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# The role of on- and off-balance-sheet leverage of banks in the late 2000s crisis

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# The role of on- and off-balance-sheet leverage of banks in the late 2000s crisis

## Abstract

Extensive regulatory changes and technological advances have transformed banking systems to a great extent. Banks have reacted to the challenges posed by the new operating environment by creating new products and expanding their activities to some uncharted business areas. In this paper, we study how modern banking which gave birth to the off-balance-sheet leverage activities affected the risk profile of U.S. banks as well as the level of systemic risk before and after the onset of the late 2000s financial crisis. Towards this, we separate on- from off-balance-sheet leverage and capture the latter with different, yet complementary, measures which do not exist in the current literature. Special attention is paid on the deleveraging process that occurred in the banking market after the crisis erupted, which is an additional innovative feature of this study. Our findings reveal that leverage, both explicit and hidden off-the-balance-sheet, increases the individual risk of banking firms making them vulnerable to financial shocks. Reverse leverage, on the other hand, is beneficial for individual banks' health, but is found to be harmful for financial stability. We also demonstrate that the banks which concentrate on traditional lines of business typically carry less risk compared to those involved with modern financial instruments.

*Keywords:* bank leverage; deleveraging process; individual bank risk; systemic risk; financial crisis  
*JEL classification:* C23; C26; D02; G21; G28

## 1. Introduction

The late 2000s financial crisis, whose origins can be traced in the rising delinquencies in the U.S. subprime mortgage market in 2006 and the succeeding collapse in housing prices in August 2007, has revealed several inadequacies in the functioning of the financial system: loose monetary policies, performance-based remuneration practices, and inefficient regulatory and supervisory rules in the years preceding the crisis are amongst the perceived causes of making the entire system more vulnerable to shocks. A factor which is related to the aforementioned shortfalls and is identified in the current crisis literature as having a substantial role in the buildup of severe structural weaknesses and adverse market dynamics during the pre-crisis period is the high leverage of financial institutions worldwide.

In general terms, leverage is viewed as one of the main underlying features of banks' balance sheets. Traditionally, leverage arises directly through formal debt where the most popular types of debt are bonds and credit lines. Nevertheless, in the years before the crisis, banking firms were deemed to have leveraged their positions to a much greater extent than they used to by taking advantage of financial engineering techniques, which allowed them to transfer a large part of their leverage off their balance sheets.<sup>1</sup> Therefore, a significant degree of leverage was assumed implicitly, in the sense that it was not recorded on the balance sheet of banks. However, shortly after the crisis erupted, financial organisations sought to deleverage their positions thus amplifying the already existing downward pressure on asset prices which, in turn, encouraged the deleveraging spiral even further. This procyclical process was exacerbated by the large size and the systemic importance of the financial institutions that were engaged in the off-balance-sheet activities. Overall, the malfunctions of the banking industry strongly affected the rest of the financial system resulting in a massive contraction of liquidity and credit availability which, shortly later, exerted a serious adverse influence on the real economy.

Even though the impact of leverage on the health of the financial system has been discussed in several policy and academic studies (see, e.g., CRMP Report, 2008; Greenlaw et al., 2008), not enough empirical evidence has been gathered to provide definite answers about the relevance of leveraging and the role of deleveraging in the propagation and prolongation of the latest financial crisis. Along these lines, little attention has been paid to the overall leverage behaviour

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<sup>1</sup> It is true that the corporate financial sector was also engaged in high-leverage business projects before the onset of the crisis. However, this issue is out of the scope of the current study.

of banks in the sense that the extant literature mainly focuses on the traditional on-balance-sheet leverage, neglecting, to a great extent, the importance of the implicit leverage in the operation and the soundness of the banking system. In this paper, we make an attempt to fill part of this void by empirically assessing how modern banking, which gave birth to the off-balance-sheet leverage, has affected the health of the U.S. systemically important banking companies as well as the level of risk of the entire U.S. banking system before and after the onset of the late 2000s crisis. To this aim, we separate on- from off-balance-sheet leverage activities and capture the latter set of activities with different, yet complementary, measures which do not exist in the current literature. Importantly, we devote special attention to the deleveraging process which took place in the banking market after the crisis erupted.

Our findings reveal, among other things, that on-balance-sheet leverage has a negative impact on the health of individual banks as well as on the stability of the system. By the same token, we find that the different types of off-balance-sheet leverage are negatively linked to the soundness of the banking system as a whole. This result is even stronger in case systemic risk is considered. Reverse leverage, on the other hand, has beneficial effects on individual banks' health, but increases the fragility of the entire system. We also demonstrate that the banks that concentrate on the traditional activity of taking deposits from households and making loans to agents who require capital carry less risk to the system compared to banks which are involved with new financial services. On the whole, our results provide a better understanding of one of the root causes of the global financial crisis and contribute to the discussion on the restructuring and strengthening of the existing regulatory framework for banks.

