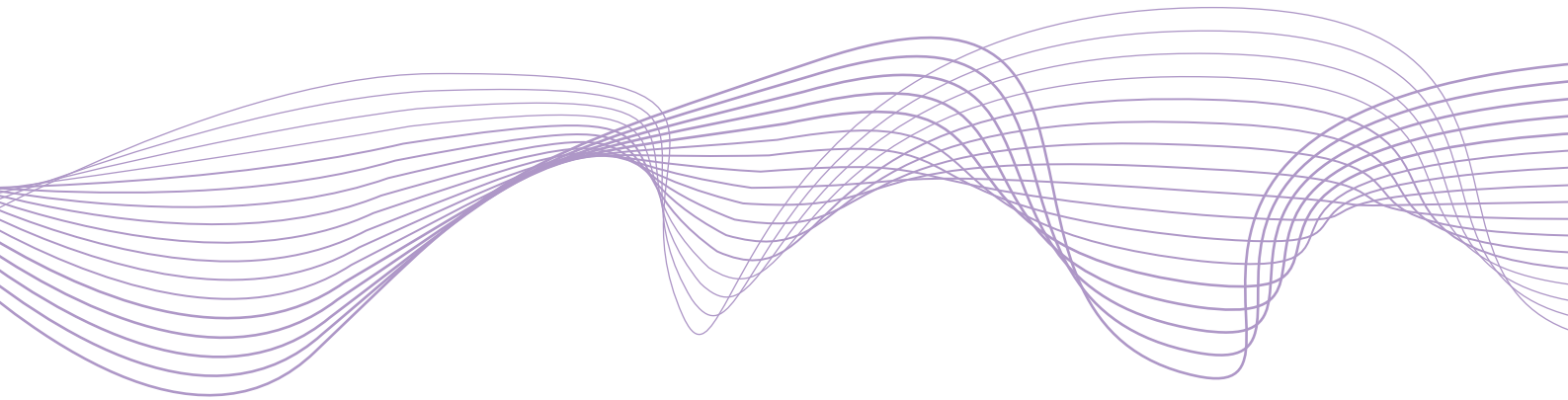


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## Prudential policy with distorted beliefs

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## Abstract

This paper studies leverage regulation and monetary policy when equity investors and/or creditors have distorted beliefs relative to a planner. We characterize how the optimal leverage regulation responds to arbitrary changes in investors' and creditors' beliefs and relate our results to practical scenarios. We show that the optimal regulation depends on the type and magnitude of such changes. Optimism by investors calls for looser leverage regulation, while optimism by creditors, or jointly by both investors and creditors, calls for tighter leverage regulation. Monetary policy should be tightened (loosened) in response to either *investors'* or creditors' optimism (pessimism).

**JEL Codes:** G28, G21, E61, E52

**Keywords:** prudential policy, distorted beliefs, leverage regulation, bailouts, monetary policy

# 1 Introduction

Financial markets have experienced recurrent booms and busts throughout their history. A growing literature identifies alternative rationales for welfare-improving prudential policy in these scenarios. For instance, investors may borrow or invest too much if they do not internalize the full social cost of future fire sales or aggregate demand shortfalls (e.g., Lorenzoni, 2008; Dávila and Korinek, 2018; Korinek and Simsek, 2016; Farhi and Werning, 2016), or if they expect government support in a downturn (e.g., Farhi and Tirole, 2012; Bianchi, 2016). In practice, policy responses involve regulating leverage decisions and managing monetary policy.

In this paper, we characterize optimal policy responses when investors and creditors have distorted beliefs, relative to those of a planner, about the returns to investment. The role played by individual beliefs in determining financial and real decisions has drawn increased attention since the global financial crisis of 2008, connecting with earlier work by Kindleberger (1972) and Minsky (1986). A widespread view is that exuberant beliefs about house prices helped to fuel the boom in subprime lending that preceded the crisis, and that it would have been valuable to combat such exuberance by decreasing leverage, perhaps by imposing a leverage cap on financial institutions or households.<sup>1</sup> However, there is little formal analysis on the form of the optimal policy in exuberant times.

Moreover, different forms of belief exuberance may call for different policy responses. For example, the car rental company Hertz filed for bankruptcy in May 2020, which made its stock effectively worthless. Nevertheless, retail investors seemed willing to buy Hertz stock at rising prices. The SEC counteracted this apparently distorted valuation by banning Hertz from selling additional shares. In other words, the regulator prevented Hertz from *decreasing* its leverage, which is the opposite of setting a leverage cap.<sup>2</sup>

We present a tractable model in which equilibrium leverage and investment are endogenously determined as a function of the beliefs of equity investors and creditors over future states of nature. Investors fund investment in risky capital with a mixture of their own equity and debt from creditors. Three forces determine the trade-off between debt and equity finance. First, creditors are more patient than investors, which encourages investors to borrow. Second, the deadweight losses associated with investors defaulting on their debt make borrowing costly. Third, the differences in beliefs between investors and creditors determine how each group values cash flows, which affects leverage choices

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<sup>1</sup>For empirical evidence that analyzes the role played by beliefs, see for example: Cheng, Raina and Xiong (2014); Greenwood and Hanson (2013); Lopez-Salido, Stein and Zakrajsek (2017); Baron and Xiong (2017).

<sup>2</sup>See Page 26 for further details on this case. As we explain there, our framework can be used to justify the SEC response in that scenario.

non-trivially, as we explain below. Initially, we characterize the optimal policy for a social planner who can only impose a leverage cap. Subsequently, we explore the role of monetary policy.

Two key objects fully characterize the equilibrium of our model. First, investment is determined by a levered version of Tobin’s  $q$ , which measures the joint market value of equity and debt per unit of investment. Second, the (private) marginal value of leverage plays a dual and critical role in our analysis. When the leverage cap does not bind, the marginal value of leverage optimally trades off the three forces described above to determine equilibrium leverage. When the leverage cap binds, the marginal value of leverage determines the sensitivity of investment to changes in the leverage limit, which proves to be a critical input for our normative results.

Using tools from variational calculus, we characterize the response of both objects to arbitrary changes in investors’ and/or creditors’ beliefs. This method is a useful contribution in its own right, since we obtain interpretable equations that can describe the consequences of flexible changes in beliefs, which may include many heuristics and biases that have been considered in behavioral economics.<sup>3</sup> Our results reveal nuanced effects, whereby both the type and extent of belief changes affect equilibrium behavior. For instance, changes in creditors’ beliefs near the default boundary are particularly important when distress costs are large, while changes in investors’ beliefs about downside (default) states are not relevant for market valuations.<sup>4</sup>

Our characterization of the equilibrium reveals a fundamental asymmetry whereby optimism (in a hazard-rate sense) among equity investors decreases the marginal value of leverage, while optimism among creditors increases it. That is, when leverage regulation does not bind, optimism among investors reduces leverage in equilibrium, while optimism among creditors increases leverage in equilibrium. This result also implies that investment becomes less sensitive to binding leverage limits when equity investors are exuberant, but more sensitive when creditors investors are exuberant.<sup>5</sup> Perhaps surprisingly, when considering an identical change in investors’ and creditors’ beliefs, the changes in leverage and investment are qualitatively the same as in the case in which only creditors’ beliefs

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<sup>3</sup>See Xiong (2013) and Simsek (2021) for recent surveys on beliefs and speculation. Variational calculus is used widely in economics, primarily to solve optimal control problems, including in the analysis of optimal taxation (e.g., Golosov, Tsyvinski and Werquin, 2014). To our knowledge, we are the first to employ these methods to explore the impact of arbitrary changes in beliefs on equilibrium outcomes and welfare.

<sup>4</sup>The upside/downside distinction is related to the analysis of Simsek (2013*a*), but not identical. We explicitly relate our positive results to his in Section E.5 of the Online Appendix.

<sup>5</sup>The positive implications of our model go some way towards reconciling the mixed empirical evidence on the relationship between risk-taking and leverage in the banking sector: bank capital is effective in curbing risk-taking incentives on average (e.g., Jiménez et al., 2014), but not to smooth out the largest booms and busts (e.g., Jorda et al., 2021).

change. This result is driven by the fact that creditors, by virtue of being more patient, attach a higher value to future payoffs, making their beliefs more important at the margin.

We then present our normative results, which are the central contribution of this paper. Formally, we study the second-best problem of a utilitarian social planner who can impose a leverage cap but cannot control the level of investment. The planner computes investors' and creditors' welfare using beliefs for each group that are potentially different from the beliefs that these agents use to make decisions. One interpretation of our results is that investors and creditors have distorted beliefs and that the planner's beliefs are correct. Following this logic, our results can be interpreted as characterizing an optimal paternalistic policy, although we also consider alternative interpretations.

The marginal welfare effect of increasing the leverage cap is the sum of two components. The first is the *inframarginal* effect of more leverage on existing units of investment. This component captures how varying the leverage cap modifies the planner's valuation of pre-existing investment at the margin. The second is the *incentive* effect, which arises because varying the leverage cap impacts investment in equilibrium. For example, a tighter leverage cap reduces equilibrium investment, which is perceived to improve welfare for the planner when the value of investment perceived by investors and creditors is higher than the value perceived by the planner. The incentive effect hinges on the sensitivity of the investment to leverage policy.

Our central normative result determines the desirability of tightening or relaxing leverage caps in response to changes in beliefs. We show that the same objects that determine leverage and investment in equilibrium — the value of investment and the marginal value of leverage — also determine the normative implications of changes in beliefs. First, the inframarginal welfare effect of more leverage is proportional to the change in the value of investment. This effect implies tighter optimal leverage limits in response to a change in beliefs if (i) equilibrium investment increases, and (ii) the private marginal benefit of leverage is higher than the marginal benefit perceived by the planner. Second, the incentive effect is proportional to the sensitivity of investment to leverage regulation, which is linked to the marginal value of leverage. This effect implies tighter optimal leverage limits in response to a change in beliefs if (i) the sensitivity of investment to leverage regulation increases, and (ii) the private value of investment is higher than the value perceived by the planner. The overall economics are subtle. For example, the same belief distortions can motivate tighter leverage regulation via the inframarginal effect, but more relaxed regulation via the incentive effect. Indeed, a core insight from our analysis is to show that, in a second-best world, the motivation for “leaning against the wind” when policymakers suspect over-optimism is not clear-cut. Nevertheless, our model provides

sharp policy prescriptions in three relevant scenarios.

First, in an “equity exuberance” scenario, in which only equity investors become optimistic relative to creditors and the planner (in a hazard-rate sense), it is never optimal to impose a binding leverage limit.<sup>6</sup> This is the result of two forces. First, the planner wishes to push investors towards issuing more debt and less equity against inframarginal units of investment, because optimistic equity investors (wrongly) consider debt to be undervalued. Second, equity optimism means that leverage limits become a blunt tool for the purpose of disciplining excessive investment. The second relevant scenario is one of “debt exuberance”. In this scenario, in which only creditors become optimistic relative to investors and the planner, optimal leverage limits are always binding and decreasing in the extent of creditors’ optimism. This is because optimism among creditors leads to an overvaluation of debt, and increases the sensitivity of investment to leverage policy. Finally, as discussed above, changes in creditors’ beliefs dominate marginal valuations in a “joint exuberance” scenario, again leading to tighter optimal regulation.

We consider three extensions to our baseline model. The first extension introduces the possibility that the government provides ex-post bailouts without commitment. This friction provides an additional rationale for government intervention. We derive several new insights from this extension that are particularly useful in the context of leverage regulation in banking. First, we show that when bailouts are a convex and decreasing function of realized investment returns, belief distortions in good states of the world become especially important for policy. Second, we show that bailouts can generate new normative implications in an equity exuberance scenario. Intuitively, the planner now has a stronger incentive to prevent increases in leverage on inframarginal units of investment, which would raise the deadweight fiscal costs of bailouts. In this context, the type of equity distortion becomes crucial, as we demonstrate in the classic case where investors are “too big to fail.” If equity exuberance mainly overstates large upside returns in solvent states of the world, as opposed to neglecting downside risk, then the inframarginal effect dominates and it becomes optimal to impose tighter leverage caps. By contrast, if equity exuberance focuses on downside risk, then the incentive effect dominates. Since leverage policy becomes a blunt tool for investment incentives when equity investors are optimistic, the optimal policy response in this case is to relax leverage caps.

In the second extension, we suppose that the government has the ability to affect the risk-free interest rate via monetary policy. Investment remains sensitive to a monetary tightening (an increase in interest rates) because this policy raises the cost of leverage

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<sup>6</sup>Indeed, this scenario generates a case for leverage floors or, conversely, limits on equity issuance. Our results can be used to rationalize recent policy interventions that limit equity issuance, as in the case of Hertz mentioned above.

and reduces the private value of investment. We show that when investors and/or creditors become optimistic (pessimistic) it is optimal to increase (lower) interest rates, which improves welfare by reducing (increasing) investment. This insight is especially relevant in an equity exuberance scenario, in which leverage regulation cannot be used to improve welfare. These results connect our paper to the literature on monetary policy as a prudential tool. Monetary policy has been advocated for in situations where traditional financial regulation cannot reach the “shadow banking” sector, or is otherwise constrained (e.g., Stein, 2013; Caballero and Simsek, 2019). Even in a model without such constraints, we show that monetary policy can be useful by affecting investment, and is particularly effective in cases where capital regulation is endogenously constrained by distorted beliefs.

Our final set of extensions explores the role played by the beliefs used by the planner to compute welfare. First, we show how our model can be used to give a positive — as opposed to normative — interpretation to changes in the planner’s beliefs. Formally, we characterize how the optimal policy responds to changes in the beliefs used by the planner to compute welfare. The results are ambiguous when the planner is subject to equity exuberance, leading to excessively tight leverage limits only when the inframarginal effect dominates incentive considerations at the margin. By contrast, debt or joint exuberance on behalf of the planner always implies excessively lenient leverage regulation. Second, we relax the assumption that the planner observes investors’ and creditors’ beliefs. Here we assume instead that the planner must choose the optimal policy before observing the realization of a “sentiment” indicator that drives the beliefs of investors and creditors. In this setting, the optimal leverage regulation depends on the covariance (across realizations of sentiment) of the desirability and effectiveness of policy. We show that this effect favors more lenient policy in response to equity investors’ sentiments, but more stringent policy in response to creditors’ sentiments.

**Related Literature** Our paper is related to several literatures. Our approach to computing welfare is related to a growing literature that explores the normative implications of belief heterogeneity. Bianchi, Boz and Mendoza (2012) study paternalistic and non-paternalistic macroprudential policies in an environment with pecuniary externalities caused by collateral constraints. Brunnermeier, Simsek and Xiong (2014) develop a criterion to detect speculation under heterogeneous beliefs, which is also used in Simsek (2013*b*), Heimer and Simsek (2019), and Caballero and Simsek (2020) to provide normative assessments of financial innovation, leverage restrictions on trading, and stabilization policy, respectively. Gilboa, Samuelson and Schmeidler (2014) propose an alternative criterion to detect speculation. Dávila (2014) characterizes the optimal financial transaction tax for a given planner’s belief in an environment with heterogeneous

beliefs. Campbell (2016), Farhi and Gabaix (2020), and Exler et al. (2019) also explore paternalistic policies in a household context, while Haddad, Ho and Loualiche (2020) do so in the context of technological innovations.

Another relevant strand of work studies the relationship between beliefs and leverage, including the contributions of Geanakoplos (1997, 2003, 2009), Fostel and Geanakoplos (2008, 2012, 2015, 2016), Simsek (2013*a*), and Bailey et al. (2019). Methodologically, we provide, to our knowledge, the first use of variational (Gateaux) derivatives to explore the impact of changes in beliefs on equilibrium outcomes and welfare. Several of our findings are connected to the well-developed literature on government bailouts, which includes the contributions of Farhi and Tirole (2012), Bianchi (2016), Chari and Kehoe (2016), Keister (2016), Gourinchas and Martin (2017), Cordella, Dell’Ariccia and Marquez (2018), ?, and Dovis and Kirpalani (2020), among others. We provide a novel analysis of how bailouts and belief distortions interact, and how they jointly shape the optimal regulatory policy. The recent work of Krishnamurthy and Li (2020) and Maxted (2020) quantitatively explores the role of beliefs on shaping business cycles in environments with financial frictions. In contrast to these two papers, our main contribution is normative and our model emphasizes the differences between investors’ and creditors’ beliefs.

Finally, our results also contribute to the literature that explores the interaction between monetary and regulatory policy. The recent work of Caballero and Simsek (2019) is the closest to this part of our analysis. While they study the design of macroprudential and monetary policy in a model with nominal rigidities and aggregate demand effects, we instead consider optimal policies in a model of risky credit with a rich specification of beliefs. Farhi and Werning (2020) also explore the role of monetary policy in an environment with nominal rigidities and belief distortions.

**Outline** The structure of the paper is as follows. Section 2 introduces our baseline model, characterizes its equilibrium, and describes some key positive properties of the model. Section 3 presents the central welfare effects that determine the optimal leverage regulation. Section 4 extends our results to an environment with government bailouts, while Section 5 considers the role of monetary policy. Section 6 explores the role of the planner’s beliefs and Section 7 concludes. All proofs and derivations are in the Appendix.

## 2 Baseline Model

We initially study how beliefs affect leverage regulation, abstracting from government bailouts and monetary policy. In Sections 4 and 5, we extend our model to incorporate both.



## 2.1 Environment

**Agents, preferences and endowments.** There are two dates  $t \in \{0, 1\}$  and a single consumption good (dollar), which serves as numeraire. There are two types of agents: a unit measure of investors, indexed by  $I$ , and a unit measure of creditors, indexed by  $C$ . There is also a social planner/regulator/government, who sets leverage regulation. We denote the possible states of nature at date 1 by  $s \in [\underline{s}, \bar{s}]$ , where  $\underline{s} \geq 0$ . As described below,  $s$  corresponds to the realization of the returns to investors' technology.

Both investors and creditors are risk-neutral. The lifetime utility of investors is

$$c_0^I + \beta^I \mathbb{E}^I [c_1^I(s)], \quad (1)$$

where  $c_0^I$  and  $c_1^I(s)$  denote the consumption of investors and  $\mathbb{E}^I[\cdot]$  denotes the expectation under the investors' beliefs, whose determination is described below. The lifetime utility of creditors is

$$c_0^C + \beta^C \mathbb{E}^C [c_1^C(s)], \quad (2)$$

where  $c_0^C$  and  $c_1^C(s)$  denote the consumption of creditors and  $\mathbb{E}^C[\cdot]$  denotes the expectation under the creditors' beliefs. We assume that  $0 < \beta^I < \beta^C \leq 1$ , so that investors are less patient than creditors.

The endowments of the consumption good of investors and creditors at dates 0 and 1 are respectively given by  $\{n_0^I, n_1^I(s)\}$  and  $\{n_0^C, n_1^C(s)\}$ . Creditors' and investors' endowments are such that their consumption is never negative.<sup>7</sup>

**Investment technology.** Investors can invest at date 0 to create  $k \geq 0$  units of productive capital. This investment in capital yields  $sk$  dollars in state  $s$  at date 1, so that  $s$  also denotes the gross return on capital investment. As in canonical "Tobin's  $q$ " models of investment, creating  $k$  units of capital at date 0 requires  $k + \Upsilon(k)$  dollars, where  $\Upsilon(k)$  is a convex adjustment cost that satisfies  $\Upsilon(0) = 0$ ,  $\lim_{k \rightarrow 0} \Upsilon'(k) = 0$ ,  $\Upsilon'(k) \geq 0$ , and  $\Upsilon''(k) > 0$ . The combination of an investment technology that scales linearly with capital and a convex adjustment cost allows investors to separate their financing decisions from their investment decisions, as shown in Lemma 1 below.

