



Anxious periods and bank lending



Manthos D. Delis^{a,*}, Georgios P. Kouretas^b, Chris Tsoumas^c

^a Surrey Business School, University of Surrey, Guildford GU2 7XH, UK

^b Department of Business Administration, Athens University of Economics and Business, 76 Patission Street, GR-10434 Athens, Greece

^c Department of Banking and Financial Management, University of Piraeus, 80 Karaoli and Dimitriou, GR-18534 Piraeus, Greece

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ABSTRACT

We examine the lending behavior of banks during anxious periods. The main characteristic of anxious periods is that the perceptions and expectations about economic conditions worsen for economic agents even though the economy is not in a recession. We identify distinct periods of anxiety for consumers, CEOs (firms) and analysts. Subsequently, we study the lending behavior of US banks during the anxious quarters from 1985 to 2010, using bank-level data. The results show that banks' lending falls when consumers and analysts are anxious, and this effect is more pronounced when banks hold a higher level of credit risk. These effects are more pronounced in anxious periods that were followed by recessions, and in these periods loan growth also responds negatively to the anxiety of CEOs. Yet, these effects are quite less prevalent in the period after 2001.

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1. Introduction

The financial turmoil that started in 2007 and the severity of the recession that followed highlights the importance of banks' lending behavior for economic fluctuations. In this paper, we explore changes in banks' lending during periods when expectations of economic agents worsen, but the economy is not in a recession. We characterize these periods as "anxious". These anxious states might be followed by a recession or the economy moves back to a "good" state. This subject is of great interest because banks' lending behavior during such periods can either ease anxiety or impose further strain on the economy. Further, anxious periods are ideal for examining banks' lending policies and risk perceptions in a framework of diminishing expectations. Clearly, it is important to know how banks' lending policies are shaped during such periods. This study aims to provide, to our knowledge for the first time in the literature, explicit answer to this question.

Banks may observe anxious periods directly: through news, their own macroeconomic analyses, or even potential pressures on the asset and liability sides of their balance sheets. In addition,

banks may identify such periods indirectly, through the screening of loan applicants, the monitoring of their existing loans' deteriorating credit risk profile, or both. The above might result to a change in banks' lending policies through changes in loan supply and/or changes in banks' perception of risk and, thus, the allocation of credit across loan categories. Bank characteristics reflecting the quality of their portfolios and managerial practices can play a key role in the lending decisions of banks during anxious periods. For example, a bank with a relatively risky portfolio might act more aggressively in cutting its loans during anxious periods, and a systemic such behavior across the industry increases the probability of a credit crunch. In contrast, a more conservative bank behavior during good times might result in lessened fluctuations in loan growth during anxious periods and may help the economy escape abrupt economic downturns.

We identify anxious periods from the households', firms' and analysts' expectations on future economic outcomes. Even though the anxieties of these agents might be interrelated and contemporaneous, households, firms and analysts can still be anxious during different times on the basis of their imperfect information about shocks in the economy (see, among others, Collard et al., 2009), rational inattention (e.g., Sims, 2010), or even their own asymmetric goals and strategies. Hence, rather than employing measures that encompass aggregate expectations about future economic

* Corresponding author. Tel.: +44 1483686332.

E-mail addresses: m.delis@surrey.ac.uk (M.D. Delis), kouretas@aueb.gr (G.P. Kouretas), ctsoum@unipi.gr (C. Tsoumas).

conditions, such as analysts' forecasts or stock market movements, we enrich our framework and employ a distinct measure of anxiety for households, firms and analysts. To this end, we use three indices, namely consumers' and CEOs' (firms') falling confidence, as well as deviations in analysts' forecasts. These indices encompass by definition diminishing expectations on economic prospects. First, consumers' confidence has information content about future economic activity rather than causes economic outcomes (Barsky and Sims, 2012); second, CEOs' confidence responds earlier and more to policy shocks than consumers' confidence (Bachmann and Sims, 2012); third deviations in analysts' forecasts are a direct measure for asymmetric information and expectations in the market. We term the falling confidence of consumers, CEOs and analysts as anxiety of these three agents, respectively.

To examine the way loan growth is shaped during the periods in which these agents are anxious, we employ quarterly data on banks from the Federal Deposit Insurance Corporation (FDIC) call reports over the 1985Q1–2010Q2 period. Given the theoretical considerations of our study, we focus only on the anxious periods identified from each of the two agent's perspective.

