

# The Emergence of a Parallel World: The Misperception Problem for Bank Balance Sheet Risk and Lending Behavior <sup>\*</sup>

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**ABSTRACT.** We examine the reason why two opposing views coexist on the distressed banks' lending behavior in Japan's postbubble period: i.e., the stagnant lending in the capital crunch and forbearance lending to low-quality borrowers. To this end, we address the measurement problem of bank balance-sheet risk. We identify the credit supply and allocation effects of bank capital in the bank loan equation specified at the loan level, thereby demonstrating that the two opposing views emerge because the regulatory capital does not reflect bank balance-sheet risk, while the market value of capital does.

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*Keywords:* bank capital structure; capital crunch; forbearance lending; loan-level data; bank asset risk; bank risk taking.

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