**Financial contracts.** Investors finance their investment by issuing bonds with face value  $b$  and price  $Q(b)$  per unit of investment. Therefore, the total face value of debt issued is  $bk$ , the total amount raised via borrowing at date 0 is  $Q(b)k$ , and an investor's leverage

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<sup>7</sup>In Section E.5 of the Online Appendix, we study an alternative scenario in which the non-negativity constraint of investors' consumption at date 0 binds. In that case, the equity contribution of investors is effectively capped and our positive results can be mapped to those in Simsek (2013a).

ratio is simply  $b$ . Any remaining financing is obtained with an equity contribution from the investor's endowment.<sup>8</sup> Note that we assume a form of market segmentation/limited participation, in the sense that creditors cannot fund investors using equity.<sup>9</sup>

At date 1, after the state  $s$  is realized, investors decide whether to default. If investors default, creditors seize all of the investors' productive capital and receive  $\phi s$  per unit of investment, where  $0 \leq \phi \leq 1$ . The remainder  $(1 - \phi)s$  measures the deadweight loss or cost of distress associated with default.

The difference in discount factors  $\beta^C - \beta^I > 0$  between creditors and investors translates into a benefit from issuing debt or, equivalently, into a cost of equity issuance.<sup>10</sup> This difference guarantees that investors always borrow in equilibrium. As explained in Section E.1 of the Online Appendix, with additional regularity conditions, our results extend to environments in which belief differences are the single rationale for investors to borrow.

**Budget constraints.** In this environment, the budget constraint of investors at date 0 is given by

$$c_0^I + k + \Upsilon(k) = n_0^I + Q(b)k, \quad (3)$$

where  $Q(b)$  denotes the price of debt per unit of investment, which is determined by creditors. Similarly, the budget constraint of investors at date 1 in state  $s$  is given by

$$c_1^I(s) = n_1^I(s) + \max\{s - b, 0\}k. \quad (4)$$

This equation already reflects the fact that investors exercise their option to default whenever  $s < b$ . In that case, creditors seize all capital and its returns, and investors consume only their endowments  $n_1^I(s)$ .

**Beliefs.** We adopt a flexible approach to model the perceptions of investors and creditors over future states of nature. Formally, we assume that investors perceive the cumulative distribution over future states to be  $F^I(s)$ , while creditors perceive it to be  $F^C(s)$ . The distributions  $F^I(s)$  and  $F^C(s)$  can differ from each other and from the true distribution,

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<sup>8</sup>In Section E.6.1 of the Online Appendix, we explain how to introduce inside equity in our model.

<sup>9</sup>An objective of part of the literature that studies belief disagreements is to endogenously determine from assumptions on beliefs which agents are borrowers and lenders in equilibrium. By segmenting equity investors from creditors at the onset, we implicitly allow for other rationales that motivate some agents to borrow or lend in equilibrium, and then consider the impact of changes in beliefs.

<sup>10</sup>There are readily available theories that make issuing debt beneficial/issuing equity costly. For example, a demand for "money-like" claims (Gorton and Pennacchi, 1990; Stein, 2012; DeAngelo and Stulz, 2015) or safe claims (Caballero and Farhi, 2018; Caballero, Farhi and Gourinchas, 2017), or the market discipline brought by debt (Diamond and Rajan, 2001).

which we do not have to specify to derive the majority of our results.

The advantage of this flexible approach is that it allows us to analyze the consequences of different belief configurations without taking a stance on the exact process of belief formation. We assume that these distributions are continuously differentiable, with densities  $f^I(s) > 0$  and  $f^C(s) > 0$  defined on  $s \in [\underline{s}, \bar{s}]$ .<sup>11</sup>

**Leverage regulation.** The planner is able to impose a leverage cap on investors at date 0. This cap is the central object of study in this paper. Formally, the planner requires that investors set  $b \leq \bar{b}$ , where  $1 - \bar{b}$  is the minimal permitted ratio of equity contribution to risky investment. This constraint imposes a leverage cap, or equivalently, a minimal equity contribution per unit of investment. In Section 3, we discuss in detail the role of the beliefs over future states  $s$  that the planner uses to evaluate welfare.

Note that the planner cannot directly control the scale  $k$  of investment. We therefore focus on a second-best policy problem, in which  $k$  remains a free choice variable for investors.<sup>12</sup> It is possible to justify this assumption, for example, because the private sector has superior information about investment opportunities (e.g., Walther, 2015). Perhaps for this reason, all relevant regulatory constraints in practice (e.g., capital requirements, leverage limits, liquidity coverage ratios, and net stable funding requirements in Basel III) focus on ratios of financial institutions' assets to liabilities. Similarly, household finance regulations are based on loan-to-value and debt-to-income ratios. All of these regulatory tools leave the scale of investment unconstrained, as in our model.

**Equilibrium definition.** Given a leverage limit  $\bar{b}$ , an *equilibrium* in this economy is defined by an investment decision,  $k \geq 0$ , a leverage decision,  $b \leq \bar{b}$ , and a default decision rule such that i) investors maximize expected utility subject to their budget constraints while taking into account that any debt issued is valued by creditors, and ii) creditors value investors' debt breaking even in expectation.

Our notion of equilibrium, in which borrowers internalize that their borrowing decisions change the payoff of lenders in equilibrium, is standard in models of default (e.g., Aguiar and Amador, 2013; Livshits, 2015). In the body of the paper, we proceed as if the environment considered here is well-behaved in the sense that optimal leverage choices are finite. We discuss the necessary regularity conditions in Section E.1 of the Online

<sup>11</sup>We assume continuous and strictly positive densities to simplify the exposition of our analysis of belief perturbations (see Section 2.3). Our results go through, with some additional technical conditions, if we impose weaker assumptions, such as absolute continuity of the relevant distributions.

<sup>12</sup>In Section E.3 of the Online Appendix, we describe the form of the first-best policy, in which the planner can also control investment directly. Dávila and Walther (2021) provide a systematic study of second-best regulation in general environments.

Appendix.

## 2.2 Equilibrium characterization

In the Appendix — see Equations (23) through (28) — we include a detailed formulation of the investors' problem. Here, we introduce Lemma 1, which presents a reformulation of the investors' problem whose solution directly characterizes equilibrium leverage and investment.

**Lemma 1.** *[Investors' problem] Equilibrium leverage and investment are given by the solution to the following reformulation of the problem faced by investors:*

$$\max_{b,k} [M(b) - 1]k - \Upsilon(k) \quad (5)$$

$$s.t. \quad b \leq \bar{b}, \quad (6)$$

where  $M(b)$  is given by

$$M(b) = \underbrace{\beta^I \int_b^{\bar{s}} (s - b) dF^I(s)}_{equity} + \underbrace{\beta^C \left( \int_b^{\bar{s}} b dF^C(s) + \phi \int_{\underline{s}}^b s dF^C(s) \right)}_{debt}. \quad (7)$$

Intuitively, it is possible to fully characterize the equilibrium of the model by incorporating the default decision of investors at date 1 and the pricing of debt by creditors into the investors' date 0 problem. First, notice that investors optimally default at date 1 whenever  $s < b$ , and repay when  $s \geq b$ .<sup>13</sup> Therefore,  $M(b)$  can be interpreted as the sum of the market value of equity and debt per unit of investment net of adjustment costs, expressed as a function of leverage  $b$ .

The first component of  $M(b)$  in Equation (7) corresponds to the present value of the equity payoffs, as perceived by investors. Since equity investors are only paid in the non-default states, this integral is over states in which  $s \geq b$ . The second component of  $M(b)$  in Equation (7) corresponds to the present value of the debt payoffs, as perceived by creditors. Since creditors are paid in both non-default and default states, this second component of  $M(b)$  accounts for both scenarios. When investors do not default ( $s \geq b$ ), creditors receive the promised  $b$  per unit of investment  $k$ . When investors default ( $s < b$ ), creditors receive  $\phi s$  per unit of investment  $k$ , which accounts for the deadweight losses of default. Importantly, while debt payoffs are valued using the creditors' discount factor  $\beta^C$

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<sup>13</sup>Our analysis extends to settings with more nuanced optimal default decisions, for example, when investors receive government assistance in states in which they would otherwise default (see Section 4), or when creditors have recourse to the market value of collateral (see Section E.6.2 of the Online Appendix).

and beliefs  $F^C(s)$ , equity payoffs are valued using the investors' discount factor  $\beta^I$  and beliefs  $F^I(s)$ .

Lemma 1 clearly highlights that the leverage decision of investors is independent of their investment decision. That is, first, investors choose the level of  $b$  that maximizes  $M(b)$ . Next, given the optimal choice of  $b$ , investors choose  $k$  to maximize Equation (5). In Proposition 1, we formalize how the solution to the investors' problem characterizes equilibrium leverage and investment.

**Proposition 1.** *[Equilibrium leverage and investment] Equilibrium leverage  $b^*$  and equilibrium investment  $k^*$  are respectively given by the solution to*

$$\frac{dM(b^*)}{db} = \mu \quad (8)$$

$$M(b^*) = 1 + \Upsilon'(k^*), \quad (9)$$

where  $\mu$  is the Lagrange multiplier on the leverage constraint, which we have expressed as  $b k \leq \bar{b} k$ . When the investors' leverage constraint doesn't bind,  $b^* < \bar{b}$  and  $\mu = 0$ . When the investors' leverage constraint binds,  $b^* = \bar{b}$  and  $\mu \geq 0$ .

Equation (8) equates the marginal value of leverage per unit of investment and the Lagrange multiplier  $\mu$  associated with the leverage constraint.<sup>14</sup> Two forces determine the marginal value of leverage per unit of investment,  $\frac{dM(b)}{db}$ , characterized in Equation (10):

$$\frac{dM(b)}{db} = \underbrace{\beta^C \int_b^{\bar{s}} dF^C(s) - \beta^I \int_b^{\bar{s}} dF^I(s)}_{\substack{\text{marginal benefit of leverage} \\ \text{(valuation difference)}}} - \underbrace{(1 - \phi) \beta^C b f^C(b)}_{\substack{\text{marginal cost of leverage} \\ \text{(distress)}}}. \quad (10)$$

The first force arises due to the differences in valuation between investors and creditors. By increasing the leverage ratio  $b$ , an investor is able to raise in present value terms  $\beta^C \int_b^{\bar{s}} dF^C(s)$  dollars per unit invested, whose repayment cost in present value terms corresponds to  $\beta^I \int_b^{\bar{s}} dF^I(s)$ . When investors have common beliefs, this first force is proportional to the difference in discount factors  $\beta^C - \beta^I > 0$ . When investors have

<sup>14</sup>Note that  $M(b)$  can be expressed in terms of i) a Modigliani-Miller valuation term, which is independent of the leverage choice, ii) a term that captures the marginal benefit of leverage, due to differences in discount factors or beliefs, and iii) a term that captures the marginal cost of leverage, due to the cost of distress associated with default:

$$M(b) = \underbrace{\beta^C \int_{\underline{s}}^{\bar{s}} s dF^C(s)}_{\substack{\text{Modigliani-Miller} \\ \text{valuation}}} - \underbrace{\int_b^{\bar{s}} (s - b) (\beta^C dF^C(s) - \beta^I dF^I(s))}_{\substack{\text{benefit of leverage} \\ \text{(valuation difference)}}} - \underbrace{(1 - \phi) \beta^C \int_{\underline{s}}^b s dF^C(s)}_{\substack{\text{cost of distress}}}.$$

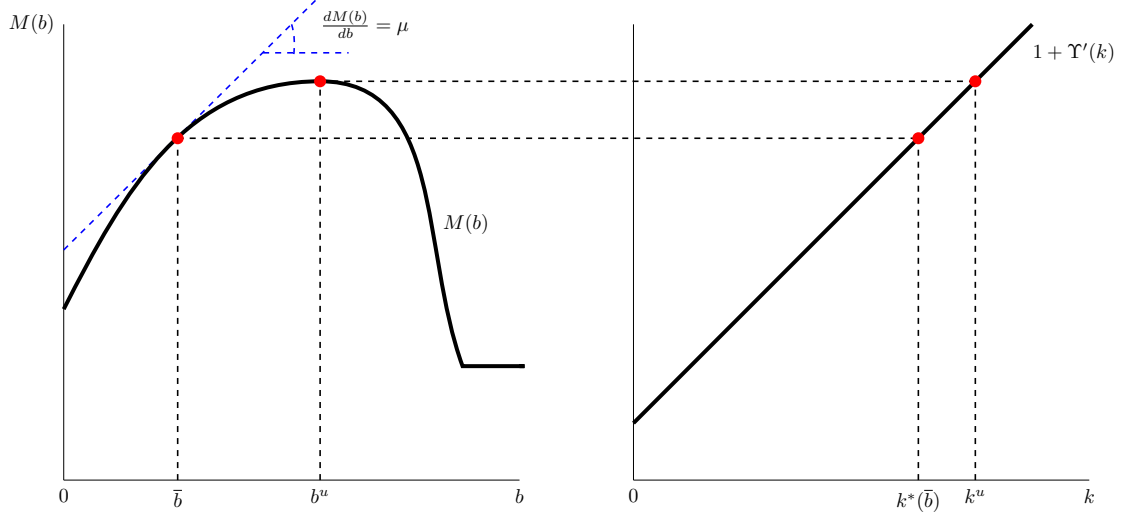


Figure 1: Sensitivity of investment to leverage limit

**Note:** Figure 1 illustrates the joint determination of equilibrium leverage (left panel) and investment (right panel), formalized in Proposition 1. Figure 1, which is designed to illustrate Lemma 2, should be read from left to right. Changes in the leverage limit  $\bar{b}$  around the laissez-faire optimum, denoted here by  $b^u$  — with the superscript  $u$  standing for unregulated — are associated with no changes in the level of investment, since  $\frac{dM(b)}{db}\big|_{b=b^u} = 0$  in that case. As shown in Lemma 2, changes in the leverage limit  $\bar{b}$  away from the laissez-faire optimum induce changes in the level of investment that are increasing in the slope of  $\frac{dM(b)}{db}\big|_{b=\bar{b}}$  and decreasing in the value of  $\Upsilon''(k)$ , which determines the slope of  $1 + \Upsilon'(k)$  in the right panel.

common discount factors, this first force is proportional to the difference in the probability of repayment between creditors and investors  $\int_{\bar{b}}^{\bar{s}} dF^C(s) - \int_{\bar{b}}^{\bar{s}} dF^I(s)$ . In this case, investors find it attractive to increase leverage when they perceive non-default states to be relatively less likely than creditors, since the amount of funds they can raise from creditors,  $\int_{\bar{b}}^{\bar{s}} dF^C(s)$ , is higher than the perceived repayment,  $\int_{\bar{b}}^{\bar{s}} dF^I(s)$ .

The second force corresponds to the marginal increase in deadweight losses associated with defaulting more frequently after increasing leverage. These two forces guarantee that equilibrium leverage is strictly positive and finite, with  $0 < b^* < \infty$ , even in a laissez-faire scenario in which the leverage constraint is not binding.<sup>15</sup>

Equation (9), which is a levered version of Tobin's marginal  $q$ , characterizes the optimal investment choice  $k^*$ . Its left-hand side,  $M(b^*)$ , captures the marginal benefit to investors associated with a marginal increase in investment given an optimal leverage choice. Its right-hand side,  $1 + \Upsilon'(k^*)$ , simply corresponds to the marginal cost of such an increase,

<sup>15</sup>To see this, note that  $\frac{dM(b)}{db}\big|_{b=0} = \beta^C - \beta^I > 0$ , so that  $b > 0$  is always optimal. Moreover, in Section E.1 of the Online Appendix, we show that finite leverage is guaranteed whenever the costs of distress are sufficiently large relative to the returns on investment.

which captures the direct cost of investing and the adjustment cost.

Proposition 1 highlights that  $\frac{dM(b)}{db}$  and  $M(b)$  are the key objects that determine the equilibrium of our model. Interestingly, the marginal value of leverage per unit of investment,  $\frac{dM(b)}{db}$ , plays a dual role, depending on whether the leverage constraint binds. If the leverage constraint does not bind, then the solution to  $\frac{dM(b^*)}{db} = 0$  determines equilibrium leverage. If the leverage constraint binds, then the marginal value of leverage per unit of investment,  $\frac{dM(\bar{b})}{db}$ , determines the *sensitivity* of equilibrium investment to changes in the leverage limit,  $\frac{dk^*}{d\bar{b}}$ , as formalized in Lemma 2.

**Lemma 2.** [*Sensitivity of investment to leverage limit*] *If the leverage constraint binds, then the sensitivity of investors' investment to the leverage limit  $\bar{b}$  is given by*

$$\frac{dk^*}{d\bar{b}} = \frac{1}{\Upsilon''(k^*)} \frac{dM(\bar{b})}{db} \geq 0. \quad (11)$$

Hence, loosening (tightening) the leverage constraint increases (decreases) investment in proportion to the marginal value of leverage per unit of investment. Figure 1 illustrates these effects. Lemma 2 is helpful because  $\frac{dk^*}{d\bar{b}}$  will be an important input for our normative results.

In summary, taken together, Proposition 1 and Lemma 2 imply that understanding the behavior of  $M(b)$  and  $\frac{dM(b)}{db}$  is sufficient to determine i) equilibrium leverage and investment, and ii) the sensitivity of investment to changes in a binding leverage limit. Next, we focus on characterizing how  $M(b)$  and  $\frac{dM(b)}{db}$  vary in response to changes in beliefs. These comparative statics provide the main ingredients for our normative analysis below.

### 2.3 Comparative statics and positive implications

Our ultimate goal is to understand how equilibrium outcomes (e.g., leverage and investment) and welfare vary in response to changes in beliefs, which are infinite-dimensional objects. Since we have specified flexible distributions of investors' and creditors' beliefs, we will characterize the responses of leverage and investment — and later of welfare — to changes in beliefs using variational (Gateaux) derivatives. Formally, we consider perturbations of beliefs of the form

$$F^j(s) + \varepsilon G^j(s),$$

where  $F^j(s)$  denotes the original cumulative distribution function of  $s$  for agents in group  $j \in \{I, C\}$ , the variation  $G^j(s)$  represents the direction of the perturbation of beliefs, and

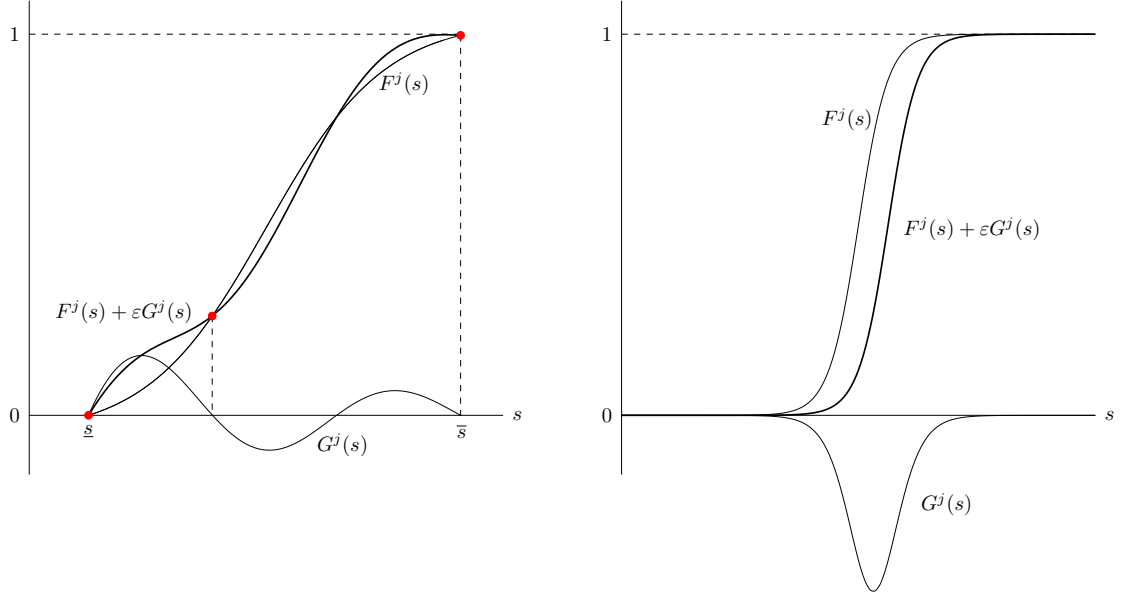


Figure 2: Beliefs' perturbations/variations (arbitrary and hazard-rate dominant)

**Note:** The left panel of Figure 2 illustrates an arbitrary perturbation/variation of beliefs, starting from the distribution of beliefs with cdf  $F^j(s)$  in the direction of  $G^j(s)$ . Note that  $G^j(s)$  is continuously differentiable and satisfies  $G^j(\underline{s}) = G^j(\bar{s}) = 0$ . The right panel of Figure 2 illustrates a hazard-rate dominant perturbation, such as those considered, for instance, in Propositions 3 and 6 below. Hazard-rate dominance is formally defined on Page 17. Note that an increase in the mean of a normal distribution, for a fixed variance, generates a hazard-rate dominant perturbation. Note also that hazard-rate dominant perturbations also satisfy first-order stochastic dominance, but the converse is not true. As explained in the text, note that  $G^j(s) < 0$  can be understood as local optimism at state  $s$ .

