

# **The Lender of Last Resort, Moral Hazard and Capital Requirements in the Subprime Mortgage Crisis**

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## **ABSTRACT**

This paper analyzes the relationship between capital adequacy ratio and moral hazard due to the central bank's bailout policy, based on models extended from Diamond and Dybvig (1983). I use a theoretical approach to show how the different capital requirements for banks lead to banks' different choices on investment projects with different risk degrees. The recent subprime mortgage crisis reveals that facing systemic risk, the central bank has to bail out banks to prevent the collapse of the financial market, even when the central bank knows that banks are insolvent. As a result, the central bank would provide liquidity assistance to both the insolvent and illiquid banks. My paper demonstrates that this bailout policy will lead to the moral hazard problem among banks. The authority should raise capital requirements for banks in order to avoid moral hazard in the future.