# Bank Performance During the Crisis

**"This Time is the Same: Using Bank Performance in 1998 to Explain Bank Performance During the Recent Financial Crisis"**

*R. Fahlenbrach, R. Prilmeier, R. Stulz*

**"Safety-Net Benefits Conferred on Difficult-to-Fail-and-Unwind Banks in the US and EU Before and During the Great Recession"**

*S. Carbo-Valverde, E. Kane, F. Rodriguez-Fernandez*

**discussion by**

**G. Udell**

# Session Overview

- **An alternative session title:**

  ***We shudda known! … (?)***

- **What the papers tell us:**
  - **Banking has recidivists.**
  - **Markets/volatility tell us something about bank behavior.**

- **Paper specific comments**

# Fahlenbrach, Prilmeier, Stulz (FPS)

- **Paper summary – key results**
  - **Bank returns during 1998 crisis predict returns during current crisis**
  - **Effect driven by larger banks, but no same-CEO effect**
  - **Explores underlying common characteristics of recidivists:**
    - **Reliance on short-term financing**
    - **Rapid growth in 3 preceding years**
    - **More leverage**

# Comments on FPS

- **Paper's main results quite persuasive**
  - –**Results robust**
  - –***We shudda known(?)***
    - **Didn't we suspect that Citi was a repeat offender?**
  - –**Why didn't supervisors use this as a tool?**
    - **Why did we let Citigroup load up on SIVs/ABCP conduits?**
      - – **Where were the firewalls?**

# Comments on FPS

- **Not so clear that the common factors identified in the paper tell the whole story**
  - **–As authors point out, these "are not sufficient to explain our result ..."**
  - **–Missing from the list of examined factors are <u>asset-side</u> characteristics, most notably:**
    - **Real estate exposure**
- **Was it Citi's short-term funding of its SIVs or**
  - **–Was it the assets themselves (Subprime CDOs)?, or**
  - **–Was it the liquidity and default guarantees from the bank sub (Acharya and Schnabl 2009)**
- **What about securitization and the adoption of the "orginate-to-distribute" model after the S&L demise? (e.g., Rosen 2011)**

# Comments on FPS

- **What about commercial real estate?**
  - **Construction loans have long been viewed as the riskiest component of bank loan portfolios**
  - **Construction lending exposure doubled**

| | 2000 | 2007 |
|---|---|---|
| Small banks | 7% | 16% |
| Large banks | 4% | 7% |

- **This does not look like *ex post* bad luck.**
- **Construction lending REITs in 1974!**

# Comments on FPS

- **What is the root cause for the asset/liability decisions associated with residivisim?**
  - **Some banks routinely exploit safety net benefits (Carbo-Valverde, Kane and Rodriguez-Fernandez 2011)**
  - **Would this be associated with lip service to risk management (Ellul and Yerramilli 2010)?**
  - **How long does a residivisim last?**
- **What about institutional memory?**
  - **What causes an institutional memory?**
    - **Maybe factors driving institutional memory (other than the CEO) differ across banks.**
  - **There is a short literature on this**
    - **e.g., Berger and Udell (2004) found some evidence in commercial lending that banks "forget" over time.**
- **What about rapid growth?**
  - **There is some literature about growth and the S&Ls**
    - ***History of the Eighties: Lessons for the Future* (1997)**
    - **Why didn't regulators key on this?**

# Carbo-Valverde, Kane, Rodriguez-Fernandez (CKR)

- **Paper summary**
  - –**Uses contingent claims framework to estimate *ex ante* benefits from leverage and volatility**
  - –**Analyzes links between benefits and DFU status**
  - –**Finds that:**
    - **Benefits significant and higher in EU**
    - **Benefits are related to DFU status**
  - –**Concludes that regulators should contain benefits by focusing on volatility as well as leverage**

# Comments on CKR

- ***We shudda known!* -- Shouldn't we have known that there was information in a contingent claims analysis?**
  - **As the authors point, the technology they use has been around for two decades.**
  - **Clearly regulators had the expertise.**
    - **Eg., TRASH section at the Fed**
    - **Maybe they didn't generate this information?**
  - **Did we know that it would map this well to *ex post* outcomes?**
    - **No. This is the contribution of the paper**
  - **But, we certainly had plenty of reason to believe that a contingent claims approach was informative**

# Comments on CKR

- **Would we have been better off if we had used the CKR approach? i.e., Would we have done things differently?**
  - **On this point I think the authors could have gone further.**
  - **The answer partially depends on whether the CKR approach would have provided additional information that regulators didn't otherwise have.**

# Comments on CKR

- **Some key questions and issues:**
  - –What would the incremental value of a contingent claims analysis have been if we had implemented Basle II a decade earlier?
  - –What would the incremental value of a contingent claim analysis have been if regulators had used the information they had about observable portfolio allocation changes
    - Rapid growth in MBS/CDO exposure
    - Rapid growth in CRE exposure (see above)
  - –The CKR analysis is at the BHC level – and, regulators in the U.S. seemed to believe that MBS/CDO exposure in SIV/ABCP conduits was fire walled
    - But SIVs and ABCP conduits not firewalled (Acharya and Schnabl 2009).
    - Regulators appeared to believe in 1974 that construction loans in REITs were commercial loans.
  - –What about risks unknown to regulators and the market?
    - E.g., counterparty risk at AIG?

# Comments on CKR

- **Suggestions**
  - **Why limit the analysis to a binary variable for DFU?**
    - **Why not a continuous variable for the amount of assistance?**
    - **It would be interesting to see the extent to which the safety net benefits measured before the crisis mapped to *ex post* taxpayer costs.**
  - **How powerful is a contingent claims approach compared to other approaches**
    - **A horse race against other proposed tools**
      - **The recidivism factor (Fahlenbrach, Prilmeier, Stulz 2011)**
      - **The non-interest income factor (Brunnermeier, Dong, Palia (2011)**
      - **Systemic risk measures (Adrian, Brunnermeier 2008, Acharya et al. 2010)**

# Comments on CKR

- **Other Suggestions**
  - –Consider adding an adjustment for sovereign debt exposure to your assessment of aid to EU DFU banks
  - –Add Federal Reserve assistance
  - –Consider assessing against calculated SCAP gaps (in a non-binary analysis)
  - –Consider other measures for regulatory capture