$\varepsilon \geq 0$  is a scalar. When  $G^j(s) < 0$ , it is natural to say that the perturbed beliefs are locally more optimistic for state  $s$ , since the probability assigned to states equal or lower than  $s$  is now lower. Figure 2 illustrates an arbitrary perturbation of  $F^j(s)$ . We consider variations  $G^j(s)$  that are continuously differentiable and satisfy  $G^j(\underline{s}) = G^j(\bar{s}) = 0$ . These conditions ensure that perturbed beliefs are still valid cumulative distribution functions for small enough values of  $\varepsilon$ , as we formally show in Section E.2 of the Online Appendix.

A variational (or Gateaux) derivative is defined as follows (e.g., Luenberger, 1997). For concreteness, consider the market value  $M(b; F^j)$  per unit of investment in Equation (7), where we have made explicit its dependence on the beliefs of group  $j \in \{I, C\}$  of agents. Its variational derivative in the direction of a perturbation  $G^j(s)$  is denoted  $\frac{\delta M}{\delta F^j} \cdot G^j$  and defined as

$$\frac{\delta M}{\delta F^j} \cdot G^j \equiv \lim_{\varepsilon \rightarrow 0} \left[ \frac{M(b; F^j + \varepsilon G^j) - M(b; F^j)}{\varepsilon} \right].$$



Intuitively, the variational derivative of  $M(b)$  measures the change in the market value per unit of investment when we perturb the beliefs among  $j$ -agents by a small amount in the direction of  $G^j$ . The same definition applies to the change in the marginal value of leverage  $\frac{dM(b)}{db}$ , which we denote by  $\frac{\delta(\frac{dM}{db})}{\delta F^j} \cdot G^j$ . Applying a variational implicit function theorem to the conditions that characterize the equilibrium in Proposition 1, we similarly obtain the variational derivatives of leverage and investment, as shown in Lemma 3.

**Lemma 3.** *[Sensitivity of leverage and investment to beliefs] The responses of equilibrium investment to investors' and creditors' beliefs are characterized by the variational derivatives*

$$\frac{\delta k^*}{\delta F^I} \cdot G^I = \frac{\frac{\delta M}{\delta F^I} \cdot G^I}{\Upsilon''(k^*)} \quad \text{and} \quad \frac{\delta k^*}{\delta F^C} \cdot G^C = \frac{\frac{\delta M}{\delta F^C} \cdot G^C}{\Upsilon''(k^*)}.$$

Moreover, if the leverage constraint does not bind, then the responses of equilibrium leverage satisfy

$$\frac{\delta b^*}{\delta F^I} \cdot G^I = \frac{\frac{\delta(\frac{dM}{db})}{\delta F^I} \cdot G^I}{-\frac{d^2 M}{db^2}} \quad \text{and} \quad \frac{\delta b^*}{\delta F^C} \cdot G^C = \frac{\frac{\delta(\frac{dM}{db})}{\delta F^C} \cdot G^C}{-\frac{d^2 M}{db^2}}.$$

Lemma 3 shows that the same perturbation of beliefs impacts leverage and investment through different channels. Investment changes in proportion to the variational derivative of the total valuation  $M(b)$ .<sup>16</sup> Leverage, if it is not determined by a binding constraint, changes in proportion to the variational derivative of the marginal value of leverage  $\frac{dM}{db}$ . This subtle distinction will be a key driver of our normative results. Next, in Proposition 2, we characterize the key variational derivatives.

**Proposition 2.** *a) [Variational derivatives: Market value] The market value per unit of investment changes in response to variations in investors' and creditors' beliefs according to*

$$\frac{\delta M}{\delta F^I} \cdot G^I = -\beta^I \int_b^{\bar{s}} G^I(s) ds \tag{12}$$

$$\frac{\delta M}{\delta F^C} \cdot G^C = -\beta^C \left[ (1 - \phi) b G^C(b) + \phi \int_{\underline{s}}^b G^C(s) ds \right]. \tag{13}$$

*b) [Variational derivatives: Marginal value of leverage] The marginal value of leverage*

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<sup>16</sup> A first look at Equation (9) may imply that  $\frac{\delta k^*}{\delta F^I} \cdot G^I$  also depends on  $\frac{\delta b^*}{\delta F^I} \cdot G^I$ , since  $\frac{\delta k^*}{\delta F^I} \cdot G^I = \frac{\frac{dM}{db} \frac{\delta b^*}{\delta F^I} \cdot G^I + \frac{\delta M}{\delta F^I} \cdot G^I}{\Upsilon''(k^*)}$ . However, the term  $\frac{dM}{db} \frac{\delta b^*}{\delta F^I} \cdot G^I$  is always 0, either because leverage is optimally chosen (and  $\frac{dM}{db} = 0$ ) or because the constraint binds (and  $\frac{\delta b^*}{\delta F^I} \cdot G^I = 0$ ).

changes in response to variations in investors' and creditors' beliefs according to

$$\frac{\delta \left( \frac{dM}{db} \right)}{\delta F^I} \cdot G^I = \beta^I G^I(b) \quad (14)$$

$$\frac{\delta \left( \frac{dM}{db} \right)}{\delta F^C} \cdot G^C = -\beta^C G^C(b) \left( 1 + (1 - \phi) b \frac{g^C(b)}{G^C(b)} \right), \quad (15)$$

where  $g^C(b) = G^{C'}(b)$ .

The general characterization in Proposition 2 shows that both the *type* and the *magnitude* of changes in beliefs are critical to understanding the behavior of leverage and investment. Part a) of Proposition 2 shows that market values  $M(b)$  respond to the variation of investors' beliefs  $G^I(s)$  in solvent states  $s \geq b$  — in Equation (12) — or to the variation of creditors' beliefs  $G^C(s)$  in default states  $s < b$  — in Equation (13). Moreover, there is a special role for creditors' optimism  $-G^C(b)$  at the default boundary, which measures the degree to which creditors understate the probability of default.<sup>17</sup> Finally, Equations (12) and (13) show that the response of  $M(b)$  to both investors' and creditors' beliefs inherits the sign of  $-G^j(s)$ , that is, market values rise with the local optimism of any agent.

By contrast, part b) of Proposition 2 points to a fundamental asymmetry between the responses of leverage to creditors' and investors' beliefs. Equations (14) and (15) imply that the marginal value of leverage  $\frac{dM(b)}{db}$  decreases when investors are optimistic about the probability of default — since it inherits the sign of  $G^I(b)$  — but increases when creditors are optimistic — since it inherits the sign of  $-G^C(b)$ . Notice also that the response of the marginal value of leverage depends only on local belief changes at the default boundary.

The general characterizations in Proposition 2 — and their welfare counterparts in Section 3 — are valuable because they can be used to explore the impact of different changes in beliefs, for instance, changes in the perception of volatility or rare events. In order to provide sharper insights, in Proposition 3 we analyze perturbations  $G^j(s)$  that induce optimism in the sense of hazard-rate dominance. Formally, an absolutely continuous distribution  $F^j(s)$  becomes more optimistic in the sense of hazard-rate dominance if the hazard rate  $h^j(s) \equiv \frac{f^j(s)}{1-F^j(s)}$  decreases for all  $s$  (e.g., Shaked and Shanthikumar, 2007, Chapter 1B). This is a stronger requirement than first-order stochastic dominance, but a weaker requirement than the monotone likelihood ratio property.<sup>18</sup>

<sup>17</sup>This property of Equation (13) arises because of the costs of distress in our model, which imply that creditors' payoffs are discontinuous in  $s$  at the default boundary whenever  $\phi < 1$ .

<sup>18</sup>Therefore, in terms of variational derivatives, a perturbation  $G^j(s)$  induces optimism in a hazard-rate

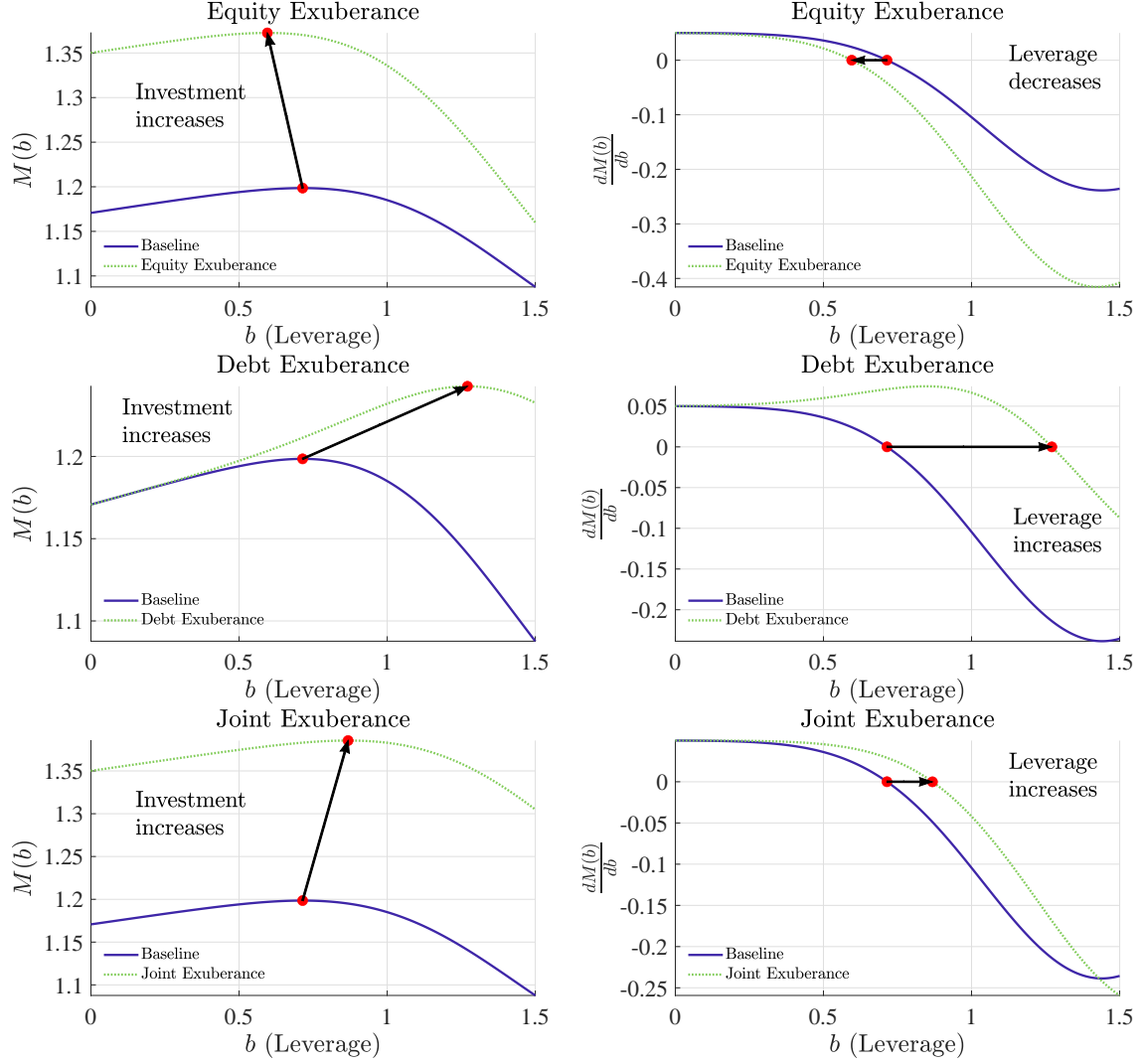


Figure 3: Differential impact of investors' and creditors' optimism

**Note:** Figure 3 illustrates the results of Proposition 3. The left plots in Figure 3 show  $M(b)$ , the market value of debt and equity per unit of investment, as a function of leverage  $b$ . The right plots in Figure 3 show  $\frac{dM(b)}{db}$ , the marginal value of leverage, as a function of leverage  $b$ . We assume that beliefs about  $s$  are normally distributed, with means indexed by  $\mu$  and standard deviations indexed by  $\sigma$ , and that investment costs are given by  $\frac{k^2}{2\varphi}$ . The parameters used in all plots are:  $\beta^I = 0.9$ ,  $\beta^C = 0.95$ ,  $\phi = 0.8$ ,  $\varphi = 1$ , and  $\sigma^I = \sigma^C = 0.4$ . The baseline beliefs are  $\mu^I = \mu^C = 1.3$ . The equity exuberance scenario corresponds to  $\mu^I = 1.5$  and  $\mu^C = 1.3$ . The debt exuberance scenario corresponds to  $\mu^I = 1.3$  and  $\mu^C = 1.5$ . The joint exuberance scenario corresponds to  $\mu^I = 1.5$  and  $\mu^C = 1.5$ .

**Proposition 3.** *[Differential impact of optimism by investors and creditors] Optimism in this proposition is defined in the sense of hazard-rate dominance.*

a) Equity exuberance: *When investors become more optimistic, the market value of investment  $M(b)$  increases but the marginal value of leverage  $\frac{dM(b)}{db}$  decreases.*

b) Debt exuberance: *When creditors become more optimistic, both the market value of investment  $M(b)$  and the marginal value of leverage  $\frac{dM(b)}{db}$  increase.*

c) Joint exuberance: *When investors and creditors have common beliefs and both become equally more optimistic, both the market value of investment  $M(b)$  and the marginal value of leverage  $\frac{dM(b)}{db}$  increase.*

Proposition 3 confirms that optimism/exuberance by any agent, in a hazard-rate sense, increases market values  $M(b)$ .<sup>19</sup> Meanwhile, investor optimism decreases the marginal value of leverage  $\frac{dM(b)}{db}$ , while creditor optimism increases it. Intuitively, optimism on the credit-supply side (i.e., by creditors) makes borrowing cheaper and encourages leverage through a substitution effect. However, optimism on the credit-demand side leads investors to believe that the likelihood of defaulting is lower and that the borrowing conditions offered by creditors are unfavorable, encouraging them to increase their equity contribution.

The proposition establishes a surprising additional result in a joint exuberance scenario, in which both investors and creditors become more optimistic starting from a common belief assessment. The sentiments of creditors dominate in this scenario, and the comparative statics are qualitatively the same as for debt exuberance. This result is driven by the relative patience of creditors, who attach a higher value to future payoffs, and whose beliefs are therefore more important for overall valuations at the margin.<sup>20</sup> We expect the logic behind this result to apply more broadly. In general, any additional force that drives creditors to become lenders in equilibrium (e.g., intertemporal substitution) will also make them value future payoffs more. Figure 3 illustrates these results.

These subtle distinctions will be key to our analysis of optimal policy below. The response of the marginal value of leverage to belief variations is especially important because it also determines the sensitivity of investment to leverage regulation — see

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sense if  $\frac{\delta h^j(s)}{\delta F} \cdot G^j \leq 0$  for all  $s$ . We present a detailed characterization of this property in Section E.4 of the Online Appendix.

<sup>19</sup>The results regarding the market value  $M(b)$  also hold when exuberance is defined in a first-order stochastic dominance (FOSD) sense. Hazard-rate dominance is the appropriate stochastic order in our setting due to the costs of distress, which scale with  $(1 - \phi)$  and are critical for the marginal value of leverage. Indeed, when  $\phi = 1$ , all our results apply in an FOSD sense.

<sup>20</sup>For instance, consider the special case where there are no costs of distress ( $\phi = 1$ ). In this case, adding up Equations (14) and (15) with a common variation  $G^C(b) = G^I(b)$  shows that the total marginal change in  $\frac{dM(b)}{db}$  is  $(\beta^C - \beta^I) G(b) < 0$ .

Lemma 2. Moreover, the results so far have interesting positive implications in their own right. We discuss these briefly before we present the main results of the paper.

Combining Lemma 3 with Proposition 3, we immediately obtain the following result:

**Corollary 1.** *[Positive implications of optimism by investors and creditors] Assume that the leverage constraint does not bind. In the equity exuberance scenario in Proposition 3, equilibrium investment increases but leverage decreases. In the debt and joint exuberance scenarios, both equilibrium investment and leverage increase.*

Corollary 1 implies that in expansions fueled by equity exuberance, investment and leverage decouple, and become *negatively* correlated. It is useful to examine the relationship between this implication of our model and related results in the existing literature. In our model, exuberant investors decide to invest more, but consider debt to be excessively expensive. Hence, they find it optimal to reduce leverage, and to fund the marginal increase in investment by reducing consumption at date 0. Relatedly, Bailey et al. (2019) consider a model with fixed investment, and show that investor optimism is associated with lower leverage, an implication which they confirm empirically for households' leverage choices. By contrast, in the model of Simsek (2013a), investors have a fixed amount of equity capital or, equivalently, face a binding non-negativity constraint on their consumption. In his analysis, investment can be increased only by additional borrowing, so that the correlation between investment and leverage is always positive, as we discuss further in Section E.5 of the Online Appendix.

### 3 Optimal Leverage Regulation

In this section, which contains the core contributions of this paper, we study the problem of a social planner who can set the leverage limit  $\bar{b}$ . Formally, social welfare for the planner is given by the sum of utilities of investors and creditors, which are computed using the planner's probability assessments for each of the agents. That is, the planner computes investors' welfare assessing the likelihood of events using a distribution  $F^{I,P}(s)$ . Similarly, the planner computes creditors' welfare assessing the likelihood of events using a potentially different distribution  $F^{C,P}(s)$ .

This approach allows us to explore a wide range of normative objectives. For instance, a planner that respects agents' beliefs will set

$$F^{I,P}(s) = F^I(s) \quad \text{and} \quad F^{C,P}(s) = F^C(s).$$

Alternatively, a planner who uses the true/objective distribution of investment returns,

which we denote here by  $F(s)$ , to compute social welfare will set

$$F^{C,P}(s) = F^{I,P}(s) = F(s).$$

Given this approach, we can now characterize the optimal policy, which takes into account the fact that investors and creditors make decisions under their own beliefs,  $F^I(s)$  and  $F^C(s)$ , but evaluates the consequences of these decisions using the planner's beliefs,  $F^{I,P}(s)$  and  $F^{C,P}(s)$ , which are taken as primitives.

It will become evident that our conclusions do not depend directly on the true distribution of  $s$ . However, one natural interpretation of our results is that investors and creditors have distorted beliefs and that the planner's beliefs are correct. Following this logic, our results can be interpreted as characterizing an optimal paternalistic policy. While this interpretation is useful to illustrate some of the underlying economics cleanly, our formal results have multiple interpretations. In particular, in Section 6, we study the impact of changes in the planner's beliefs on the optimal regulation, which can be interpreted as describing how the optimal policy changes when the planner's beliefs depart from the correct beliefs. Moreover, in Section E.7 of the Online Appendix, we consider an environment in which the planner is uncertain about the beliefs of investors and creditors. Both of these extensions illustrate how our results can also be used to explore the limitations of paternalism.

### 3.1 Planner's problem

The first step is to formulate the planner's problem. The planner chooses the leverage limit  $\bar{b}$ , taking into account that leverage and investment decisions react to this policy. Indeed, the optimality conditions (8) and (9) jointly define equilibrium leverage and investment as implicit functions  $b^*(\bar{b})$  and  $k^*(\bar{b})$  of the policy. Lemma 4 formally characterizes social welfare from the perspective of the utilitarian planner as a function of the leverage cap  $\bar{b}$ .

