

# SUMMARY BANK BALANCE SHEETS AND LIQUIDATION VALUES: EVIDENCE FROM REAL ESTATE COLLATERAL

RODNEY RAMCHARAN



The details are still unknown, but the Trump administration wants to roll-back some of the post crisis financial regulation. After the 2008-2009 financial crisis, banking regulators in the United States for the first time imposed liquidity requirements on the largest American banks. Rather than lending out deposits to businesses and individuals, these requirements obligate banks to maintain a significant cushion of their assets in liquid securities such as government bonds. Similarly, after the crisis, US financial institutions must now fund their assets with a

larger fraction of equity, rather than relying on mostly short-term debt and deposits — liabilities that can be quickly withdrawn at the first sign of trouble. To attain this larger equity to asset ratio, a number of banks have limited the growth of assets, again possibly squeezing loans to businesses. For regulators intent on fostering faster economic growth and lending, weakening the new liquidity and capital requirements seem like a natural step.

But new research by Rodney Ramcharan at the University of Southern California's Marshall School of Business suggests that these liquidity and equity requirements might be critical in protecting the broader economy from woes in the banking system. Most asset prices decline when the banking system is in distress. But this deflation can last years and sometimes decades in the case of some assets like real estate (Figure 1). The problem here with deflation is that real estate is a key source of collateral for most households and businesses. And any prolonged deflation in real estate prices tends to shrink the net worth of borrowers, leading to more defaults and depressing economic activity long after the initial banking sector distress. The evidence in Ramcharan (2017) however suggests that the balance sheet of banks — their liquidity and solvency — might be key to limiting this cycle of debt-deflation in real estate assets.

In particular, Ramcharan (2017) shows that as depositors became concerned about the safety of their deposits during the financial crisis and withdrew their deposits, banks tended to sell-off on balance sheet foreclosed real estate assets faster and more cheaply in order to raise cash

and repay depositors: the bigger the deposit withdrawal, the lower the price of these distressed real assets at auction. Moreover, these effects were especially large for banks that came into the financial crisis with less liquid assets on their balance sheet. To wit, because these banks had less liquid assets, like government bonds, that could be used to quickly repay creditors, these relatively illiquid banks were forced to sell-off real estate even more quickly, sometimes at big discounts, in order to rapidly raise cash and repay their depositors.

Banks with thinner equity cushions also sold-off real estate assets at bigger discounts. When computing equity cushions, regulations generally use a higher risk-weight for riskier assets. That is, more capital must be set aside to fund riskier assets. Thus, when a bank forecloses upon a borrower and takes possession of the loan collateral, the risk weight on the collateral, which is now an asset on the bank's balance sheet, is often much higher than on the original loan. A bank with scarce equity then has a bigger incentive to sell-off quickly the "capital intensive" foreclosed property, often fetching lower prices at auction.

These liquidity and solvency pressures at banks led to sizeable discounts not only of bank-owned properties, but also depressed prices in local real estate markets. Most pricing in real estate is based on "comparables". Buyers and sellers use nearby recent sales in order to help price the current property. And the results in Ramcharan (2017) show that the selling by banks also pushed down the prices of nearby properties that later sold in the

area. The balance sheet adjustments at banks took several years, and the “collateral damage” of bank selling on real estate markets continued well after the initial crisis shock in 2008-2009.

It is impossible to know the full economic cost of the new post crisis liquidity and capital regulations. But the economic and social costs associated with the debt-deflation cycle after banking sector shocks is enormous. And the evidence drawn from the Great Depression, the Japanese banking crisis of the early 1990s, along

with the new results in Ramcharan (2017) suggest that the prolonged deflation in real estate prices common after crisis events might in part reflect balance sheet adjustments at financial institutions. Therefore, despite their potential economic costs, regulations that constrain balance sheet choices during boom times might in turn limit the potential for prolonged real asset price busts when adverse banking sector shocks occur.

