reallocation channel.

In a two-sector general equilibrium model calibrated to the Chinese data, we show that the bank risk-taking channel has quantitatively important macroeconomic implications. Consistent with our empirical evidence, the model predicts that an expansionary monetary policy shock raises bank lending to SOEs, leading to persistent TFP declines that partially offset the expansionary effects of the shock. Moreover, the model predicts that a shift in bank lending towards SOEs lending exacerbates the financial instability due to higher insolvency risks, even though the bank's risk-taking is mitigated. Therefore, the micro-prudential policy such as the CAR regulation leads to opposing effects on the bank's credit risks and insolvency risks.

Although our data are from China, the general implications of our findings for the interconnection between monetary policy, bank risk-taking, and capital allocation efficiency are not specific to that country. Our evidence suggests that changes in capital regulations that increase the sensitivity of risk weighting helps reduce bank risk-taking following monetary policy expansions. However, in the presence of other distortions such as industrial policies that favor some inefficient firms (e.g., SOEs in China), banks reduce

FIGURE 5. Transition dynamics following an expansionary monetary policy: riskier SOE loans

Notes: This figure shows the dynamic responses to an expansionary monetary policy shock under different riskiness of SOE loans. The endogenous risk-weighting function satisfies $h(\omega_t) = \xi [\phi \omega_t^2 \tilde{\sigma}_s^2 + (1 - \omega_t)^2 \tilde{\sigma}_p^2]^\rho$. The parameter ϕ captures the bank's evaluation on the riskiness of SOE loans when calculating the risk weight. A larger ϕ implies that the bank considers the SOE loans much riskier for the risk weight. The vertical axes show percentage deviations from the initial steady state (e.g., 0.01 corresponds to 1%). The horizontal axes show the periods after the impact period of the shock. The solid lines denote the responses in the benchmark model; the dashed/dotted lines are those in the counterfactual cases with different values of ϕ .

risk-taking by increasing lending to those favored firms, creating capital misallocations that depress aggregate productivity. The tradeoff between bank risk-taking and capital misallocations identified in our study is likely to play an important role for designing optimal macroeconomic stabilization policies.

Appendices

APPENDIX A. BASEL III IMPLEMENTATION AND CHANGES IN CHINA'S BANK CAPITAL REGULATIONS

In June 2012, the China Banking Regulatory Commission (CBRC) issued the “Capital Rules for Commercial Banks (Provisional)” (or *Capital Rules*), formally announcing the implementation of the Basel III capital regulations in China for all 511 commercial banks in the country, effective on January 1, 2013. The new policy specified in the *Capital Rules* requires commercial banks to have a CAR of at least 8%, where the CAR is calculated as the ratio of bank capital net of deductions to risk-weighted assets. Commercial banks are required to hold an additional capital conservation buffer equivalent to 2.5% of risk-weighted assets, bringing the minimum CAR requirement to 10.5%. For systemically important banks, the minimum CAR was raised further to 11.5%. Banks should also hold a countercyclical capital buffer, the size of which varies between 0 and 2.5% of risk-weighted assets.¹

The implementation of Basel III regulation in China not just raised the minimum CAR, but also changed the approach to measuring bank assets for calculating the CAR. Before 2013, bank assets were calculated based on the *Regulatory Weighting (RW) Approach*. The RW approach assigns ad hoc risk weights to different categories of loans, independent of credit risks.² Under the new regulatory regime after 2013, a commercial bank is allowed (and often encouraged) to calculate its assets using the *Internal Ratings Based (IRB) Approach*.³ The IRB approach assigns risk weights to loans based on their credit risks. A loan with a higher credit rating would receive a lower risk weight.⁴ All else being equal, SOE loans receive higher credit ratings than private firms. Thus, the IRB approach assigns a lower risk weight on SOE loans.

¹For more details about the new regulation, see <http://www.cbrc.gov.cn/EngdocView.do?docID=86EC2D338BB24111B3AC5D7C5C4F1B28>.

²For example, the risk weight on a commercial bank's claims on corporates is 100%, regardless of the firms' credit rating.

³The CBRC encouraged commercial banks to adopt the Internal Ratings Based Approach when evaluating risk-weighted assets. According to the regulation, the commercial bank can apply to the CBRC for adopting the Internal Ratings Based Approach. The minimal requirement for the applicant bank is that the coverage of the Internal Ratings Based Approach should be no less than 50% of the total risk-weighted assets, and this ratio must reach 80% within three years.

⁴For example, Article 76 of the *Capital Rules* specifies that the risk weights for non-retail exposures not in default are calculated based on the probability of default (PD), loss at given default (LGD), exposure at default (EAD), correlation and maturity (M) of each individual exposure.

The introduction of the IRB approach to calculating risk-weighted assets has changed the effective CAR. Since 2013, the “Big Five” commercial banks started to regularly release an annual report of their CARs, with different definitions: one based on the pre-2013 Regulatory Weighting (RW) approach, and the other on the new IRB approach.⁵

The difference between the effective CAR calculated based on these two different approaches is illustrated by Table A.1, which shows the CAR disclosure from the 2013 annual report of the Bank of China (BoC), one of the Big Five, and the Bank of China Group.

TABLE A.1. Capital and Capital Adequacy Ratios

	End of 2014		End of 2013	
	BoC Group	BoC	BoC Group	BoC
CAR based on IRB approach under the new (2012) <i>Capital Rules</i>				
Core Tier 1 Capital	1,054,389	929,096	912,948	802,861
Tier 1 Capital	1,127,312	1,000,841	913,646	802,861
Capital	1,378,026	1,234,879	1,173,347	1,040,740
Core CAR (Tier 1)	10.61%	10.48%	9.69%	9.55%
CAR (Tier 1)	11.35%	11.29%	9.70%	9.55%
CAR	13.87%	13.93%	12.46%	12.38%
CAR based on RW approach under the old (2004) regulations				
Core CAR	11.04%	11.20%	10.73%	10.92%
CAR	14.38%	14.45%	13.47%	13.43%

Notes: The amounts of capital are in units of million Yuans. For the CARs in the first panel, the bank uses the Internal Ratings Based (IRB) approach to assess risk-weighted assets for 2014 and Regulatory Weighting (RW) approach for 2013.

Figure A.1 shows the quarterly average value of the RW-based CAR (the dashed line) and the IRB-based CAR (the solid line) for the Big Five banks. In 2013 when the

⁵The Industrial and Commercial Bank of China (ICBC), the Bank of China (BOC), the Construction Bank of China (CBC), the Agricultural Bank of China (ABC), and the Bank of Communications (BCM) are the top five commercial banks in China. They are also state-owned banks. According to China Banking Regulatory Commission, from 2007 to 2017, the Big Five banks accounted for approximately half of the total loans in the banking sector.

FIGURE A.1. The Average Capital Adequacy Ratios for “Big Five” with Different Definitions

Notes: This figure presents the quarterly average CARs of the “Big Five” commercial banks. The “old” definition of CAR uses the regulatory weighting (RW) approach (the dashed line) and the “new” definition uses the Internal Ratings -Based (IRB) approach (the solid line). The shaded area indicates the periods from 2013Q1 to 2014Q1, when the new regulation has enacted but the banks still use the Regulatory Weighting approach to assess risk-weighted assets when calculating their CARs. Data source: WIND.

CBRC began to implement the Basel III regulations, the IRB-based CAR was substantially below the traditional RW-based CAR (with the period highlighted by the shadow area). The IRB-based CAR caught up quickly with the RW-based CAR by mid-2014. Since 2017, the IRB-based CAR has exceeded the traditional RW-based CAR. The time-variation of the gap between the IRB-based and RW-based CARs reflects (at least partly) the banks’ risk-weight adjustments in their asset allocations following the implementation of Basel III regulations.

APPENDIX B. CALIBRATION DETAILS

This section describes our approach to calibrating the TFP distribution parameters for each sector and the parameters in the risk-weighting function in our dynamic model.

Calibrating sector-level TFP distributions. We first discuss the procedure for the calibration of sectoral TFP distribution. We use the Annual Survey of Industrial Firms conducted by China's National Bureau of Statistics for calibrating the model parameters. The survey data cover all the state-owned firms and non-state firms with sales above 5 million RMB from 1998-2007. We clean up the sample by discarding some observations with extreme or implausible values. [Liu et al. \(2021\)](#) give more descriptions about the dataset we use.

We compute firm-level TFP based on the production function, using data on capital and labor inputs and value-added output. In particular, the production function for firm i in industry m takes Cobb-Douglas form that used in the model

$$y_{mit} = (z_{mit}k_{mit})^\alpha (l_{mit})^{1-\alpha}, \quad (\text{B.1})$$

where y_{mit} denotes output, k_{mit} and l_{mit} denote the inputs of capital and labor, respectively, and z_{mit} denotes the firm-level TFP. The parameter $\alpha \in (0, 1)$ denotes the capital share. We assume that all the firms face the same production function parameters, which are calibrated at $\alpha = 0.5$. The production function implies that the firm-level TFP for j -type firms z_t^j , $j \in \{s, p\}$, is given by

$$z_{mit}^j = \left[\frac{y_{mit}^j}{(k_{mit}^j)^\alpha (l_{mit}^j)^{1-\alpha}} \right]^{\frac{1}{\alpha}}, \quad (\text{B.2})$$

where we measure the firm's output by value added, capital input by the value of fixed assets, and labor input by its employment size.⁶

After obtaining the firm-level TFP, we can compute the industry-level TFP for POEs using the relation

$$\bar{z}_{mt}^p = \frac{1}{N_{mt}^p} \sum_i z_{mit}^j, \quad (\text{B.3})$$

where $\bar{z}_{mt}^p$ denotes the industry-level TFP for POE firms in industry m , N_{mt}^p denotes the number of POE firms in industry m , and year t . We normalize a firm's idiosyncratic component of productivity to be $\tilde{z}_{mit}^j = \frac{z_{mit}^j}{\bar{z}_{mt}^p}$, which corresponds to the $\tilde{z}_j$ in our baseline

⁶The units of value added, fixed assets are expressed in trillions of RMB. The unit of employment is in millions of workers. SOEs are defined based on the firms' registration code "141", "143" and "151".

model. We then compute the economy-wide average TFP for j -type firms $\bar{z}_t^j$ as the average of the scaled industry-level TFP. In particular, TFP for j -type firms is given by

$$\bar{z}_t^j = \frac{1}{M_t} \sum_m \left(\frac{1}{N_{mt}^j} \sum_i \tilde{z}_{mit}^j \right), \quad j \in \{s, p\}. \quad (\text{B.4})$$

Notice that according to the definition of $\tilde{z}_{mit}^j$, the average of the industry-level TFP for POE firms $\frac{1}{N_{mt}^j} \sum_i \frac{1}{N_{mt}^j} \tilde{z}_{mit}^j$ is 1, so we set $\mu_p = 1$. To calibrate μ_s , we compute the average value of $\bar{z}_t^s$ over the sample years (1998-2007), which is 0.55, so we set $\mu_s = 0.55$. To calibrate σ_j , we compute the economy-wide standard deviation of $\tilde{z}_{mit}^j$, and obtain $\sigma(\tilde{z}_{mit}^s) = 1.42$ and $\sigma(\tilde{z}_{mit}^p) = 1.70$. So we calibrate $\sigma_s = 1.42$ and $\sigma_p = 1.70$.

