

RESEARCH BUZZ



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More Myths about the Financial Crisis of 2008

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There are numerous myths or at least serious data anomalies that surround the financial crisis that began in August 2007 as a result of the foreclosure crisis which began at the end of 2006. Some of these myths are about the role of bank credit in the crisis, while others reported here concern the weakness of the U.S., banking system and supposed excess leverage—the ratio of assets to equity in banks-- in contributing to the crisis. V.V. Chary, Lawrence Christiano and Patrick J. Kehoe (2008) attempt to dispel four major myths. They argue that 1) there was no credit crunch at banks, 2) interbank lending is healthy, 3) only financial commercial paper has declined and only recently and the interest rates on nonfinancial commercial paper have generally fallen for both nonfinancial commercial paper and, until a month ago, for financial commercial paper, and 4) banks do not play a large role in channeling funds from savers to borrowers anyway. The absence of a credit crunch, at least until March 2008, has been noted by Tatom (2008). Ivashina and Scharstein (2008) argue that

bank credit has declined, but they concede that the principal data show that bank credit has not. They focus on new lending at large banks primarily though syndicated lending, suggesting that firms are drawing on existing lines of credit at banks, but that new credit facilities are not rising. However firms are getting their bank credit, the evidence suggests that bank credit has not declined sharply since August 2007, especially not before March 2008.

