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Review - Others

Why US banks aren't lending

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ON DEC 2, the US Federal Reserve announced that, 'in the light of continuing strains in financial markets', it would extend its primary dealer credit facility, asset-backed commercial paper money market fund liquidity facility, and term securities lending facility from Jan 30 to April 30 next year. With the extension, the three liquidity mechanisms were brought in line with the term of the commercial paper funding facility, the money market investor funding facility, and swap lines with 14 other central banks.

The purpose of the Fed's liquidity facilities and the US Treasury's US\$700 billion (\$1 trillion) troubled asset relief programme was to restore credit markets. If banks could continue to lend, businesses and consumers could continue to borrow, and the US and world economies would be prevented from stalling.

So what is the report card on the Treasury and Fed initiatives? Each Friday at 4.15pm, the Fed publishes the assets and liabilities of banks in the United States, including both US-owned banks and the US operations of foreign-owned banks.

Figure 1 is based on the Fed's Dec 5 report. It depicts bank credit (with respect to the left axis), and interbank loans, cash assets and other assets (with respect to the right axis).

Apparently, in terms of overall lending to end-user consumers and businesses, the US government initiatives seems to have averted a breakdown in lending. Bank lending accelerated from US\$9,414.5 billion in August to US\$9,958.1 billion in October, and then fell by just US\$55 billion to US\$9,903.1 billion last month. These statistics contrast with the chorus of complaints from consumers and industry that they are being starved of credit.

The bankruptcy of Lehman Brothers and the ensuing crisis had a larger impact on banks' lending to each other. Inter-bank lending fell by one-quarter from

US\$434.8 billion in August to US\$324.2 billion. Even more dramatic was the near trebling of cash assets from US\$297.8 billion in August to US\$843.7 billion last month.

What explains the banks' huge accumulation of cash? The answer can be summed up with three-and-a-half words - 'risk aversion' and 'Basel II'.

The Basel committee on banking supervision sets capital standards for internationally active banks. In 2004, the committee agreed on the new Basel II framework. This specifies a minimum regulatory standard - that banks must have capital equivalent to at least 8 per cent of risk-weighted assets.

Basel II recognises three tiers of capital. Tier-1 (core) capital is a common international standard, and includes common shares, non-cumulative perpetual preferred shares and disclosed reserves from retained earnings. Tier-2 (supplementary) capital depends on national regulation and includes undisclosed reserves, revaluation reserves, general provisions/general loan-loss reserves, hybrid debt capital instruments and subordinated term debt. Tier-3 capital comprises short-term subordinated debt covering market risk and can be used at the discretion of the national regulator.

From the viewpoint of a bank, tier-2 capital is cheaper than tier-1 capital. Accordingly, the Basel II standard limits the extent to which tier-2 capital may be counted towards the capital standard. The amount of tier-2 capital counted may not exceed the amount of tier-1 capital.

To understand why banks have hoarded cash, consider a hypothetical bank with a very simplified balance sheet, in billions of dollars (Figure 2).

With \$5 billion of retained earnings and \$5 billion of ordinary share capital, the bank's tier-1 capital was \$10 billion. On the assets side, suppose that the loans were risk-weighted at 100 per cent, while the cash was risk-weighted at 0 per cent, so the bank's total risk-weighted assets were \$90 billion. Hence, its capital ratio was $10 \div 90 = 11.1$ per cent, so it comfortably met the 8 per cent capital adequacy ratio.

Now, suppose that, owing to the financial crisis, the bank must write down its outstanding loans by 5 per cent or \$4.5 billion. Its loans outstanding would be reduced to \$85.5 billion and total risk-weighted assets would fall to \$85.5 billion.

However, the bank's liabilities did not change. To balance its balance sheet, it must write down its retained earnings by the same \$4.5 billion, thus reducing its tier-1 capital to \$5.5 billion. Relative to total risk-weighted assets of \$85.5 billion, the bank's capital ratio would now be $5.5 \div 85.5 = 6.4$ per cent.