Calibrating the risk weighting function. We use the information from the bank-level risk-adjusted weight h_t^i and the share of safe loans ω_t^i for bank i in year t to calibrate the parameters in the risk weighting function $h_t^i = \xi [\sigma_{zt}(\omega_t)]^\rho$. The risk weighting function can be written in log terms as

$$\log(h_t^i) = \log(\xi) + \rho \log(\sigma_{zt}(\omega_t^j)), \quad (\text{B.5})$$

where $\sigma_{zt}(\omega_t^j) = \sqrt{(\omega_t^j)^2 \sigma_s^2 + (1 - \omega_t^j)^2 \sigma_p^2}$. To calibrate parameters ξ and ρ , we regress the observed $\log(h_t^i)$ on a constant and the constructed $\sigma_{zt}(\omega_t^j)$.

The data that we use are from the annual CAR reports issued by the Big Five banks over the periods of 2014 to 2018. The risk-adjusted weight h_t^i for bank i in year t is measured by the average weight for the non-retail risk exposure at the bank level.⁷ The annual CAR report for individual bank discloses the detailed information of non-retail risk exposure based on the internal ratings approach. Each bank classifies the loans into different ratings according to the default risks. We define those loans with default probability below 1% as safe loans. We then measure ω_t^i by the share of safe loans in all loans for bank i in year t . The sample covers the Big Five banks for the years from 2013 to 2017, the periods after China's implementation of Basel III regulations.

We use these observed data to estimate the empirical specification in Eq. (B.5) using the OLS approach. We obtain a point estimate of the intercept of -0.3389 and a slope of 0.7395 , both statistically significant at the 99% confidence level. These estimates imply that $\xi = \exp(-0.3389) = 0.7126$ and $\rho = 0.7395$, which are the calibrated values that we use for solving the dynamic model.

⁷According to the annual CAR report of commercial banks, the non-retail risk exposure includes loans issued to corporations, public institutions and professional loan customers.

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Supplemental Appendices: For Online Publication

APPENDIX S.1. PROOFS

This section provides the proofs of the propositions in Section 3.

Proof of Proposition 1.

Proof. The optimizing condition (11) can be written as

$$g(\sigma; r, \Delta) \equiv \frac{v(\sigma; r, \Delta)}{2 \left[(\phi_1 - \phi_2 \sigma + \frac{1}{2} \Delta) \sigma - r(1 - \psi \Delta^\rho \sigma^\rho) \right]} = 0, \quad (\text{S.1.1})$$

where

$$v(\sigma; r, \Delta) = -(3 - \rho) \phi_2 \sigma^2 + (1 - \rho) \left(\phi_1 + \frac{1}{2} \Delta \right) \sigma + (1 + \rho) r - (1 - \rho) r \psi (\Delta \sigma)^\rho.$$

Therefore, $g(\sigma; r, \Delta) = 0$ is equivalent to $v(\sigma; r, \Delta) = 0$.

Under the CAR constraint, we have $\frac{e}{k} = \psi (\Delta \sigma)^\rho < 1$. Then, we have

$$v(\sigma; r, \Delta) > -(3 - \rho) \phi_2 \sigma^2 + (1 - \rho) \left(\phi_1 + \frac{1}{2} \Delta \right) \sigma + 2\rho r > \left[-(3 - \rho) \phi_2 \sigma + (1 - \rho) \left(\phi_1 + \frac{1}{2} \Delta \right) \right] \sigma.$$

The last equation implies that $v(\sigma; r, \Delta) > 0$ for any $\sigma \in (0, \hat{\sigma})$, where $\hat{\sigma} \equiv \frac{(1-\rho)(\phi_1 + \frac{1}{2}\Delta)}{(3-\rho)\phi_2}$.

Moreover, for any $\sigma \in [\hat{\sigma}, \bar{\sigma})$ we have

$$\frac{\partial v(\sigma; r, \Delta)}{\partial \sigma} \equiv v_\sigma = -2(3 - \rho) \phi_2 \sigma + (1 - \rho) \left(\phi_1 + \frac{1}{2} \Delta \right) - (1 - \rho) \rho r \psi \Delta^\rho \sigma^{\rho-1}. \quad (\text{S.1.2})$$

Notice that the RHS in the last equation is less than $-(1 - \rho) \left(\phi_1 + \frac{1}{2} \Delta \right) - (1 - \rho) \rho r \psi \Delta^\rho \sigma^{\rho-1}$, due to the fact that $-2(3 - \rho) \phi_2 \sigma + (1 - \rho) \left(\phi_1 + \frac{1}{2} \Delta \right) \leq -2(3 - \rho) \phi_2 \hat{\sigma} + (1 - \rho) \left(\phi_1 + \frac{1}{2} \Delta \right) = -(1 - \rho) \left(\phi_1 + \frac{1}{2} \Delta \right)$. Therefore, we have

$$v_\sigma \leq -(1 - \rho) \left(\phi_1 + \frac{1}{2} \Delta \right) - (1 - \rho) \rho r \psi \Delta^\rho \sigma^{\rho-1} < 0. \quad (\text{S.1.3})$$

We also have

$$v(\hat{\sigma}; r, \Delta) = (1 + \rho) r - (1 - \rho) r \psi \Delta^\rho \hat{\sigma}^\rho > 2\rho r > 0, \quad (\text{S.1.4})$$

and

$$\begin{aligned} v(\bar{\sigma}; r, \Delta) &= -(3 - \rho) \phi_2 \bar{\sigma}^2 + (1 - \rho) \left(\phi_1 + \frac{1}{2} \Delta \right) \bar{\sigma} + (1 + \rho) r - (1 - \rho) r \psi \Delta^\rho \bar{\sigma}^\rho \\ &= -\rho [\bar{R}(\sigma, \Delta) - r] - (1 - \rho) r \psi \Delta^\rho \bar{\sigma}^\rho < 0. \end{aligned} \quad (\text{S.1.5})$$

The second line for $v(\bar{\sigma}; r, \Delta)$ is obtained by using the definition of $\bar{\sigma}$, the optimal choice of an unconstrained bank, i.e. $3\phi_2 \bar{\sigma}^2 = (\phi_1 + \frac{1}{2} \Delta) \bar{\sigma} + r$. The intermediate value theorem implies that there exists a unique $\sigma \in (0, \bar{\sigma})$ that maximizes the bank's expected profit (i.e., Eq. (S.1.1) holds).

We first show that $\frac{\partial \sigma}{\partial \psi} < 0$. From $v(\sigma; r, \Delta) = 0$, we have $\frac{d\sigma}{d\psi} = -\frac{v_\psi}{v_\sigma}$. Since $v_\psi = -(1-\rho)r\Delta^\rho\sigma^\rho < 0$ and $v_\sigma < 0$ for any $\sigma \in [\hat{\sigma}, \bar{\sigma})$, we obtain $\frac{d\sigma}{d\psi} < 0$.

We next show that $\frac{\partial \sigma}{\partial \rho} < 0$. Based on $v(\sigma; r, \Delta) = -(3-\rho)\phi_2\sigma^2 + (1-\rho)(\phi_1 + \frac{1}{2}\Delta)\sigma + (1+\rho)r - (1-\rho)r\psi\Delta^\rho\sigma^\rho = 0$, we have

$$\begin{aligned} v_\rho &= \phi_2\sigma^2 - (\phi_1 + \frac{1}{2}\Delta)\sigma + r + r\psi(\sigma\Delta)^\rho - (1-\rho)r\psi(\sigma\Delta)^\rho \log(\sigma\Delta) \\ &= \frac{1}{\rho} \left[3\phi_2\sigma^2 - (\phi_1 + \frac{1}{2}\Delta)\sigma - r + r\psi(\sigma\Delta)^\rho \right] - (1-\rho)r\psi(\sigma\Delta)^\rho \log(\sigma\Delta) \\ &< -\frac{1}{\rho} \left[-3\phi_2\sigma^2 + (\phi_1 + \frac{1}{2}\Delta)\sigma + R^*(\sigma, \Delta) \right] < 0 \end{aligned}$$

The term in the bracket is the F.O.C. for portfolio decision without CAR constraint, which is definitely positive for the problem with CAR constraint. Therefore,

$$\frac{\partial \sigma}{\partial \rho} = -\frac{v_\rho}{v_\sigma} < 0$$

Finally, we show that $\frac{\partial \sigma}{\partial \Delta} > 0$. Applying the implicit function theorem to the optimal condition $v(\sigma; r, \Delta) = 0$ yields

$$\begin{aligned} \frac{\partial \sigma}{\partial \Delta} &= -\frac{\nu_\Delta}{\nu_\sigma} \\ &= -\frac{(1-\rho)}{2\nu_\sigma} (\sigma - 2\rho r\psi\Delta^{\rho-1}\sigma^\rho) \\ &= -\frac{(1-\rho)}{2\nu_\sigma\Delta\lambda} (\lambda\Delta\sigma - 2\rho r) \\ &> -\frac{(1-\rho)}{2\nu_\sigma\Delta\lambda} \left(\frac{1}{\psi} - 2\rho r \right) > 0, \end{aligned}$$

where the last inequality obtains under the assumptions that $r\psi < \frac{1}{2}$ and $\rho \in (0, 1)$, because $\nu_\sigma < 0$. $\square$

Proof of Proposition 2.

Proof. Applying the implicit function theorem to $v(\sigma; r, \Delta) = 0$ yields

$$\frac{d\sigma}{dr} = -\frac{v_r}{v_\sigma} = -\frac{(1+\rho) - (1-\rho)\psi(\sigma\Delta)^\rho}{v_\sigma}, \quad (\text{S.1.6})$$

where v_σ is given by (S.1.3). The second equality is from the definition of v_r . Notice that under the binding CAR constraint, we have $\lambda = \frac{1}{\psi(\sigma\Delta)^\rho} > 1$ and $v_\sigma < 0$, therefore $(1+\rho) - (1-\rho)\frac{(\sigma\Delta)^\rho}{\psi} > 0$ implying $\frac{d\sigma}{dr} > 0$. Moreover, from the CAR constraint we have

$$\frac{d\lambda}{dr} = -\frac{\rho}{\psi\Delta^\rho\sigma^{\rho-1}} \frac{d\sigma}{dr} < 0. \quad (\text{S.1.7})$$

$\square$

Proof of Proposition 3.