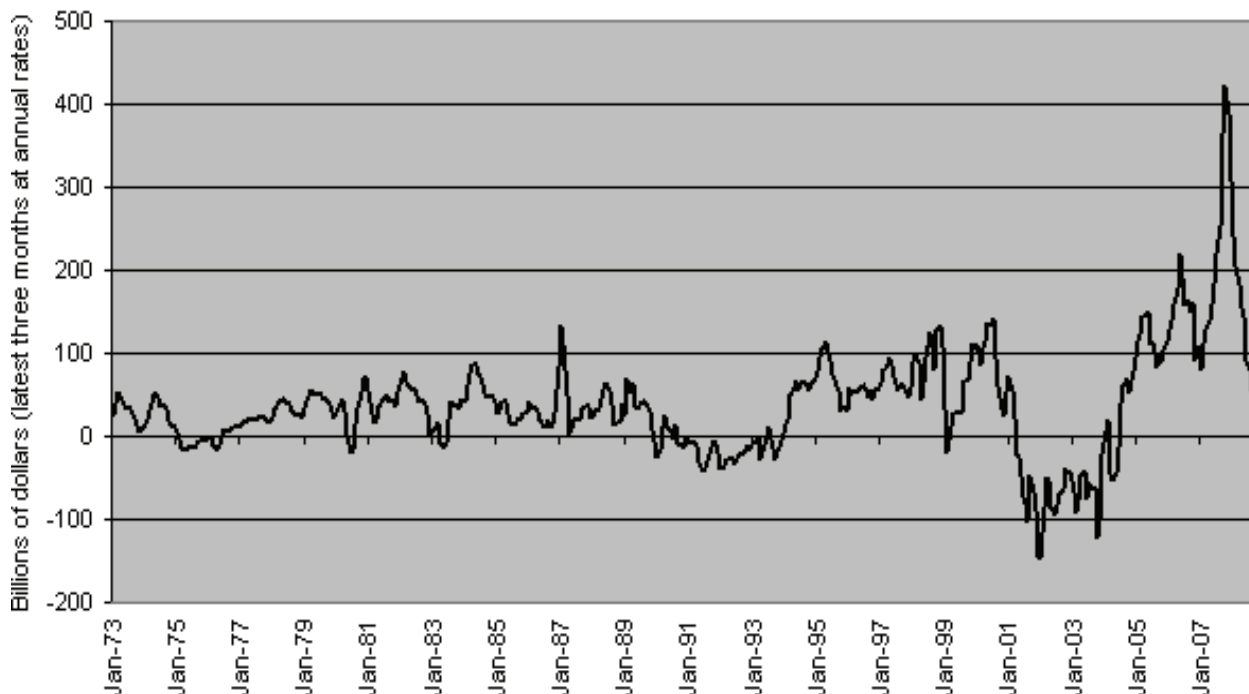
Stocks versus flows of bank credit

Ivashina and Scharstein (2008) point out that their data are for new loans whereas Chary, Christiano and Kehoe focus on the outstanding stocks of loans at commercial banks. There are several measures that one could use, such as all bank credit or only business loans, and at various groupings of institutions. The broadest for the purposes here are all commercial banks and the issue revolves around business lending, typically measured by commercial and industrial (C&I) loans. Figure 1 shows the change in C&I loans for three month periods at annual rates since 1973. From 1947 through 1972 the average pace of net new lending was steady and low, averaging \$4.7 billion per year (standard deviation \$4.7 billion). The largest pace was in November 1972 when it reached \$20 billion per year.

Note that there is no evidence of a slowing or tight credit before the financial crisis began in August 2007. Nor is there any slowing in the early months. There is an acceleration that began in January 2007 that peaked at \$422 billion per year in October 2007 based on the pace of net new lending from August to October 2007. There was a subsequent slowing that brought the pace down especially from March 2008 on and reaching its lowest pace in June-August 2008. So there was an apparent slowing in new bank credit, but it did not precede the crisis, and in fact did not begin into well after the crisis began. Moreover, even at its worst, it was not particularly severe.

Figure 1
Net new bank lending to business did not collapse

Net increase in C&I loans at all commercial banks



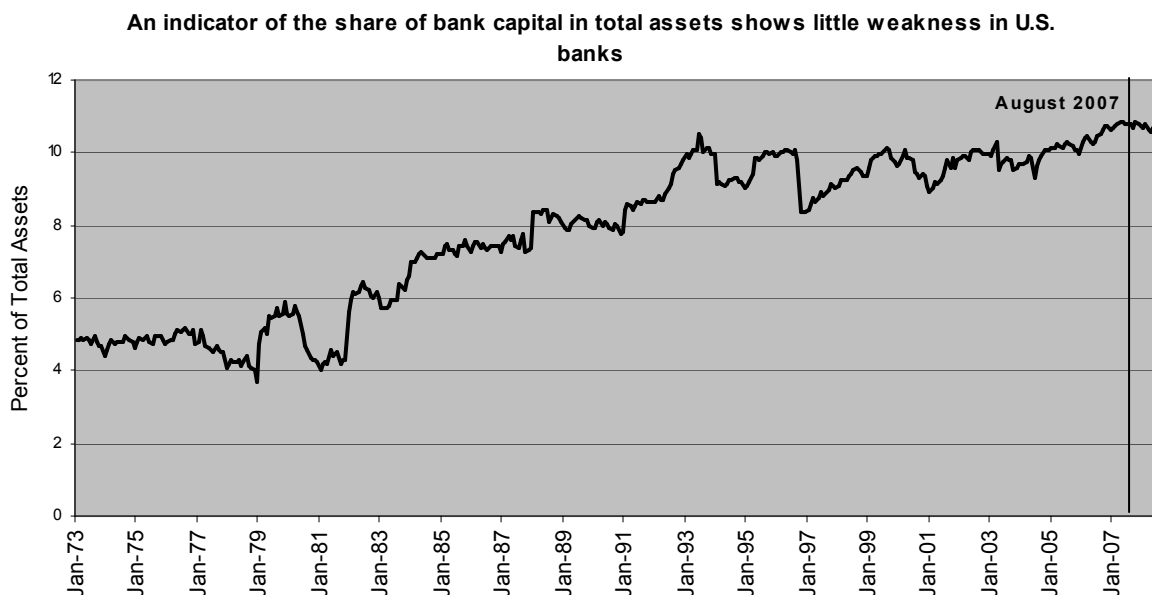
Source: Federal Reserve Bank of St. Louis

