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Bank asset structure, real-estate lending, and risk-taking

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Abstract

The banking industry changed substantially in the 1990s as the number of banks declined rapidly, and as we document, commercial banks dramatically shifted their assets to real-estate loans. The portfolio restructuring seems to be followed mainly by capital-constrained banks as real-estate banks have lower risk-based-capital ratios relative to those of our benchmark group. Trading off credit risk for interest-rate risk is only one of the ways to arbitrage regulatory capital. We also show that real-estate banks keep higher ratios of fixed-rate loans to total assets and face higher probabilities of insolvency. The increasing proportion of banks specializing in real-estate lending, the incentives of regulatory discipline, and the weaknesses of risk-management strategies could stress the condition of the banking system during periods of large unexpected increases in interest-rates and are important issues for regulators and bank managers.

JEL classification: G21; G28; G32

Keywords: Commercial banks; Real-estate banks; Financial risk management; Interest-rate risk; Regulatory capital arbitrage; Risk shifting

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1. Introduction

The banking industry and housing finance have changed substantially since the savings-and-loan crisis of the 1980s. Prior to this, traditional banking markets were fragmented, containing a large number of small and specialized firms. Structural changes (e.g., technology and deregulation) slowly but surely transformed segmented banking firms into one of consolidated, multiple-product financial institutions and marked the birth of the financial-services industry. During this transition, commercial banks increasingly shifted their product and asset portfolios into consumer lending, traditionally a specialty of thrifts and credit unions. This paper investigates real-estate lending, asset structure, and risk-taking of all insured commercial banks during 1989–1996. We focus primarily on banks specializing in real-estate lending (REBs), defined as commercial banks holding more than 40% of their total assets in loans secured by real estate. All other commercial banks in the economy provide a benchmark used to compare and contrast the behavior of REBs. Given the changes in bank capital regulation as well as the greater interest-rate risk of fixed-rate mortgages, we also explore how bankers manage risk.

We present evidence that commercial banks have increasingly shifted their portfolios to real-estate loans. For example, the number of REBs has increased from 1724 at year-end 1989 to 2835 at year-end 1996. This bank-level shift to real-estate lending has been paralleled by an equivalent increase in real-estate loans at the macro-industry level. This finding is especially noteworthy given the substantial consolidation in the banking industry, which experienced a drop from 12,702 banks (1989) to 9529 banks (1996).[2] This shift in portfolio strategy seems to be followed mainly by banks constrained by regulatory requirements. We find that REBs have lower risk-based-capital (RBC) ratios relative to ratios of our benchmark group. This result can be explained, in part, by the existence of RBC standards that allowed banks to shift their portfolios to presumably safer assets, such as mortgages, with the benefit of lower capital requirements but without accountability for interest-rate risk. Trading off credit risk for interest-rate risk is only one of the ways to manipulate regulatory discipline.[3]

Based on our risk measures, we show that REBs, relative to less-specialized banks, face higher probabilities of insolvency. While the overall riskiness of the banking sector declined during our sample period, the higher riskiness of REBs is observed in most of the sample years and confirmed by a multivariate linear regression model. Given the ex-post construction of our risk measure, the higher riskiness of real-estate banks can be attributable either to their higher natural economic risk exposures (bank equity risk), or to desired risk-level targets. It is not the goal of this paper to test which explanation is correct.

[2] The consolidation in the banking industry accompanied the contraction of the thrift industry. Although some thrifts converted to bank charters, the number of conversions was dwarfed by the increase in the number of REBs.

[3] Merton (1995) provides additional examples of loopholes that allow bank managers to circumvent regulatory-capital rules for risk-weighted assets. In general, banks can create the economic equivalent of the same desired portfolio that is treated differently under the current rules governing regulatory capital requirements.