**Lemma 4.** *[Planner's problem] The planner's problem can be expressed as*

$$\max_{\bar{b}} W(b^*(\bar{b}), k^*(\bar{b})),$$

where social welfare  $W(b, k)$  is given by

$$W(b, k) = [M^P(b) - 1]k - \Upsilon(k),$$

and where  $M^P(b)$  denotes the present value of payoffs under the planner's beliefs

$$M^P(b) = \beta^I \int_b^{\bar{s}} (s - b) dF^{I,P}(s) + \beta^C \left( \int_b^{\bar{s}} b dF^{C,P} + \phi \int_{\underline{s}}^b s dF^{C,P}(s) \right).$$

Lemma 4 shows that the planner's objective mimics the objective of the reformulated investors' problem introduced in Lemma 1 after incorporating the planner's beliefs. This result is intuitive, but not obvious. The welfare of investors and creditors as perceived by the planner depends on their actual beliefs through the equilibrium choices of investment and leverage, but the social valuation of investment in  $M^P(b)$  depends only on the planner's beliefs.

There are three observations worth highlighting. First, note that whenever leverage regulation is binding, social welfare depends on investors' and creditors' beliefs only through the investment choice  $k^*$  since, in that case,  $b^*(\bar{b}) = \bar{b}$  is directly controlled by the planner. Second, note that the economy is constrained efficient for a planner that respects agents' beliefs, since  $M^P(b) = M(b)$  in that case. This is a useful baseline scenario that allows us to isolate the role of changes in beliefs. In Section 4, we describe how to adapt our results when the economy is constrained inefficient for a planner that respects agents' beliefs. Finally, note that Lemma 4 relies on assigning equal welfare weights to all agents. While the linearity of preferences makes this criterion natural, we explain how our results generalize in the Appendix.

### 3.2 Marginal welfare effects

Proposition 4 presents the marginal welfare effect of varying the leverage cap,  $\frac{dW}{db}$ , which will be central to our analysis of optimal policy.

**Proposition 4.** *[Marginal welfare effect of varying the leverage cap] The marginal welfare impact of increasing the leverage cap, whenever the leverage cap is binding, is*

$$\frac{dW}{d\bar{b}} = \underbrace{\frac{dM^P(\bar{b})}{db} k^*(\bar{b})}_{\text{Inframarginal Effect}} + \underbrace{\left[ M^P(\bar{b}) - M(\bar{b}) \right] \frac{dk^*(\bar{b})}{d\bar{b}}}_{\text{Incentive Effect}}, \quad (16)$$

where we provide an explicit characterization of each of its elements in the Appendix.

Proposition 4 shows that knowledge of  $M^P(b)$ ,  $M(b)$ , and  $k^*(\bar{b})$  and their derivatives is sufficient to determine whether it is desirable to increase or decrease the leverage cap. We refer to the first term in Equation (16) as the inframarginal effect. This term captures how varying the leverage cap modifies the planner's valuation of pre-existing investment at

the margin. We refer to the second term in Equation (16) as the incentive effect. This term captures the investment response associated with a change in  $\bar{b}$ . Lemma 2 implies that the sign of the incentive effect term is determined by the sign of the difference  $M^P(\bar{b}) - M(\bar{b})$ , which is negative (positive) when investors and/or creditors are optimistic (pessimistic) relative to the planner.

Furthermore, Proposition 4 implies a simple test for whether the marginal welfare effect of raising the leverage cap is positive:

$$\frac{dW}{d\bar{b}} > 0 \iff \frac{d \ln M^P(\bar{b})}{d\bar{b}} + \left[ \frac{M^P(b) - M(b)}{M^P(b)} \right] \frac{d \ln k(\bar{b})}{d\bar{b}} > 0. \quad (17)$$

Equation (17) reveals three sufficient statistics that determine whether leverage regulation should become tighter or looser. The first corresponds to the marginal social benefit  $\frac{d \ln M^P(\bar{b})}{d\bar{b}}$  of leverage. The second is the wedge  $\frac{M^P(b) - M(b)}{M^P(b)}$ , which measures the proportional difference between the planner's and the agents' perception of the present value of investment. The third is the semi-elasticity  $\frac{d \ln k(\bar{b})}{d\bar{b}}$  of investment to leverage requirements. While the first sufficient statistic is exclusively a function of the planner's beliefs, the second one requires a direct assessment of belief differences between the agents' and the planner's beliefs, while the third one could be directly recovered from a regression of log investment on exogenous leverage limit changes. If one could measure or infer the elements of Equation (17), it would be possible to provide explicit quantitative guidance on the optimal leverage regulation.

Finally, note that if one starts from the laissez-faire allocation, the incentive effect vanishes and  $\frac{d \ln k(\bar{b})}{d\bar{b}} = 0$ , as illustrated in Figure 1 above. In that case, the only sufficient statistic that characterizes the marginal effect is  $\frac{d \ln M^P(b)}{db}$  evaluated at the laissez-faire optimum. This is an interesting observation, since it is sufficient for the planner to form an assessment over the value of  $\frac{dM^P(b)}{db}$ , which does not require the planner to know the beliefs of investors or creditors.

Proposition 4 illustrates again that the single rationale for regulation is the difference in beliefs between the planner and the agents in the economy. When the planner and the agents have the same set of beliefs, the incentive effect vanishes — since  $M^P(\bar{b}) = M(\bar{b})$  — and the inframarginal effect is always positive whenever the constraint binds, so it is optimal to never set a leverage cap.

### 3.3 The impact of beliefs on optimal regulation

This subsection introduces the main results of the paper. It characterizes how a change in beliefs by investors or creditors modifies the form of the optimal leverage regulation. We



begin by analyzing how the marginal effect of leverage regulation on welfare  $\frac{dW}{db}$  responds to changes in beliefs. Since beliefs are infinite-dimensional objects in our analysis, we focus on the variational derivative of  $\frac{dW}{db}$  with respect to beliefs in Proposition 5. Under appropriate regularity conditions, one can translate claims about the marginal response of  $\frac{dW}{db}$  to changes in beliefs into implications for the optimal leverage regulation; see, for example, Proposition 6 and our discussion in the Appendix.

**Proposition 5.** *[Impact of beliefs on leverage regulation: General characterization] The change in the marginal welfare effect of varying the leverage cap, whenever the leverage cap is binding, in response to a change in beliefs by either investors or creditors,  $j = \{I, C\}$ , is given by*

$$\frac{\delta \frac{dW}{db}}{\delta F^j} \cdot G^j = \left[ \frac{dM^P(\bar{b})}{db} - \frac{dM(\bar{b})}{db} \right] \left[ \frac{\delta k^*(\bar{b})}{\delta F^j} \cdot G^j \right] + [M^P(\bar{b}) - M(\bar{b})] \left[ \frac{\delta \frac{dk^*(\bar{b})}{db}}{\delta F^j} \cdot G^j \right]. \quad (18)$$

The characterization of marginal welfare effects in Proposition 5 permits a clearer assessment of how, and why, the rationale for leverage regulation changes when investors' and/or creditors' beliefs change. Changes in investors' or creditors' beliefs affect the marginal welfare effect of leverage regulation through two channels, namely, through the change in optimal investment  $k^*(\bar{b})$  and the change in the sensitivity of investment to policy  $\frac{dk^*(\bar{b})}{db}$ . These effects correspond to the inframarginal and incentive effects identified in Proposition 4. Intuitively, when deciding how to adjust the leverage policy in response to a change in beliefs, the planner must assess i) the extent to which the change in beliefs affects investment behavior and the desirability of regulation, and ii) the extent to which the change in beliefs affects the sensitivity or effectiveness of regulation.

The comparative statics in Lemma 3 imply that the variational derivatives of  $k^*(b)$  and  $\frac{dk^*(\bar{b})}{db}$  are directly related to the variational derivatives of the market value of investment  $M(b)$  and the marginal value of leverage  $\frac{dM}{db}$ . Therefore, the effects of investors' beliefs on leverage regulation inherit the nuanced patterns associated with  $\frac{\delta M}{\delta F^j} \cdot G^j$  and  $\frac{\delta \frac{dM}{db}}{\delta F^j} \cdot G^j$ , characterized in Section 2. As implied by our detailed discussion of Propositions 2 and 3, the type of belief variation considered is important. In particular, the magnitude of the variation at the default boundary,  $G^j(b)$ , plays a special role, and there is a fundamental asymmetry between investors and creditors.

It is particularly instructive to consider the case of quadratic adjustment costs. Therefore, for the remainder of this section, we assume that  $\Upsilon(k) = \frac{k^2}{2\varphi}$ . In that case, Equation (18) simplifies to

$$\frac{\delta \frac{dW}{db}}{\delta F^j} \cdot G^j = \varphi \cdot \left( \left[ \frac{dM^P(\bar{b})}{db} - \frac{dM(\bar{b})}{db} \right] \left[ \frac{\delta M(\bar{b})}{\delta F^j} \cdot G^j \right] + [M^P(\bar{b}) - M(\bar{b})] \left[ \frac{\delta \frac{dM}{db}}{\delta F^j} \cdot G^j \right] \right). \quad (19)$$

We can now directly rely on the results in Proposition 3 to characterize the effect of belief changes on the optimal regulation. Following Proposition 3, we consider three scenarios in Proposition 6.

**Proposition 6.** *[Impact of beliefs on optimal regulation: Specific scenarios]*

a) Equity exuberance: Assume that creditors and the planner share common beliefs  $F^C(s) = F^{C,P}(s) = F^{I,P}(s)$ , and investors' beliefs are more optimistic than the planner's beliefs in a hazard-rate sense. Then, increased optimism by investors implies  $\frac{\delta \frac{dW}{db}}{\delta F^I} \cdot G^I > 0$ . Hence, it is never optimal to impose a binding leverage cap.

b) Debt exuberance: Assume that investors and the planner share common beliefs  $F^I(s) = F^{I,P}(s) = F^{C,P}(s)$ , and creditors' beliefs are more optimistic than the planner's beliefs in a hazard-rate sense. Then, increased optimism by creditors implies  $\frac{\delta \frac{dW}{db}}{\delta F^C} \cdot G^C < 0$ . Hence, the optimal leverage cap is binding and decreasing in optimism.

c) Joint exuberance: Assume that creditors and investors share common beliefs  $F^C(s) = F^I(s) = F^0(s)$  that is more optimistic than the planner's beliefs  $F^{C,P}(s) = F^{I,P}(s) = F^P(s)$  in a hazard-rate sense. Then, as in the debt exuberance scenario, increased optimism by investors and creditors implies  $\frac{\delta \frac{dW}{db}}{\delta F^0} \cdot G^0 < 0$ . Hence, the optimal leverage cap is binding and decreasing in optimism.

Proposition 6 shows a clear distinction between the effects of equity and debt exuberance. In the case of equity exuberance, there are two effects. First, investors consider creditors' beliefs to be excessively pessimistic, which leads them to take too little leverage (i.e., issue too much equity) from a social perspective. Thus, the inframarginal effect increases the social benefit of encouraging leverage. Second, the incentive effect becomes weaker with exuberance due to the reduced sensitivity of investment to leverage. Both effects imply that equity exuberance increases the marginal benefit of permitting leverage. Starting from a case with common beliefs, in which there is no rationale for a binding leverage cap, we therefore find that equity exuberance only serves to make a binding cap *less* desirable. We conclude that it is never optimal to impose a binding cap. Instead, it would be optimal to impose a binding leverage floor, although this is not a policy we have considered in our analysis.

In the case of debt exuberance, both the inframarginal and incentive effects are reversed. First, investors find the borrowing conditions offered by creditors very attractive, which leads them to take too much leverage from the planner's perspective. Second, the incentive effect becomes stronger due to the increased sensitivity of investment to leverage. Both effects work in the same direction, and imply that a tightening of a binding leverage cap is optimal. Finally, we show that the case of joint exuberance leads to the same

qualitative result as the case of debt exuberance. As discussed in the context of Proposition 3, this occurs because creditors are more patient and their valuation of marginal default states is higher than the valuation of investors. As a result, joint exuberance also supports a tightening of a binding leverage cap.

Figure 4 illustrate how the optimal regulation responds to changes in investors' and creditors' beliefs. It compares equilibrium leverage and investment without regulation and under the optimal regulation when varying the beliefs of investors, creditors, or both, while holding fixed the planner's beliefs. The top row of Figure 4 shows the levels of leverage and investment without regulation. The bottom row shows leverage and investment under the optimal leverage regulation. More precisely, as explained in the note that describes Figure 4, assuming that the beliefs about  $s$  are normally distributed, the horizontal axis represents the perceived expected return on investment by investors in the equity exuberance scenario, by creditors in the debt exuberance scenarios, and by both investors and creditors in the joint exuberance scenario. Perhaps surprisingly, the optimal leverage cap in a joint exuberance scenario is tighter than the cap in a debt exuberance scenario. This result is driven by the scale of investment: while investment is lower whenever leverage is regulated, it is still that case that investment in the joint exuberance scenario is significantly larger than in the debt exuberance scenario. Therefore, because investment is larger in the joint exuberance case, the inframarginal effect defined in Equation (16) becomes more important, so reducing leverage becomes highly desirable for the planner. Intuitively, when investment is large, the same reduction in leverage generates a larger overall welfare gain since it applies to more units of capital.

**Equity, debt, and joint exuberance in practice** One can interpret the recent experience of Hertz and the associated intervention by the SEC as a manifestation of an equity exuberance scenario.<sup>21</sup> In June 2020, there seemed to be retail investors willing to purchase Hertz's stock even though the company had declared bankruptcy and it was unlikely that equityholders would receive any funds at all. Hertz's management, seeking to maximize the firm's value, promptly decided to sell shares in the open market. The regulator (in this case, the SEC) intervened by vetoing the equity issuance, which can be interpreted as a cap on equity (a leverage floor), as predicted by Proposition 6. One could argue that the SEC was only considering the welfare of equity investors, while the planner

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<sup>21</sup>For an account of the equity issuance of Hertz and the response of the SEC, see, for instance, <https://www.wsj.com/articles/hertz-sold-29-million-in-stock-before-sec-stepped-in-11597100128>. Similar concerns about exuberant equity valuations have emerged recently, when retail investors generated rising demand for stocks such as Gamestop, which have gained popularity via social media. See, for instance, <https://www.reuters.com/article/us-gamestop-stocks/gamestop-to-capitalize-on-stonks-rally-with-1-billion-stock-sale-plan-idUSKBN2BS0SN>.

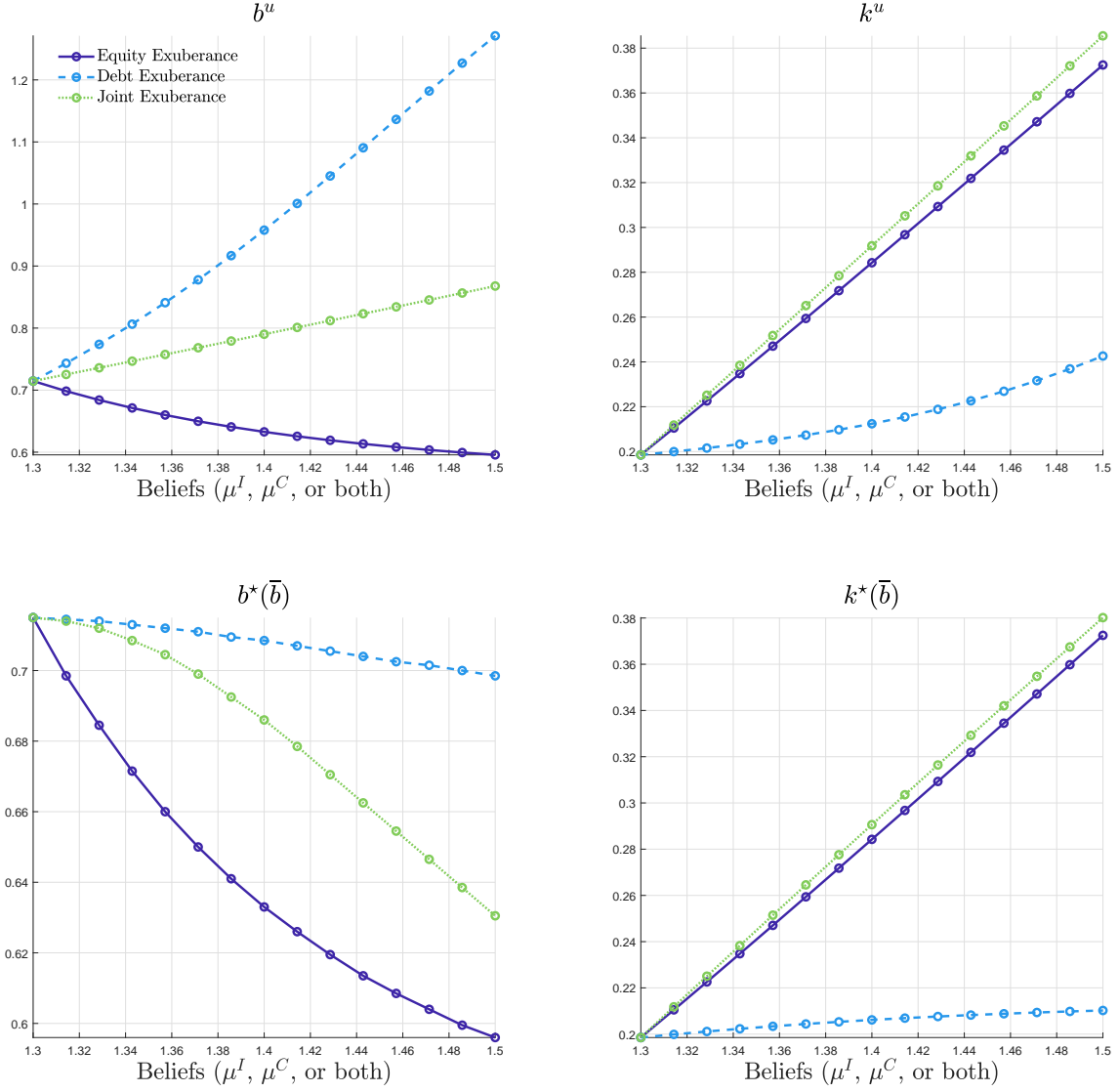


Figure 4: Impact of beliefs on optimal regulation: comparative statics

**Note:** Figure 4 compares equilibrium leverage and investment without regulation and under the optimal regulation when varying the beliefs of investors, creditors, or both, while holding fixed the planner's beliefs. The top left and top right plots respectively show equilibrium leverage and investment without regulation,  $b^u$  and  $k^u$ , where the superscript  $u$  stands for unregulated. The bottom left and bottom right plots respectively show equilibrium leverage and investment under the optimal regulation,  $b^*(\bar{b})$  and  $k^*(\bar{b})$ . As shown in Proposition 6, note that  $b^*(\bar{b}) = b^u$  in the equity exuberance scenario and  $b^*(\bar{b}) = \bar{b}$  in both the debt exuberance and the joint exuberance scenario. We assume that beliefs about  $s$  are normally distributed, with means indexed by  $\mu$  and standard deviations indexed by  $\sigma$ , and that investment costs are given by  $\frac{k^2}{2\varphi}$ . The parameters used in all plots are:  $\beta^I = 0.9$ ,  $\beta^C = 0.95$ ,  $\phi = 0.8$ ,  $\varphi = 1$ , and  $\sigma^I = \sigma^C = 0.4$ . The planner's beliefs are fixed in all plots at  $\mu^{I,P} = \mu^{C,P} = 1.3$  and  $\sigma^{I,P} = \sigma^{C,P} = 0.4$ . The baseline beliefs are  $\mu^I = \mu^C = 1.3$ . The equity exuberance outcome in each plot varies the expected return on investment perceived by investors,  $\mu^I$ , between 1.3 and 1.5, while keeping  $\mu^C = 1.3$ . The debt exuberance outcome in each plot varies the expected return on investment perceived by creditors,  $\mu^C$ , between 1.3 and 1.5, while keeping  $\mu^I = 1.3$ . The joint exuberance outcome in each plot varies at the same the expected return investment perceived by both investors and creditors,  $\mu^I = \mu^C$ , between 1.3 and 1.5.

in our model considers the welfare of both equity investors and creditors. As we describe in the Appendix, the conclusion that a cap on equity is optimal is also valid under that criterion.<sup>22</sup>

Alternatively, one can interpret the boom in subprime lending that preceded the global financial crisis of 2008 as a debt exuberance or joint exuberance scenario (e.g., Cheng, Raina and Xiong, 2014). Our results would have provided a clear rationale for limiting leverage in the years prior to 2007/2008. Note that, in our model, periods with compressed credit spreads — which have been shown to forecast negative excess returns (Greenwood and Hanson, 2013; Lopez-Salido, Stein and Zakrajsek, 2017) — may be a symptom of debt exuberance. Interestingly, our illustration in Figure 4 suggests that periods of joint exuberance, in which leverage and investment would increase simultaneously without regulation, are those in which the optimal leverage regulation ought to be tighter.<sup>23</sup>

## 4 Government Bailouts

In this section, we study an extension of our baseline model featuring government bailouts. We do so for three reasons. First, bailouts are pervasive and are a common rationale for ex-ante regulation. Second, since bailouts normally take place in downturns, their interaction with different types of beliefs is highly nonlinear. Third, the presence of bailouts determined ex-post under lack of commitment makes our economy constrained inefficient even with homogeneous beliefs. This fact allows us to provide an illustration of how changes in beliefs can also impact the optimal leverage regulation in the presence of an additional wedge between private and social incentives.<sup>24</sup>

In practical terms, we show that the equity exuberance result derived in Proposition 6, which calls for higher/no leverage caps, can change in the presence of bailouts. Intuitively, the increase in investment associated with optimism on the side of equity investors can make bailouts so costly that an ex-ante planner who anticipates the possibility of bailouts ex-post finds it optimal to limit leverage.