Proof. Without loss of generality, we assume $\Delta = 1$. The proof proceeds similarly for any $\Delta > 1$. We first show that $\frac{\partial^2 \sigma}{\partial r \partial \psi} < 0$, which is equivalent to

$$\begin{aligned}
\frac{\partial^2 \sigma}{\partial r \partial \psi} &= \frac{\partial}{\partial r} \left[\frac{\partial \sigma}{\partial \psi} \right] = \frac{\partial}{\partial r} \left[\frac{1-\rho}{v_\sigma} r \sigma^\rho \right] \\
&= \frac{1-\rho}{v_\sigma} \sigma^\rho - \frac{1-\rho}{v_\sigma^2} r \sigma^\rho \frac{dv_\sigma}{dr} + \frac{(1-\rho)\rho}{v_\sigma} r \sigma^{\rho-1} \frac{\partial \sigma}{\partial r} \\
&= \frac{1-\rho}{v_\sigma} \sigma^\rho - \frac{1-\rho}{v_\sigma} r \sigma^\rho \frac{\partial \sigma}{\partial r} \left(\frac{v_{\sigma\sigma}}{v_\sigma} - \frac{\rho}{\sigma} \right) + \frac{\rho(1-\rho)^2}{v_\sigma^2} r \psi \sigma^\rho \sigma^{\rho-1} \\
&= \frac{1-\rho}{v_\sigma} \sigma^\rho + \frac{(1-\rho)(1+\rho)}{v_\sigma^2} r \sigma^\rho \left(1 - \frac{1-\rho}{1+\rho} \psi \sigma^\rho \right) \left(\frac{v_{\sigma\sigma}}{v_\sigma} - \frac{\rho}{\sigma} \right) + \frac{\rho(1-\rho)^2}{v_\sigma^2} r \psi \sigma^\rho \sigma^{\rho-1} \\
&= \frac{1-\rho}{v_\sigma^2} \sigma^\rho \left[v_\sigma + \rho(1-\rho) r \psi \sigma^{\rho-1} + \frac{(1+\rho)r}{\sigma} \left(1 - \frac{1-\rho}{1+\rho} \psi \sigma^\rho \right) \left(\frac{\sigma v_{\sigma\sigma}}{v_\sigma} - \rho \right) \right] \\
&= \frac{1-\rho}{v_\sigma^2} \sigma^\rho \left[-2(3-\rho) \phi_2 \sigma + (1-\rho) \left(\phi_1 + \frac{1}{2} \right) + \frac{(1+\rho)r}{\sigma} \left(1 - \frac{1-\rho}{1+\rho} \psi \sigma^\rho \right) \left(\frac{\sigma v_{\sigma\sigma}}{v_\sigma} - \rho \right) \right].
\end{aligned}$$

The last line is obtained with v_σ given by (S.1.3). To further simplify the last equation, from $v(\sigma; r, \psi) = 0$, we have

$$-(3-\rho) \phi_2 \sigma = -\frac{(1+\rho)r}{\sigma} \left(1 - \frac{1-\rho}{1+\rho} \psi \sigma^\rho \right) - (1-\rho) \left(\phi_1 + \frac{1}{2} \right). \quad (\text{S.1.8})$$

Therefore, $\frac{\partial^2 \sigma}{\partial r \partial \psi}$ can be further expressed as

$$\frac{\partial^2 \sigma}{\partial r \partial \psi} = -\frac{1-\rho}{v_\sigma^3} \sigma^\rho \Psi, \quad (\text{S.1.9})$$

where

$$\begin{aligned}
\Psi &= (3-\rho) \phi_2 \sigma v_\sigma + \frac{(1+\rho)r}{\sigma} \left(1 - \frac{1-\rho}{1+\rho} \psi \sigma^\rho \right) [(1+\rho) v_\sigma - \sigma v_{\sigma\sigma}], \\
v_{\sigma\sigma} &= -2(3-\rho) \phi_2 + (1-\rho)^2 \rho r \psi \sigma^{\rho-2}, \\
v_\sigma &= -2(3-\rho) \phi_2 \sigma + (1-\rho) \left(\phi_1 + \frac{1}{2} \right) - (1-\rho) \rho r \psi \sigma^{\rho-1}.
\end{aligned}$$

Since we have $v_\sigma < 0$, to $\frac{\partial^2 \sigma}{\partial r \partial \psi} < 0$ is equivalent to $\Psi < 0$. We simplify Ψ as

$$\Psi = -(3-\rho) \phi_2 \sigma \left[(3-\rho) \phi_2 \sigma + \frac{\rho(1+\rho)r}{\sigma} \right] - (1+\rho) \frac{r}{\sigma} \left(1 - \frac{1-\rho}{1+\rho} \psi \sigma^\rho \right) \Xi, \quad (\text{S.1.10})$$

where $\Xi = [(3-\rho) \phi_2 (\rho+1) \sigma - (1-\rho)(1+\rho) (\phi_1 + \frac{1}{2}) + 2(1-\rho) \rho r \psi \sigma^{\rho-1}]$. Notice that from the previous analysis, we have $\sigma > \hat{\sigma} = \frac{(1-\rho)(\phi_1 + \frac{1}{2})}{(3-\rho)\phi_2}$.

Therefore, we obtain

$$\Xi > (3 - \rho) \phi_2 (\rho + 1) \sigma - (1 - \rho) (1 + \rho) \left(\phi_1 + \frac{1}{2} \right) > 0, \quad (\text{S.1.11})$$

which implies that $\Psi < 0$, and thereby $\frac{\partial^2 \sigma}{\partial r \partial \psi} < 0$.

We next show that $\frac{\partial^2 \sigma}{\partial r \partial \rho} > 0$, which is equivalent to

$$\begin{aligned} \frac{\partial}{\partial \rho} \left[\frac{\partial \sigma}{\partial r} \right] &= -\frac{\partial}{\partial \rho} \left[\frac{v_r}{v_\sigma} \right] = -\frac{v_{r\rho} + v_{r\sigma} \frac{d\sigma}{d\rho}}{v_\sigma} + \frac{v_r}{v_\sigma^2} \left[v_{\sigma\rho} + v_{\sigma\sigma} \frac{d\sigma}{d\rho} \right] \\ &= \frac{v_{r\sigma} v_\rho + v_{\sigma\rho} v_r - v_{r\rho} v_\sigma}{v_\sigma^2} - \frac{v_r v_\rho v_{\sigma\sigma}}{v_\sigma^3} > 0 \end{aligned}$$

where

$$\begin{aligned} v_\sigma &= -2(3 - \rho) \phi_2 \sigma + (1 - \rho) \left(\phi_1 + \frac{1}{2} \right) - \rho(1 - \rho) r \psi \sigma^{\rho-1} < 0 \\ v_r &= (1 + \rho) - (1 - \rho) \psi \sigma^\rho > 0 \\ v_\rho &= \phi_2 \sigma^2 - \left(\phi_1 + \frac{1}{2} \right) \sigma + r + r \psi \sigma^\rho - (1 - \rho) r \psi \sigma^\rho \log \sigma < 0 \\ v_{r\sigma} &= -\rho(1 - \rho) \psi \sigma^{\rho-1} < 0 \\ v_{r\rho} &= 1 + \psi \sigma^\rho - (1 - \rho) \psi \sigma^\rho \log \sigma > 0 \\ v_{\sigma\rho} &= 2\phi_2 \sigma - \left(\phi_1 + \frac{1}{2} \right) - (1 - 2\rho) r \psi \sigma^{\rho-1} - \rho(1 - \rho) r \psi \sigma^{\rho-1} \log \sigma \\ v_{\sigma\sigma} &= -2(3 - \rho) \phi_2 + \rho(1 - \rho)^2 r \psi \sigma^{\rho-2} \end{aligned}$$

First,

$$\begin{aligned} v_{\sigma\sigma} &= -2(3 - \rho) \phi_2 + \rho(1 - \rho)^2 r \psi \sigma^{\rho-2} < -2(3 - \rho) \phi_2 + \rho(1 - \rho)^2 \frac{r}{\sigma} \psi \sigma^\rho \frac{1}{\sigma} \\ &= -2(3 - \rho) \phi_2 + \rho(1 - \rho)^2 \frac{r}{\sigma} \psi \sigma^\rho \frac{(3 - \rho) \phi_2}{(1 - \rho) \left(\phi_1 + \frac{1}{2} \right)} \\ &= -(3 - \rho) \phi_2 \left[2 - \rho(1 - \rho) \frac{r}{\sigma} \psi \sigma^\rho \frac{1}{\left(\phi_1 + \frac{1}{2} \right)} \right] < 0 \end{aligned}$$

Second,

$$\begin{aligned} &v_{r\sigma} v_\rho + v_r v_{\sigma\rho} - v_\sigma v_{r\rho} \\ &= -\rho(1 - \rho) \psi \sigma^\rho \left[\phi_2 \sigma - \left(\phi_1 + \frac{1}{2} \right) + \frac{r}{\sigma} + r \psi \sigma^{\rho-1} \left(1 - (1 - \rho) \log \sigma \right) \right] \\ &\quad + [(1 + \rho) - (1 - \rho) \psi \sigma^\rho] \left[2\phi_2 \sigma - \left(\phi_1 + \frac{1}{2} \right) - (1 - \rho) r \psi \sigma^{\rho-1} + \rho r \psi \sigma^{\rho-1} \left(1 - (1 - \rho) \log \sigma \right) \right] \\ &\quad + \left[2(3 - \rho) \phi_2 \sigma - (1 - \rho) \left(\phi_1 + \frac{1}{2} \right) + \rho(1 - \rho) r \psi \sigma^{\rho-1} \right] \left[1 + \psi \sigma^\rho \left(1 - (1 - \rho) \log \sigma \right) \right] \\ &= 8\phi_2 \sigma - 2 \left(\phi_1 + \frac{1}{2} \right) + (1 - \rho)(1 + \rho) \psi \sigma^\rho \left[\left(\phi_1 + \frac{1}{2} \right) - \frac{2 + \rho}{1 + \rho} \phi_2 \sigma - \frac{r}{\sigma} \left(1 - \frac{1 - \rho}{1 + \rho} \psi \sigma^\rho \right) \right] \end{aligned}$$

$$\begin{aligned}
& + \psi \sigma^\rho \left[1 - (1 - \rho) \log \sigma \right] \left[2(3 - \rho) \phi_2 \sigma - (1 - \rho) \left(\phi_1 + \frac{1}{2} \right) + \rho(1 + \rho) \frac{r}{\sigma} \left(1 - \frac{1 - \rho}{1 + \rho} \psi \sigma^\rho \right) \right] \\
& = 8\phi_2 \sigma - 2 \left(\phi_1 + \frac{1}{2} \right) + (1 - \rho) \psi \sigma^\rho \left[2 \left(\phi_1 + \frac{1}{2} \right) - 5\phi_2 \sigma \right] \\
& + \psi \sigma^\rho \left[1 - (1 - \rho) \log \sigma \right] \left[2(3 - \rho) \phi_2 \sigma - (1 - \rho) \left(\phi_1 + \frac{1}{2} \right) + \rho(1 + \rho) \frac{r}{\sigma} \left(1 - \frac{1 - \rho}{1 + \rho} \psi \sigma^\rho \right) \right] \\
& > 0
\end{aligned}$$