How could a mere 5 per cent writedown of loans cause the capital ratio to fall by

almost two-thirds from 11.1 per cent to 6.4 per cent? The answer: leverage. The bank operated with a leverage of 9 to 1 (\$90 billion of deposits to just \$10 billion of retained earnings and share capital).

Compounding the effect of the Basel II standard was risk aversion. The sub-prime crisis triggered a wave of risk aversion. Within days of the Lehman Brothers bankruptcy, investors, creditors and financial institutions began to question the solvency of other financial institutions.

An important way for a bank to assure others was to increase its capital ratio above the Basel II standard. Within the last month, even well-regarded institutions like Banco Santander of Spain have raised additional capital - \$7.2 billion (\$14.3 billion) to raise its tier-1 capital ratio from 6.3 per cent to 7 per cent. The name of the game in banking has been who can boast the highest capital ratio.

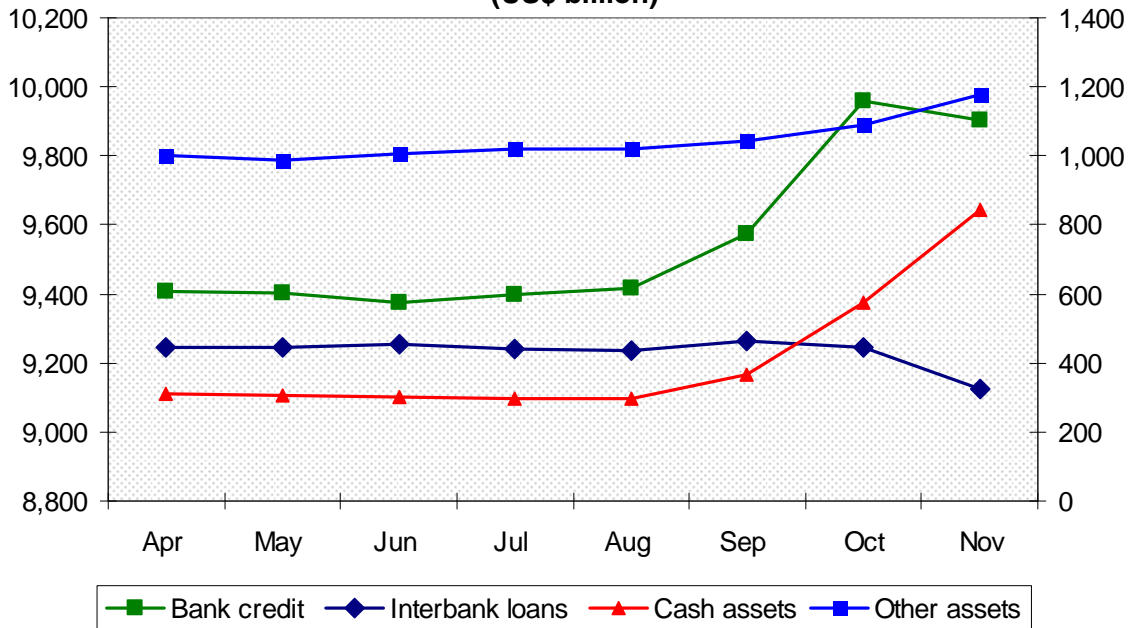
So when the US Treasury and Fed ploughed hundreds of billions of dollars into the financial system, much of the cash did not flow through to lending. It remained as cash.

In a climate of extreme risk aversion, the choice is obvious: Keep the funds in cash for a higher capital ratio. In just three months, banks in the US accumulated more than half a trillion of the green stuff.

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**Commercial banks in U.S., assets
(US\$ billion)**



**Hypothetical bank balance sheet
(billion dollars)**

<i>Assets</i>		<i>Liabilities</i>	
Loans	90	Deposits	90
Cash	10	Retained earnings	5
Total	100	Ordinary shares	5
		Total	100