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More myths about the financial crisis of 2008

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More Myths about the Financial Crisis of 2008

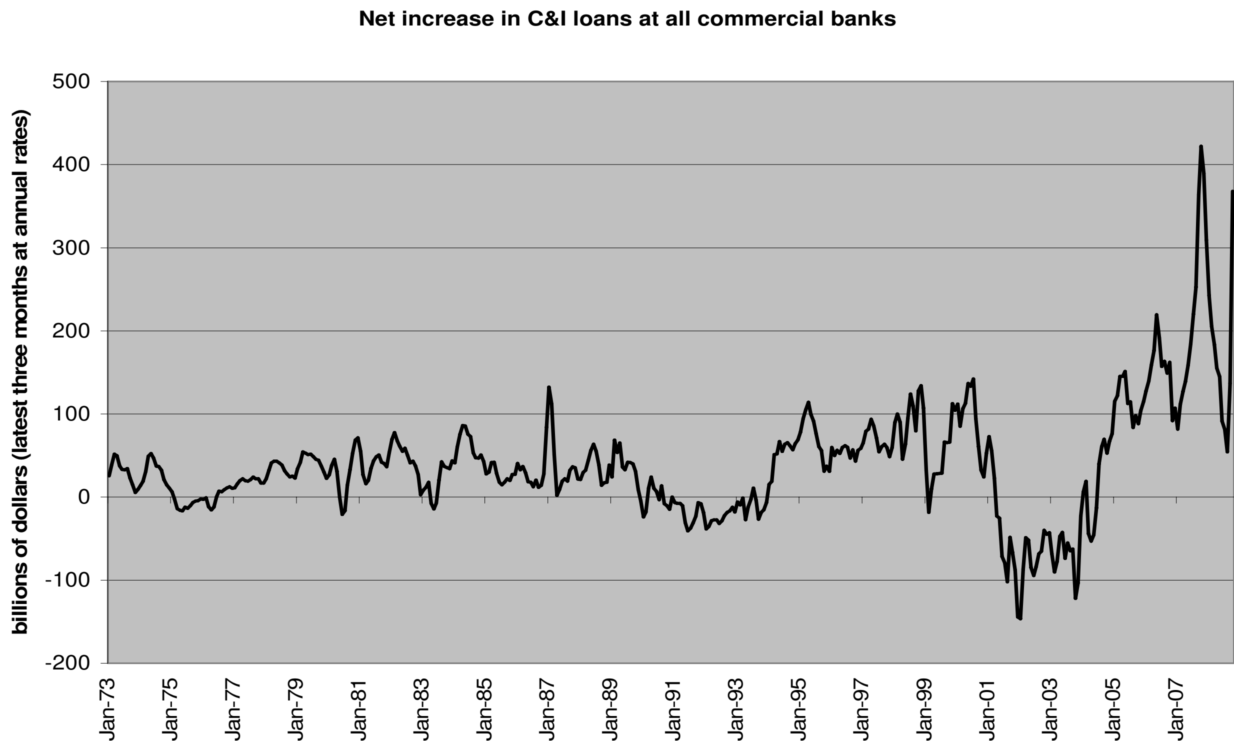
There are numerous myths or at least serious data anomalies that surround the financial crisis that began in August 2007 as a result of the foreclosure crisis which began at the end of 2006. Some of these myths are about the role of bank credit in the crisis, while others reported here concern the weakness of the U.S., banking system and supposed excess leverage—the ratio of assets to equity in banks-- in contributing to the crisis. V.V. Chary, Lawrence Christiano and Patrick J. Kehoe (2008) attempt to dispel four major myths. They argue that 1) there was no credit crunch at banks, 2) interbank lending is healthy, 3) only financial commercial paper has declined and only recently and the interest rates on nonfinancial commercial paper have generally fallen for both nonfinancial commercial paper and, until a month ago, for financial commercial paper, and 4) banks do not play a large role in channeling funds from savers to borrowers anyway. The absence of a credit crunch, at least until March 2008, has been noted by Tatom (2008). Ivashina and Scharstein (2008) argue that bank credit has declined, but they concede that the principal data show that bank credit has not. They focus on new lending at large banks primarily though syndicated lending, suggesting that firms are drawing on existing lines of credit at banks, but that new credit facilities are not rising. However firms are getting their bank credit, the evidence suggests that bank credit has not declined sharply since August 2007, especially not before March 2008.