The remainder of the paper proceeds as follows. In Section 2, we examine how on- and off-balance-sheet leverage as well as reverse leverage are linked to the soundness of individual banks and to the health of the banking system; both an empirical and a theoretical approach are taken to illustrate the aforementioned relationships. Section 3 provides a description of the data set and a justification of the variables used in our baseline empirical analysis; the regression model, together with the descriptive statistics and the estimation methodology are also presented in this section. Section 4 then reports and discusses the empirical results, which are subjected to robustness checks in Section 5. The policy implications of our findings along with the concluding remarks are presented in Section 6.

## 2. The nexus between leverage, reverse leverage and risk in the banking system

### 2.1. An empirical perspective

Generally speaking, bank leverage refers to the use of debt in financing new assets and investments. Regarding the on-balance-sheet leverage of banks, this is related to the use of deposited funds or any other balance sheet items like, for instance, bonds to supplement banks' equity capital in financing fresh loans and investments. Banks expect that the granted loans will produce a higher rate of return compared to the interest rate that they have agreed to pay to their depositors (or, investors in the case of bonds). If the loan/investment return rates turn out to be lower than anticipated, the bank's equity capital (or net worth) will inevitably shrink since the bank will have to cover the difference between deposit and lending rates by resorting to its equity capital. Further, if we presume that a loan fails to perform and that the bank is not able to recover it, the loan will be charged off, implying that the institution will lose an amount of assets equal to the loan loss. Charge-offs will have an impact on the liabilities side of the bank's balance sheet as they will reduce the bank's net worth by the amount of the loss. Overall, equity is viewed as a buffer against the losses a bank suffers in case loans -or other bank investments- go sour. Apparently, if several -let alone many- borrowers default on their obligations, then the equity capital will be in peril. Should nonperforming and defaulted loans accumulate, which is a common phenomenon in bad economic times, equity capital would disappear. In sum, on-balance-sheet leverage maps the riskiness of a bank's asset position into the riskiness of its equity stake.

Leverage can also be traced off the balance sheet of banking organisations. Specifically, in the years running up to the crisis, banks have been transferring a part of their leverage and the accompanying risk off their balance sheets mainly through their engagement in securitisation activities and Over-The-Counter (OTC) derivatives trading. Both these undertakings are strongly linked to the so-called 'regulatory arbitrage'. This sort of arbitrage refers to the response of banks to regulatory restrictions (especially those on capital requirements) that were imposed by Basel I and II. In more details, regulatory arbitrage is the game that takes place between banking firms and regulatory authorities, whereby the former innovate and develop new financial instruments in order to elude the scrutiny of supervisors and increase their returns, and the latter tighten the

rules to avoid excessive risk-taking with the utmost purpose to safeguard the stability of the financial system.<sup>2</sup>

Securitisation was mainly achieved through the setup of Asset Backed Commercial Paper (ABCP) conduits and Structured Investment Vehicles (SIVs) where banks could transfer large portions of their assets. More concretely, a considerable amount of bank assets was transferred to the above-mentioned investment pools, whilst, at the same time, the sponsoring banking institutions were providing these pools with liquidity and credit enhancements (or backstops) in order to ensure funding liquidity for them. Those backstops could attract a low charge under Basel Agreements and were funded mostly by short-term securitised debt and only by very little equity capital -or any other long-term investments- which has been always costly for banks. In so doing, the sponsoring institutions were able to free up capital and, hence, originate more assets -generally of lower quality (like, e.g., subprime mortgage loans)- that were typically hidden in the so-called shadow banking system.<sup>3</sup> Therefore, banks deliberately avoided issuing new equity capital in order to originate new assets and, more generally, to finance their activities.<sup>4</sup> As a consequence, conduits and SIVs contained a significant degree of bank leverage and risk in an implicit form that was achieved through the structuring of the financial instruments *per se*. Nonetheless, under the aforementioned business scheme of funding which had come to be known as the 'originate-to-distribute model', investors in conduits and SIVs would return the assets back to the originating bank once they suffered a loss; and banks were, indeed, legally obliged to take bad assets back on their books. This is to say, asset risk was still burdened the sponsoring institutions.

Derivative products, on the other hand, grew up as part of an effort to better manage the investment risks amongst international market participants. In specific, derivatives trading facilitated capital flows worldwide by unbundling and more efficiently reallocating the various sources of risk which were associated with traditional banking products such as bank loans, bonds, and securities. Hence, the financial innovation of introducing derivatives to capital

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<sup>2</sup> For a thorough discussion of regulatory capital arbitrage through derivative instruments, see Breuer (2002).

<sup>3</sup> Shadow banking consisted of non-bank financial institutions like hedge funds, insurance funds, investment funds, pension funds, SIVs, conduits, to name the most important ones. Some of these institutions, like SIVs and conduits, are not in operation anymore.

