Bailed-out banks issued riskier loans

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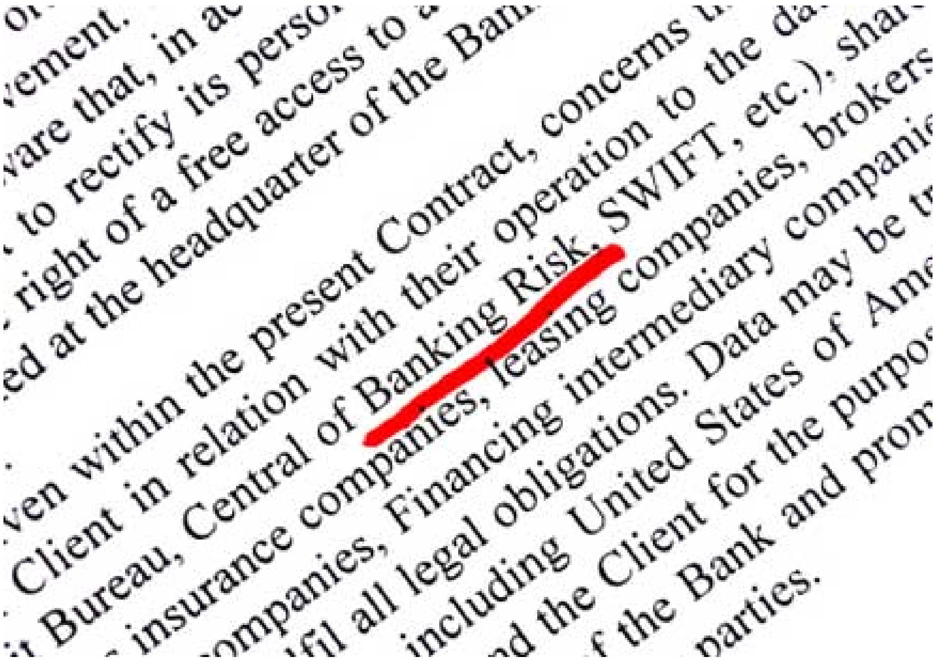

(Phys.org) —Banks that received federal bailout money approved riskier loans and shifted capital toward risky investments, according to a University of Michigan researcher.

In a study on risk-taking by banks that received funds from the Troubled Asset Relief Program, Denis Sosyura, assistant professor of finance at the Ross School of Business, found that the default risk rose 21 percent after the bailout compared to non-TARP banks.

Sosyura and colleague Ran Duchin of the University of Washington found that TARP banks were no more likely to issue loans than non-TARP banks, even though the declared objective of the federal program was meant 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.

TARP banks shifted their credit origination toward riskier mortgages, as measured by the borrower's loan-to-income ratio and the fraction of subprime loans in originated credit, the study found. The approval rate of mortgage applications by the riskiest groups of borrowers increased by 5.4 percentage points in 2009-2010.

"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 (e.g., mortgages) 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, or the amount of money a bank must have in the form of shareholders' capital, the more sound the bank. The average capital ratio for TARP banks improved from about 10.7 percent in the third quarter 2008 to 11.6 percent in the first quarter 2009 after receiving federal money.

The banks appeared steadier on paper, but were increasing their likelihood of running aground again.

"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 non-agency mortgage-backed securities, and reduced their allocations to low-risk securities, such as Treasury bonds.

"Our analysis suggests that TARP participants actively increased their risk exposure after receiving federal capital," Duchin said. "The net effect was a significant increase in systematic risk and the probability of distress at approved banks."

Overall, the authors show that the bailout, while solving a short-term liquidity crunch, is likely to have deep long-run consequences for financial stability. And while bank capital requirements are relied upon as a key mechanism in bank regulation, banks' strategic response to this mechanism erodes its efficacy in monitoring risk.

The research paper is to be published later this year in the *Journal of Financial Economics*.

More information: Duchin, Ran and Sosyura, Denis, Safer Ratios, Riskier Portfolios: Banks' Response to Government Aid (September 12, 2013). *Journal of Financial Economics* (JFE), Forthcoming. Available at SSRN: ssrn.com/abstract=1925710 or dx.doi.org/10.2139/ssrn.1925710

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