The last inequality requires

$$\left[8 - 5(1 - \rho) \psi \sigma^\rho \right] \phi_2 \sigma - 2 \left[1 - (1 - \rho) \psi \sigma^\rho \right] \left(\phi_1 + \frac{1}{2} \right) > 0$$

A sufficient condition

$$\begin{aligned}
& \left[8 - 5(1 - \rho) \psi \sigma^\rho \right] \phi_2 \hat{\sigma} - 2 \left[1 - (1 - \rho) \psi \sigma^\rho \right] \left(\phi_1 + \frac{1}{2} \right) > 0 \\
& (1 - \rho) \left[8 - 5(1 - \rho) \psi \sigma^\rho \right] - 2(3 - \rho) \left[1 - (1 - \rho) \psi \sigma^\rho \right] > 0 \\
& 2(1 - 3\rho) + \psi \sigma^\rho (1 - \rho)(1 + 3\rho) > 0
\end{aligned}$$

which holds for relatively small ρ .

Thus, we obtain

$$\frac{\partial}{\partial \rho} \left[\frac{\partial \sigma}{\partial r} \right] = \frac{v_{r\sigma} v_\rho + v_{\sigma\rho} v_r - v_{r\rho} v_\sigma}{v_\sigma^2} - \frac{v_r v_\rho v_{\sigma\sigma}}{v_\sigma^3} > 0$$

□

Proof of Proposition 4.

Proof. We first prove $\frac{\partial^2 \sigma}{\partial \Delta \partial \rho} < 0$. It is equivalently to show

$$\frac{\partial}{\partial \Delta} \left[-\frac{v_\rho}{v_\sigma} \right] = v_{\rho\sigma} v_\Delta + v_\rho v_{\sigma\Delta} - v_{\rho\Delta} v_\sigma - v_\rho v_\Delta \frac{v_{\sigma\sigma}}{v_\sigma} < 0.$$

From the proof in Proposition 1, we can derive $v_{\rho\sigma}$, v_Δ , $v_{\sigma\Delta}$ and $v_{\sigma\sigma}$. Then, we can further write

$$\begin{aligned}
v_{\rho\sigma} v_\Delta + v_\rho v_{\sigma\Delta} - v_{\rho\Delta} v_\sigma & = \frac{(1 - \rho)}{2} \left[3\phi_2 \sigma^2 - \left(\phi_1 + \frac{1}{2} \Delta \right) \sigma + r \right] - (3 - \rho) \phi_2 \sigma^2 \\
& \quad - r \psi \Delta^{\rho-1} \sigma^{\rho-1} \left[(3 - 8\rho - \rho^2) \phi_2 \sigma^2 + 2\rho r - \rho \frac{(1-\rho)}{2} \Delta \sigma \right. \\
& \quad \left. + (1 - \rho)^2 r (1 - \psi \Delta^\rho \sigma^\rho) \right], \\
-v_\rho v_\Delta \frac{v_{\sigma\sigma}}{v_\sigma} & = -\frac{(1 - \rho)}{2} \sigma v_\rho \frac{v_{\sigma\sigma}}{v_\sigma} + (1 - \rho) \rho r \psi \Delta^{\rho-1} \sigma^\rho v_\rho \frac{v_{\sigma\sigma}}{v_\sigma}.
\end{aligned}$$

Therefore, we obtain

$$\begin{aligned}
& v_{\rho\sigma}v_{\Delta} + v_{\rho}v_{\sigma\Delta} - v_{\rho\Delta}v_{\sigma} - v_{\rho}v_{\Delta}\frac{v_{\sigma\sigma}}{v_{\sigma}} \\
& < -\frac{(1-\rho)}{2}\sigma\nu_{\rho}\frac{v_{\sigma\sigma}}{v_{\sigma}} + \frac{(1-\rho)}{2}\left[3\phi_2\sigma^2 - \left(\phi_1 + \frac{1}{2}\Delta\right)\sigma + r\right] - (3-\rho)\phi_2\sigma^2 \\
& = \frac{(1-\rho)}{v_{\sigma}}\left\{\frac{(3-\rho)}{(1-\rho)}\phi_2^2\sigma^3 + r\left[3\phi_2\sigma + \frac{(1-\rho)}{2}\left(\phi_1 + \frac{1}{2}\Delta\right)\right](1-\psi\Delta^{\rho}\sigma^{\rho})\right. \\
& \quad + \frac{6\rho r\phi_2\sigma}{(1-\rho)} + \frac{(1+\rho)r}{2}\left(\phi_1 + \frac{1}{2}\Delta\right) - r\psi\Delta^{\rho}\sigma^{\rho-1}\frac{(2-\rho)(1-\rho)}{2}\rho r \\
& \quad + r\psi\Delta^{\rho}\sigma^{\rho-1}\left[\left((3-\rho)\phi_2\sigma^2 - \frac{(1-\rho)^2}{2}\rho r\psi\Delta^{\rho}\sigma^{\rho}\right)(1-(1-\rho)\log(\Delta\sigma))\right. \\
& \quad \left. + \frac{(1-\rho)(2-\rho)\rho}{2}\left(\phi_1 + \frac{1}{2}\Delta\right)\sigma + \rho\frac{2+3\rho-\rho^2}{2}\phi_2\sigma^2\right]\left.\right\} \\
& < 0.
\end{aligned}$$

The last inequality holds as $v_{\sigma} < 0$, $\sigma > \hat{\sigma}$, and $\bar{R}(\sigma, \Delta) > r$, i.e.

$$\begin{aligned}
& \frac{6\rho r\phi_2\sigma}{(1-\rho)} - r\psi\Delta^{\rho}\sigma^{\rho-1}\frac{(2-\rho)(1-\rho)}{2}\rho r > 6\rho r\frac{\phi_1 + \frac{1}{2}\Delta}{3-\rho} - \frac{r}{\lambda\sigma}\frac{(2-\rho)(1-\rho)}{2}\rho r \\
& > \frac{\rho r}{\sigma}\left[\frac{6}{3-\rho}\bar{R}(\sigma, \Delta) - r\frac{(2-\rho)(1-\rho)}{2}\right] > \frac{\rho r^2}{\sigma}\left[2 - \frac{(2-\rho)(1-\rho)}{2}\right] > 0
\end{aligned}$$

and

$$\begin{aligned}
& (3-\rho)\phi_2\sigma^2 - \frac{(1-\rho)^2}{2}\rho r\psi\Delta^{\rho}\sigma^{\rho} > (1-\rho)\left[\left(\phi_1 + \frac{1}{2}\Delta\right)\sigma - \frac{\rho(1-\rho)r}{2\lambda}\right] \\
& > (1-\rho)\left[\bar{R}(\sigma, \Delta) - \frac{\rho(1-\rho)r}{2}\right] > (1-\rho)r\left[1 - \frac{\rho(1-\rho)}{2}\right] > 0.
\end{aligned}$$

We then prove $\frac{\partial}{\partial\Delta}\left[\frac{\partial\sigma}{\partial r}\Big|_{\rho=1} - \frac{\partial\sigma}{\partial r}\Big|_{\rho=0}\right] > 0$. In the case of $\rho = 0$, the sensitivity of bank risk-taking to the monetary policy shock satisfies

$$\frac{\partial\sigma}{\partial r}\Big|_{\rho=0} = \frac{1-\psi}{\sqrt{(\phi_1 + \frac{1}{2}\Delta)^2 + 12r(1-\psi)\phi_2}} > 0.$$

In the case of $\rho = 1$, the effect of interest rate on bank risk-taking is

$$\frac{\partial\sigma}{\partial r}\Big|_{\rho=1} = \sqrt{\frac{(1+\rho)}{(3-\rho)\phi_2}}\frac{1}{2\sqrt{r}} = \frac{1}{2\sqrt{r\phi_2}},$$

which does not depend on the bank's ability of risk management, Δ .

From last two equations, we can derive the impact of regulation change on the sensitivity of bank risk-taking to monetary policy shocks

$$\frac{\partial \sigma}{\partial r}|_{\rho=1} - \frac{\partial \sigma}{\partial r}|_{\rho=0} = \frac{1}{2\sqrt{r}\phi_2} - \frac{1-\psi}{\sqrt{(\phi_1 + \frac{1}{2}\Delta)^2 + 12r(1-\psi)\phi_2}} > 0,$$

which is increasing in the bank-specific risk Δ . $\square$

APPENDIX S.2. ROBUSTNESS OF EMPIRICAL ANALYSIS

Our baseline estimation results are robust to alternative measurements, model specifications, and additional controls.

Controlling for loan demand factors. Our baseline regression uses variations across time and across risk types of bank branches to identify the effects of changes in banking regulations and monetary policy. A potential concern is that increases in SOE lending in the post-2013 period might be driven by changes in loan demand of SOEs (relative to non-SOEs), instead of changes in lender decisions under the new regulations. This concern seems plausible, because China's economic growth has slowed during that period, discouraging production and investment activities of non-SOE firms.

To address this concern, we focus on the subsample of firms that borrow from multiple bank branches. This subsample allows us to control for time-varying borrower characteristics and therefore to isolate the effects of the policy changes through the loan supply channel. We use this subsample to estimate the impact of monetary policy shocks on the loan interest rate for different types of firms (SOE or non-SOE), before and after the implementation of Basel III. We use the same difference-in-difference identification approach as in the baseline case, exploiting the differences in the loan rates offered by high-risk vs. low-risk bank branches. Since we control for demand factors, changes in the loan rate should reflect changes in loan supply behaviors.

In the regression models that we consider here, the dependent variable is the firm-specific loan interest rate (denoted by $LoanRate_{i,j,t}$) offered to firm i by branch j in quarter t . We are interested in studying how a monetary policy shock affects the loan interest rates for an SOE firm relative to non-SOEs in the post-2013 period, and how the loan rate responses differ between high-risk and low-risk branches. This effect is captured by the coefficient on the quadruple interaction term $RiskH_j \times SOE_{i,t} \times MP_t \times Post_y$. Here, the term $SOE_{i,t}$ is a dummy variable, which equals one if firm i is an SOE firm and zero otherwise. The other variables are the same as defined in the baseline regression (18).