Stocks versus flows of bank credit

Ivashina and Scharfstein (2008) point out that their data are for new loans whereas Chary, Christiano and Kehoe focus on the outstanding stocks of loans at commercial banks. There are several measures that one could use, such as all bank credit or only business loans, and at various groupings of institutions. The broadest for the purposes here are all commercial banks and the issue revolves around business lending, typically measured by commercial and industrial (C&I) loans. Chart 1 shows the change in C&I loans for three month periods at annual rates since 1973. From 1947 through 1972 the average pace of net new lending was steady and low, averaging $4.7 billion per year (standard deviation $4.7 billion). The largest pace was in November 1972 when it reached $20 billion per year.

Note that there is no evidence of a slowing or tight credit before the financial crisis began in August 2007. Nor is there any slowing in the early months. There is an acceleration that began in January 2007 that peaked at $422 billion per year in October 2007 based on the pace of net new lending from August to October 2007. There was a subsequent slowing that brought the pace down especially from March 2008 on and reaching its lowest pace in June-August 2008. So there was an apparent slowing in new bank credit, but it did not precede the crisis, and in fact did not begin into well after the crisis began. Moreover, even at its worst, it was not particularly severe.

Figure 1
Net new bank lending to business did not collapse

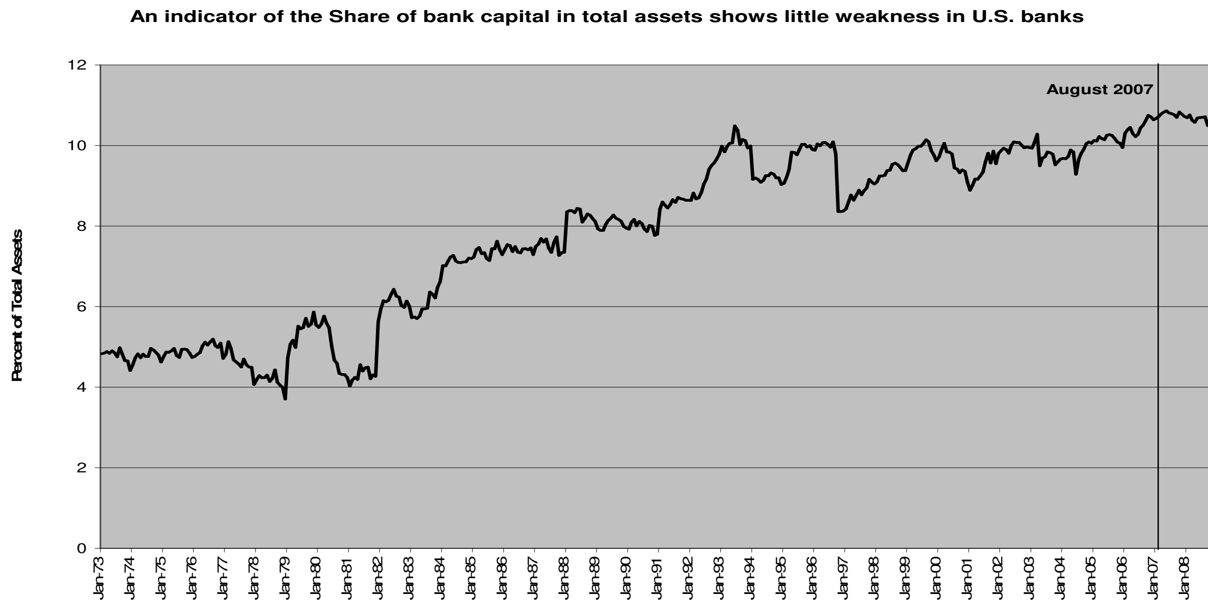


U.S. banks are unusually sound and not over-leveraged
There are at least two other myths that can be noted. Since September 2008, the President and officials from the Treasury and the Federal Reserve (Fed) have implied that bank asset losses have resulted in equity losses that have made banks unsafe or unsound and that the banking sector is in decline. Indeed, the Treasury has diverted the first installment from the "Troubled Asset Relief Program" (TARP), $250 billion, to the purchase of stock