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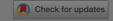
Original Articles

Modelling the causes and manifestation of bank stress: an example from the financial crisis

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Abstract

In this study, I model the predictors and manifestation of bank stress during the financial crisis using a Multiple Indicator Multiple Cause model. Unlike most early warning models that predict failure probabilities, this article describes a framework for predicting a broader notion of bank stress that need not rely on regulatory decisions. As

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the Basel III recommended increases in banks' capital adequacy, liquidity and stable funding.

Q Keywords: bank stress early warning model financial crisis financial regulation bank failure

Q JEL Classification: G17 G21 G28

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Notes

- ¹ I should note that although regulatory forbearance during the early and middle stages of the S&L crisis presents an issue, the regulatory reform during the S&L crisis may mean that the bank failures during 2007–2011 can be used to form a more reasonable baseline for comparison with expected future regulatory procedures and attitudes.
- ² Although I apply the method described in this section to larger financial institutions, the method is very flexible and can easily be applied to small banks as well.
- ³ All of the analysis presented in this article is done on a 'highest holder' basis.

 Specifically, I aggregate to bank holding company level using Call Report information on equity stakes in each bank

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normalizes by the bank-level excess capital above the regulatory minimum. The main results hold.

- ⁷ Using loan charge-offs in place of securities losses produces very similar results. As mentioned previously, many different indicators of bank stress can be used, but I limit the number presented here for parsimony. Furthermore, loan charge-offs can be subject to evergreening practices and may not be fully realized during a high-stress period.
- ⁸ As will be demonstrated, the conclusions are not sensitive to excluding TARP injections from the measures of bank stress indicators.
- ⁹ Indeed, the stigma associated with accessing the discount window was a motivating factor behind the creation of the Term Auction Facility, which allowed banks to borrow term funds anonymously from the Federal Reserve.
- ¹⁰ In the accompanying Appendix, I produce a time series of system-wide bank holding company stress by plotting an aggregated version of the latent stress factors over time.
- ¹¹ However, in <u>Section V</u>, I present evidence that the latent stress factor derived in the MIMIC model is consistent with other notions of bank stress.
- ¹² I direct readers to the literature described in <u>Section II</u> and, in particular, the following studies, which have used most of the variables that appear in Table 4: Cole et al. (<u>1995</u>), Cole and Gunther (<u>1995</u>) and Kolari et al. (<u>2002</u>). The data set used for this study may be accessed at http://dx.doi.org/10.1080/00036846.2014.955257
- ¹³ This result extends to alternate definitions of capital adequacy, such as Tier 1 plus Tier 2 capital.
- ¹⁴ These results are robust to using either savings or demand deposits separately.

Additionally replacing core deposits with pondenosit liabilities shows a significant

positive

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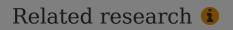
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with higher revers imanicial discress during the crisis, but the differential composition of

the off-balance sheet activity could be driving the results. For example, some off-balance sheet items could represent beneficial derivative-based hedging activity, while others could be concentrated in toxic collateralized debt obligations and subprime MBSs.

- ¹⁷ Three of the acquirers in the high stress quintile were among the nine healthiest banks of the quintile.
- ¹⁸ Because of the unavailability of certain regulatory capital data and definition changes, the stress factor 1 construct here plotted in Fig. A1 is generated using the Call Report series RCFD3210 to measure bank capital.



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