Table S.2.1 displays the regression results. Column (1) shows that, controlling for the branch fixed effects and the firm-year-quarter fixed effects, an expansionary monetary

TABLE S.2.1. Controlling for time-varying borrower characteristics

	(1)	(2)	(3)	(4)
	$LoanRate_{i,j,t}$	$RateGap_{i,j,t}$	$LoanRate_{i,j,t}$	$RateGap_{i,j,t}$
$RiskH_j \times SOE_{i,t} \times MP_t \times Post_y$	-18.86** (9.169)	-2.779** (1.407)	-19.31** (9.233)	-2.878** (1.435)
$RiskH_j \times MP_t \times Post_y$	15.58** (6.309)	2.239* (1.174)	15.70** (6.467)	2.336* (1.208)
$RiskH_j \times SOE_{i,t} \times MP_t$	7.960* (4.750)	1.597** (0.673)	8.407* (4.724)	1.609** (0.674)
$RiskH_j \times MP_t$	-15.34*** (2.699)	-2.186*** (0.414)	-15.33*** (2.684)	-2.180*** (0.414)
$RiskH_j \times SOE_{i,t} \times Post_y$	-0.0115 (0.0885)	0.00867 (0.0142)	-0.0169 (0.0881)	0.00806 (0.0143)
$RiskH_j \times SOE_{i,t}$	-0.281*** (0.0541)	-0.0387*** (0.00839)	-0.273*** (0.0538)	-0.0381*** (0.00836)
$RiskH_j \times Post_y$	0.124 (0.0781)	0.0235* (0.0133)	0.123 (0.0780)	0.0238* (0.0133)
$\ln(LoanAmount_{i,j,t})$			0.0102*** (0.0025)	0.001*** (0.0003)
Observations	15,552	15,552	15,470	15,470
R-squared	0.966	0.937	0.966	0.937
Branch FE	yes	yes	yes	yes
Firm-Year-Quarter FE	yes	yes	yes	yes

Notes: This table reports the estimation results using the subsample of firms that borrow from multiple bank branches. *LoanRate* is the loan interest rate (in %) on each loan. *RateGap* is the deviations of the loan rate from the benchmark loan rate. The monetary policy shock is constructed using the approach in [Chen et al. \(2018\)](#). Both models include controls for the branch fixed effects and the firm-year-quarter fixed effects. The numbers in the parentheses indicate robust standard errors. The levels of statistical significance are denoted by the asterisks: *** for $p < 0.01$, ** for $p < 0.05$, and * for $p < 0.1$. The data sample ranges from 2008:Q1 to 2017:Q4.

policy shock in the post-2013 period leads to a significant decline in the loan interest rate offered by a high-risk branch to an SOE firm relative to non-SOEs (i.e., a negative coefficient on $RiskH_j \times SOE_{i,t} \times MP_t \times Post_y$). The point estimate implies that a positive one standard deviation monetary policy shock (0.007) reduces the loan rate for

an SOE relative to non-SOEs by about 13 basis points ($-18.86 \times 0.007 \approx -0.13$). The same monetary policy shock raises the loan rate for a non-SOE firm (i.e., a positive coefficient on $RiskH_j \times MP_t \times Post_y$) by about 11 basis points ($15.58 \times 0.007 \approx 0.11$). These post-2013 lending behaviors of high-risk branches stand in contrast to those in the pre-2013 period. An expansionary monetary policy shock before 2013 raised the loan rate for SOEs and reduced that for non-SOEs for loans originated from high-risk branches (i.e., the coefficient on $RiskH_j \times SOE_{i,t} \times MP_t$ is positive whereas that on $RiskH_j \times MP_t$ is negative). These results suggest that, with increased risk-weighting sensitivity under the new regulations, bank lending behaviors have changed significantly following a monetary policy shock. Consistent with our baseline finding, monetary policy easing in the post-2013 period reduced bank risk-taking because bank lending favors SOEs, which are perceived as low-risk borrowers under government guarantees.⁸

These empirical patterns are robust to alternative measures of the loan costs. In particular, Column (2) in the table shows the regression results when we replace the loan interest rate $LoanRate_{i,j,t}$ by its deviations from the benchmark lending rate (denoted by $RateGap_{i,j,t}$). The qualitative results are the same. The results are also robust to controlling for the loan amount, as shown in Columns (3)-(4).

The difference between the pre- and post-2013 lending behaviors confirms our baseline finding that, under the new capital regulations, high-risk branches favored SOE lending following expansionary monetary policy shocks. Since we have controlled for time-varying borrower characteristics, the observed changes in lending behaviors following monetary policy shocks cannot be explained by changes in demand conditions; they are more likely driven by changes in lender decisions under the new regulations.

Using data from multiple banks. The advantage of using our baseline sample is that we have detailed loan-level data. The disadvantage is that the data are from a single bank. One concern is that the CAR regulations are applied to the bank-level consolidated balance sheet, not directly to the branch level. As we have argued, branches can still respond to regulation changes by adjusting the risk weights on their loans to conform with the bank-level guidance on risk-weighted assets. However, they cannot directly influence the bank-level capitalization.

⁸The table also shows that, absent monetary policy shocks, there is no significant difference in the loan rates that a high-risk branch charged on loans to SOE borrowers vs. non-SOEs in the post-2013 period, although SOE borrowers faced a lower loan rate before 2013.

To address this concern, we use confidential data from 17 Chinese banks for the period from 2007Q1 to 2013Q2 to examine how changes in the CAR regulations in 2013 have changed bank risk-taking.⁹

We measure the riskiness of a bank's loans by the share of the number of SOE loans in the total number of corporate loans ($SOE_{b,t}$), which is the dependent variable in our regressions. We measure the risk history of a bank by two alternative indicators. One is a dummy variable that equals one if a bank's average non-performing loan ratio (NPL) before 2013 (i.e., 2007-2012) is above the median; the other is a dummy variable that equals one if a bank's average loan delinquency ratio ($Delinq$) before 2013 is above the median. We use the same measures for monetary policy shocks (MP_t) and the post-Basel III indicator ($Post_y$) as in the baseline specification.

Table S.2.2 displays the regression results. Column (1) shows that high-risk banks (measured by the past NPL) respond to monetary policy easing by raising the share of SOE lending after the implementation of the Basel III regulations, confirming the baseline finding. However, absent monetary policy shocks, the average effect of the regulation changes on high-risk banks' SOE lending is no longer significant. We obtain similar results when we measure the risk history using the loan delinquency ratio (Column (2)).

Columns (3) and (4) add controls for the effects from the level of capitalization. In particular, we construct a dummy variable $CAR_{b,t}$ that equals one if and only if bank b is systemically important and the quarter t is after the implementation of the Basel III regulations in the beginning of 2013. This dummy variable captures the differential impact of the regulations on the required capitalization levels for systemically important banks, because the new regulations raised the minimum CAR for systemically important banks from 8% to 11.5% (compared to 10.5% for other banks). As shown in the table, banks with higher capitalization under the new regulations responded to an expansionary monetary policy shock by *reducing* the share of SOE loans, implying increased risk-taking (the coefficient on the tripple interaction term $RiskH_b \times MP_t \times CAR_{b,t}$ is significantly negative). After controlling for the heterogeneous changes in the required CAR across banks, the new regulations still significantly reduce bank risk-taking conditional on monetary policy easing (the coefficient on the tripple interaction term $RiskH_b \times MP_t \times Post_y$ is significantly positive).

These results from the multiple-bank sample confirm our baseline finding: under the new capital regulations, high-risk banks respond to a monetary policy easing by reducing

⁹Unfortunately, we do not have loan-level data from these banks and the sample ends by 2013Q2. Thus, the sample size here is much smaller than that in the baseline regressions.

TABLE S.2.2. Regressions using the sample with multiple banks

	(1)	(2)	(3)	(4)
DV: $SOE_{b,t}$	$RiskH = \text{NPL}$	$RiskH = \text{Delinq}$	$RiskH = \text{NPL}$	$RiskH = \text{Delinq}$
$RiskH_b \times MP_t \times Post_y$	0.652*** (0.127)	2.605*** (0.165)	0.797*** (0.124)	3.190*** (0.195)
$RiskH_b \times MP_t$	0.073 (0.816)	0.607 (0.777)	0.073 (0.818)	0.607 (0.780)
$RiskH_b \times Post_y$	-0.002 (0.012)	-0.012 (0.012)	-0.001 (0.013)	-0.013 (0.013)
$RiskH_b \times MP_t \times CAR_{b,t}$			-0.582** (0.245)	-2.338*** (0.775)
$RiskH_b \times CAR_{b,t}$			0.000 (0.000)	0.005 (0.006)
Observations	442	442	442	442
R-squared	0.246	0.249	0.246	0.250
Other Controls	-	-	yes	yes
Bank FE	yes	yes	yes	yes
Year-Quarter FE	yes	yes	yes	yes

Notes: The columns report OLS estimation results using the sample with 17 Chinese banks over the periods from 2007:Q1 to 2013:Q2. The dependent variable ($SOE_{b,t}$) for each regression is the share of the number of SOE loans in the total number of corporate loans for bank b in quarter t . The set of independent variables includes a bank's risk history ($RiskH_b$), which is a dummy variable that equals one if the bank's average non-performing loan ratio (NPL) in 2007-2012 is above the median (Columns (1) and (3)) or the average loan delinquency ratio (Delinq) in 2007-2012 is above the median (Columns (2) and (4)); a measure of monetary policy shocks (MP_t) constructed using the approach in [Chen et al. \(2018\)](#); and the post-Basel III dummy ($Post_y$). In Columns (3) and (4), the regressions include the interactions of an indicator for the level of capitalization $CAR_{b,t}$ with the risk history and the monetary policy shock, where $CAR_{b,t}$ is a dummy variable that equals one if and only if the bank b is systemically important and the quarter t is after the implementation of the Basel III regulations in the beginning of 2013. All regressions include controls for bank fixed effects and the year-quarter fixed effects. The regressions in Columns (3) and (4) also include controls for the level of $CAR_{b,t}$ and its interactions with MP_t and with $RiskH_b$. The numbers in the parentheses indicate robust standard errors. The levels of statistical significance are denoted by the asterisks: *** for $p < 0.01$, ** for $p < 0.05$, and * for $p < 0.1$.

risk-taking; and the reduction in risk-taking works mainly through the risk-weighting channel.