in banks. The concern is that bank assets are troubled so that banks could have to "deleverage" or reduce lending as their equity declines. Banks hold roughly 10 percent of assets in equity, in part because they have capital adequacy requirements, but largely because investors know that well-capitalized banks are less likely to fail and so they pay higher stock prices for well capitalized banks. If each dollar of capital or equity supports ten dollars of assets, then a loss of a dollar in capital would lead a bank to cut back its lending and other assets by ten dollars. This phenomenon is what is meant by deleveraging.

The fallacy here is that banks have not been losing capital, on net, until just recently. While they have incurred massive losses associated with the foreclosure crisis, they have been able to raise new capital that almost fully offsets the losses. See Tatom (2008) for example. Second, banks that lose capital can reduce their investment assets instead of loans. Loans do not have to decline when banks suffer losses in equity or decide to hold a higher equity ratio. Figure 2 shows that banks have not suffered significant declines in their equity ratios and that they are holding near record equity ratios. As of mid-2008,

Federal Deposit Insurance Corporation (FDIC) data show that about 98 percent of banks are "well capitalized." The Federal Reserve's monthly data through September reinforce this. The figure uses the Fed's residual estimate of assets less liabilities for all banks, not seasonally adjusted, as a measure of equity, which the Fed explicitly warns is not accurate because it is a residual estimate and not an actual measurement. Nonetheless, it is the best measure available until new quarterly bank capital measures are released; by using not seasonally adjusted data it does not suffer from biases arising from different seasonal patterns in balance sheet items.

Figure 2
U.S. bank capital is at record levels relative to bank assets



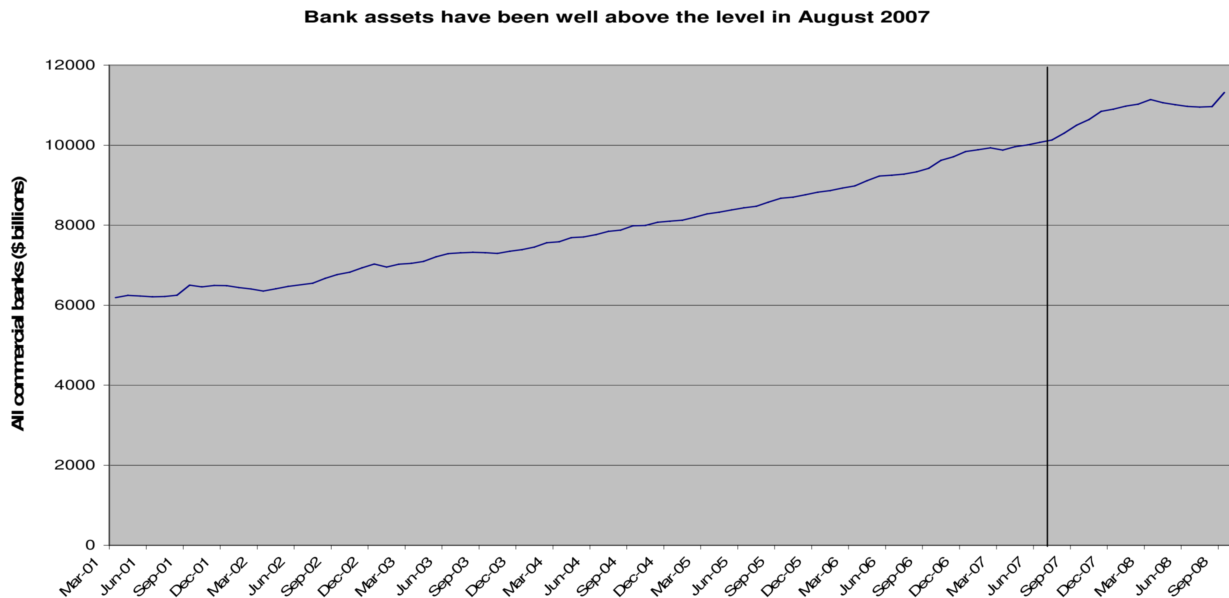
Source: Board of Governors of the Federal Reserve System H.8 release

