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Bank Balance Sheets and the Transmission of Financial Shocks to Borrowers: Evidence from the 2007-2008 Crisis

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Enrico Sette (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=930760)

Bank of Italy

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Abstract


We use Italian data on bank lending to firms to study the transmission of shocks affecting bank balance sheets to the volume and cost of credit granted to business borrowers and to the probability of banks accepting loan applications from new borrowers during the 2007-2008 financial crisis. The identification of the credit-supply effect is based on a difference-in-difference approach because: a large number of firms in Italy borrow from more than one bank; the shocks to the wholesale funding market were exogenous to Italian banks; and Italian banks were affected to a varying extent by the crisis depending on their funding structure. Results indicate that supply conditions worsened most for the banks that were most exposed to the interbank market and for those that made the most use of securitization. While the initial capital position of banks did not significantly affect their lending, the deterioration of bank capitalization as proxied by charge-offs and profitability had a significant impact. Furthermore, our results suggest that bank capital influenced lending indirectly, with higher capital reducing the elasticity of lending to the shocks on the funding side.

Keywords: bank balance sheet, transmission of shocks, credit supply, financial crisis

JEL Classification: G21, E51, E44

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