# Bailed-out banks issued riskier loans

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Banks that received federal bailout money ended up approving riskier loans and shifting capital toward risky investments after getting government help, say University of Michigan researchers.

In a new study on risk-taking by banks that received funds from the Troubled Asset Relief Program, finance professors Ran Duchin and Denis Sosyura of Michigan's Ross School of Business found that the overall risk level of TARP banks increased 10 percent. Further, these banks were no more likely to issue loans, overall, than non-TARP banks, in contrast to the declared objective of the federal program to increase lending.

The U.S. government established TARP in late 2008—the largest federal investment program in American history—to increase financial stability and stimulate lending to U.S. consumers and businesses. The Capital Purchase Program, the first and largest TARP initiative, invested $205 billion in more than 700 financial institutions in 2008-09.

"While we do not find a significant effect of TARP on the aggregate amount of originated credit, our results do suggest a considerable impact of TARP on the risk of originated credit," Duchin said.

The researchers found that TARP banks shifted their credit origination toward riskier mortgages, as measured by the borrower's loan-to-income ratio. The approval rate of mortgage applications by the riskiest groups of borrowers increased about 9 percent in 2009—equivalent to nearly $860 million in new loans to these groups.

"An important question is why the potential increase in banks' risk tolerance manifested itself through a shift toward originating riskier loans rather than through originating more credit," Sosyura said. "Indeed, one of the simplest ways for a bank to increase its risk would be to loosen credit standards across all loan types and issue a greater amount of credit."

One explanation, the researchers say, is that a shift in the riskiness of loan portfolios—rather than an increase in loan volume—may reflect banks' strategic response to federal capital requirements. Unlike the origination of new credit, a shift toward riskier lending practices within the same asset class (mortgages, for example) does not affect the capitalization ratios monitored by banking regulators.

As a result, banks can achieve better capitalization levels. The higher the capital-to-assets ratio (the amount of money a bank must have in the form of shareholders' capital, shown as a percentage of its assets), the more sound the bank. The average capital-to-assets ratio for TARP banks improved from about 10 percent in the third quarter 2008 to 11 percent in the first quarter 2009 after receiving federal money.

"However, the reduction in leverage was more than offset by an increase in earnings volatility associated with riskier lending," Sosyura said.

Besides loans (both consumer and corporate), Duchin and Sosyura also studied the changes in TARP banks' investment strategies. They found that after receiving federal money, TARP banks increased their investments in risky securities, such as mortgage-backed securities, long-term corporate debt and equities "acquired to profit from short-term price movements," by 9 percent, displacing safer assets, such as Treasury bonds, short-term paper and cash equivalents.

"Our analysis suggests that TARP participants actively increased their risk exposure after receiving federal capital," Duchin said. "In particular, recipients invested capital in riskier asset classes, tilted portfolios to higher-yielding securities, and engaged in more speculative trading, compared to nonrecipient banks."

Provided by University of Michigan