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<sup>22</sup>There is a large literature on behavioral corporate finance that explores the roles of beliefs for equity issuance, see e.g., Baker and Wurgler (2002, 2013). Many findings in this literature can be mapped to the equity exuberance scenario.

<sup>23</sup>We should caveat that our illustration of the results in Figure 4 does depend on the assumed distribution of beliefs — unlike most of the results in the paper. While we do not include a full quantitative exploration in the paper, we conjecture that debt exuberance by itself may have stronger quantitative effects in models in which beliefs feature a thick left tail (e.g., rare disasters).

<sup>24</sup>There is scope to further study how beliefs interact with other motives for regulation, like pecuniary externalities or aggregate demand externalities.

## 4.1 Environment

Starting from the baseline model, we now assume that at date 1, after the state  $s$  is realized, the government makes a transfer  $t(b, s)$  to investors. The funds for this transfer are raised using a tax  $(1 + \kappa)t(b, s)$  on creditors, where  $\kappa > 0$  measures the marginal deadweight loss associated with taxation. Similar results obtain if the tax is paid by investors. If investors default, creditors seize all of the investors' resources — including any government transfer — receiving  $\phi s + t(b, s)$  per unit of investment.

We assume throughout that the value of banks' assets including the bailout,  $s + t(b, s)$ , is increasing in  $s$ . This implies the existence of a unique threshold  $s^*(b)$  such that investors default if  $s < s^*(b)$  and repay otherwise. Making  $t(b, s)$  a primitive of the model is without loss of generality whenever the government has lack of commitment ex-post. We define the expected fiscal burden perceived by the planner, per unit of investment, as

$$\gamma(b) = (1 + \kappa) \beta^C \int_{\underline{s}}^{\bar{s}} t(b, s) dF^{C,P}(s).$$

As we show below, this burden will exactly determine the additional wedge between private and public incentives. Note that as long as  $\frac{\partial t(b, s)}{\partial b} \geq 0$ , it is true that  $\frac{d\gamma(b)}{db} \geq 0$ , as one would expect.

## 4.2 Marginal welfare effects and bailouts

In Proposition 7, we characterize the effect of changes in beliefs on leverage regulation with bailouts by extending Proposition 5.

**Proposition 7.** *[Impact of beliefs on optimal regulation with bailouts] The change in the marginal welfare effect of varying the leverage cap, whenever the leverage cap is binding, in response to a change in beliefs by either investors or creditors,  $j = \{I, C\}$ , is given by*

$$\begin{aligned} \frac{\delta \frac{dW}{db}}{\delta F^j} \cdot G^j &= \left[ \frac{dM^P(\bar{b})}{db} - \overbrace{\frac{d\gamma(b)}{db}}^{\text{bailouts}} - \frac{dM(\bar{b})}{db} \right] \left[ \frac{\delta k^*(\bar{b})}{\delta F^j} \cdot G^j \right] \\ &+ \left[ M^P(\bar{b}) - \underbrace{\gamma(b)}_{\text{bailouts}} - M(\bar{b}) \right] \left[ \frac{\delta \frac{dk^*(\bar{b})}{db}}{\delta F^j} \cdot G^j \right], \end{aligned} \quad (20)$$

where the adjusted valuation functions  $M^P(b)$  and  $M(b)$  are characterized in the Appendix.

The first term in Equation (20), reflecting the inframarginal effect of raising the leverage cap, now includes the increase in the fiscal burden  $\frac{d\gamma(b)}{db}$ . The second term, reflecting the incentive effect, scales with the total wedge between social and private incentives, which now includes the level of the fiscal burden  $\gamma(b)$  per unit of investment. Therefore, the presence of bailouts provides new rationales for intervention, directly via  $\frac{d\gamma(b)}{db}$  and  $\gamma(b)$ , and indirectly via the determination of the model's endogenous variables.

In particular, the presence of  $\frac{d\gamma(b)}{db}$  and  $\gamma(b)$  in Equation (20), in contrast to the baseline model, opens the door to binding optimal leverage limits in an equity exuberance scenario. Proposition 6 in the baseline model shows that equity exuberance always decreases the incentive to regulate, in part because the inframarginal effect of raising leverage caps is always positive. In the model with bailouts, by contrast, the inframarginal effect can change sign due to the presence of bailouts, because  $\frac{d\gamma(b)}{db} > 0$ . We return to this point below, when we consider a concrete example of the bailout policy  $t(b, s)$ .

In Proposition 8, which is the counterpart of Proposition 2, we further explore the impact of general changes in beliefs when bailouts are present by characterizing the key variational derivatives.

**Proposition 8.** *a) [Variational derivatives: Market value with bailouts] The market value per unit of investment changes in response to variations in investors' and creditors' beliefs according to*

$$\begin{aligned}\frac{\delta M}{\delta F^I} \cdot G^I &= -\beta^I \int_{s^*(b)}^{\bar{s}} \left(1 + \frac{\partial t(b, s)}{\partial s}\right) G^I(s) ds \\ \frac{\delta M}{\delta F^C} \cdot G^C &= -\beta^C \left[ (1 - \phi) s^*(b) G^C(s^*(b)) + \int_{\underline{s}}^{s^*(b)} \left(\phi + \frac{\partial t(b, s)}{\partial s}\right) G^C(s) ds \right].\end{aligned}$$

*b) [Variational derivatives: Marginal value of leverage with bailouts] The marginal value of leverage changes in response to variations in investors' and creditors' beliefs according to*

$$\begin{aligned}\frac{\delta \left(\frac{dM}{db}\right)}{\delta F^I} \cdot G^I &= -\beta^I \left[ \int_{s^*}^{\bar{s}} dG^I(s) + \frac{\partial t(b, s^*)}{\partial b} G^I(s^*) + \int_{s^*}^{\bar{s}} \frac{\partial^2 t(b, s)}{\partial b \partial s} G^I(s) ds \right] \\ \frac{\delta \left(\frac{dM}{db}\right)}{\delta F^C} \cdot G^C &= -\beta^C \left[ G^C(s^*(b)) \frac{\partial s^*(b)}{\partial b} \left(1 + \frac{\partial t(b, s^*(b))}{\partial s}\right) + (1 - \phi) s^*(b) \frac{g^C(s^*(b))}{G^C(s^*(b))} \right. \\ &\quad \left. + \int_0^{s^*(b)} \frac{\partial^2 t(b, s)}{\partial b \partial s} G^C(s) ds \right].\end{aligned}$$

Proposition 8 conveys several insights. Part a) shows that, if bailouts satisfy  $\frac{\partial t(b, s)}{\partial s} \leq 0$ , then the presence of bailouts attenuates the sensitivity of the market valuation  $M(b)$  to the

changes in beliefs  $G^I(s)$  and  $G^C(s)$ . Moreover, if bailouts are convex in  $s$ , so that  $\frac{\partial t(b,s)}{\partial s}$  is larger in absolute value for low  $s$ , then the attenuation effect is skewed towards belief distortions in bad states. Intuitively, bailouts imply that agents' beliefs about downside risk become less important for market valuation.

Part b) shows that, if bailouts also satisfy  $\frac{\partial t(b,s)}{\partial b} \geq 0$ , then the effect of changes in beliefs over the marginal default state  $s^*(b)$  on the marginal valuation  $\frac{dM}{db}$  is attenuated towards zero by the presence of bailouts. In addition, both variational derivatives of  $\frac{dM}{db}$  contain a term with the sign of  $-\frac{\partial^2 t(b,s)}{\partial b \partial s} G^j(s)$  for  $j \in \{I, C\}$ . These terms arise because changes in beliefs affect investors' strategic incentive to take on leverage in order to increase bailouts. If the strategic incentive  $\frac{\partial t(b,s)}{\partial b}$  is decreasing in  $s$ ,<sup>25</sup> then optimism increases  $\frac{dM}{db}$ . This effect of bailouts strengthens the negative effect of investors' optimism on the incentives to take on leverage, but weakens the positive effect of creditors' optimism.

These results further demonstrate the usefulness of our variational approach to characterizing changes in beliefs. For a general specification of bailouts  $t(b, s)$ , the marginal value of leverage cannot be ranked in terms of standard stochastic orders such as hazard-rate dominance. Nevertheless, our characterization yields clear economic insights.

### 4.3 Too-Big-To-Fail scenario

It is instructive to consider the common special case in which bailouts are perfectly targeted towards avoiding bankruptcy, so that  $t(b, s) = \max\{b - s, 0\}$ . This scenario corresponds to interpreting investors in our model as an agent that is “too big to fail” (TBTF). It illustrates clearly that bailouts attenuate the role of creditors' beliefs, and that they can lead to different normative conclusions in an equity exuberance scenario.

**Example.** [*Too-Big-To-Fail scenario.*] Assume that bailouts satisfy  $t(b, s) = \max\{b - s, 0\}$ . In this case, the market value per unit of investment  $M(b)$  reduces to

$$M(b) = \beta^I \int_{s^*(b)}^{\bar{s}} (s - b) dF^I(s) + \beta^C b,$$

where  $s^*(b) = b$ .

In this limiting case, there is no risk of default, which makes the valuation of debt fully independent of creditors' beliefs  $F^C(s)$ . We can therefore focus on the impact of changes in investors' beliefs. We can rely on Propositions 7 and 8 to show that the impact of optimism by investors on the optimal leverage regulation is now ambiguous.

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<sup>25</sup>Bailouts are often modeled as a convex function of the shortfall  $b - s$  of asset values from debt obligations. This directly implies  $\frac{\partial^2 t(b,s)}{\partial b \partial s} \leq 0$ .



In order to recover the same conclusion as in the equity exuberance scenario described in Proposition 6, we can simplify Equation (20) to obtain the following necessary condition:

$$\frac{\delta \frac{dW}{db}}{\delta F^I} \cdot G^I \leq 0 \iff \frac{G^I(b)}{\int_{s^*(b)}^{\bar{s}} G^I(s) ds} \leq \frac{\beta^C(1+\kappa) - \beta^I F^{I,P}(b) + \beta^I F^I(b)}{\gamma(b) + \beta^I \int_{s^*(b)}^{\bar{s}} (F^{I,P}(s) - F^I(s)) ds}. \quad (21)$$

In the case in which the variational derivative  $\frac{\delta \frac{dW}{db}}{\delta F^j} \cdot G^j$  is instead positive, equity exuberance increases incentives to constrain leverage, in contrast to the result in the baseline model. Indeed, perfect bailouts are guaranteed to change the sign of the inframarginal term in Equation (20), so that the planner always has an additional inherent incentive to discourage leverage.<sup>26</sup> Equation (21) shows that the type of exuberance is key when determining the strength of this effect. Indeed, the incentive to cap leverage dominates when the “downside” belief change in marginal bailout states  $G^I(b)$  is small relative to the overall “upside” belief change in solvent states  $\int_{s^*(b)}^{\bar{s}} G^I(s) ds$ . Intuitively, the inframarginal term scales with the level of investment  $k^*(b)$ , which in this scenario is determined purely by investors’ beliefs about solvent states. Therefore, large upside optimism generates a strong incentive to constrain leverage. By contrast, changes in beliefs in marginal states mostly result in a decreased sensitivity  $\frac{dk^*(b)}{db}$  of investment to leverage regulation. Thus, large downside optimism makes regulation less attractive at the margin.

## 5 Monetary Policy

In this section, we return to our baseline model without bailouts and explore the role of monetary policy, which here operates via an investment channel. Formally, we refer to the natural interest rate in debt markets in our model as  $r^* = \frac{1-\beta^C}{\beta^C}$ . We further suppose that the planner can set an interest rate  $r \neq r^*$  at a cost. Deviations from the natural rate incur a deadweight loss given by  $\mathcal{L}(r) \geq 0$ , which is a convex function of  $r$  and satisfies  $\mathcal{L}(r^*) = 0$ .<sup>27</sup>

We focus on the welfare effect of interest rate policy when beliefs are distorted. Lemma 5, which is the counterpart of Lemma 1, presents a reformulation of the investors’ problem whose solution directly characterizes equilibrium leverage and investment.

<sup>26</sup>In the TBTF scenario, we have  $\frac{dM^P}{db} - \frac{d\gamma}{db} - \frac{dM}{db} = -((\beta^C(1+\kappa) - \beta^I) F^{I,P}(b) + \beta^I F^I(b)) < 0$ .

<sup>27</sup>A simple micro-foundation for this deadweight loss is that the government can impose distortionary taxes or subsidies on a risk-free storage technology that returns  $r^*$  in the absence of taxation (e.g., Farhi and Tirole, 2012).

**Lemma 5.** *[Investors' problem with active monetary policy] In the model with monetary policy, equilibrium leverage and investment are given by the solution to the following reformulation of the problem faced by investors:*

$$\begin{aligned} \max_{b,k} & [M(b, r) - 1] k - \Upsilon(k) \\ \text{s.t.} \quad & b \leq \bar{b}, \end{aligned}$$

where  $M(b, r)$  is given by

$$M(b, r) = \underbrace{\beta^I \int_b^{\bar{s}} (s - b) dF^I(s)}_{\text{equity}} + \underbrace{\beta(r) \left( \int_b^{\bar{s}} b dF^C(s) + \phi \int_{\underline{s}}^b s dF^C(s) \right)}_{\text{debt}},$$

and where  $\beta(r) \equiv \frac{1}{1+r}$  is the discount factor used to value debt when the interest rate is  $r$ .

The investors' problem in Lemma 5 is the same as the investors' problem in the baseline model except for the valuation function  $M(b, r)$ . The value of debt now depends on monetary policy, because creditors use the discount factor  $\beta(r) = \frac{1}{1+r}$  to value debt. Throughout this section, we focus on the case in which  $\beta(r) < \beta^I$ , so that investors remain natural borrowers and the equity payoffs are valued using  $\beta^I$ .

We write  $b^*(\bar{b}, r)$  and  $k^*(\bar{b}, r)$  for the equilibrium choices of leverage and investment as a function of the leverage cap  $\bar{b}$  and the interest rate  $r$ . Lemma 6, which is the counterpart of Lemma 4, presents the planner's problem in this context.

**Lemma 6.** *[Planner's problem with active monetary policy] The planner's problem can be expressed as*

$$\max_{\bar{b}, r} W(b^*(\bar{b}, r), k^*(\bar{b}, r), r),$$

where social welfare is given by

$$W(b, k, r) = [M^P(b) - 1] k - \Upsilon(k) - \mathcal{L}(r),$$

and where  $M^P(b)$ , as defined in Lemma 4, denotes the present value of payoffs under the planner's beliefs, which is independent of  $r$ .

There are two differences between this problem and the planner's problem in Lemma 4. First, the planner realizes that equilibrium leverage  $b$  and investment  $k$  are driven by both leverage caps and the interest rate. Second, the welfare function  $W(b, k, r)$  is adjusted for the deadweight cost of monetary distortions. However, the function  $M^P(b)$  used by the planner to value the payoff from investments is identical to the one in the baseline model,

and does not depend on monetary policy. This arises because monetary policy operates by changing the value of debt at date 0, which is a welfare-neutral transfer in our model.

Relying on the characterizations in Lemmas 5 and 6, we analyze the welfare effect  $\frac{\partial W(\bar{b}, r)}{\partial r}$  of raising interest rates and its dependence on beliefs. We focus on the effects of beliefs in the equity exuberance and debt exuberance scenarios defined in Proposition 6. In the Online Appendix, we include a full variational characterization of these effects.

**Proposition 9.** *[Marginal welfare effect of monetary policy/Impact of beliefs on optimal monetary policy] The marginal welfare effect of increasing the interest rate is given by*

$$\frac{\partial W(\bar{b}, r)}{\partial r} = [M^P(b) - M(b, r)] \frac{dk^*(\bar{b}, r)}{dr} - \mathcal{L}'(r), \quad (22)$$

where  $\frac{dk^*(\bar{b}, r)}{dr} = \frac{1}{\Upsilon''(k^*(\bar{b}, r))} \frac{dM(b, r)}{dr} < 0$ . In both equity exuberance and debt exuberance scenarios, optimism (pessimism) by investors or creditors in a hazard-rate sense calls for increasing (lowering) interest rates.

Proposition 9 shows that the welfare effect of monetary policy depends on the difference between the planner's and investors' valuations of investment,  $M^P(b) - M(b, r)$ , as well as the derivative of investment with respect to interest rates,  $\frac{dk^*(\bar{b}, r)}{dr}$ . This derivative is always negative because an increase in  $r$  lowers bond values, thus raising the effective cost of capital investment. Proposition 9 further describes the role of beliefs in the welfare effect of monetary policy. Unlike in Proposition 5, there is no inframarginal effect associated with raising the interest rate in our model because changes in the value of debt are welfare-neutral transfers. Accordingly, Equation (22) exclusively contains an incentive effect.

Increased optimism in either a debt or equity exuberance scenario implies that the incentive effect that we have identified becomes stronger. This is the result of two forces. First, increased optimism implies that the valuation wedge  $M^P(b) - M(b, r)$  becomes more negative (larger in absolute value). Second, increased optimism implies that the effect of the interest rate  $r$  on bond values is stronger when bond values are elevated, so that investment becomes more sensitive to monetary policy. Both forces increase the planner's incentive to raise (lower) interest rates in response to optimistic (pessimistic) beliefs. Consequently, Proposition 9 shows that monetary policy, through an investment channel, can be used to optimally counteract optimism/pessimism in the economy.

This result stands in contrast to the more nuanced effect of changes in beliefs on leverage regulation. A central reason for this difference is that optimistic investors become *more* sensitive to contractionary monetary policy, but tend to become *less* sensitive to leverage caps. Therefore, monetary policy is a natural substitute when optimism blunts

the effectiveness of leverage regulation. These results connect our paper to the literature on monetary policy as a prudential tool. Monetary policy has been advocated for in situations where traditional financial regulation cannot reach the “shadow banking” sector, or is otherwise constrained (e.g., Stein, 2013; Caballero and Simsek, 2019). Even in a model without such constraints, we show that monetary policy can be useful by affecting investment, and is particularly effective in cases where capital regulation is endogenously constrained by distorted beliefs.

## 6 Planner’s Beliefs and Optimal Leverage Regulation

So far, our analysis has focused on characterizing optimal policy as a function of investors’ and creditors’ beliefs, holding constant the beliefs under which the planner evaluates optimal policy. In this section, we characterize the impact of changes in the beliefs  $F^{I,P}(s)$  and  $F^{C,P}(s)$  that the planner uses to evaluate the welfare of investors and creditors when setting the optimal policy.

This exercise has a dual interpretation. First, under the paternalistic view that investors and creditors have distorted beliefs and that the planner’s beliefs are correct, one can view these comparative statics as showing the effect of changes in the planner’s beliefs when she observes new information that is ignored by investors and creditors. Alternatively, assuming that the planner’s beliefs differ from the true/objective beliefs, one can use the comparative statics below to explore the limits of paternalism, namely how the optimal policy changes when the planner’s beliefs change. We focus on the latter interpretation in this section.

