The Financial Crisis of 2008

Comments on papers by Bruno Martins, Leonardo Alencar and Jacky Mallet

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The Financial Crisis of 2008

Credit Markets and Effects on Developed and Emerging Economies

Two Papers

- Jacky Mallet: "What are the Limits for Commercial Bank Lending?"
- Bruno Martins, Leonardo Alencar: "Banking Concentration, Profitability, and Systemic Risk: an Indirect contagion approach."

Focus on Big Issues of 2008 Financial Crisis

- The role of regulation: question the use of equity capital requirements according to Basel Treaties.
- The role of novel financial instruments: the banking system is actually able to circumvent the limits imposed by regulation
- The role of the structure of the banking system:
  - Systemic Risk: Effects of banking consolidation on financial stability .

Objective of the papers

- Jacky Mallet: explanation for the crisis by investigating the reasons why in times of excessive demand for credit, constraint on loans are not, in fact, binding.

- Bruno Martins, Leonardo Alencar: existence of an indirect contagion channel in the brazilian banking system by investigating the impact of banking concentration on the markets perception of financial intitutions interdependencies.

Main contribution of the two papers

- Jacky Mallet: Links the implications of novel financial instruments and bank equity capital requirements in a description of an intuitive chain of implications building up a logic sequence that could potentially result in one explanation for the crisis.

- Bruno Martins, Leonardo Alencar: Suggest the existence of an indirect contagion effect in the brazilian banking system using an original indicator to measure the inter-relationships on banks.

“What are the Limits for Commercial Bank Lending?”

- The proposal: Explanation for the crisis based on the failure of the system of rules regulating loans at the banking system.
  - Presence of securitized loans.
  - Regulation allows debt instrument to be part of bank equity capital reserve creating a feedback loop between loans and regulatory capital

- The argument: together these two features has led to an imbalance – lending from the banking system increases at a faster rate than the money supply to back it.

“What are the Limits for Commercial Bank Lending?”

- The method: Present statistics and hypothetical examples to illustrate the arguments and uses them to derive the implications.
  - Shift in the proportion of total borrowing from government towards private borrowing – mortgages.
  - Largest source of credit has been commercial banks, followed by Mortgages pools and ABS issuers.
  - Total amount of equity capital held by US banks has nearly doubled between 2001 and 2008.
  - Aggregate US ABS issuance and US banks assets.

Comments:
"What are the Limits for Commercial Bank Lending?"

- Some implications derived from the hypothetical examples and statistics presented may be too strong.
  - Example assumes 90% of deposits are transformed in mortgages backed Security.
  - Growth of debt is increasing faster than underlying liabilities => as a direct consequence of loan securitization.
  - Correlation between ABS issuance and the beginning of the crisis + increase in bank lending => credit crisis was triggered by the removal from credit markets of the loans represented by new securitized loans.

“Banking Concentration, Profitability, and Systemic Risk: an Indirect contagion approach”

- <u>The proposal</u>: If higher concentration in the banking system is associated with higher perception of the inter-relationship between similar banks, then, more concentrated banking system display higher systemic risk.

- <u>The argument</u>: Looking at profitability correlation among similar banks, agents infer solvency condition of a segment is conditional on the impact of an idiosyncratic shock in a bank of that segment.

“Banking Concentration, Profitability, and Systemic Risk: an Indirect contagion approach”

- The method:
  - Verify if there is an increase in profitability correlation within similar groups as banking concentration increases.
- Results:
  - Positive correlation between the return of each bank and the return of similar bank.
  - Increase in bank concentration may increase the market perception that there is a higher interdependence in the profitability of banks, increasing systemic risks

Comments:

“Banking Concentration, Profitability, and Systemic Risk: an Indirect contagion approach”

- There is surely a delay for the market to observe profitability. Specially in times of crises price of stocks, promptly available, for example would contain more information on interdependence.
- Results are somewhat weaker for increase in concentration and higher interdependence. Only significant for the banks grouped by credit and leverage.
- Is there a role for economic relevance of these coefficients?

THANK YOU