Some banks holding large shares of mortgages or mortgage-backed securities in their asset portfolios have taken heavy losses and those unable to raise new capital have suffered losses in their equity ratios, the ratio of equity to assets. In a few cases, such banks have failed or been merged with stronger banks. Overall, however, the banking system has unusually strong capital on average. Some "banks" that have received attention for being less well-capitalized are investment banks, not commercial banks, including Bear Stearns and Lehman Brothers. Investment banks have much lower capital ratios and requirements. Not surprisingly, they fail more easily when they have losses. Nonetheless it is commercial bank stock that is being purchased under the TARP. Investment banks do not create the same potential for systemic risk to the payments system and the economy and so historically have not been beneficiaries of government safety nets or bail-outs.

The strong equity positions do not reflect shrinking equity and assets. Figure 3 shows the Fed's monthly data for total bank assets. There was a slight decline in bank assets from March 2008 to August 2008, but assets have remained well above the level achieved

before the financial crisis began in August 2008, indicated by the vertical line on the chart. According to FDIC data, Total equity of U.S. bank and savings institutions rose $59 billion to $1.307 trillion from the end of 2006 to the end of the third quarter of 2008. Over the same period, these institutions provisioned $200 billion for loan losses so that new capital formation was $275.4 billion. For all institutions, the equity capital ratio fell to 9.6 percent at the end of the third quarter from 10.2 percent in the previous quarter as equity fell $44 billion and total assets rose $273 million, or 2.1 percent. Despite the decline in equity in the third quarter of 2008, the equity ratio remains at an historically high level and total assets continue to grow rapidly. The creation of the TARP in October and its injections of bank capital have dried up private sector injections that had appeared on the horizon from sovereign wealth funds and private equity. Equity ratios of banks could become strained in future as total loans and assets continue to expand.

Figure 3
Bank asset growth slowed last March, but are well above pre-crisis levels



Source: Board of Governors of the Federal Reserve System H.8 release

There are many myths associated with the current financial crisis. In part these are motivated by the response of financial institutions to government and Fed actions, including new bail-out opportunities, new subsidies, and even mandates to participate in emergency lending or capital purchase programs. So far at least, the financial crisis has not undermined the safety and soundness of the commercial banking system. It is not likely to do so either, at least not because of the foreclosure crisis, because most of the expected losses from it have already been taken into provisions. A few banks have failed, 22 this year (to November 21, 2008), 24 since August 2007, and more failures are expected, perhaps up to a hundred or so over the next year. A few banks have been forced into mergers in 2007, most notably Countrywide and Wachovia. Banks have also been affected by the freezing up of markets for some mortgage-related securities, caused, in

part, by expectations of government intervention to hold up the prices of these depreciated assets.

The decision on November 23, 2008 to declare Citi too big to fail and to invoke special facilities for its support reflects some substantial overvaluation of assets on their part, despite the large provisions previously taken. Most notably, Citigroup received $20 billion under the Troubled Asset Relief Program (TARP), on top of the $25 billion already received, and substantial Treasury and FDIC guarantees on $306 billion of assets, which obviously are of questionable value. Most of the losses on mortgages and mortgage related securities have already been written off, but Citi's revelations are a reminder that leverage ratios could be overstated by overvaluations of assets and equity. Moreover, the Citi case is also a reminder that just because all banks have, on average, historically high capital relative to assets, it may not be sufficient to assuage the fears of investors.

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