In addition, Appendix E.7 considers an extension that allows us to consider the limits of paternalism from a different perspective. We assume that the planner’s beliefs are fixed and rational, but that the planner has to choose the leverage limit  $\bar{b}$  before observing the realization of a “sentiment” indicator that drives the beliefs of investors and creditors. We show that uncertainty can drive the planner towards setting either higher or lower leverage limits, and characterize how these effects depend on the type of exuberance generated by sentiments.

For brevity, we focus here on comparative statics in three scenarios, which are the analogue to our treatment of investors’ and creditors’ beliefs in Proposition 6. Under the same conditions on  $\Upsilon(\cdot)$  used to derive Proposition 6, we provide the following characterization:

**Proposition 10.** *[Impact of the planner’s beliefs on optimal regulation: Specific scenarios]*  
a) Planner’s equity exuberance: Consider changes in the belief  $F^{I,P}(s)$  that the planner

uses to evaluate investors' utility, and hold fixed the belief  $F^{C,P}(s)$  that the planner uses to evaluate creditors' utility. Then, increased optimism in a hazard-rate sense by the planner can imply either  $\frac{\delta \frac{dW}{db}}{\delta F^{I,P}} \cdot G^{I,P} > 0$  or  $\frac{\delta \frac{dW}{db}}{\delta F^{I,P}} \cdot G^{I,P} < 0$ . Hence, it is ambiguous whether planner's equity exuberance leads to tighter or looser perceived optimal regulation.

b) Planner's debt exuberance: Consider changes in the belief  $F^{C,P}(s)$  that the planner uses to evaluate creditors' utility, and hold fixed the belief  $F^{I,P}(s)$  that the planner uses to evaluate investors' utility. Then, increased optimism by the planner in a hazard-rate sense implies  $\frac{\delta \frac{dW}{db}}{\delta F^{C,P}} \cdot G^{C,P} > 0$ . Hence, the planner's debt exuberance always leads to more lenient perceived optimal regulation.

c) Planner's joint exuberance: Assume that the planner uses a single belief  $F^P(s) = F^{I,P}(s) = F^{C,P}(s)$  to evaluate agents' utility. Then, increased optimism by the planner in a hazard-rate sense implies  $\frac{\delta \frac{dW}{db}}{\delta F^P} \cdot G^P > 0$ . Hence, the planner's joint exuberance always leads to more lenient perceived optimal regulation.

The economic intuition for this result follows from our characterization of the marginal welfare effect  $\frac{dW}{db}$  in Proposition 4. The marginal effect is increasing in the marginal value of leverage  $\frac{dM^P(\bar{b})}{db}$  under the planner's beliefs, and also increasing in the planner's total valuation of investment  $M^P(\bar{b})$ .<sup>28</sup> Both equity and debt exuberance on behalf of the planner increase the total valuation  $M^P(\bar{b})$ . However, using a parallel argument to Proposition 3, we can show that the marginal value  $\frac{dM^P(\bar{b})}{db}$  is decreasing with debt exuberance, but increasing with equity exuberance in the planner's beliefs. Hence, the overall effects of the planner's equity exuberance are ambiguous, while debt exuberance always leads to an increase in  $\frac{dW}{db}$ , meaning a more lenient perceived optimal policy. As in our previous analysis, the case of joint exuberance inherits the properties of debt exuberance, because the beliefs of patient creditors dominate the relevant valuations.

Note that the results in Propositions 6 and 10 jointly provide a general characterization of the impact of the planner's beliefs and beliefs of investors and creditors. Hence, we can extract insights about several scenarios that may arise if the planner is not perfectly rational. First, consider a scenario where investors and creditors are rational but the planner's beliefs are distorted. In this case, a laissez-faire policy is clearly optimal, but the planner might wrongly "over-regulate" by imposing a binding constraint. Proposition 10 shows when over-regulation is possible. For example, pessimism in the planner's beliefs about creditors' payoffs (in the sense of the hazard rates of  $F^{C,P}(s)$ ) always brings about over-regulation by decreasing the perceived benefit  $\frac{dW}{db}$  of permitting more leverage.

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<sup>28</sup>This follows because  $k^*(\bar{b}) > 0$  and, by investors' first-order condition in Equation (8),  $\frac{dk^*(\bar{b})}{db} \geq 0$ .

Second, one can imagine a model where private agents agree with the planner’s beliefs, but those beliefs themselves are irrational. In this case, it is optimal to impose a binding leverage constraint if there is debt exuberance or joint exuberance among private agents (see Proposition 6). However, since the planner is also exuberant, she continues to regard a laissez-faire policy as optimal, and will therefore “under-regulate”, failing to impose a constraint. Finally, in a mixed scenario where agents and the planner are irrational but disagree with one another, either over-regulation or under-regulation becomes possible, and Proposition 10 delineates both cases.

## 7 Conclusion

This paper characterizes leverage regulation and monetary policy in environments in which equity investors’ and creditors’ beliefs differ from the beliefs of a planner. We show that the optimal policy response to changes in beliefs depends on the type and the magnitude of the beliefs held by investors and creditors. We show that optimism by investors is associated with loosening the optimal leverage cap, while optimism by creditors, or jointly by both investors and creditors, is associated with a tighter optimal leverage cap. We explain how our framework can be used to rationalize regulatory policies used in specific contexts that increase or decrease leverage.

When belief differences and government bailouts coexist, increased optimism by equity investors may call for a tighter optimal leverage cap too, depending on whether equity optimism is concentrated on upside or downside risk. We also show that monetary tightening can act as a useful substitute for financial regulation since increased optimism by either equity investors or creditors is associated with higher incentives to raise interest rates. Finally, we explore the role of changes in the planner’s beliefs for the optimal policy response.

There are many fruitful avenues for further research on the design of prudential policies with distorted beliefs. For instance, exploring many of the effects that we have identified in this paper in a dynamic quantitative framework that includes multiple rationales for regulation is one of the most promising ones. Lastly, we hope that the variational approach that we have introduced here to characterize the impact of general changes in beliefs can be used in other scenarios.

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## A Proofs and Derivations: Section 2

We prove the results in this section, with the exception of Proposition 3, in a general model that allows for monetary policy and bailouts. Therefore, the proofs presented here also establish the corresponding results in Sections 4 and 5. The baseline model is recovered when  $t(b, s) = 0$  and when the discount factor implied by monetary policy satisfies  $\beta(r) = \beta(r^*) = \beta^C$ .

### Proof of Lemma 1 [Investors' problem]

The problem that investors face at date 0, after anticipating their optimal default decision, can be expressed as follows:

$$V(\bar{b}, r) = \max_{b, k, c_0^I, c_1^I(s)} c_0^I + \beta^I \int c_1^I(s) dF^I(s), \quad (23)$$

subject to budget constraints at date 0 and in each state  $s$  at date 1, the creditors' debt-pricing equation, the non-negativity constraint of consumption at date 0, and the leverage constraint set by the planner:

$$c_0^I + k + \Upsilon(k) = n_0^I + Q(b, r)k \quad (\lambda_0) \quad (24)$$

$$c_1^I(s) = n_1^I(s) + \max\{s + t(b, s) - b, 0\}k, \forall s \quad (25)$$

$$Q(b, r) = \beta(r) \left( \int_{s^*(b)}^{\bar{s}} b dF^C(s) + \int_{\underline{s}}^{s^*(b)} (\phi s + t(b, s)) dF^C(s) \right) \quad (26)$$

$$c_0^I \geq 0 \quad (\eta_0) \quad (27)$$

$$bk \leq \bar{b}k \quad (\mu). \quad (28)$$

Note that the debt-pricing equation  $Q(b, r)$  is derived from the behavior of creditors. In Lagrangian form, this problem can be expressed as follows:

$$\begin{aligned} \mathcal{L}^I = & c_0^I + \beta^I \int_{s^*(b)}^{\bar{s}} (s + t(b, s) - b) dF^I(s) k \\ & - \lambda_0 (c_0^I - n_0^I - Q(b, r)k + k + \Upsilon(k)) \\ & + \eta_0 c_0^I + \mu k (\bar{b} - b). \end{aligned} \quad (29)$$

Equations (5) and (6), as well as the results in Lemma 5, follow directly from Equation (29) when  $\eta_0 = 0$ .

### Proof of Proposition 1 [Equilibrium leverage and investment]

Equation (8) follows from maximizing Equation (5) subject to Equation (6) (multiplied by  $k$ ). Equations (9) and (10) follow from differentiating Equation (5) with respect to  $k$  and (7) with respect to  $b$ . These conditions are necessary for optimality and sufficient under the regularity conditions described in the Online Appendix. It follows immediately from Equation (7) that a necessary regularity condition for investment to be positive is that  $M(b^*) > 1$ .

### Proof of Lemma 2 [Sensitivity of investment to leverage limit]

Differentiating Equation (9) with respect to  $\bar{b}$  implies that  $\frac{dM}{db}(b^*) \frac{db^*}{d\bar{b}} = \Upsilon''(k^*) \frac{dk^*}{d\bar{b}}$ . Equation (11) follows immediately by rearranging this expression and noticing that  $\frac{db^*}{d\bar{b}} = 1$  when  $\mu > 0$  and  $\frac{db^*}{d\bar{b}} = 0$  when  $\mu = 0$ .

### Proof of Lemma 3 [Sensitivity of leverage and investment to beliefs]

Note the first-order condition for leverage can be written as  $\frac{dM}{db}(b^*; F^I, F^C) = 0$ . An application of the implicit function theorem implies that

$$\frac{\delta b^*}{\delta F^I} \cdot G^I = \frac{\frac{\delta(\frac{dM}{db})}{\delta F^I} \cdot G^I}{-\frac{d^2 M}{db^2}}.$$

The same approach applies when (variationally) differentiating with respect to  $F^C$ .

Similarly, the first-order condition for leverage can be written as  $\frac{dM}{db}(b^*; F^I, F^C) = 0$ . An application of the implicit function theorem implies that

$$\frac{\delta k^*}{\delta F^I} \cdot G^I = \frac{\frac{dM}{db} \left( \frac{\delta b^*}{\delta F^I} \cdot G^I \right) + \frac{\delta M}{\delta F^I} \cdot G^I}{\Upsilon''(k^*)} = \frac{\frac{\delta M}{\delta F^I} \cdot G^I}{\Upsilon''(k^*)}.$$

Notice that this derivation exploits the fact that  $\frac{dM}{db} = 0$ . The same approach applies when (variationally) differentiating with respect to  $F^C$ .

### Proof of Proposition 2 [Variational derivatives]

For completeness, we include here the counterparts of Equations (7) and (10), making explicit their dependence on  $F^I(s)$  and  $F^C(s)$ :

$$\begin{aligned} M(b; F^I, F^C) &= \beta^I \int_{s^*(b)}^{\bar{s}} (s + t(b, s) - b) dF^I(s) + \beta(r) \left( \int_{s^*(b)}^{\bar{s}} b dF^C + \int_{\underline{s}}^{s^*(b)} (\phi s + t(b, s)) dF^C(s) \right) \\ \frac{dM(b; F^I, F^C)}{db} &= \beta(r) \int_{s^*(b)}^{\bar{s}} dF^C(s) + \beta(r) \int_{\underline{s}}^{s^*(b)} \frac{\partial t(b, s)}{\partial b} dF^C(s) \\ &\quad - (1 - \phi) \beta(r) s^*(b) f^C(s^*(b)) \frac{ds^*(b)}{db} - \beta^I \int_{s^*(b)}^{\bar{s}} \left( 1 - \frac{\partial t(b, s)}{\partial b} \right) dF^I(s). \end{aligned}$$

To simplify the notation, we often suppress the explicit dependence of  $s^*$  on  $b$ . We compute  $\frac{\delta M}{\delta F^I} \cdot G^I$  as follows:

$$\begin{aligned} \frac{\delta M}{\delta F^I} \cdot G^I &\equiv \lim_{\varepsilon \rightarrow 0} \frac{M(b; F^I + \varepsilon G^I, F^C) - M(b; F^I, F^C)}{\varepsilon} \\ &= \lim_{\varepsilon \rightarrow 0} \frac{\beta^I \int_{s^*}^{\bar{s}} (s + t(b, s) - b) d(F^I(s) + \varepsilon G^I(s)) - \beta^I \int_{s^*}^{\bar{s}} (s + t(b, s) - b) dF^I(s)}{\varepsilon} \\ &= \beta^I \int_{s^*}^{\bar{s}} (s + t(b, s) - b) dG^I(s) \\ &= -\beta^I \int_{s^*}^{\bar{s}} \left( 1 + \frac{\partial t(b, s)}{\partial s} \right) G^I(s) ds. \end{aligned}$$

where the last line follows after integrating by parts.

We compute  $\frac{\delta M}{\delta F^C} \cdot G^C$  as follows:

$$\begin{aligned} \frac{\delta M}{\delta F^C} \cdot G^C &\equiv \lim_{\varepsilon \rightarrow 0} \frac{M(b; F^I, F^C + \varepsilon G^C) - M(b; F^I, F^C)}{\varepsilon} \\ &= \beta(r) \left( \int_{s^*}^{\bar{s}} b dG^C(s) + \int_{\underline{s}}^{s^*} (\phi s + t(b, s)) dG^C(s) \right) \\ &= -\beta(r) \left( (1 - \phi) s^* G^C(s^*) + \int_{\underline{s}}^{s^*} \left( \phi + \frac{\partial t(b, s)}{\partial s} \right) G^C(s) ds \right). \end{aligned}$$

where the last line follows after integrating by parts.

We compute  $\frac{\delta \frac{dM}{db}}{\delta F^I} \cdot G^I$  as follows:

$$\begin{aligned} \frac{\delta \frac{dM}{db}}{\delta F^I} \cdot G^I &= \lim_{\varepsilon \rightarrow 0} \frac{\left( -\beta^I \int_{s^*}^{\bar{s}} d(F^I + \varepsilon G^I) + \beta^I \int_{s^*}^{\bar{s}} \frac{\partial t}{\partial b} d(F^I + \varepsilon G^I) \right) - \left( -\beta^I \int_{s^*}^{\bar{s}} dF^I + \beta^I \int_{s^*}^{\bar{s}} \frac{\partial t}{\partial b} dF^I \right)}{\varepsilon} \\ &= \beta^I \left( - \int_{s^*}^{\bar{s}} dG^I(s) + \int_{s^*}^{\bar{s}} \frac{\partial t(b, s)}{\partial b} dG^I(s) \right) \\ &= \beta^I \left( \left( 1 - \frac{\partial t(b, s^*(b))}{\partial b} \right) G^I(s^*(b)) - \int_{s^*}^{\bar{s}} \frac{\partial^2 t(b, s)}{\partial b \partial s} G^I(s) ds \right). \end{aligned}$$

We compute  $\frac{\delta \frac{dM}{db}}{\delta F^C} \cdot G^C$  as follows:

$$\begin{aligned} \frac{\delta \frac{dM}{db}}{\delta F^C} \cdot G^C &= \beta(r) \left( \int_{s^*}^{\bar{s}} dG^C(s) - (1 - \phi) s^*(b) g^C(s^*) \frac{\partial s^*}{\partial b} + \int_{\underline{s}}^{s^*} \frac{\partial t}{\partial b} dG^C(s) \right) \\ &= -\beta(r) \left( G^C(s^*(b)) \frac{\partial s^*(b)}{\partial b} \left( 1 + \frac{\partial t(b, s^*(b))}{\partial s} + (1 - \phi) s^*(b) \frac{g^C(s^*(b))}{G^C(s^*(b))} \right) + \int_0^{s^*} \frac{\partial^2 t(b, s)}{\partial b \partial s} G^C(s) ds \right). \end{aligned}$$

where the last line follows after integrating by parts. In the baseline model, we use the fact that  $s^*(b) = b$ , implying  $\frac{\partial s^*}{\partial b} = 1$ .

### Proof of Proposition 3 [Differential impact of optimism by investors and creditors]

a) From Lemma 3, it follows that  $\frac{\delta b^*}{\delta F^I} \cdot G^I$  and  $\frac{\delta k^*}{\delta F^I} \cdot G^I$  will have the same sign as  $\frac{\delta(\frac{dM}{db})}{\delta F^I} \cdot G^I$  and  $\frac{\delta M}{\delta F^I} \cdot G^I$ , respectively. From Equations (12) and (14), if investors are optimistic in a hazard-rate sense,  $G^I(\cdot) \leq 0$ , and it is immediate that  $\frac{\delta(\frac{dM}{db})}{\delta F^I} \cdot G^I < 0$  and  $\frac{\delta M}{\delta F^I} \cdot G^I > 0$ , and therefore  $\frac{\delta b^*}{\delta F^I} \cdot G^I < 0$  and  $\frac{\delta k^*}{\delta F^I} \cdot G^I > 0$ .

b) From Lemma 3, it follows that  $\frac{\delta b^*}{\delta F^C} \cdot G^C$  and  $\frac{\delta k^*}{\delta F^C} \cdot G^C$  will have the same sign as  $\frac{\delta(\frac{dM}{db})}{\delta F^C} \cdot G^C$  and  $\frac{\delta M}{\delta F^C} \cdot G^C$ , respectively. From Equations (13) and (15), if creditors are optimistic in a hazard-rate sense,  $G^C(\cdot) \leq 0$ , so it is sufficient to show that

$$1 + (1 - \phi) s^*(b) \frac{g^C(s^*(b))}{G^C(s^*(b))} \geq 0.$$

At an interior optimum with common beliefs, Equation (10) implies that

$$\frac{dM}{db} = \beta(r) - \beta^I - \beta(r) (1 - \phi) s^*(b) \frac{f^C(s^*(b))}{1 - F^C(s^*(b))} = \mu \geq 0$$

or, equivalently,

$$\beta(r) - \beta^I \geq \beta(r) (1 - \phi) s^*(b) \frac{f^C(s^*(b))}{1 - F^C(s^*(b))}.$$

As shown in Section E.4 of the Online Appendix, hazard-rate dominance implies that  $\frac{f^C(s)}{1-F^C(s)} \geq -\frac{g^C(s)}{G^C(s)}$ , so the following relation holds:

$$\beta(r) - \beta^I \geq -\beta(r)(1-\phi)s^*(b)\frac{g^C(s)}{G^C(s)},$$

which implies that

$$1 + (1-\phi)s^*(b)\frac{g^C(s)}{G^C(s)} \geq \frac{\beta^I}{\beta(r)} \geq 0.$$

It is then immediate that  $\frac{\delta(\frac{dM}{db})}{\delta F^C} \cdot G^C > 0$  and  $\frac{\delta M}{\delta F^C} \cdot G^C > 0$ , and therefore  $\frac{\delta b^*}{\delta F^C} \cdot G^C > 0$  and  $\frac{\delta k^*}{\delta F^I} \cdot G^I > 0$ .

c) Suppose that  $F^C = F^I = F^0$ . Then the effect of joint exuberance on  $\frac{dM}{db}$  is

$$\begin{aligned} \frac{\delta\left(\frac{dM}{db}\right)}{\delta F^0} \cdot G &= \frac{\delta\left(\frac{dM}{db}\right)}{\delta F^I} \cdot G + \frac{\delta\left(\frac{dM}{db}\right)}{\delta F^C} \cdot G \\ &= -G(s^*(b)) \left( \beta(r) - \beta^I + \beta(r)(1-\phi)s^*(b)\frac{g(s^*(b))}{G(s^*(b))} \right). \end{aligned}$$

Since optimism in a hazard-rate sense implies that  $G(s^*(b)) \leq 0$ , we need to show that

$$\beta(r) - \beta^I + \beta(r)(1-\phi)s^*(b)\frac{g(s^*(b))}{G(s^*(b))} \geq 0.$$

At an interior optimum with common beliefs, Equation (10) implies that

$$\frac{dM}{db} = \beta(r) - \beta^I - \beta(r)(1-\phi)s^*(b)\frac{f^0(s^*(b))}{1-F^0(s^*(b))} = \mu \geq 0,$$

or, equivalently,

$$\beta(r) - \beta^I \geq \beta(r)(1-\phi)s^*(b)\frac{f^0(s^*(b))}{1-F^0(s^*(b))}.$$

As shown in Section E.4, hazard-rate dominance implies that  $\frac{f^0(s)}{1-F^0(s)} \geq -\frac{g^0(s)}{G^0(s)}$ , so the following relation holds:

$$\beta(r) - \beta^I \geq -\beta(r)(1-\phi)s^*(b)\frac{g^0(s)}{G^0(s)},$$

which implies, as required, that

$$\beta(r) - \beta^I + \beta(r)(1-\phi)s^*(b)\frac{g^0(s)}{G^0(s)} \geq 0.$$

## B Proofs and Derivations: Section 3

We prove the results in this section in a general model that allows for monetary policy and bailouts. Therefore, the proofs presented here also establish the corresponding results in Sections 4 and 5. The baseline model is recovered when  $t(b, s) = 0$  and when the discount factor implied by monetary policy satisfies  $\beta(r) = \beta(r^*) = \beta^C$ .

