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Bank Off-balance-sheet Leverage: Some Lessons from the Financial Crisis

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Leverage is one of the main underlying features of banks' balance sheets. Traditionally, leverage arises directly through the use of deposited funds or other balance-sheet items, such as bonds and credit lines, as a supplementary tool of banks' equity capital in financing fresh loans and investments. However, leverage can also be traced off the balance sheet of banking organisations. More specifically, in the years before the outbreak of the late 2000s crisis, banking firms took advantage of financial engineering that allowed them to transfer a large part of their leverage off their balance sheets.

This chapter will examine how modern banking and the related off-balance-sheet leverage activities have affected the individual soundness of US banks, as well as the systemic health of the US banking industry, both before and after the onset of the 2007–08 financial crisis. To help achieve this, we will capture off-balance-sheet leverage with different, yet complementary, measures, and also empirically assess the impact of these measures on the overall risk-taking behaviour of US banks and on systemic risk. The details of the empirical analysis can be found in a complementary study (Papanikolaou and Wolff, 2013), which more technically oriented readers can explore.[1]

OFF-BALANCE-SHEET LEVERAGE

In the years running up to the crisis – that is, from the late 1990s onwards – banks were capable of transferring a part of their leverage