U.S. banks are unusually sound and not over-leveraged

There are at least two other myths that can be noted. Since September 2008, the President and officials from the Treasury and the Federal Reserve (Fed) have implied that bank asset losses have resulted in equity losses that have made banks unsafe or unsound and that the banking sector is in decline. Indeed, the Treasury has diverted the first installment from the “Troubled Asset Relief Program” (TARP), \$250 billion, to the purchase of stock in banks. The concern is that bank assets are troubled so that banks could have to “deleverage” or reduce lending as their equity declines. Banks hold roughly 10 percent of assets in equity, in part because they have capital adequacy requirements, but largely because investors know that well-capitalized banks are less likely to fail and so they pay higher stock prices for well capitalized banks. If each dollar of capital or equity supports ten dollars of assets, then a loss of a dollar in capital would lead a bank to cut back its lending and other assets by ten dollars. This phenomenon is what is meant by deleveraging.

The fallacy here is that banks have not been losing capital, on net, until just recently. While they have incurred massive losses associated with the foreclosure crisis, they have been able to raise new capital that almost fully offsets the losses. See Tatom (2008) for example. Second, banks that lose capital can reduce their investment assets instead of loans. Loans do not have to decline when banks suffer losses in equity or decide to hold a higher equity ratio. Figure 2 shows that banks have not suffered significant declines in their equity ratios and that they are holding near record equity ratios. As of mid-2008, Federal Deposit Insurance Corporation (FDIC) data show that about 98 percent of banks are “well capitalized.” The Federal Reserve’s monthly data through September reinforce this. The figure uses the Fed’s residual estimate of assets less liabilities for all banks, not seasonally adjusted, as a measure of equity, which the Fed explicitly warns is not accurate because it is a residual estimate and not an actual measurement. Nonetheless, it is the best measure available until new quarterly bank capital measures are

Figure 2
U.S. bank capital is at record levels relative to bank assets



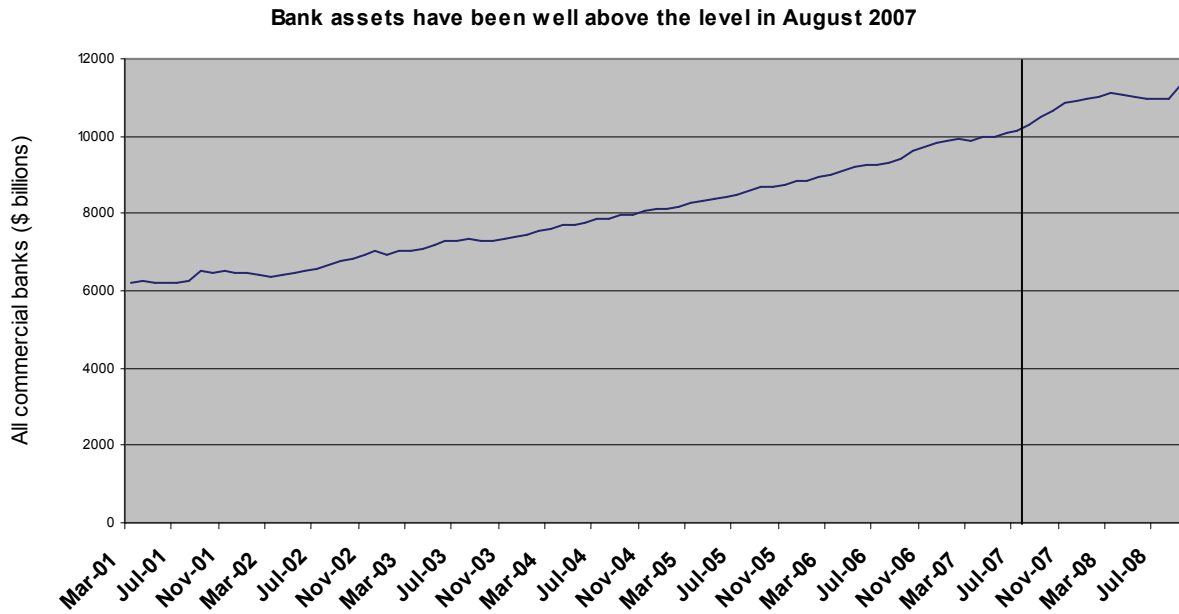
Source: Board of Governors of the Federal Reserve System H.8 release.

released; by using not seasonally adjusted data it does not suffer from biases arising from different seasonal patterns in balance sheet items.