<sup>4</sup> Banks were very keen on engaging in securitised activities not only because they could qualify for lower capital requirements, but also because securitisation had the extra advantage of generating fee income. Fees did not have to be returned in case securities suffer losses thus providing banks with an additional incentive to structure products and leverage their positions even further.

markets allowed the rather traditional arrangements of risk to be redesigned in order to better meet the desired risk profiles of the issuers and holders of these instruments. To put it differently, through the use of derivatives, a part of risk is taken away from investors who are not willing to undertake it and move towards those who are more risk-lovers and thus more willing and (probably) more able to bear it.

While the risk-shifting function of derivatives can play the useful role of hedging and thereby facilitating capital flows, derivatives can at the same time create new risks for the health of banking institutions and for the soundness of the system. The extensive use of derivative contracts is likely to lead to a lower degree of transparency between counterparties and also between regulators and market investors which can potentially harm the stability of the financial system. This holds true especially for derivative products which are traded over-the-counter and are directly related to the off-balance-sheet leverage exposure of banking enterprises. Indeed, derivatives are traded in two main ways: either on exchanges, where trading is public and can be regulated by governments while observed and controlled by market participants, or in the OTC markets where trading is non-public and remains outside authorities' supervision and regulation. That is, unlike derivatives trading on stock exchanges, transactions in the OTC markets are neither registered nor systematically reported to the public and, as such, comprehensive information on them is limited.

In addition, derivatives can be utilised for non-productive purposes such as avoiding capital adequacy requirements (what has been already mentioned as 'regulatory arbitrage'), evading taxation, manipulating accounting figures, and misleading credit rating agencies. For instance, derivative products can be used to raise the level of market risk exposure relative to the bank capital in the pursuit of banks for higher-yielding investment opportunities. In case of an unexpected or a sharp change in the exchange rate or any other market prices, the larger the amount of market exposure -most likely created by open positions in derivatives contracts-, the greater will be the effect on the asset portfolio of individual banks and, hence, on the banking sector as a whole. In this regard, the use of derivatives to reduce the amount of capital which acts as a cushion to market turmoil raises the risk of bank failure and heightens doubts about the soundness of the entire sector.

As is apparent from the discussion so far, leverage, either on- or off-the-balance-sheet of banks, can be potentially harmful for the stability of the financial system. Equally, if not more



harmful than leverage itself is the so-called ‘reverse leverage’, or ‘deleveraging’, which refers to the phenomenon in which financial intermediaries all attempt to shrink their balance sheets together by selling part of their assets or by reducing their debt with the chief purpose to return to a safe level of capital. When a significant number of banks attempt to deleverage their balance sheets with the aim to strengthen their leverage ratios, various destabilising factors can be set in motion. If, for instance, several institutions attempt to sell part of their assets at the same time, the market prices of these assets will almost immediately fall, especially in the case that the selling assets are of the same class (e.g., mortgage loans, housing assets, etc.). Asset prices will then decline to the point where the sale proceeds will not retire enough debt to improve leverage ratios. In fact, ratios may actually deteriorate. Banks will, in turn, hold off selling as long as possible and the market will freeze up. As a consequence, a large volume of hard-to-value assets carried by highly leveraged institutions is looming over the markets. Overall, any serious fall in asset prices, or any large losses in loans or securities, or any cut in cash flows can exert reverse leverage effects on the system. Arguably, the deleveraging process puts additional downward pressure on financial markets, especially in a system that consists of highly leveraged banks.

## *2.2. A theoretical perspective*

In a theoretical analysis of the causes of the late 2000s crisis, Brunnermeier (2009) focuses on the U.S. banking industry to claim that the traditional relationship business model, in which banks issue loans and hold them until they are repaid, has been replaced by a new model. Under this new model, financial engineering techniques help banks to pool the loans, slice them into tranches, and sold them to both primary and secondary markets via securitisation. This transformation has, on the one hand, weakened the ability of banks to monitor the incentives of the agencies involved in this ‘originate-to-distribute-process’ while, on the other, it has increased the possibility for investors of holding a large amount of securities without fully understanding the associated risk.

Van Oordt (2013) makes an attempt to shed more light on the dark side of diversification. He constructs a theoretical model to show that tranching plays an important role for the economy from both microprudential and macroprudential perspectives. Regarding the former perspective, tranching is found to promote a fall in the likelihood of individual failures beyond the minimum level that could be achieved by linear diversification policies. This latter kind of policies is

referred to the diversification of asset holdings by the construction of linear combinations of loan portfolios. In fact, Wagner (2010), again in a theoretical modelling context, illustrates how linear diversification can lead to an upsurge in the probability of joint failures amongst financial institutions and, hence, to an increase in the level of systemic risk. Turning to the macroprudential view, Van Oordt (2013) proves that tranching offers the opportunity to banks to adopt diversification strategies which are non-linear, and that these non-linearities can reduce the bankruptcy risk of individual institutions beyond the minimum level attainable by linear diversification. Importantly, these non-linear diversification policies are not found to increase systemic risk.

