A Appendix

A.1 Proof of Lemma 2

From (13), $\Delta\pi(\psi) = \int_0^{\psi} [F_B(s) - F_G(s)]\, ds$, so that

$$\Delta\pi(\psi) = \begin{cases} \int\limits_0^{\psi} F_B(s)\, ds & \text{if } \psi < 1-\alpha \\ \\ \int\limits_0^{1-\alpha} F_B(s)\, ds - \int\limits_{1-\alpha}^{\psi} [1 - F_B(s)]\, ds & \text{if } \psi \geq 1-\alpha \end{cases} \tag{39}$$

Thus $\Delta\pi(\psi)$ is single-peaked, reaching its maximum at $\psi = 1-\alpha$. From (12),

$$\lim_{\psi\to 1} \Delta\pi(\psi) = h$$

so that $\Delta\pi(\psi)$ approaches h from above as $\psi \to 1$. Since $\psi < 1$ for a bank with positive equity, there is a unique solution to $\Delta\pi(\psi) = h$ where the solution is in the range where $\Delta\pi(\psi)$ is increasing. Therefore $\psi < 1-\alpha$. This proves the lemma.

Robustness tests and additional results

A.2 Endogeneity

We examine a dynamic system GMM that uses a stacked system consisting of both first-differenced and level equations. In the system GMM regression we treat all the regressors as endogenous and include one lag of the dependent variable ΔL. In order to avoid overfitting and instrument proliferation, we use one lag (the first quarter lag or the first annual lag depending on whether the variable has a quarter or annual frequency) and combine instruments into smaller sets. By adopting this specification, we end up using 17 or 27 instruments depending on the specification implemented. Table 2 shows two specifications: one that includes *Global Leverage* and *Local Leverage* only (column 1) and one where all global and local variables are included (column 2).[8] The results show that *Global Leverage* and ΔRER continue remaining highly significant.

[8] The AR(1) test yields a p-value of 0.000 in both cases. The AR(2) test yields a p-value of 0.697 in the first specification and a p-value of 0.871 in the second specification, which means that we cannot