Controlling for the impact of interest rate liberalization. China has traditionally maintained interest-rate controls. Under the interest-rate control regime, the PBOC sets the benchmark deposit interest rate and the loan interest rate, and allow banks to offer a range of interest rates that are within a narrow band of those benchmark rates. In 2013, the PBOC relaxed controls over bank lending rates. Subsequently, in 2015, the PBOC also widened the range of the deposit rates that banks can offer. These interest-rate liberalization policies might confound the effects of the Basel III regulatory regime.

To address this concern, we expand the set of independent variables in our baseline specification and include controls for the effects of interest rate fluctuations. In particular, we include the interaction terms $RiskH_j \times LoanRateGap_t$ and $RiskH_j \times MP_t \times LoanRateGap_t$ as additional independent variables in our regression. Here, the variable $LoanRateGap_t$ measures the percentage deviations of the average lending interest rate across all loans from the benchmark lending rate in quarter t . A larger deviation from the benchmark indicates more flexibility for the bank to set lending rates. Thus, including this variable in the regression helps capture the effects of interest-rate liberalization on the risk-taking channel of monetary policy.

Table S.2.3 displays the estimation results when we include controls for interest-rate liberalization. In the periods when the bank's average lending rate exceeds the benchmark rate (i.e., when $LoanRateGap_t > 0$), the branches with high risk exposures in the past increase the share of SOE lending to reduce loan risks. This effect is statistically significant at the 99% level. However, when $LoanRateGap_t < 0$, an expansionary monetary policy shock *reduces* the share of SOE lending (indicating more risk-taking), although this latter effect is insignificant.

After controlling for the effects of interest-rate liberalization, we still obtain large and significant impact of the new capital regulation regime for the risk-taking channel. After implementing the new regulations, high-risk branches increased their lending to SOEs in the post-2013 periods (relative to low-risk branches), both on average and in response to an expansionary monetary policy shock. As in the baseline estimation, these effects are statistically significant at the 99% level. Thus, the changes in risk-taking that we have identified in the baseline regression is associated with changes in capital regulations; they are not driven by other reforms such as interest-rate liberalization.

Controlling for the effects of the anti-corruption campaign. In late 2012, China started a sweeping anti-corruption campaign that has brought down numerous officials at all

TABLE S.2.3. Controlling for the impact of interest-rate liberalization

	(1)	(2)
$SOE_{i,j,t}$	OLS	Probit
$RiskH_j \times MP_t \times Post_y$	0.708*** (0.223)	0.551*** (0.190)
$RiskH_j \times Post_y$	0.00737*** (0.00152)	0.0060*** (0.0014)
$RiskH_j \times MP_t$	0.213 (0.340)	0.1602 (0.325)
$RiskH_j \times MP_t \times LoanRateGap_{t-1}$	-3.518 (3.121)	-2.857 (3.148)
$RiskH_j \times LoanRateGap_{t-1}$	0.0624*** (0.0185)	0.0424*** (0.0186)
Branch FE	yes	yes
Year-quarter FE	yes	yes
Initial controls $\times$ year FE	yes	yes
R ²	0.350	0.510
Observations	330,473	312,053

Notes: Columns (1) and (2) report the results in OLS estimations, respectively. The margin effects are reported for the Probit model. The monetary policy shock is constructed using the approach in [Chen et al. \(2018\)](#). $LoanRateGap_t$ is the deviation of the average lending rate of all loans from the benchmark lending rate in quarter t . The absolute size of $LoanRateGap_t$ captures the effectiveness of interest-rate liberalization on lending interest rates. Both models include controls for the branch fixed effects, the year-quarter fixed effects, and the average firm characteristics (including size, age, leverage, and ROA) in the years before 2013 interacted with the year fixed effects. The numbers in the parentheses indicate robust standard errors. The levels of statistical significance are denoted by the asterisks: *** for $p < 0.01$, ** for $p < 0.05$, and * for $p < 0.1$. The data sample ranges from 2008:Q1 to 2017:Q4.

levels of the government. The timing of the anti-corruption campaign coincides with the implementation of Basel III, potentially confounding the effects of the regulation changes. For example, banks might want to shift lending to SOEs from private firms to avoid potential anti-corruption investigations. To address this concern, we add controls in our regressions to capture the effects of the anti-corruption campaign on bank lending behaviors. We measure the local impact of the campaign by a dummy variable (denoted

by $AntiCorrup_j$) that is equal to one if, in the province where city j is located, at least one province-level official has been imprisoned for corruption since 2012.

Table S.2.4 shows the OLS regression results, controlling for the effects of the anti-corruption campaign. The estimated coefficient on the interaction term $AntiCorrup_j \times Post_y$ is positive and significant, regardless of whether we control for the effects of the capitalization level (CAR_{y-1}). This finding confirms that bank branches located in areas hit by the anti-corruption campaign are more likely to lend to SOEs in the post-2013 period, possibly in fear of being investigated.

However, adding controls for the anti-corruption effects does not affect our main empirical finding. As shown in Table S.2.4, in the post-2013 period, high-risk branches are more likely to lend to SOEs, both on average and conditional on an expansionary monetary policy shock.

Effects of deleveraging policy: A placebo test. The Chinese government responded to the 2008-09 global financial crisis by implementing a large-scale fiscal stimulus (equivalent to about 12% of GDP). The fiscal stimulus helped cushion the downturn during the crisis periods, but it has also led to a surge in leverage and over-investment, particular in those sectors with a high share of SOEs (Cong et al., 2019). In December 2015, the Chinese government implemented a deleveraging policy, aiming to reduce the leverage in the over-capacity industries. It is possible that the deleveraging policy might have played a role in driving the observed relation between bank risk-taking and monetary policy shocks.

To examine this possibility, we conduct a placebo test using China's deleveraging policy. We define a dummy variable, $DeLev_y$, which is equal to one if the year is 2016 or after, and zero otherwise. In the placebo test, we estimate the baseline empirical model (18), replacing the variable $Post_y$ in the baseline model with $DeLev_y$. Table S.2.5 shows the estimation results. Unlike the banking regulation policy changes under Basel III, the deleveraging policy had no significant impact on bank risk-taking.

Additional controls. Our baseline regression includes controls for branch fixed effects, year-quarter fixed effects, and interactions between firms' initial characteristics and the year fixed effects. To examine the robustness of our results, we now consider three additional controls.

The first control variable that we include is the interaction between bank branches' initial profits (denoted by $InitProfit_j$) and the year fixed effects, where the initial profit of branch j is measured by its net interest income in the first year when the branch

TABLE S.2.4. Controlling for effects of anti-corruption campaigns

$SOE_{i,j,t}$	(1) OLS	(2) OLS
$RiskH_j \times MP_t \times Post_y$	0.550** (0.215)	1.237*** (0.353)
$RiskH_j \times Post_y$	0.00677*** (0.00149)	0.00376* (0.00213)
$RiskH_j \times MP_t$	-0.0295 (0.172)	6.136** (2.415)
$RiskH_j \times MP_t \times CAR_{y-1}$		-0.487** (0.192)
$RiskH_j \times CAR_{y-1}$		0.00192* (0.00108)
$AntiCorrup_j \times Post_y$	0.00673*** (0.00154)	0.00672*** (0.00154)
$AntiCorrup_j \times MP_t$	0.207 (0.174)	0.204 (0.174)
$AntiCorrup_j \times MP_t \times Post_y$	-0.319 (0.218)	-0.317 (0.218)
Branch FE	yes	yes
Year-quarter FE	yes	yes
Initial controls $\times$ year FE	yes	yes
R ²	0.354	0.354
Observations	333,500	333,500

Notes: $AntiCorrup_j$ is a dummy variable, which is equal to one if the bank branch is located in a city which belongs to a province where at least one province-level official was investigated for corruption in 2012. Both models include controls for the branch fixed effects, the year-quarter fixed effects, and the average firm characteristics (including size, age, leverage, and ROA) in the years before 2013 interacted with the year fixed effects. The numbers in the parentheses show the robust standard errors. The levels of statistical significance are denoted by the asterisks: *** for $p < 0.01$, ** for $p < 0.05$, and * for $p < 0.1$.

TABLE S.2.5. Deleveraging Policy

	(1)	(2)	(3)	(4)
$SOE_{i,j,t}$	OLS	OLS	Probit	Probit
$RiskH_j \times Delev_y$	0.001 (0.002)	0.001 (0.002)	0.002 (0.002)	0.016 (0.036)
$RiskH_j \times MP_t \times Delev_y$		0.150 (0.563)		-0.504 (0.531)
$RiskH_j \times MP_t$		0.072 (0.098)		0.036 (0.087)
Branch FE	yes	yes	yes	yes
Year-quarter FE	yes	yes	yes	yes
Initial control $\times$ year FE	yes	yes	yes	yes
R ²	0.353	0.353	—	—
Observations	333,500	333,500	315,382	315,382

Notes: Columns (1)-(2) and (3)-(4) report the results in OLS and Probit estimations, respectively. $DeLev_y = 1$ if $y \geq 2016$ and 0 otherwise. All other variables have the same definitions as those in the baseline estimations. The margin effects are reported for the Probit model. The monetary policy shock is constructed using the approach in [Chen et al. \(2018\)](#). All models include controls for the branch fixed effects, the year-quarter fixed effects, and the average firm characteristics (including size, age, leverage, and ROA) in the years before 2013 interacted with the year fixed effects. The numbers in the parentheses indicate robust standard errors. The levels of statistical significance are denoted by the asterisks: *** for $p < 0.01$, ** for $p < 0.05$, and * for $p < 0.1$. The data sample ranges from 2008:Q1 to 2017:Q4.

is observed in our sample. Including this control helps rule out the possibility that the banking regulation may change a branch's lending behavior through affecting its profit.¹⁰

The second additional control variable that we include in the regression is the interaction between the initial share of SOE loans (denoted by $InitSOE_j$) and the year fixed effects, where the initial SOE share is measured by the average share of SOE loans issued by bank branch j before 2013. This control variable addresses the possibility that issuing more SOE loans may lead to a higher NPL ratio for a branch, such that the independent variable $RiskH_j$ can be potentially endogenous.

The third additional control that we consider is the industry fixed effects.

¹⁰The bank headquarter may set a requirement on a branch's profit, which might influence the branch's lending behaviors in response to changes in banking regulations.