Kiff and Kisser (2013) investigate the economics of securitisation comparing the results of equity and mezzanine tranche retention in the context of systemic risk, moral hazard, accounting frictions and funding distortions. They show that loan screening activity is maximised via the maximisation of due diligence when the bank which originates the loan retains the equity tranche. Moving further into the heart of securitisation puzzle, they evaluate the relevance of market frictions in their conclusions testing whether equity or mezzanine tranche retention maximises the profits of banks. They document that, in case capital structure irrelevance does not hold and the costs of debt and equity are very high, mezzanine tranche retention is more likely to help banks maximising their profits.

Regarding the derivatives trading activity of banks, Fabozzi and Choudhry (2004) argue that the use of credit derivatives allow banks to increase the use of scarce capital by means of risk mitigation where, at the same time, help them to improve their management of regulatory capital. Duffee and Zhou (2001) and Morrison (2005) develop two theoretical models which demonstrate how credit derivatives markets can reduce economic welfare. They show that credit risk transfer can lead to a decline in welfare through contagious effects that can harm the stability of the entire system. More specifically, Morrison illustrates that credit derivatives can destroy the signaling value of debt and this may cause disintermediation and welfare reduction.

Turning to reverse leverage which typically takes place during economic downturns, Cornett et al. (2011) demonstrate that the pressure for banking firms to deleverage after the onset of the crisis was exacerbated by the fact that they had to honour prior commitments to credit lines which were mainly nominated in U.S. dollars. They further show that the sharp decrease in

leverage is due to the need of banks to dump off risky assets. The impressive extent to which financial institutions deleveraged during the crisis is also discussed in Adrian and Shin (2010).

### 3. Empirical analysis

#### 3.1. Description of the data set

Our empirical analysis is based on a data set that consists of 20 U.S. banks as reported in the Table 1 that follows. These banks are of the same institution type as they are all defined as ‘Domestic U.S. Financial Holding Companies’ by the National Information Center of the Federal Financial Institutions Examination Council (NIC/FFIEC). The sample institutions have been selected primarily on the basis of their systemic importance (as we discuss in detail below) and the degree of their off-balance-sheet exposure as documented in the ‘Bank Derivatives Reports’ of the Office of the Comptroller of the Currency (OCC).

**Table 1**

Sample of banks. This table reports the 20 U.S. banks which are employed in our empirical analysis.

<b>Bank name</b>	
1. BANK OF AMERICA CORP.	11. JP MORGAN CHASE & CO
2. BANK OF NY MELLON CORP.	12. KEYCORP
3. BB&T CORP.	13. NORTHERN TRUST CORP.
4. CAPITAL ONE FINANCIAL CORP.	14. PNC FIN. SERVICES GROUP INC.
5. CITIGROUP INC.	15. REGIONS FINANCIAL CORP.
6. CITY NATIONAL CORP.	16. STATE STREET CORP.
7. COMERICA INC.	17. SUNTRUST BANKS INC.
8. FIFTH THIRD BANKCORP	18. US BANK CORP.
9. FIRST HORIZON NATIONAL CORP.	19. WELLS FARGO & CO
10. HUNTINGTON BANKSHARES INC.	20. ZIONS BANKCORP.

We incorporate a larger number of institutions in our analysis compared to previous studies (see, e.g., O’Hara and Shaw, 1990; Flannery & Sorescu, 1996; De Nicoló and Kwast, 2002) which are also focused on Systemically Important Financial Institutions (SIFIs).<sup>5</sup> The 20 banks of our sample possess more than 50% of the entire sector’s total assets,<sup>6</sup> whereas their relative

<sup>5</sup> A sample of the more recent works that belong to the burgeoning crisis literature and focus exclusively on large, systemically important financial institutions are those of Huang et al. (2009) that constructs a framework for measuring and stress testing the systemic risk of 12 U.S. major commercial and investment banks, Adrian and Shin (2010) that examines the procyclicality in leverage of the 5 biggest U.S. investment banks before the crisis, and Patro et al. (2013) that uses the 22 largest commercial and investment banks in U.S. to analyse the relevance of stock return correlations in assessing the level of systemic risk.