Some banks holding large shares of mortgages or mortgage-backed securities in their asset portfolios have taken heavy losses and those unable to raise new capital have suffered losses in their equity ratios, the ratio of equity to assets. In a few cases, such banks have failed or been merged with stronger banks. Overall, however, the banking system has unusually strong capital on average. Some “banks” that have received attention for being less well-capitalized are investment banks, not commercial banks, including Bear Stearns and Lehman Brothers. Investment banks have much lower capital ratios and requirements. Not surprisingly, they fail more easily when they have losses. Nonetheless it is commercial bank stock that is being purchased under the TARP. Investment banks do not create the same potential for systemic risk to the payments system and the economy and so historically have not been beneficiaries of government safety nets or bail-outs.

The strong equity positions do not reflect shrinking equity and assets. Figure 3 shows the Fed’s monthly data for total bank assets. There was a slight decline in bank assets from March 2008 to August 2008, but assets have remained well above the level achieved before the financial crisis began in August 2008, indicated by the vertical line on the chart. According to FDIC data, Total equity of U.S. bank and savings institutions rose \$59 billion to \$1.307 trillion from the end of 2006 to the end of the third quarter of 2008. Over the same period, these institutions provisioned \$200 billion for loan losses so that new capital formation was \$275.4 billion. For all institutions, the equity capital ratio fell to 9.6 percent at the end of the third quarter from 10.2 percent in the previous quarter as equity fell \$44 billion and total assets rose \$273 billion, or 2.1 percent. Despite the decline in equity in the third quarter of 2008, the equity ratio remains at an historically high level and total assets continue to grow rapidly. The creation of the TARP in October and its injections of bank capital have dried up private sector injections that had appeared on the horizon from sovereign wealth

Figure 3
Bank asset growth slowed last March, but are well above pre-crisis levels



Source: Board of Governors of the Federal Reserve System H.8 release.

funds and private equity. Equity ratios of banks could become strained in future as total loans and assets continue to expand.

There are many myths associated with the current financial crisis. In part these are motivated by the response of financial institutions to government and Fed actions, including new bail-out opportunities, new subsidies, and even mandates to participate in emergency lending or capital purchase programs. So far at least, the financial crisis has not undermined the safety and soundness of the commercial banking system. It is not likely to do so either, at least not because of the foreclosure crisis, because most of the expected losses from it have already been taken into provisions. A few banks have failed, 22 this year (to November 21, 2008), 24 since August 2007, and more failures are expected, perhaps up to a hundred or so over the next year. A few banks have been forced into mergers in 2007, most notably Countrywide and Wachovia. Banks have also been affected by the freezing up of markets for some mortgage-related securities,

caused, in part, by expectations of government intervention to hold up the prices of these depreciated assets.

The decision on November 23, 2008 to declare Citi too big to fail and to invoke special facilities for its support reflects some substantial overvaluation of assets on their part, despite the large provisions previously taken. Most notably, Citigroup received \$20 billion under the Troubled Asset Relief Program (TARP), on top of the \$25 billion already received, and substantial Treasury and FDIC guarantees on \$306 billion of assets, which obviously are of questionable value. Most of the losses on mortgages and mortgage related securities have already been written off, but Citi's revelations are a reminder that leverage ratios could be overstated by overvaluations of assets and equity. Moreover, the Citi case is also a reminder that just because all banks have, on average, historically high capital relative to assets, it may not be sufficient to assuage the fears of investors.