TABLE S.2.6. Additional Controls

	(1)	(2)	(3)	(4)	(5)	(6)
$SOE_{i,j,t}$	OLS	OLS	OLS	Probit	Probit	Probit
$RiskH_j \times Post_y$	0.007*** (0.0015)	0.006*** (0.0015)	0.002 (0.0014)	0.006*** (0.0014)	0.005*** (0.0014)	0.006*** (0.0014)
$RiskH_j \times MP_t \times Post_y$	0.541** (0.215)	0.522** (0.214)	0.688*** (0.203)	0.475*** (0.184)	0.453** (0.184)	0.594*** (0.188)
$RiskH_j \times MP_t$	-0.0178 (0.172)	-0.0268 (0.170)	-0.136 (0.160)	-0.0675 (0.126)	-0.066 (0.128)	-0.140 (0.123)
$InitProfit_j \times \text{year FE}$	yes	yes	yes	yes	yes	yes
$InitSOE_j \times \text{year FE}$	no	yes	yes	no	yes	yes
Industry FE	no	no	yes	no	no	yes
Branch FE	yes	yes	yes	yes	yes	yes
Year-quarter FE	yes	yes	yes	yes	yes	yes
Initial controls $\times$ year FE	yes	yes	yes	yes	yes	yes
R ²	0.355	0.359	0.448	—	—	—
Observations	333,500	333,500	303,404	315,382	315,382	276,893

Notes: Columns (1)-(3) and (4)-(6) report the results in OLS and Probit estimations, respectively. The $InitProfit_j$ is measured by the interest income of bank branch j in the first year that the branch was observed in our sample. The variable $InitSOE_j$ is measured by the average share of SOE loans issued by bank branch j before 2013. All other variables have the same definitions as those in the baseline estimations. All models include controls for the branch fixed effects, the year-quarter fixed effects, and the average firm characteristics (including size, age, leverage, and ROA) in the years before 2013 interacted with the year fixed effects. The numbers in the parentheses indicate robust standard errors. The levels of statistical significance are denoted by the asterisks: *** for $p < 0.01$, ** for $p < 0.05$, and * for $p < 0.1$. The data sample ranges from 2008:Q1 to 2017:Q4.

Table S.2.6 shows the regression results with these additional controls (one at a time), for both the OLS (the first three columns) and the Probit (the last three columns) estimation approaches. Our main findings in the baseline estimation remain robust: the regulation changes raised the relative share of SOE lending by high-risk branches in response to a positive monetary policy shock.

Further robustness checks. Our main empirical results are robust to alternative measurements, specifications, and controls. In particular, we have obtained similar results when we consider (1) clustering the standard errors at the bank branch and year-quarter level instead of computing robust standard errors, (2) using alternative definitions of SOEs, (3) using alternative measures of CAR, (4) using a measure of aggregate credit supply shocks instead of monetary policy shocks, and (5) using direct measures of IRB coverage instead of the post-2013 year dummy. To conserve space, we report these results in this section.

Ex post loan performance. Our micro-level evidence shows that, under tightened capital regulations, a monetary policy expansion raises the share of bank lending to low-risk borrowers, and in particular, to SOEs. In China, SOE loans receive high credit ratings because of government guarantees. Since SOEs have lower productivity than private firms, increasing lending to SOEs may worsen ex post loan performance and reduce aggregate productivity. We now provide evidence that supports this misallocation channel.

We measure the ex post loan performance by the NPL ratio of new loans or the share of overdue loans. Table S.2.7 shows that, all else being equal, a new loan to an SOE tends to have a poorer ex post performance, with a higher probability of becoming non-performing or overdue. In contrast, a new loan with a high credit rating has better ex post performance. These results suggest that the ex ante high credit ratings of SOE loans mainly reflect government guarantees. When we control for the firm characteristics and the credit ratings, SOE loans tend to have poor ex post performance. Thus, by raising the share of new loans to SOEs, a monetary policy expansion can contribute to credit misallocation. The results show that the implementation of the Basel III regulations reduces aggregate productivity.

Clustering standard errors at bank branch and year-quarter levels. In the text, we have reported regression results with robust standard errors. Here, we show that the results are robust when the standard errors are clustered at the bank branch and year-quarter levels. The regression results are shown in Table S.2.8 below.

Alternative definitions of SOEs. In the baseline estimation, we identify the ownership of the individual loans according to the bank's own definition. Here, we consider two alternative definitions of SOEs using the firm-level information in the ASIF: one using the registration type of the firm, and the other using the ownership controls (administrative subordinations). We re-estimate our baseline model using these alternative SOE definitions. Table S.2.9 shows that the main results obtained in our baseline regressions are not sensitive to these alternative SOE definitions.

TABLE S.2.7. Ex Post Performances of SOE Loans

	(1)	(2)	(3)	(4)
	NPL	NPL	Overdue	Overdue
	OLS	Probit	OLS	Probit
SOE Loan	0.0286*** (0.0021)	0.0197*** (0.0012)	0.0121*** (0.0019)	0.0290*** (0.0022)
Credit Rating	-0.0051*** (0.0001)	-0.0056*** (0.0001)	-0.0160*** (0.0002)	-0.0149*** (0.0002)
Branch FE	yes	yes	yes	yes
Year FE	yes	yes	yes	yes
Initial controls $\times$ year FE	yes	yes	yes	yes
R ²	0.075	—	0.111	—
Observations	241,688	225,845	241,086	236,923

Notes: This table reports the estimated ex post performance of SOE loans and loans with high credit ratings. The ex post performance is measured by either the NPL ratio of the new loans or the share of overdue loans. The variable NPL is a dummy that is equal to one if the status of the loan at end of the issue year is classified as “substandard,” “doubtful,” or “loss”; and it is zero otherwise. The variable Overdue is also a dummy that is equal to one if the loan is overdue or rolled over by the bank at the due time; and it is zero otherwise. The definitions of SOE Loan and Credit Rating are the same as those in Table 2. Columns (1) and (3) show the estimates of OLS, while Columns (2) and (4) show the estimates from a Probit model. Margins are reported for the Probit models. All models include controls for the branch fixed effects, the year-quarter fixed effects, and the average firm characteristics (including size, age, leverage, and ROA) in the years before 2013 interacted with the year fixed effects. The numbers in the parentheses indicate robust standard errors. The levels of statistical significance are denoted by the asterisks: *** for $p < 0.01$, ** for $p < 0.05$, and * for $p < 0.1$. The data sample ranges from 2008:Q1 to 2017:Q4.

Alternative measures of CAR. Our results are also robust to alternative measures of the CAR, as shown in Table S.2.10.

Aggregate credit supply shocks. Under given capital regulations, a bank needs to reduce risk-taking if its leverage increases. An increase in bank leverage can be caused by an increase in money supply, as we have examined, or by an increase in the supply of aggregate credit measured by total social financing (TSF) in China. In recent years, the People’s Bank of China (PBOC) has also targeted TSF growth for macroeconomic

TABLE S.2.8. Clustered standard errors

	(1)	(2)
$SOE_{i,j,t}$	OLS	OLS
$RiskH_j \times MP_t \times Post_y$	1.221** (0.480)	1.221** (0.523)
$RiskH_j \times Post_y$	0.00411 (0.00666)	0.00411 (0.00681)
$RiskH_j \times CAR_{y-1} \times MP_t$	-0.487** (0.227)	-0.487* (0.262)
$RiskH_j \times CAR_{y-1}$	0.00192 (0.00271)	0.00192 (0.00250)
$RiskH_j \times MP_t$	6.137** (2.919)	6.137* (3.294)
Double-Clustered at	Branch & Year-quarter	Firm & Year-quarter
Branch FE	yes	yes
Year-quarter FE	yes	yes
Initial controls $\times$ year FE	yes	yes
R ²	0.353	0.353
Observations	333,500	333,500

Notes: The numbers in the parentheses indicate robust standard errors. The numbers in the parentheses show the robust standard errors double clustered at branch (firm) and year-quarter levels. The levels of statistical significance are denoted by the asterisks: *** for $p < 0.01$, ** for $p < 0.05$, and * for $p < 0.1$. The data sample ranges from 2008:Q1 to 2017:Q4.

stabilization. To examine the robustness of our baseline findings, we replace the monetary policy shock (MP_t) in the baseline model by an aggregate credit supply shock (denoted by SF_t) based on total social financing data, constructed using the same approach as in [Chen et al. \(2018\)](#).

Table [S.2.11](#) report the estimation results in the case with credit supply shocks. These results are similar to those obtained from our baseline estimation. Under the post-2013 new regulations, an expansionary credit supply shock increases the share of SOE loans

TABLE S.2.9. Alternative Definitions of SOEs

	(1)	(2)	(3)	(4)
	SOE 1		SOE 2	
$SOE_{i,j,t}$	OLS	Probit	OLS	Probit
$RiskH_j \times MP_t \times Post_y$	0.275* (0.142)	0.276* (0.151)	0.512*** (0.151)	0.871*** (5.494)
$RiskH_j \times Post_y$	0.0025*** (0.0010)	0.0025** (0.0011)	0.0076*** (0.0010)	-0.0005 (0.0012)
$RiskH_j \times MP_t$	-0.220* (0.116)	-0.317*** (0.098)	-0.136 (0.123)	-0.132 (0.103)
Branch FE	yes	yes	yes	yes
Year-quarter FE	yes	yes	yes	yes
Initial control $\times$ year FE	yes	yes	yes	yes
R ²	0.238	—	0.244	—
Observations	333,500	248,450	295,729	193,814

Notes: Columns (1)-(2) and (3)-(4) respectively report the results in OLS and Probit estimations for two alternative definitions of SOEs using the information in ASIF. “SOE 1” corresponds to the definition based on the registration type, and “SOE 2” corresponds to the definition based on ownership controls (administrative subordinations). All the other variables have the same definitions as those in the baseline estimations. The margin effects are reported for the Probit model. The monetary policy shock is constructed using the approach in [Chen et al. \(2018\)](#). All models include controls for the branch fixed effects, the year-quarter fixed effects, and the average firm characteristics (including size, age, leverage, and ROA) in the years before 2013 interacted with the year fixed effects. The numbers in the parentheses indicate robust standard errors. The levels of statistical significance are denoted by the asterisks: *** for $p < 0.01$, ** for $p < 0.05$, and * for $p < 0.1$. The data sample ranges from 2008:Q1 to 2017:Q4.

extended by the branches with high NPL ratios in the past, as does an expansionary money supply shock.¹¹

¹¹Total social financing measures all sources of credit supply, including bank loans and shadow bank lending. China experienced a rapid expansion of shadow banking activities following the large-scale fiscal stimulus implemented during the global financial crisis period ([Chen et al., 2018](#); [Sun, 2019](#)). Shadow bank lending can potentially mitigate the misallocation of capital between SOEs and POEs. For example, low-productivity SOEs could channel bank funds to high-productivity POEs through trusted loans or

