

Abstract. This paper studies the impact of the strengthening bank capital regulation on bank heterogeneity in lending, capital accumulation, charter values, and default decisions. In a dynamic model of banks facing idiosyncratic profitability shocks, highly profitable banks, in the short run, are more likely to respond to the strengthening capital regulation such that they more decrease charter values and lending than lowly profitable banks, while all banks accumulate regulatory capitals and decrease charter values and lending; however, in the long run, such accumulation of regulatory capitals leads to the stability of the overall banking system. To test the short-run implications of our model, we utilize as a natural experiment the introduction of the prompt corrective action (PCA) program in Japan, which began in April 1998 and requested banks to rigorously self assess their assets in order to lessen forbearance. Using a difference-in-difference specification, we find that the PCA decreased highly profitable banks' lending and charter values more substantially among banks, albeit increasing all banks' regulatory capitals and decreasing their charter values and loans in consistent with our theoretical predictions.