Banks have difficulty adapting in crisis: study

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(PhysOrg.com) -- Can the financial sector regulate itself? A study carried out by EPFL's Swiss Finance Institute, involving 350 American institutions, shows that those that perform poorly in times of crisis will also be adversely affected the next time. The choice of the starting business model seems to be crucial.

Do the banks implement changes that would enable them to better confront turbulence in the markets? Not really, according to a study by EPFL's Swiss Finance Institute, recently published in the journal *Social Science Research Network*.

The researchers analyzed the performance and data of 350 American banks between the two most recent important financial crises: involving the Russian debt of 1998 and then the subprime crisis of 2007-2008. A

sample of this study concerns both large and small institutions, and includes investment banks, savings banks, and commercial banks.

“Those which had performed poorly during the first crisis were also adversely affected during the second”, notes Rüdiger Fahlenbrach, Tenure Track Assistant Professor at the College of Management of Technology, who, with his team, looked into the reasons behind these results.

They noticed in particular that the Managing Director in charge at the time had very little influence on the performance of these companies. Neither does it depend on the nature of the two crises, both called “the most serious crisis of the last 50 years”, but caused by very different phenomena. In 1998, Russia was not able to meet its debts, which created a chain reaction, with investors registering big losses and trying to get rid of their shares quickly. In 2007, the crisis was essentially caused by a poor estimation of the risks associated with mortgage debts and the over-estimation of the value of certain investments (mortgage-backed securities).

Risk-taking in re-financing doesn’t pay

“Contrary to popular belief, small institutions are often less affected by crises – it’s the big banks that are worst affected”, Rüdiger Fahlenbrach points out. “The determining factor is in fact the business model chosen at the beginning.”

According to this expert, the methods used by banks to finance their debts – which are very difficult to sell off or to re-finance in times of crisis – is crucial. The study confirms that the institutions that use these methods in the short-term, and that have only limited capital, will perform less well in the event of a crisis. Those banks that opt for aggressive growth and excessive risk are also among the more fragile

institutions. One reason why these companies are reluctant to change their model is that it serves them well when the markets are booming.

The message of the research – based on experimental work and empirical data – is to have more capital and less financing in the short term. Rüdiger Fahlenbrach is now attempting to disseminate these ideas through the publication of his article and by participating in various international conferences.

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