TABLE S.2.10. Alternative Measures of CAR

$SOE_{i,j,t}$	(1) CAR1	(2) CAR2	(3) CAR3
$RiskH_j \times MP_t \times Post_y$	0.449** (0.216)	1.016*** (0.359)	0.492** (0.215)
$RiskH_j \times Post_y$	0.00750*** (0.00151)	0.00442** (0.00217)	0.00699*** (0.00150)
$RiskH_j \times CAR_{y-1} \times MP_t$	-0.602* (0.331)	-0.602* (0.331)	-0.487** (0.192)
$RiskH_j \times CAR_{y-1}$	0.00327* (0.00188)	0.00327* (0.00188)	0.00192* (0.00108)
$RiskH_j \times MP_t$	7.605* (4.173)	7.604* (4.173)	6.137** (2.415)
Branch FE	yes	yes	yes
Year-quarter FE	yes	yes	yes
Initial controls $\times$ year FE	yes	yes	yes
R ²	0.353	0.353	0.353
Observations	333,500	333,500	333,500

Notes: CAR 1 is measured by old CAR for the year before 2013, and the average value of old CAR before 2013 for the year after 2013. CAR 2 is measured by old CAR for the year before 2013, and the value of old CAR in 2013 for the year after 2013. CAR 3 is measured by old CAR before 2013, and the demeaned new CAR plus the average value of old CAR before 2013 for the year after 2013. All models include controls for the branch fixed effects, the year-quarter fixed effects, and the average firm characteristics (including size, age, leverage, and ROA) in the years before 2013 interacted with the year fixed effects. The numbers in the parentheses show the robust standard errors. The levels of statistical significance are denoted by the asterisks: *** for $p < 0.01$, ** for $p < 0.05$, and * for $p < 0.1$.

entrusted loans (Allen et al., 2019). In practice, however, these trusted or entrusted loans are very small relative to the size of bank loans, suggesting that they are likely not very important for alleviating credit misallocations. For example, the PBOC data show that the stock of aggregate entrusted loans was about 11.4 trillion RMB at the end of 2019, which is relatively small compared to the aggregate bank loans (about 151.6 trillion RMB). Furthermore, SOEs are less efficient in financial intermediation than banks. Thus, having SOEs to re-channel bank funds to POEs likely adds to misallocation.

TABLE S.2.11. Aggregate Credit Supply Shocks

$SOE_{i,j,t}$	(1) OLS	(2) Probit
$RiskH_j \times SF_t \times Post_y$	2.017*** (0.277)	1.367*** (0.2794)
$RiskH_j \times Post_y$	0.00383** (0.00153)	0.0042*** (0.0015)
$RiskH_j \times SF_t$	-1.105*** (0.144)	-0.637*** (0.120)
Branch FE	yes	yes
Year-quarter FE	yes	yes
Initial controls $\times$ year FE	yes	yes
R ²	0.354	—
Observations	333,500	315,382

Notes: Columns (1)-(2) report the results in OLS and Probit estimations, respectively, where the monetary policy shock MP_t in the baseline model is replaced by the aggregate credit supply shock SF_t constructed from the total social financing data using the identification approach in [Chen et al. \(2018\)](#). The margin effects are reported for the Probit model. Both models include controls for the branch fixed effects, the year-quarter fixed effects, and the average firm characteristics (including size, age, leverage, and ROA) in the years before 2013 interacted with the year fixed effects. The numbers in the parentheses indicate robust standard errors. The levels of statistical significance are denoted by the asterisks: *** for $p < 0.01$, ** for $p < 0.05$, and * for $p < 0.1$. The data sample ranges from 2008:Q1 to 2017:Q4.

IRB coverage. In the baseline regressions, we use the post-2013 dummy ($Post_y$) to indicate the period under the new capital regulations that introduced the IRB approach, which increased the sensitivity of risk-weighted assets to loan risks. Here, we use an alternative indicator of the new regulatory regime. In particular, we replace the post-2013 dummy variable by the the share of IRB-covered loans in the entire bank. The qualitative results do not change, as shown in [Table S.2.12](#).

Risk History. In the baseline regressions, we use average non-performing loan ratios (NPL) of each bank branches to measure the risk attitude of the branch. For sake that NPL is a ex-post measure and it is affected by local economic conditions, we take an alternative measure that based on the average credit rating of bank branches. Based on

TABLE S.2.12. IRB Coverage

	(1)	(2)
$SOE_{i,j,t}$	OLS	OLS
$RiskH_j \times MP_t \times IRB_y$	0.639** (0.305)	1.085** (0.503)
$RiskH_j \times IRB_y$	0.0101*** (0.00217)	0.00516 (0.00335)
$RiskH_j \times MP_t$	0.0595 (0.159)	3.079 (2.542)
$RiskH_j \times CAR_{y-1} \times MP_t$		-0.236 (0.201)
$RiskH_j \times CAR_{y-1}$		0.00215* (0.00117)
Branch FE	yes	yes
Year-quarter FE	yes	yes
Initial controls $\times$ year FE	yes	yes
R ²	0.353	0.353
Observations	333,500	333,500

Notes: We measure the IRB coverage by the IRB-covered share of loans in the entire bank. The model specification is the same as that in the baseline regression. The numbers in the parentheses show the robust standard errors. The levels of statistical significance are denoted by the asterisks: *** for $p < 0.01$, ** for $p < 0.05$, and * for $p < 0.1$.

the new measure, $RiskH_j$ is equal to 1 if and only if the average credit rating of all loans from 2008 to 2012 in branch j is less than BBB. The results do not change for the triple interaction term, which confirm the results of risk weighting channel of monetary policy , as shown in Table [S.2.13](#).

APPENDIX S.3. APPROXIMATION OF THE SUM OF LOG-NORMAL RANDOM VARIABLES

In the quantitative exercise, considering the sum of two independently distributed log-normal random variables (RVs) is too computationally time consuming. To alleviate the computational burden, we follow [Pratesi et al. \(2006\)](#) to use the log-normal distribution to approximate the PDF of z_t . The mathematical problem can be described as follows.

TABLE S.2.13. Alternative measure of *RiskH*

	(1)	(2)
$SOE_{i,j,t}$	OLS	Probit
$RiskH_j \times MP_t \times Post_y$	1.361*** (0.419)	1.922*** (0.446)
$RiskH_j \times Post_y$	-0.0207*** (0.00319)	-0.0208*** (0.0029)
$RiskH_j \times MP_t$	-0.427 (0.342)	-0.359 (0.267)
Branch FE	yes	yes
Year-quarter FE	yes	yes
Initial controls $\times$ year FE	yes	yes
R ²	0.353	—
Observations	333,336	315,257

Notes: Columns (1)-(2) report the results in OLS and Probit estimations, respectively, where the NPL history of bank branches $RiskH_j$ in the baseline model is replaced a new measure based on the average credit rating of bank branches. $RiskH_j$ is equal to 1 if and only if the average credit rating of all loans from 2008 to 2012 in branch j is less than BBB. The margin effects are reported for the Probit model. Both models include controls for the branch fixed effects, the year-quarter fixed effects, and the average firm characteristics (including size, age, leverage, and ROA) in the years before 2013 interacted with the year fixed effects. The numbers in the parentheses indicate robust standard errors. The levels of statistical significance are denoted by the asterisks: *** for $p < 0.01$, ** for $p < 0.05$, and * for $p < 0.1$. The data sample ranges from 2008:Q1 to 2017:Q4.

We have two RVs $\tilde{z}_j$ that follows log-normal distribution with mean $\tilde{\mu}_j$ and standard deviation $\tilde{\sigma}_j$. Then, the portfolio of two assets has the return

$$z = \sum_{j=\{s,p\}} \omega_j \tilde{z}_j, \quad (\text{S.3.1})$$

where $\omega_s = \omega$ and $\omega_p = 1 - \omega$. We use a log normal distribution to approximate the true distribution of z , i.e., $\log(z)$ approximately follows $\mathbf{N}(\mu, \sigma^2)$. We need to derive the formula for μ and σ^2 as functions of $\tilde{\mu}_j$ and $\tilde{\sigma}_j^2$.

The mean of z satisfies

$$\mu_z = \mathbf{E} \left[\sum_{j=\{s,p\}} \omega_j \tilde{z}_j \right] = \sum_{j=\{s,p\}} \omega_j \mathbf{E}(\tilde{z}_j) = \omega \tilde{\mu}_s + (1 - \omega) \tilde{\mu}_p. \quad (\text{S.3.2})$$

The variance of z satisfies

$$\sigma_z^2 = \mathbf{Var} \left(\sum_{j=\{s,p\}} \omega_j \tilde{z}_j \right) = \sum_{j=\{s,p\}} \omega_j^2 \tilde{\sigma}_j^2. \quad (\text{S.3.3})$$

Therefore, the RV $\log(z)$ follows $\mathbf{N}(\mu, \sigma^2)$ where μ and σ^2 satisfies

$$\mu = \log \left(\frac{\mu_z^2}{\sqrt{\mu_z^2 + \sigma_z^2}} \right), \quad (\text{S.3.4})$$

$$\sigma^2 = \log \left(1 + \frac{\sigma_z^2}{\mu_z^2} \right). \quad (\text{S.3.5})$$

The PDF of z is

$$f(z, \omega) = \frac{1}{z\sigma\sqrt{2\pi}} \exp \left\{ -\frac{(\log z - \mu)^2}{2\sigma^2} \right\}. \quad (\text{S.3.6})$$

Then, we have

$$\frac{\partial f(z, \omega)}{\partial \omega} = \frac{1}{\sigma} f(z, \omega) \left\{ \left[\frac{(\log z - \mu)^2}{\sigma^2} - 1 \right] \frac{\partial \sigma}{\partial \omega} + \frac{\log z - \mu}{\sigma} \frac{\partial \mu}{\partial \omega} \right\}, \quad (\text{S.3.7})$$

where

$$\begin{aligned} \frac{\partial \mu}{\partial \omega} &= \left[\frac{2}{\mu_z^2} - \frac{1}{\mu_z^2 + \sigma_z^2} \right] \mu_z \frac{\partial \mu_z}{\partial \omega} - \frac{1}{2(\mu_z^2 + \sigma_z^2)} \frac{\partial \sigma_z^2}{\partial \omega}, \\ \frac{\partial \sigma}{\partial \omega} &= \frac{1}{2\sigma} \frac{1}{\mu_z^2 + \sigma_z^2} \left(\frac{\partial \sigma_z^2}{\partial \omega} - 2 \frac{\sigma_z^2}{\mu_z} \frac{\partial \mu_z}{\partial \omega} \right), \\ \frac{\partial \mu_z}{\partial \omega} &= \tilde{\mu}_s - \tilde{\mu}_p, \\ \frac{\partial \sigma_z^2}{\partial \omega} &= 2\omega \tilde{\sigma}_s^2 - 2(1 - \omega) \tilde{\sigma}_p^2. \end{aligned}$$