<sup>6</sup> This percentage is based on the average size of each sample bank as measured by the ratio of a bank’s assets to the sector’s total assets over the whole data period.

importance (*i.e.*, their relative size) is getting higher throughout the data period.<sup>7</sup> In fact, the U.S. federal authorities have been reluctant to let any of them to go bankrupt as this would have shattering effects on the entire financial system. To provide strong support to this argument, we mention that all sample banking firms are amongst the top 50 Holding Companies as reported in the relevant list of the NIC/FFIEC. Further, not a single entity among those failed or acquired by some other financial institution from the beginning of the crisis onwards is included in our data set. To the contrary, all sample banks have received significant financial assistance from the U.S. government through the Troubled Asset Relief Program (TARP) according to data from the U.S. Department of Treasury. It is also important to note that, in early 2009, the U.S. government performed a series of stress tests on the 19 largest banks and near-banks that were of systemic importance for the economy. Under that exercise, which was named as Supervisory Capital Assessment Program (SCAP), each bank would need to safeguard that it had sufficient capital in case the economy got even worse. All the 14 commercial pure banking organisations which took part in SCAP in 2009 are included in our sample.<sup>8 9</sup>

To sum up, we have constructed a homogeneous set of banks which provide the bulk of financing to industry and households in U.S. and elsewhere, meaning that, if any of them were allowed to fail, this would inevitably cause, *inter alia*, serious systemic liquidity shortages in the economy.<sup>10</sup> As a consequence, our data set is very representative of the ‘operating behaviour’ of this very special category of banking firms (that is, the SIFIs) and also of the way the U.S. banking industry operates as a whole. We, therefore, expect to get meaningful and robust empirical results.

On the basis of the discussion so far, it does not come by surprise that the banking organisations that comprise our data set have been engaged in non-traditional banking activities

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<sup>7</sup> Several prominent studies focus on the biggest U.S. Bank Holding Companies -on the basis of their relative size- that account for approximately half of the total U.S. bank population: Keeley (1990), Demsetz and Strahan (1997), Galloway et al. (1997), just to name a few.

<sup>8</sup> Five of the institutions which participated in SCAP were not part of the commercial banking industry. These were: American Express Company, GMAC Inc., Goldman Sachs Group, Inc., Metlife Inc., and Morgan Stanley. Apparently, none of these institutions is included in our analysis.

<sup>9</sup> SCAP was limited to Holding Companies with total assets not less than \$100 billion. Based on U.S. Department of Treasury data, the 14 banks that were qualified to participate in SCAP and take part in our sample are the following: Bank of America Corp., Bank of NY Mellon Corp., BB&T Corp., Capital One Financial Corp., Citigroup Inc., Fifth Third Bankcorp., JP Morgan Chase & Co, Keycorp, PNC Financial Services Group Inc., Regions Financial Corp., State Street Corp., Suntrust Banks Inc., US Bank Corp., and Wells Fargo & Co.

<sup>10</sup> Clearly, institutions other than commercial banks like, for instance, insurance companies (e.g., AIG) or investment banks (e.g., Lehman Brothers) also had a systemic role and largely contributed to the emergence of the crisis.

to a much greater extent than their smaller counterparts. Large banks have indeed been entangled with a very broad range of bank-related activities, others than pure commercial banking activities like loan granting and deposit taking. These activities are explicitly defined by the Gramm-Leach-Bliley Act of 1999 and include, amongst others, securities dealing and underwriting, insurance underwriting, financial and investment advisory services, merchant banking, and issuing or selling securitised interests in bank-eligible assets. Indeed, literature (see, e.g., Rime and Stroh, 2003) demonstrates that big banks are very prone to universal banking activities in contrast to small and mid-sized institutions, which are less diversified and resemble single-line businesses. Therefore, by relying on a sample that consists exclusively of very large financial entities, we expect the distinction between on- and off-balance-sheet leverage to be clear and transparent.

The key reason why we restrict our attention on commercial banks (and not, for instance, on investment or savings banks) is because the commercial banking sector is both heavily regulated and largely supervised. This is in sharp contrast to what holds for investment banks as well as near- and non-banks that do not rely on deposits and, hence, do not need to keep much money in the form of capital. To give an example, the larger U.S. investment Bank Holding Companies and their subsidiaries were regulated by the U.S. Securities and Exchange Commission and were not subjected to any leverage requirements. Indeed, under the ‘net capital rule’, light leverage restrictions were only imposed (at individual firm level) on the amount of customer receivables an investment bank could hold as a multiple of capital. In other words, the non-commercial banking institutions face no significant restrictions on the level of their leverage.

We believe it is also important to justify at this point why we focus our analysis on the U.S. banking sector. First and foremost, the crisis originated in the U.S. before spilled over to other economies around the globe. Hence, by looking at the U.S. banking industry, we are capable of better tracing some of the root causes of the current financial turmoil. Second, the differences in the accounting regimes can lead to large variations in the off-balance-sheet leverage, which lie at the centre of the present study. Evidently, Generally Accepted Accounting Principles (GAAP) allowed U.S. commercial banks to treat their SIVs and ABCP conduits as being entirely off their balance sheets before the crisis. In contrast, the International Financial Reporting Standards (IFRS) that European institutions followed were somewhat less tolerant toward off-balance-sheet business as they required from banks to keep record of this sort of items on their balance sheets.