### Proof of Lemma 4 [Planner's problem]

The planner's objective is given by the sum of investors' and creditors' expected utility. Formally, ignoring constant terms that depend only on endowments, we have  $W = u^{I,P} + u^{C,P}$ , where  $u^{I,P}$  and  $u^{C,P}$  are given by

$$\begin{aligned} u^{I,P} &= \left[ Q(b, r) - 1 + \beta^I \int_{s^*(b)}^{\bar{s}} (s + t(b, s) - b) dF^{I,P}(s) \right] k - \Upsilon(k), \\ u^{C,P} &= \left[ -Q(b, r) + \beta^C \left( \int_{s^*(b)}^{\bar{s}} b dF^{C,P} + \int_{\underline{s}}^{s^*(b)} (\phi s + t(b, s)) dF^{C,P}(s) \right) \right] k, \end{aligned}$$

which imply that

$$W = \left[ \beta^I \int_{s^*(b)}^{\bar{s}} (s + t(b, s) - b) dF^{I,P}(s) + \beta^C \left( \int_{s^*(b)}^{\bar{s}} b dF^{C,P} + \int_{\underline{s}}^{s^*(b)} (\phi s + t(b, s)) dF^{C,P}(s) \right) - 1 \right] k - \Upsilon(k).$$

We define  $M^P(b)$  as follows:

$$M^P(b) = \beta^I \int_{s^*(b)}^{\bar{s}} (s + t(b, s) - b) dF^{I,P}(s) + \beta^C \left( \int_{s^*(b)}^{\bar{s}} b dF^{C,P} + \int_{\underline{s}}^{s^*(b)} (\phi s + t(b, s)) dF^{C,P}(s) \right).$$

The results in Lemmas 4 and 6 follow immediately by setting  $t(b, s) = 0$ .

Note that a planner that exclusively values the welfare of investors simply maximizes  $u^{I,P}$ , taking as given  $Q(b, r)$  as defined in Equation (26). This is as if the planner decided to set  $F^{C,P}(s) = F^C(s)$ . This observation is useful when relating our results to the Hertz scenario on page 26. A planner that assigns different welfare weights to investors and creditors simply maximizes a linear combination of  $u^{I,P}$  and  $u^{C,P}$ .

### Proof of Proposition 4 [Marginal welfare effect of varying the leverage cap]

The result follows directly by totally differentiating the characterization of the planner's objective in Lemma 4, applying the envelope theorem, and noting that  $\frac{db^*}{db} = 1$  whenever

the leverage cap is binding. Its general version with bailouts and monetary policy is

$$\frac{dW}{d\bar{b}} = \underbrace{\left[ \frac{dM^P(\bar{b})}{d\bar{b}} - \frac{d\gamma(b)}{db} \right] k^*(\bar{b}, r)}_{\text{Inframarginal Effect}} + \underbrace{\left[ M^P(\bar{b}) - \gamma(b) - M(\bar{b}) \right] \frac{dk^*(\bar{b}, r)}{d\bar{b}}}_{\text{Incentive Effect}}.$$

**Proof of Proposition 5 [Impact of beliefs on optimal regulation: General characterization]**

The variational derivative of Equation (16) with respect to beliefs  $F^j$  for  $j \in \{I, C\}$  is

$$\begin{aligned} \frac{\delta \frac{dW}{d\bar{b}}}{\delta F^j} \cdot G^j &= \left[ \frac{dM^P(\bar{b})}{db} - \frac{d\gamma(b)}{db} \right] \left[ \frac{\delta k^*(\bar{b})}{\delta F^j} \cdot G^j \right] \\ &+ \left[ M^P(\bar{b}) - \gamma(b) - M(\bar{b}) \right] \left[ \frac{\delta \frac{dk^*}{d\bar{b}}}{\delta F^j} \cdot G^j \right] - \left[ \frac{\delta M(\bar{b})}{\delta F^j} \cdot G^j \right] \frac{dk^*(\bar{b})}{d\bar{b}}. \end{aligned}$$

Notice that we can express optimal investment as  $k^*(\bar{b}) = \Psi(M(\bar{b}) - 1)$ , where  $\Psi(\cdot)$  is the inverse function of  $\Upsilon'(\cdot)$ . This implies that

$$\frac{\delta k^*(\bar{b})}{\delta F^j} \cdot G^j = \Psi'(\cdot) \left[ \frac{\delta M(\bar{b})}{\delta F^j} \cdot G^j \right] \quad \text{and} \quad \frac{dk^*(\bar{b})}{d\bar{b}} = \Psi'(\cdot) \frac{dM(\bar{b})}{d\bar{b}}.$$

Hence, the last term in the variational derivative is

$$\begin{aligned} \left[ \frac{\delta M(\bar{b})}{\delta F^j} \cdot G^j \right] \frac{dk^*(\bar{b})}{d\bar{b}} &= \frac{dM(\bar{b})}{d\bar{b}} \Psi'(\cdot) \left[ \frac{\delta M(\bar{b})}{\delta F^j} \cdot G^j \right] \\ &= \frac{dM(\bar{b})}{d\bar{b}} \left[ \frac{\delta k^*(\bar{b})}{\delta F^j} \cdot G^j \right]. \end{aligned}$$

Combining our results, we obtain the required expression in Equation (18), and also the result in Proposition 4 with bailouts.

Whenever the planner's objective is well-behaved in  $\bar{b}$ , establishing that  $\frac{\delta \frac{dW}{d\bar{b}}}{\delta F^j} \cdot G^j > 0$  guarantees that optimal leverage regulation involves a looser leverage cap. Formally, this is the case whenever (i) the planner's objective is quasi-concave in  $\bar{b}$  and  $\frac{\delta \frac{dW}{d\bar{b}}}{\delta F^j} \cdot G^j > 0$  evaluated at the optimal (second-best) policy or (ii) welfare takes any shape and  $\frac{\delta \frac{dW}{d\bar{b}}}{\delta F^j} \cdot G^j > 0$  for all  $\bar{b}$ . As is standard in normative exercises, the planner's objective need not be quasi-concave without imposing additional restrictions on primitives — even though we find the



problem to be well-behaved when simulating the model for standard functional forms and belief distributions.

### **Proof of Proposition 6 [Impact of beliefs on optimal regulation: Specific scenarios]**

The results in this proposition follow directly by combining the comparative statics in Propositions 3 with the general characterization in Proposition 5 and Equation (19).<sup>29</sup> Our conclusions about optimal policy follow directly, because those results provide signs for  $\frac{\delta \frac{dW}{db}}{\delta F^j} \cdot G^j > 0$  for all  $\bar{b}$ .

## **C Proofs and Derivations: Sections 4 and 5**

In Appendices A and B, we have proved the results in Sections 2 and 3 using a general model that allows for flexible monetary policy and bailouts. Therefore, the results in Sections 4 and 5 follow immediately from those characterizations.

## **D Proofs and Derivations: Section 6**

### **Proof of Proposition 10 [Impact of the planner's beliefs on optimal regulation: Specific scenarios]**

Each case in the proposition holds constant the beliefs of creditors and investors. Hence, the terms  $M(\bar{b}) > 0$ ,  $k^*(\bar{b}) > 0$ , and  $\frac{dk^*(\bar{b})}{db} \geq 0$  in the marginal welfare effect  $\frac{dW}{db}$  (see Proposition 4) are also held fixed. It is then clear that  $\frac{dW}{db}$  is increasing in the planner's marginal value  $\frac{dM^P(\bar{b})}{db}$  of leverage and weakly increasing in the planner's valuation  $M^P(\bar{b})$  of investment.

By a parallel argument to Proposition 3, it follows that (i)  $M^P(\bar{b})$  increases with the planner's equity exuberance, debt exuberance, and joint exuberance, and that (ii)  $\frac{dM^P(\bar{b})}{db}$  increases with the planner's debt exuberance or joint exuberance but decreases with the planner's equity exuberance. This establishes the claims in the proposition.

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<sup>29</sup>In general, note that  $\frac{\delta \frac{dk^*}{db}}{\delta F^j} \cdot G^j = \Psi'(\cdot) \frac{\delta \frac{dM}{db}}{\delta F^j} \cdot G^j + \Psi''(\cdot) \frac{\delta M(\bar{b})}{\delta F^j} \cdot G^j$ . When adjustment costs are quadratic,  $\Psi'(\cdot) = \varphi$  — a scalar defined in the text — and  $\Psi''(\cdot) = 0$ .

# ONLINE APPENDIX

## FOR ONLINE PUBLICATION ONLY

### E Additional proofs and derivations

#### E.1 Regularity conditions

Note that investors always find it optimal to choose non-negative leverage in equilibrium, since

$$\left. \frac{dM}{db} \right|_{b=0} = \beta^C - \beta^I > 0.$$

Therefore, for a given leverage constraint  $\bar{b}$ , our problem always features a solution for leverage in  $[0, \bar{b}]$  and a finite solution for investment, since  $\frac{d^2 V}{dk^2} = -\Upsilon''(k) < 0$ . A sufficient condition that guarantees a finite solution without leverage regulation is that creditors perceive the net present value of investment to be negative if there is always default, that is,  $\beta^C \phi \mathbb{E}^C[s] < 1$ , since

$$\lim_{b \rightarrow \infty} M(b) = \beta^C \phi \mathbb{E}^C[s].$$

This sufficient condition extends directly to the environment studied in Sections 4 and 5 after imposing that bailouts are bounded above,  $t(b, s) \leq \bar{t}$ , and that investment has negative net present value if always in distress, even under the maximum bailout,  $\beta(r) (\phi \mathbb{E}^C[s] + \bar{t}) < 1$ .

In order to explore the quasi-concavity of the investors' objective, it is useful to normalize  $\frac{dM}{db}$ , characterized in Equation (10), as follows:

$$J(b) = \frac{\frac{dM}{db}}{\beta^C (1 - F^C(b))} \equiv 1 - \frac{\beta^I}{\beta^C} \frac{1 - F^I(b)}{1 - F^C(b)} - (1 - \phi) b \frac{f^C(b)}{1 - F^C(b)},$$

where the normalization is valid for any non-zero level of  $b$ . Therefore, it follows that the quasi-concavity of the investors' objective can be established by characterizing the conditions under which  $J'(b)$  is negative. Note that

$$J'(b) = -\frac{\beta^I}{\beta^C} \frac{\partial}{\partial b} \left( \frac{1 - F^I(b)}{1 - F^C(b)} \right) - (1 - \phi) \left[ \frac{f^C(b)}{1 - F^C(b)} + b \frac{\partial}{\partial b} \left( \frac{f^C(b)}{1 - F^C(b)} \right) \right].$$

There are two sufficient conditions that, when jointly satisfied, guarantee that  $J'(b) < 0$ .

First, when the hazard rate of creditors' beliefs is monotone increasing, then

$$\frac{\partial}{\partial b} \left( \frac{f^C(b)}{1 - F^C(b)} \right) > 0.$$

Second, if investors are more optimistic than creditors in the hazard-rate sense, then

$$\frac{\partial}{\partial b} \left( \frac{1 - F^I(b)}{1 - F^C(b)} \right) > 0.$$

Therefore, when both conditions are satisfied, we have  $J'(b) < 0$ , which yields the result. We formally state this result as Lemma 7.

**Lemma 7. (*Single-peaked objective function without bailouts*)** Suppose that there is no bailout, and:

1. Equity investors are weakly more optimistic than creditors in the hazard-rate order;
2. Creditors' hazard rate  $\frac{f^C(s)}{1 - F^C(s)}$  is increasing in  $s$ .

Then  $M(b)$  is single peaked.

Notice that the solution for optimal leverage can be expressed in general as follows:

$$b = \frac{1}{(1 - \phi) \frac{f^C(b)}{1 - F^C(b)}} \left( 1 - \frac{\beta^I}{\beta^C} \frac{1 - F^I(b)}{1 - F^C(b)} \right).$$

Note also that whenever  $\beta^I = \beta^C$ ,  $\frac{dM}{db} \Big|_{b=0} = 0$ , but the rest of the results remain valid.

## E.2 Variations and cumulative distribution functions

For simplicity, we drop the superscript  $j$  and work with  $F(s)$  and  $G(s)$  in this appendix. Recall that a function  $F(s)$  is a cumulative distribution function if and only if it is non-decreasing, right-continuous, and satisfies  $F(\underline{s}) = 0$  and  $F(\bar{s}) = 1$ . We say a variation  $G(s)$  of beliefs is valid if, for small enough  $\varepsilon$ , the perturbed belief  $F(s) + \varepsilon G(s)$  remains a cumulative distribution function.

**Definition 1.** A right-continuous function  $G(s)$  is a *valid variation* of a cumulative distribution function  $F(s)$  if  $G(\bar{s}) = G(\underline{s}) = 0$ , and there exists an  $\bar{\varepsilon} > 0$  such that for all  $\varepsilon \in [0, \bar{\varepsilon}]$ , the following conditions are satisfied:

1.  $F(s) + \varepsilon G(s)$  is non-decreasing in  $s$ ;
2.  $0 \leq F(s) + \varepsilon G(s) \leq 1$ ,  $\forall s$ .

The following lemma shows that our regularity conditions in the baseline model are sufficient to guarantee that all variations are valid.

**Lemma 8.** *(Regularity conditions on belief variations) If (i)  $F(s)$  and  $G(s)$  are continuously differentiable, (ii)  $f(s) = F'(s) > 0$ , and (iii)  $G(\bar{s}) = G(\underline{s}) = 0$ , then  $G(s)$  is a valid variation of  $F(s)$ .*

*Proof.* By assumption,  $f(s) = F'(s)$  and  $g(s) = G'(s)$  are continuous and therefore bounded on the interval  $[\underline{s}, \bar{s}]$ , so that we can define  $\underline{f} = \inf \{g(s) | s \in [\underline{s}, \bar{s}]\} > 0$  and  $\underline{g} = \inf \{f(s) | s \in [\underline{s}, \bar{s}]\}$ . For all  $s$ , we have

$$F'(s) + \varepsilon G'(s) = f(s) + \varepsilon g(s) \geq \underline{f} + \varepsilon \underline{g},$$

Hence,  $F(s) + \varepsilon G(s)$  is non-decreasing for all  $\varepsilon \leq \underline{f}/\underline{g} \equiv \bar{\varepsilon}$ .

Moreover, note that, for all  $\varepsilon \leq \bar{\varepsilon}$ , and for all  $s$ , we have

$$F(s) + \varepsilon G(s) = \underbrace{F(\underline{s})}_{=0} + \underbrace{\varepsilon \int_{\underline{s}}^s (f(s) + \varepsilon g(s)) ds}_{\geq 0, \forall \varepsilon \leq \bar{\varepsilon}} \geq F(\underline{s}) = 0,$$

and similarly,

$$F(s) + \varepsilon G(s) = \underbrace{F(\bar{s})}_{=0} - \underbrace{\varepsilon \int_s^{\bar{s}} (f(s) + \varepsilon g(s)) ds}_{\geq 0, \forall \varepsilon \leq \bar{\varepsilon}} \leq F(\bar{s}) = 1.$$

Hence,  $0 \leq F(s) + \varepsilon G(s) \leq 1$  for all  $\varepsilon \leq \bar{\varepsilon}$ , as required.  $\square$

### E.3 First-best corrective policy

The first-best problem when the planner can control both  $b$  and  $k$  is

$$\max_{b,k} W(b,k) = \left[ M^P(b) - 1 \right] k - \Upsilon(k),$$

with first-order conditions

$$\begin{aligned} \frac{dM^P(b^1)}{db} &= 0 \\ M^P(b^1) - 1 &= \Upsilon'(k^1), \end{aligned}$$

where we denote by  $b^1$  and  $k^1$  the first-best leverage and investment. Formally, we consider an equilibrium with Pigouvian taxes  $\tau = (\tau_k, \tau_b)$ , where investors pay  $\tau_k k + \tau_b b$  at date 0 to the government, which is then rebated as a lump sum to either investors or creditors.

Investors solve

$$V(\tau) = \max_{b,k} [M(b) - 1]k - \Upsilon(k) - \tau_k k - \tau_b b,$$

with first-order conditions

$$\begin{aligned} \frac{dM(b)}{db} k &= \tau_b \\ M(b) - 1 &= \Upsilon'(k) + \tau_k. \end{aligned}$$

It follows that the corrective policy that achieves the first-best solution is

$$\begin{aligned} \tau_b &= \left[ \frac{dM(b^1)}{db} - \frac{dM^P(b^1)}{db} \right] k^1 \\ \tau_k &= M(b^1) - M^P(b^1). \end{aligned}$$

#### E.4 Properties of hazard-rate dominant perturbations

We often rely on the following two properties of hazard-rate dominant variations/perturbations.

**Property 1** The hazard rate after an arbitrary perturbation of the form described in Section 2 of the paper is given by  $h(s) = \frac{f(s) + \varepsilon g(s)}{1 - (F(s) + \varepsilon G(s))}$ . Its derivative with respect to  $\varepsilon$  takes the form

$$\frac{dh(s)}{d\varepsilon} = \frac{g(s)}{1 - (F(s) + \varepsilon G(s))} + \frac{(f(s) + \varepsilon g(s)) G(s)}{(1 - (F(s) + \varepsilon G(s)))^2}.$$

In the limit in which  $\varepsilon \rightarrow 0$ , for hazard-rate dominance to hold, it must be the case that  $\lim_{\varepsilon \rightarrow 0} \frac{dh(s)}{d\varepsilon} < 0$ , therefore

$$\begin{aligned} \lim_{\varepsilon \rightarrow 0} \frac{dh(s)}{d\varepsilon} &= \frac{g(s)}{1 - F(s)} + \frac{f(s)}{1 - F(s)} \frac{G(s)}{1 - F(s)} < 0 \\ &\iff g(s) + \frac{f(s)}{1 - F(s)} G(s) < 0 \\ &\iff \frac{g(s)}{G(s)} + \frac{f(s)}{1 - F(s)} > 0 \\ &\iff \frac{f(s)}{1 - F(s)} > -\frac{g(s)}{G(s)}, \end{aligned}$$

where in the second-to-last line the sign of the inequality flips because  $G(s)$  is negative, since hazard-rate dominance implies first-order stochastic dominance.

**Property 2** Hazard-rate dominance implies that a perturbation increases  $\frac{1-F(s)}{1-F(b)}$ , where  $s > b$ . This implies that

$$\lim_{\varepsilon \rightarrow 0^+} \frac{\partial}{\partial \varepsilon} \left( \frac{1 - F(s) - \varepsilon G(s)}{1 - F(b) - \varepsilon G(b)} \right) = \frac{(-G(s))(1 - F(b)) - (1 - F(s))(-G(b))}{(1 - F(b))^2} \geq 0,$$

or equivalently

$$(-G(s))(1 - F(b)) \geq (1 - F(s))(-G(b)). \quad (30)$$

## E.5 Binding equity constraint

Whenever the investors' date 0 non-negativity constraint is binding, the total amount of equity is effectively fixed to  $n_0^I$ , and Lemma 1 ceases to hold. Equation (23) and Equations (24) through (28) remain valid in that case. For simplicity, we consider here the case without bailouts, no monetary policy, and  $\Upsilon(k) = 0$ . These assumptions imply that  $s^*(b) = b$ , and allow us to focus on equilibrium leverage.