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G-20 Communiqué on the Financial Turmoil

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In light of the Fall 2008 financial turmoil involving mortgage defaults, bank failures, credit tightening and other market instabilities, both perceived and real, the leaders of the Group of Twenty¹ (G-20) nations held a meeting in Washington, D.C. on November 15, 2008, in order to seek means to revive their national economies. A communiqué issued from the event promised renewed attention to supervision of banks and credit rating agencies, attention to executive compensation packages, tightening of controls on complex derivatives and a credit default swap clearinghouse. Given the imminent change of administration in the United States, however, the summit attendees did

delay decisions on difficult financial regulation issues until their next meeting, scheduled for late April 2009. President-elect Obama was not present at the event but was represented by two advisors, former Secretary of State Madeleine Albright and former Iowa representative James A. Leach, now a professor at Princeton's Woodrow Wilson School of Public and International Affairs; they conducted private sideline meetings with summit attendees, while the U.S. was officially represented by President Bush and Treasury Secretary Henry Paulson. Mr. Obama supports a further stimulus program in the United States, which President Bush opposes, but in general terms the U.S. is seen as less amenable to cross-border authority over financial markets while Europeans favor more state control, up to and including some international regulation.²

Some proposed solutions deferred for further consideration until the April 2009 meeting include the European Union (EU) proposal for a "college of supervisors," an informational exchange group focused on the operations of global banks with operations; an expansion of the membership of the Financial Stability Forum to include representation from emerging markets such as Brazil and China; enhanced hedge fund regulation; and an increase in International Monetary Fund (IMF) lending resources.³

The official communiqué issued from the summit recognizes the efforts of individual member countries to support their national and the global financial markets but cites also the need for coordinated international efforts that are guided by shared beliefs in "market principles, open trade and investment regimes, and effectively regulated financial markets."⁴ Attributing the crisis to markets seeking higher yields in an environment of unsound risk management, lack of due diligence, weak underwriting standards, product complexity and opacity and consequent excessive leverage, and uncoordinated and insufficient macroeconomic policies and structural reforms, the summit statement promises "vigorous efforts" and "further actions" toward financial system stability that support monetary policy, rapidly stimulate domestic demands and shore up emerging and developing economies' access to finance through IMF, World Bank and other multilateral development banks

(MDBS) liquidity facilities.

As stated above, the summit statement walks a fine line on the issue of domestic versus international regulation. Reinforcing the primacy of national regulatory oversight, G-20 leaders recognize that financial markets operate globally and that international cooperation is needed, while hedging somewhat more on the implementation of cross-border standards. In addition to calling for enhanced, sound regulation and international cooperation, summit participants call for:

- Strengthening of transparency and accountability – enhanced disclosure on complex financial product lines and of the financial conditions that firms find themselves in;
- Financial market integrity – the bolstering of investor and consumer protections promoting improved information sharing and addressing conflicts of interest, illegal market manipulation, fraud and abuse, illicit finance risks (from non-cooperative and often secretive jurisdictions); and
- Reforming international financial institutions⁵ – increasing the legitimacy and effectiveness of financial institutions of emerging and developing nations as they ascend in the global economy.

G-20 finance ministers are tasked with rapidly generating the processes and timelines, specifically in regards to the high priority accounting and other actions to be completed prior to March 31, 2009. Several additional medium-term actions are also outlined by the summit statement.⁶ G-20 finance ministers are also encouraged to develop further recommendations in the areas of mitigation against pro-cyclicality in regulatory policy; the review and alignment of global accounting standards; strengthening of the credit derivatives market; the review of compensation practices and also of the mandates, governance and resource requirements of international finance institutions (IFIs); and lastly, defining the scope and appropriate oversight of systemically important institutions.

Media reports of the event tend to assess the summit as weak in specific outcomes due to the lame duck status of President Bush, who served as

the event's official host, and the conspicuous absence of President-elect Obama. The *Sunday Herald* noted that world leaders prefer to “wait for Barack Obama to enter the White House before taking any major decisions affecting the global financial crisis,” and the *Sofia Echo* noted that “the most significant absence from the summit was that of US president-elect Obama, who declined to attend on the grounds that Bush is president. . . . Several reports noted that the timing of the next G20 summit was about 100 days after Obama is inaugurated as president.”⁷

Media reports also remark upon the shifting global financial context implied by the strong and growing presence of emerging and developing national economies represented. IMF manager director Dominique Strauss-Kahn commented that the summit is “significant because of the people present. A new world economic order is developing that is more dynamic and more inclusive than any we have yet seen.”⁸ Japanese Prime Minister Taro Aso, Canadian Prime Minister Stephen Harper, British Prime Minister Gordon Brown and Australian Prime Minister Kevin Rudd also are on record hailing the significance of the inclusiveness of new international players in these recent and upcoming financial summits.⁹