Along the same lines, the use of IFRS may result in significantly higher amounts of total assets and, hence, lower leverage ratios for the same or similar exposures, compared to the use of U.S. GAAP. The reason for this is the netting of OTC derivatives, which is allowed under the former reporting systems. More concretely, the netting conditions are stricter under IFRS in that the gross replacement value of derivatives is generally shown on the balance sheet even when positions are held under master netting agreements with the same counterparty. To illustrate this with an example, we examine Deutsche Bank's balance sheet which is reported under both accounting principles. In 2009, the systemically important German bank reported an amount of total assets of approximately 1.5 trillion euros under IFRS standards, where total assets were equal to almost 0.9 trillion euros if U.S. GAAP were taken into account. Given that the reported equity capital is (more or less) the same under both accounting principles, the on-balance-sheet leverage ratio for Deutsche Bank in 2009 was much higher in IFRS values. And, of course, this has been the case for every other accounting year. Apparently, GAAP provided U.S. banks with more incentives to undertake a higher degree of leverage compared to their European counterparts. In consequence, our emphasis on U.S. banking organisations allows us to develop more solid measures of their off-balance-sheet leverage exposure, and then proceed to empirically gauge the effects of this exposure on individual bank soundness and on the system's health, which are the key issues examined in this study.

### *3.2. Sample period*

The data we employ in our analysis are of quarterly frequency and cover the period 2002q1-2012q3. We do not examine the years before 2002 mainly for two reasons. First, the two international financial crises which erupted in East Asia and in Russia at the end of the 90s together with the Long Term Capital Management (LTCM) crisis of 1998 all had a destabilising impact on the U.S. banking system. Second, no considerable regulatory or other similar reforms occurred in the U.S. banking market from 2002 onwards, meaning that the operation of banks has remained largely unaffected by exogenous factors throughout the examined period. In fact, the latest legislative activity in the U.S. that largely influenced the operation of the entire banking sector was the already mentioned Gramm-Leach-Bliley Act of 1999, which opened up the local market allowing commercial and investment banks, securities firms and insurance companies to merge their activities. If any considerable reforms had taken place in the banking

regulatory environment during our sample period, it would be highly likely to have exerted an impact on the leverage decisions of banks and hence to have biased our results.<sup>11</sup> Indeed, it is well-established in the banking literature that regulation strongly affects industry structure and alters the behaviour of banks in terms of performance and risk-taking (see, e.g., Brissimis et al., 2008).

The whole data period is divided into two sub-periods: the earlier one (2002q1-2007q2) includes the years before the outbreak of the crisis, that is before August 2007 when the difference between the yield on three-month London Interbank Offered Rate (LIBOR) and the yield on three-month U.S. Treasury bills (the so-called TED spread) widened to 150-200 basis points relative to a historically stable range of 10-50 basis points. Apparently, the pre-crisis years were characterised by stable financial conditions and strong economic expansion. The second period extends from 2007q3 to 2012q3 and refers to the crisis period in which financial turbulence, uncertainty, and distress prevailed in the economy.<sup>12</sup>

We perform a simple Chow (1960) test for a structural break at the beginning of the crisis (that is, in 2007q3), and find strong evidence of a structural change. In particular, the Chow test rejects the null hypothesis of no break (or constant parameter values), thereby providing evidence that the difference in the sub-period regressions is statistically significant. We further split the crisis period into two and run a Chow test for the following two periods: 2007q3-2008q3 and 2008q4-2012q3. The breakpoint in 2008q3 is based on the collapse of Lehmann Brothers on 15 September 2008. We basically fail to reject  $H_0$ , thus providing little or no evidence of structural changes in the on- and off-balance-sheet leverage variables which we employ in our analysis and are described below.

### 3.3. Variables selection

In this Section, we describe the variables employed in our baseline econometric model. All variables together with the relevant data sources are summarised in Appendix A.

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<sup>11</sup>It has to be mentioned here that the U.S. government enacted the Sarbanes-Oxley Act in mid-2002 with the purpose to set new or enhanced disclosure standards for all U.S. public company boards including those of banking firms. However, that Act had a partial effect on the operation of the banking industry as it only targeted the listed banks; further, it was introduced in the very beginning of our sample period implying that its overall impact is reflected in our data.

<sup>12</sup> Other recent studies -like that of Cornett et al. (2011)- also use 2007q3 as the starting point of the crisis.