Under those assumptions, when the date 0 non-negativity constraint binds, the problem that investors face can be expressed as

$$\max_{b,k} \beta^I \int_{s^*(b)}^{\bar{s}} (s - b) dF^I(s) k,$$

where  $k = \frac{n_0^I}{1-Q(b)}$  and  $Q(b) = \beta^C \left( \int_{s^*(b)}^{\bar{s}} b dF^C(s) + \phi \int_{\underline{s}}^{s^*(b)} s dF^C(s) \right)$ . Intuitively, investors maximize the leverage return on their initial wealth  $n_0^I$ . Under natural regularity conditions, the solution to this problem is given by the first-order condition on  $b$

$$\frac{1 - Q(b^*)}{Q_b(b^*)} = \frac{\int_{s^*(b^*)}^{\bar{s}} (s - b^*) dF^I(s)}{\int_{s^*(b^*)}^{\bar{s}} dF^I(s)}, \quad (31)$$

where  $Q_b(b) = \beta^C \left( \int_{s^*(b)}^{\bar{s}} dF^C(s) - (1 - \phi) s^*(b) f^C(s^*(b)) \right)$ . Equation (31) is the counterpart of Equation (11) in Simsek (2013a), after accounting for the cost of distress associated with bankruptcy. In this appendix, to highlight the differences with Simsek (2013a), we focus on the case of equity exuberance, although our approach can be used to study other scenarios. Formally, we consider the case in which  $F^C(s) = F^{C,P}(s) = F^{I,P}(s)$ .

In order to understand whether equilibrium leverage increases or decreases in response to a perturbation in investors' leverage, it follows from Equation (31) that it is sufficient to characterize the behavior of  $T(b) \equiv \frac{\int_{s^*(b)}^{\bar{s}} s dF^I(s)}{\int_{s^*(b)}^{\bar{s}} dF^I(s)} = \int_b^{\bar{s}} (s - b) \frac{f^I(s)}{1 - F^I(b)} ds$ . The change in

$T(b)$  induced by a change in investors' beliefs in the direction  $G^I$  is given by

$$\frac{\delta T}{\delta F^I} \cdot G^I = \frac{\int_b^{\bar{s}} (s-b) \left[ g^I(s) (1 - F^I(b)) - f^I(s) (-G^I(b)) \right] ds}{(1 - F^I(b))^2}.$$

If  $\frac{\delta T}{\delta F^I} \cdot G^I$  is positive (negative), leverage will increase (decrease). This characterization allows to consider any perturbation of beliefs. However, if we are interested in hazard-rate dominant perturbations, it can be shown that when investors become more optimistic in a hazard-rate sense and they are constrained on the amount of equity issued, leverage increases in equilibrium. Formally,  $\frac{\partial T}{\partial F^I} \cdot G^I \geq 0$  if

$$\left( \int_b^{\bar{s}} (s-b) g^I(s) ds \right) (1 - F^I(b)) - \left( \int_b^{\bar{s}} (s-b) f^I(s) ds \right) (-G^I(b)) \geq 0,$$

which is equivalent to

$$\left( \int_b^{\bar{s}} (-G^I(s)) ds \right) (1 - F^I(b)) - \left( \int_b^{\bar{s}} (1 - F^I(s)) ds \right) (-G^I(b)) \geq 0,$$

which follows by integrating (30) over  $s \in [b, \bar{s}]$ . This argument is an alternative way to formalize some of the main results in Simsek (2013a), in particular Theorems 4 and 5.

Finally, we can consider the normative implications of this case. In this scenario, the planner's objective can be written as  $\beta^I \int_{s^*(b)}^{\bar{s}} (s-b) dF^{I,P}(s) k$ . With a single degree of freedom, since  $b$  and  $k$  are connected via the date 0 budget constraint of investors, it is straightforward to show that an increase in optimism by investors in the hazard-rate sense calls for tightening leverage regulations.

## E.6 Alternative modeling assumptions

### E.6.1 Outside equity issuance

We consider an extension of our baseline model in which, in addition to investors and creditors, there are shareholders (denoted  $S$ ) who are able to invest in outside equity claims against investors' cash flows. The lifetime utility of a representative shareholder is  $c_0^S + \beta^S \mathbb{E}^S [c_1^S(s)]$ , where  $\mathbb{E}^S$  is the expectation under shareholders' beliefs  $F^S(s)$ . For simplicity, we continue to assume segmented markets: creditors do not invest in equity, and shareholders do not invest in bonds.

In addition to leverage  $b$ , investors choose a share  $\sigma \in [0, 1]$  of equity to retain, and sell a share  $1 - \sigma$  of equity claims to shareholders. The market value of outside equity in

equilibrium is then given by

$$P^S(b, \sigma) = (1 - \sigma) \beta^S \int_b^{\bar{s}} (s - b) dF^S(s).$$

By contrast, the market value of debt  $Q(b)$  remains unchanged from the baseline model, since the payoff to debtholders is unaffected by inside or outside ownership of equity shares. Repeating the steps leading to Lemma 1 in the text, we find that the following reformulation of the investors' problem characterizes the equilibrium:

**Lemma 9.** *[Investors' problem with outside equity issuance] Investors solve the following problem to decide their optimal investment, outside equity issuance, and leverage choices at date 0:*

$$\begin{aligned} V(\bar{b}) = \max_{b, k; \sigma \in [0, 1]} & [M(b, \sigma) - 1]k - \Upsilon(k) \\ \text{s.t. } & b \leq \bar{b} \quad (\mu), \end{aligned}$$

where  $\mu$  denotes the Lagrange multiplier on the leverage constraint imposed by the government (reformulated as  $bk \leq \bar{b}k$ ), and  $M(b, \sigma)$  is given by

$$\begin{aligned} M(b, \sigma) = & \underbrace{\sigma \beta^I \int_{s^*(b)}^{\bar{s}} (s - b) dF^I(s)}_{\text{inside equity}} + \underbrace{(1 - \sigma) \beta^S \int_{s^*(b)}^{\bar{s}} (s - b) dF^S(s)}_{\text{outside equity}} \\ & + \underbrace{\beta^C \left( \int_{s^*(b)}^{\bar{s}} b dF^C(s) + \phi \int_{\underline{s}}^{s^*(b)} s dF^C(s) \right)}_{\text{debt}}. \end{aligned} \quad (32)$$

Lemma 9 shows that investors continue to maximize the same objective as in the baseline model, but must first solve an auxiliary maximization problem in Equation (32), which determines the optimal value  $\sigma$  of the share of equity retained by insiders. The auxiliary problem is clearly linear in  $\sigma$ . Hence, for any given choice of  $b$ , it is either optimal to retain all shares ( $\sigma = 1$ ) or sell all shares to outsiders ( $\sigma = 0$ ), depending on the differences between insiders' and outsiders' discount factors and beliefs.

This result clarifies how our main results are affected by outside equity issuance. On the one hand, if inside and outside shareholders have the same preferences and beliefs, then investors are indifferent between all values of  $\sigma$ , and their problem reduces to the exact same problem as in the baseline model. In this case, all of our positive and normative results on the marginal effects of changes in beliefs carry over without modification.

On the other hand, if there are differences in preferences or belief disagreements



between insiders and outsiders, then investors' choices are affected only by marginal changes in the beliefs of (outside) shareholders if it is optimal to sell all shares with  $\sigma = 1$ , and only by marginal changes in their own beliefs if  $\sigma = 0$ . However, all of our results on the effects of equity exuberance continue to remain true after a modification to the definition of exuberance, namely, that *both* investors' beliefs  $F^I(s)$  and outsider shareholders' beliefs  $F^S(s)$  become more optimistic in the sense of hazard-rate dominance.

### E.6.2 Collateralized credit

In the body of the paper, we consider an environment in which creditors can seize from investors the full gross return on investment in case of default. If we assume that capital trades at a price  $q(s)$  at date 1, and that credit is collateralized exclusively by the market value of the investment at date 1, we can reformulate the two relevant equations in Equation (26) to accommodate collateralized borrowing as follows:

$$c_1^I(s) = n_1^I(s) + (s + t(b, s))k + \max\{q(s) - b, 0\}k, \forall s$$

$$Q(b, r) = \beta(r) \left( \int_{s^*(b)}^{\bar{s}} b dF^C(s) + \phi \int_{\underline{s}}^{s^*(b)} q(s) dF^C(s) \right),$$

where  $s^*(b)$  now solves  $q(s^*) = b$ . It is straightforward to extend our results to this case.

## E.7 Uncertainty about investors' and creditors' beliefs

In the body of the paper, the planner is able to condition the optimal policy on the beliefs  $F^I(\cdot)$  and  $F^C(\cdot)$  that investors and creditors use to evaluate the returns  $s$  to investment. In this section, we study an extension of the model in which the planner faces uncertainty about the beliefs of investors and creditors. Formally, we assume that the planner faces uncertainty about some abstract random variable, which in turn drives the beliefs of investors and creditors. That is, we introduce a random "sentiment" variable  $\xi \in [\underline{\xi}, \bar{\xi}]$  with distribution  $H(\xi)$ , which indexes market sentiment about investment returns and induces beliefs  $F^I(s; \xi)$  and  $F^C(s; \xi)$  among investors and creditors. By contrast, the planner's beliefs  $F^{I,P}(s)$  and  $F^{C,P}(s)$  are independent of sentiment.<sup>30</sup> For simplicity, we concentrate on the baseline model without bailouts and monetary policy.

The timing of events at date 0 is as follows: First, the planner sets the leverage cap  $\bar{b}$  before observing the realization of sentiment  $\xi$ . Second, sentiment  $\xi$  is realized and observed by investors and creditors. Third, investors choose leverage  $b$  and investment  $k$ .

<sup>30</sup> Alternatively, one can consider an environment where the planner's beliefs also respond to sentiment. By continuity, our qualitative results below all go through in this context as long as the relative responsiveness of investors' and creditors' beliefs to sentiment is sufficiently large relative to the planner's.

In this environment, a version of Lemma 1 applies, except for the fact that the market valuation  $M(b; \xi)$  becomes a function of sentiments:

**Lemma 10.** *[Investors' problem with sentiments] Investors solve the following problem to decide their optimal investment and leverage choices at date 0 when sentiment is  $\xi$ :*

$$\begin{aligned} V(\bar{b}; \xi) &= \max_{b, k} [M(b; \xi) - 1] k - \Upsilon(k) \\ \text{s.t. } & b \leq \bar{b} \quad (\mu(\xi)), \end{aligned}$$

where  $\mu(\xi)$  denotes the Lagrange multiplier on the leverage constraint imposed by the government when sentiment is  $\xi$ , and  $M(b; \xi)$  is given by

$$M(b; \xi) = \underbrace{\beta^I \int_b^{\bar{s}} (s - b) dF^I(s; \xi)}_{\text{equity}} + \underbrace{\beta^C \left( \int_b^{\bar{s}} b dF^C(s; \xi) + \phi \int_{\underline{s}}^b s dF^C(s; \xi) \right)}_{\text{debt}}.$$

We let  $k^*(\bar{b}; \xi)$  and  $b^*(\bar{b}; \xi)$  denote investors' optimal choice of investment  $k$  in this problem. Repeating the steps leading to Lemma 4 and Proposition 4 in the baseline model, we find that the planner's problem with sentiments is

$$\max_{\bar{b}, r} \int_{\underline{\xi}}^{\bar{\xi}} W(b^*(\bar{b}; \xi), k^*(\bar{b}; \xi)) dH(\xi) \equiv \mathbb{E} \left[ W(b^*(\bar{b}; \xi), k^*(\bar{b}; \xi)) \right],$$

where the social welfare function is again given by

$$W(b, k) = [M^P(b) - 1] k - \Upsilon(k),$$

with the planner's valuation  $M^P(b)$  of investment defined as in Lemma 4. Notice that  $W(b, k)$  is independent of sentiments  $\xi$  since they do not affect the planner's beliefs. Hence, the only source of randomness in welfare stems from the fact that the choices of leverage and investment depend on  $\xi$ .

We now characterize the ex-ante marginal welfare effect  $\mathbb{E} \left[ \frac{dW}{db} \right]$  of leverage regulation. In order to isolate the impact of imperfect targeting, we compare the ex-ante effect to a benchmark with perfect targeting. The benchmark is defined as the marginal welfare effect  $\frac{dW^0}{db}$  that would arise if investors and creditors held their average beliefs with probability one.<sup>31</sup> In the remaining of this section, we assume that investment costs are quadratic

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<sup>31</sup>Formally, the average beliefs are defined as  $F^j(s) = \int_{\underline{\xi}}^{\bar{\xi}} F^j(s; \xi) dH(\xi)$  for  $j \in \{I, H\}$ . The benchmark value of the marginal welfare effect  $\frac{dW^0}{db}$  is obtained by evaluating the expression in Proposition 4 at the average belief.

with  $\Upsilon(k) = \frac{k^2}{2\varphi}$ .

**Proposition 11.** *[Marginal welfare effect with imperfect targeting] The expected marginal welfare impact of increasing the leverage cap is*

$$\mathbb{E} \left[ \frac{dW}{db} \right] = \frac{dW^0}{db} - \varphi \cdot \text{Cov} \left[ M(\bar{b}; \xi), \frac{dM(\bar{b}; \xi)}{db} \right] - \int_{\{\xi: \mu(\xi)=0\}} \frac{d\hat{W}(\bar{b}; \xi)}{db} dH(\xi), \quad (33)$$

where  $\hat{W}(\bar{b}; \xi)$ , defined in the appendix, is the hypothetical level of welfare obtained by enforcing leverage  $b = \bar{b}$  in states where the leverage cap is not binding.

Equation (33) shows two differences between leverage regulation with perfect and imperfect targeting. First, the expected welfare effect of raising the leverage cap is reduced by the covariance between market valuations and investment sensitivity. Intuitively, when this covariance is positive, states of the world with overinvestment (high  $M(\bar{b}; \xi)$ ) coincide with states where investment is sensitive to leverage regulation (high  $\frac{dM(\bar{b}; \xi)}{db}$ ). In that case, it is particularly valuable ex-ante to push for lower investment by lowering the leverage cap. Second, the leverage constraint may not always be binding if there are realizations of  $\xi$  for which the associated Lagrange multiplier is  $\mu(\xi) = 0$ . If the (hypothetical) benefit of enforcing more leverage in these states would be positive, then the ex-ante benefit of raising  $\bar{b}$  is less than  $\frac{dW^0}{db}$ , which is reflected in the third term in (33).

These effects have ambiguous implications for optimal policy. For example, consider the case where  $\xi$  indexes the optimism of equity investors in a hazard-rate sense, while creditors' beliefs agree with the planner. Equation (33) in this case implies two counteracting effects. On the one hand, our analysis above implies that the covariance between valuations and sensitivity in (33) is negative, which increases  $\mathbb{E} \left[ \frac{dW}{db} \right]$  and decreases the planner's incentive to constrain leverage. On the other hand, Proposition 3 implies that incentives to take on leverage are decreasing in  $\xi$ , so that the constraint is slack in optimistic states. This effect decreases  $\mathbb{E} \left[ \frac{dW}{db} \right]$  because (by Proposition 6) the welfare benefit of more leverage is greatest when investors are optimistic.

However, we note that these effects become unambiguous when the leverage constraint always binds.<sup>32</sup>

**Proposition 12.** *[Welfare effects with imperfect targeting: Binding constraints] In this proposition, we assume that adjustment costs are quadratic. We fix a value of  $\bar{b}$  for which the leverage constraint  $b \leq \bar{b}$  binds for all realizations  $\xi$  of sentiment.*

<sup>32</sup>Equivalently, the characterization below applies to the case where the planner imposes an equality constraint  $b = \bar{b}$  on investors instead of the cap  $b \leq \bar{b}$  that we have considered.

a) *Equity sentiments:* Assume that creditors and the planner share common beliefs regardless of sentiments  $F^C(s; \xi) = F^{C,P}(s) = F^{I,P}(s)$ ,  $\forall \xi$ , and investors' beliefs  $F^I(s; \xi)$  exhibit increasing optimism in  $\xi$  in a hazard-rate sense. Then,  $\mathbb{E} \left[ \frac{dW}{db} \right]$  is higher than in the benchmark with perfect targeting.

b) *Debt sentiments:* Assume that investors and the planner share common beliefs regardless of sentiments  $F^I(s; \xi) = F^{C,P}(s) = F^{I,P}(s)$ ,  $\forall \xi$ , and creditors' beliefs  $F^C(s; \xi)$  exhibit increasing optimism in  $\xi$  in a hazard-rate sense. Then,  $\mathbb{E} \left[ \frac{dW}{db} \right]$  is lower than in the benchmark with perfect targeting.

With binding constraints, the covariance in Equation (33) determines welfare effects with imperfect targeting. In the case of equity sentiments, the covariance is negative as argued above. In the case of debt sentiments, the covariance is positive because market valuations and incentives to take on leverage are both increasing in creditors' optimism. Thus, relaxing the assumption that the planner has perfect knowledge of the beliefs of investors and creditors may have an impact on the optimal policy, depending on the type of the belief variation.

### E.7.1 Proofs

#### Proof of Proposition 12

Let average beliefs be  $F^j(s) = \int_{\underline{\xi}}^{\bar{\xi}} F^j(s; \xi) dH(\xi)$ ,  $j \in \{I, C\}$ , and let the market valuation under average beliefs be  $M(b)$ , as defined in Equation (7). Since  $M(b)$  and  $\frac{dM(b)}{db}$  are linear functionals of beliefs, we have  $M(b) = \mathbb{E} [M(\bar{b}; \xi)]$  and  $\frac{dM(b)}{db} = \mathbb{E} \left[ \frac{dM(\bar{b}; \xi)}{db} \right]$ . Now consider the value of  $\frac{dW}{db}$  in the benchmark with perfect targeting, which we denote as  $\frac{dW^0}{db}$ . With quadratic costs, Equation (9) implies that the sensitivity of investment to leverage regulation is  $\frac{dk^*(\bar{b}; \xi)}{db} = \varphi \frac{dM(\bar{b}; \xi)}{db}$ . Therefore, starting from Proposition 4, we get

$$\frac{dW^0}{db} = \varphi \left( \frac{dM^P(\bar{b})}{db} \mathbb{E} [M(\bar{b}; \xi) - 1] + \mathbb{E} [M^P(\bar{b}; \xi) - M(\bar{b}; \xi)] \mathbb{E} [M(\bar{b}; \xi)] \right).$$

Moreover, Equation (33) with imperfect targeting becomes

$$\mathbb{E} \left[ \frac{dW}{db} \right] = \int_{\{\xi: \mu(\xi) > 0\}} \frac{d\hat{W}(\bar{b}; \xi)}{db} dH(\xi),$$

where

$$\frac{d\hat{W}(\bar{b}; \xi)}{d\bar{b}} \equiv \varphi \left[ \frac{dM^p(\bar{b})}{db} (M(\bar{b}; \xi) - 1) + (M^p(\bar{b}) - M(\bar{b}; \xi)) \frac{dM(\bar{b}; \xi)}{d\bar{b}} \right].$$

Moreover, we can write

$$\int_{\underline{\xi}}^{\bar{\xi}} \frac{d\hat{W}(\bar{b}; \xi)}{d\bar{b}} dH(\xi) = \frac{dW^0}{d\bar{b}} - \varphi \mathbb{C}ov \left[ M(\bar{b}; \xi), \frac{dM(\bar{b}; \xi)}{d\bar{b}} \right],$$

so that we obtain

$$\mathbb{E} \left[ \frac{dW}{d\bar{b}} \right] = \frac{dW^0}{d\bar{b}} - \varphi \cdot \mathbb{C}ov \left[ M(\bar{b}; \xi), \frac{dM(\bar{b}; \xi)}{d\bar{b}} \right] - \int_{\{\xi: \mu(\xi) \leq 0\}} \frac{d\hat{W}(\bar{b}; \xi)}{d\bar{b}} dH(\xi),$$

as required.

### Proof of Proposition 12

This result follows directly by noting that the third term in Equation (33) is zero when the constraint is binding for all  $\xi$ , and evaluating the covariance terms in each scenario using the comparative statics in Proposition 3.

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