Endnotes

1. From the Group of Twenty website: The Group of Twenty (G-20) Finance Ministers and Central Bank Governors was established in 1999 to bring together systemically important industrialized and developing economies to discuss key issues in the global economy. . . . The members of the G-20 are the finance ministers and central bank governors of 19 countries: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom and the United States of America. The European Union is also a member, represented by the rotating Council presidency and the European Central Bank. To ensure global economic fora and institutions work together, the Managing Director of the International Monetary Fund (IMF) and the President of the World Bank, plus the chairs of the International Monetary and Financial Committee and Development Committee of the IMF and World Bank, also

participate in G-20 meetings on an ex-officio basis.
<http://www.g20.org/G20/>

2. Landler, Mark (2008), "World Leaders Vow Joint Push to Aid Economy," *New York Times*, November 16.
3. Landler (2008).
4. Group of Twenty (G-20) (2008), "Statement from G-20 Summit," *New York Times*, November 16.
5. The summit statement singles out the Breton Woods Institutions – for more information on them, see <http://www.brettonwoods.org/institutions.html> - including the World Bank, IMF and World Trade Organization (WTO) plus several regional development banks. Additionally it calls for expansion of the Financial Stability Forum, <http://www.fsforum.org/>, which promotes international financial stability through information exchange and international co-operation in financial supervision and surveillance.
6. For a summary of the immediate and medium-term actions, under the categories of strengthening transparency and accountability, enhancing sound regulation, regulatory regimes, prudential oversight, risk management, promoting integrity in financial markets, reinforcing international cooperation, and reforming international financial institutions, see <http://www.nytimes.com/2008/11/16/washington/summit-text.html?pagewanted=print>.
7. "Brown has to wear his brave face," *Sunday Herald*, November 16, 2008, <http://www.sundayherald.com/misc/print.php?artid=2468266>. See also Leviev-Sawyer, Clive, "Credit crunch: The G20 summit's main resolutions—and reactions," *Sofia Echo*. November 16, 2008, http://www.sofiaecho.com/article/credit-crunch-the-g20-summit-s-main-resolutions-and-reactions/id_32999/catid_66.
8. Leviev-Sawyer 2008.
9. Reuters, "Leaders comment on G20 communique," November 15, 2008, <http://www.reuters.com/article/newsOne/idUSTRE4AE2MD20081115?virtualBrandChannel=10341>.

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Delivery of Financial Literacy Programs to Adults

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The continuing instability in the housing and financial sectors points up the urgent need to step up financial literacy efforts that will enhance informed decision-making. This need is reaffirmed in a draft of the 2008 Annual Report to be submitted by the President's Advisory Council on Financial Literacy (hereafter the 'Council') to the President. Whether it is saving, purchasing a home, credit card usage or even budgeting, awareness of how to make sound financial decisions can make a difference. For educators, policy makers and other community leaders, knowing what financial literacy efforts are required may be the easy part, but effective delivery of these programs may be equally, if not more, important. The annual report submits several recommendations that could raise financial literacy levels. Broadly, these recommendations are as follows;

- Expand financial education for students from kindergarten through post-secondary education.
- Support the increasingly important role of employers as providers and conduits of financial education to their employees.
- Increase access to financial services for the millions of unbanked and underserved Americans.
- Identify and promote a standardized set of skills and behaviors that a financial education program should teach an individual in order for that individual to be considered financially literate.
- Promote more awareness among Americans of the state of financial literacy generally and of their own financial literacy, and dedicate more resources toward educating Americans how to improve on the results.