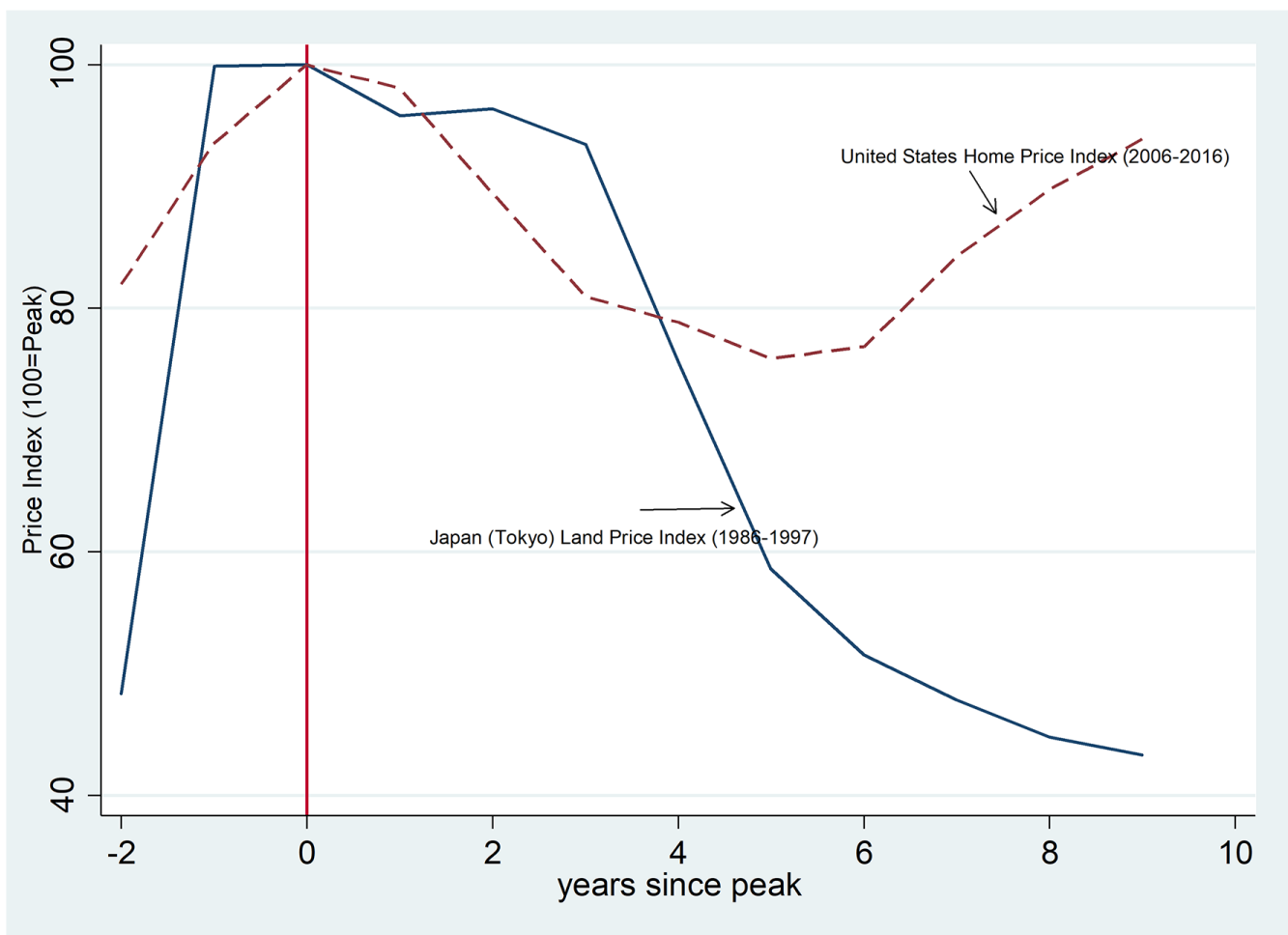


Figure 1. Real Estate Prices After Crises: Japan and the United States

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# USC Lusk

650 Childs Way  
Lewis Hall 331  
Los Angeles, CA 90089-0626  
[lusk.usc.edu](http://lusk.usc.edu)