Our empirical framework has a number of notable characteristics. First, by following a well-established literature on the bank lending channel (e.g., Kashyap and Stein, 2000; Cetorelli and Goldberg, 2012) we identify the effect of increased anxiety on loan growth through the heterogeneous characteristics of bank balance sheets. These bank characteristics refer to heterogeneity in bank risk, capitalization, liquidity, size and efficiency, which allow banks with healthier such indicators to respond differently than those with inferior indicators. That is, loan supply responds during anxious periods differently between banks with different levels in the health of their balance sheets. Second, the fact that recessions do not follow all declines in agents' expectations, may suggest a special role for banks' lending in shaping future real developments. In this way, we aim to shed some light to the possible asymmetries in banks' lending activity during the anxious periods that led to recessions and those that did not. Third, we examine whether the more important banks follow different strategies due to moral-hazard issues associated with too-big-to-fail concerns of governments, regulators, and the public. Last but not least, we offer some insights on the competitive conduct of banks during periods characterized by anxiety about future economic outcomes. The importance of competitive conduct of banks in loan growth has recently been established by Olivero et al. (2011).

Our main results indicate that consumers' and analysts' anxiety negatively affect loan supply. This response is primarily distributed through higher credit risk, indicating a heterogeneous impact of anxiety on the banking sector. There is also some evidence that during these anxious periods the loan growth of banks with higher levels of equity capital is higher than that of the average bank. Other bank characteristics, such as liquidity, size and efficiency do not seem to drive banks' lending decisions in anxious periods.

In contrast, total loan growth is less sensitive to CEOs' anxiety throughout the whole sample period. Notably, the findings concerning CEOs' anxiety are different in anxious periods that actually lead to a recession. In particular, CEOs' anxiety leads to a decline in loan growth, which is distributed primarily through credit risk and size. This difference potentially suggests a special role for banks in exacerbating the economic downturn. In addition, our evidence suggests that very large banks tend to react more than the average bank to the signs of anxiety. Their reaction involves a decline in loan growth due to the anxiety of all agents, and this decline is distributed through credit risk. Several robustness checks provide strong support to these results.

Our study relates to at least three strands of literature. The first identifies the impact of certain events or periods on banks' lending, such as the effect of the recent financial crisis on credit (e.g.,

Ivashina and Scharfstein, 2010); the liquidity shock experienced during the crisis on bank lending (Cornett et al., 2011); and monetary and non-monetary shocks on bank loan portfolios (Den Haan et al., 2007). Unlike the present paper, the focus of this literature is primarily crises periods. The second stresses the essential role that banks play as liquidity providers and transmitters of monetary policy shocks (e.g., Bernanke and Gertler, 1995). The third highlights the strong impact of expectations over the business cycle for leverage and, thus, credit (e.g., Bhattacharya et al., 2011; Fostel and Geanakoplos, 2008). This literature shows that changes in expectations can cause credit cycles; namely, fluctuations in leverage and credit can affect the path of the economy. These fluctuations range from expansions, in which banks' lending increases and risk aversion decreases, to contractions or even crises, in which lending deteriorates and risk preferences shift to safer assets.

Here, we essentially borrow elements from these strands of the literature by focusing, however, on periods of diminishing expectations. In other words, we contend that bank lending should be studied, not only in relation with the monetary policy transmission mechanism or during crises periods, but also in relation to expectations of the agents involved in the lending process and during periods of diminishing such expectations that might or might not evolve to a crisis.

The rest of the paper is organized as follows: Section 2 analyzes the reasons behind the importance of anxious periods in shaping bank lending. This section also places our study within the literature on consumers' and CEOs' expectations. Section 3 describes the data and the identification strategy of the anxious periods, while Section 4 discusses the empirical method. Section 5 presents and discusses the empirical results and Section 6 concludes the paper.

2. Anxious periods

We borrow the discussion of an anxious economy from Fostel and Geanakoplos (2008) who define anxious periods as intermediate states of the economy related to bad news in the market. Here, we place the concept of anxiety within a real-economy framework with incomplete information and bring financial intermediaries explicitly into the picture. The rest of this section (i) highlights why anxious periods are important and banks' lending might be shaped differently during these periods, and (iii) suggests why anxiety is potentially different between the major agents involved into the lending process.

2.1. Anxious periods and bank behavior

As already mentioned, the main characteristic of anxious periods is that the perceptions and expectations about economic conditions worsen, even though the economy is not in a recession. These anxious periods might be followed by a recession or, as in most cases, the economy moves back to a good state. In other words, anxious periods are characterized by diminishing expectations about future economic conditions. The importance of these periods for the lending behavior of banks and the composition of their loan portfolios is large, since it is during such periods that deleverage may start and, under certain circumstances, might lead to a banking crisis. Moreover, the reallocation of credit during periods of heightened uncertainty and diminishing expectations allows us to observe the perceptions of banks about risk.

According to Ruckes (2004), the collection and the processing of information by banks, as well as the degree of competition among them, varies with the business cycle resulting in changing bank credit standards. Put it differently, it is not only the change in the credit quality of borrowers i.e., the demand side, but also

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