While these recommendations provide a framework for what needs to be done, this article examines suggestions made by Maude Toussaint-Comeau and Sherrie L.W. Rhine (2000) on effective

tive means of delivery. Making sound financial decisions has become a challenge on several fronts. Technological changes have affected the type of financial services offered as well as their delivery. This has also led to an increase in the variety of services offered, often more complex in their makeup, and has made it more difficult to choose appropriate services. Despite these increased challenges, personal financial literacy levels have declined over the past 10 years in high schools (see Ochieng 2008). Also, there is a high proportion of financially illiterate, lower-income consumers who may be unable to make informed decisions (Hogarth and O'Donell 1997). To improve these levels, questions are being raised by educators, community leaders and policy makers. What are

the best ways to share this information? Which consumers should be targeted? Should different programs be offered to different target groups?

In initiating an appropriate financial literacy program, Toussaint-Comeau and Rhine first identify appropriate subject areas and audiences with a caveat that most consumers could benefit from all topics. Based on focus groups that were looked into, a summary of findings are shown in Table 1. For example budgeting, record keeping and personal finance were seen to be more important to students and low income individuals. Use of alternative services such as check-cashing outlets seems prevalent in low-income, less-educated environments are likely to be more prevalent in minority

Table 1

Topics and Target Groups for Financial Literacy

Topic	Target Consumers
Budgeting/personal finances/record keeping Obtaining/maintaining a checking account Using mainstream banking	Lower income Elderly/widower Students Rebanked Immigrants/minorities
Assessing the relative costs (or benefits) of using alternative financial services	Less educated/lower income/minorities
Small business finance/planning	Small business owners/contractors Women business owners/entrepreneurs
Home purchase counseling	Homebuyers, those in transition from public housing
Home Loan Products Reverse mortgage Home equity Home expansion Home mortgage	Older, low-to-moderate income homeowners Homeowners Homeowners First-time homebuyers and homeowners
Consumer credit/financial products Financing durables goods Credit/charge cards ATM cards/machines usage Savings accounts Special savings (e.g., Individual Development Accounts or matching funds programs) Retirement and Investing	All College students, those with credit problems Checking accounts holders All, children Lower income Employees
Other Credit reports Predatory lending Identity thefts Consumer protection	All Older, lower income, marginal borrowers with imperfect credit All All

groups. Culture influences also play a part in financial decisions. For example, some segments are less likely to use formal banking institutions and instead rely on informal borrowing and lending habits such as friends and family. For these groups, information on how and why to use checking and savings accounts could improve access to credit and, for example, boost home ownership. Stressing that these traditional financial services are covered by various consumer protection laws would be helpful and would encourage their acceptance. Programs such as the Community Financial Access Pilot endorsed by the Council and set up by the Treasury's Office of Financial Education to reach unbanked and underserved individuals are one example of initiatives being put in place to correct the situation.

Delivery methods

Delivery methods may vary depending on the targeted consumers. To be effective, it may be necessary to combine delivery methods as each method has its benefits and drawbacks. Focus group participants in the Toussaint-Comeau and Rhine study found the following to be some of the most effective.

Information seminars. Respondents sometimes find these intimidating. They could be held in settings which are culturally and linguistically comfortable to attendees. Venues such as community centers, community colleges, K-12 schools, the workplace and churches could be used. Presenters who are culturally similar to the audience can play an important role in disseminating this information. The day and times of the seminars are also important. For example, working adults may only be able to attend either in the evening or on weekends. The same seminar may be offered on different days to increase attendance.

Advertising is a good complementary tool if done well. Knowing the target group, the media to be used and, also, advertising well in advance can make all the difference. A clear message is important and potential benefits to consumers should be well articulated. Offering a gift or free service may attract more attendees. *Pamphlets and Booklets* as part of a seminar are most effective. They should

be truly educational, catchy, and if necessary, in multiple languages depending on where they will be distributed.

Newspaper/Radio/Television/Video are effective but costly ways of passing information. They are, however, better suited to reach audiences with mobility issues such as the elderly. The *internet* is a convenient, cost-effective and efficient tool for those who can afford it. It may therefore not be as suitable for low-income consumers, though many local libraries offer internet access to the community.

Whichever delivery method is chosen, the goal is to reach and impact as many consumers as possible, and that losses on individuals, communities and to the wider economy are minimized.

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