To start with the left-hand-side variables, we measure individual bank soundness with total bank risk (*TOTRISK*), which is calculated as the quarterly standard deviation of each sample bank's daily stock market returns.<sup>13</sup> This metric of risk captures the total volatility of equity prices for each individual bank. As such, it incorporates credit risk, market risk, and liquidity risk. To calculate *TOTRISK*, we first obtain the weekly (Friday-to-Friday) returns for each individual bank using its stock market prices:

$$R_{iw} = \ln \bar{P}_{iw} - \ln \bar{P}_{i(w-1)} \quad (1)$$

where  $R_{iw}$  denotes the weekly ( $w=1, 2, \dots, W$ ) stock market returns of bank  $i$  ( $i=1, 2, \dots, N=20$ ), and  $\ln \bar{P}_{iw}$  stands for the natural logarithm of the weekly average of bank  $i$ 's stock market daily price  $P$ , where daily returns are adjusted to account for dividend payouts and stock splits. In the cases where Friday is a holiday and no stocks are traded, we use the Thursday-to-Friday, or Friday-to-Thursday returns instead. Additionally, when the return of a given stock is not available on a given Friday, that stock's weekly return is coded as missing. *TOTRISK* is then obtained by the following formula:

$$\sigma_{iq} = \sqrt{\frac{\sum_{w=1}^W (R_{iw} - \bar{R})^2}{W-1}} \quad (2)$$

where  $\sigma_{iq}$  is the quarterly ( $q=2002q1, 2002q2, \dots, 2012q3$ ) standard deviation of bank  $i$ 's daily returns and  $\bar{R}$  is the quarterly average of bank  $i$ 's weekly returns. The lower-case sigma is strongly related to bankruptcy both statistically and conceptually: if a bank has more variable cash flows (and, hence, more volatile stock returns), then the bank is expected to have a higher probability of bankruptcy.

We measure systemic risk (*CoVaR*) relying on the approach of Adrian and Brunnermeier (2011). *CoVaR* is the Value at Risk (*VaR*) of a financial institution conditional on other

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<sup>13</sup> Similar risk measures have been used in the study of Galloway et al. (1997) and -more recently- in those of Gonzalez (2005) and Wu et al. (2011).



institutions of the financial system being in distress. The analytical procedure we follow to calculate  $CoVaR$  is as follows:

We start by defining  $VaR_{p,q}^i$  as the  $p$ -quantile of the asset return  $R_q^i$  that bank  $i$  will lose with probability  $p$  over time  $q$ , where  $q$ , as previously noted, stands for quarters:

$$Prob(R_q^i \leq VaR_{p,q}^i) = p \quad (3)$$

We then define  $CoVaR_{p,q}^{system|i}$  as the  $VaR$  of the entire banking system (treated as a portfolio of banks) conditional upon bank  $i$  being in financial distress:

$$Prob\left(R_q^{system} \leq CoVaR_{p,q}^{system|i} \mid R_q^i = VaR_{p,q}^i\right) = p \quad (4)$$

In a similar vein, we define  $CoVaR_{p,q}^{system|i,normal}$  as the  $VaR$  of the banking system conditional upon bank  $i$  operating under normal conditions (*i.e.*, when  $R_q^i$  is equal to its median level):

$$Prob\left(R_q^{system} \leq CoVaR_{p,q}^{system|i,normal} \mid R_q^i = R_q^{i,normal}\right) = p \quad (5)$$

The contribution of bank  $i$  to the risk of the whole system (systemic risk) is given by:

$$\Delta CoVaR_{p,q}^i = CoVaR_{p,q}^{system|i} - CoVaR_{p,q}^{system|i,normal} \quad (6)$$

To estimate the contribution of bank  $i$  to systemic risk as given by  $\Delta CoVaR_{p,q}^i$  in eq. (6), we need to first estimate the two right-hand side terms and then calculate their simple difference. To this purpose, we resort to quantile regression analysis. A quantile regression, first introduced by Koenker and Bassett (1978), estimates the conditional probability that a variable falls below a given threshold (quantile) when another random variable is also below the same quantile.<sup>14</sup> In the

<sup>14</sup> An overview of quantile regression analysis illustrated with a comprehensive empirical application can be found in Chernozhukov and Umantsev (2001).

context of *CoVaR* measurement, quantile regression techniques are preferred compared to their OLS counterparts. In Appendix B, we analytically explain the main reasons behind this.

We obtain  $CoVaR_{p,q}^{system|i}$  by running the following two quantile regressions setting  $p$  equal to 0.01, which corresponds to the 1% distress level:

$$R_q^i = \alpha^i + \beta^i M_{q-1} + \varepsilon_q^i \quad (7)$$

$$R_q^{system|i} = \alpha^{system|i} + \beta^{system|i} M_{q-1} + \gamma^{system|i} R_q^i + \varepsilon_q^{system|i} \quad (8)$$

where  $R_q^i$  is the quarterly growth rate of bank  $i$ 's total assets conditional on bank  $i$  being distressed, and  $R_q^{system|i}$  is the quarterly growth rate of total assets of all  $N=20$  institutions which comprise our banking system conditional on bank  $i$  being distressed. Both bank  $i$ 's total assets and system's total assets are expressed in market values.

Similarly, we calculate  $CoVaR_{p,q}^{system|i,normal}$  by running the following quantile regressions at the 50% level this time, where 50% corresponds to the median level of asset returns under normal financial and economic conditions:

$$R_q^{i,normal} = \alpha^{i,normal} + \beta^{i,normal} M_{q-1} + \varepsilon_q^{i,normal} \quad (9)$$

$$R_q^{system|i,normal} = \alpha^{system|i,normal} + \beta^{system|i,normal} M_{q-1} + \gamma^{system|i,normal} R_q^{i,normal} + \varepsilon_q^{system|i,normal} \quad (10)$$

where  $R_q^{i,normal}$  is the quarterly growth rate of bank  $i$ 's total assets conditional on bank  $i$  operating under normal conditions and  $R_q^{system|i,normal}$  is the quarterly growth rate of total assets of all  $N=20$  banks of our system conditional on bank  $i$ 's normal operation. Like it was the case in eq. (7) and (8), total assets in eq. (9) and (10) are also expressed in market values.

In eq. (7), (8), (9) and (10),  $M_{q-1}$  is the one-quarter lag of the vector of the financial and macroeconomic state variables that influence bank soundness. These state variables are: i) the market return volatility measured with the implied volatility index (VIX) found in the Chicago

Board Options Exchange Market, ii) the liquidity risk spread given by the quarterly difference between the 3-month LIBOR rate and the 3-month U.S. T-bill rate, iii) the change in the slope of the yield curve given by the change in the quarterly difference between the 10-year U.S. T-bill rate and the 3-month U.S. T-bill rate, iv) the interest rate risk defined as the quarterly standard deviation of the day-to-day 3-month U.S. T-bill rate,<sup>15</sup> and v) the credit risk, measured by the quarterly change in the credit spread between the 10-year BAA-rated bonds and the 10-year U.S. T-bill rate.

We resort to the Im-Pesaran-Shin (2003)'s unit root test for panel data to test for stationarity of the data series included in the return equations (eq. 7, 8, 9 and 10). This test relies upon the Augmented Dickey-Fuller (ADF) methodology and, contrary to the widely used Levin-Lin-Chu (2002) test, it allows for heterogeneity in both the constant and the slope terms of the ADF regression. We incorporate an individual specific constant term and run the test with and without a time deterministic trend that picks up the non-stochastic influence of common factors on asset returns across banks over time. The null hypothesis of the Im-Pesaran-Shin test is that the considered variables contain a unit root against the alternative hypothesis of stationarity. The test rejects the null at 1% and 5% significance levels for all series except the liquidity risk spread, and the credit risk. In other words, only these two data series exhibit some non-stationary behaviour as shown in Table 2 (Panel A).

Since the levels of liquidity risk spread and of credit risk are found to be integrated of order 1, we express the two variables in first differences with the purpose to remove the possible trends in their variances. The differences specification guarantees that all panels are stationary as we are able to reject the null hypothesis of Im-Pesaran-Shin's test at 1% significance level for both variables, which implies that the non-stationary process that the two variables follow is a random walk. Consequently, instead of level series we include the differenced data series of liquidity risk spread and credit risk in the return equations (eq. 7, 8, 9 and 10).

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<sup>15</sup> This measure describes the changes in interest rates and/or security prices that are expected to have an impact on bank income and on the market value of bank equity. To be more specific, interest rate risk arises predominantly from mismatches in the durations of assets and liabilities. It, therefore, reveals the interest rate cycle movements which influence the deposit-taking and lending activities of banks.

**Table 2**

Panel unit root test and cointegration test. Panel A reports the values of  $W$ -statistic from the panel unit root test of Im-Pesaran-Shin (2003) and the corresponding  $p$ -values. All data series included in the return equations (eq. 7, 8, 9 and 10) in the *CoVaR* measurement are tested for stationarity. The null hypothesis under study is that of a unit root against the alternative of stationarity. Panel B summarises the results of the Pedroni cointegration test, which examines the null hypothesis of no cointegration between the variables of interest. The Pedroni test relies on four statistics: the panel  $v$ -statistic, the panel PP  $\rho$ -statistic, the panel PP  $t$ -statistic, and the panel DF  $t$ -statistic. These statistics account for common time factors and heterogeneity across the sample banking institutions.

<b>Panel A: Panel Unit root test</b>		
Variables	Im-Pesaran-Shin $W$ -statistic	$p$ -value
<i>Growth rate of total assets</i>	-2.345**	(0.031)
<i>Market return volatility</i>	-3.519**	(0.028)
<i>Liquidity risk spread</i>	-1.810	(0.341)
<i>Yield curve</i>	-3.109***	(0.007)
<i>Interest rate risk</i>	-2.930***	(0.005)
<b>Panel B: Cointegration test</b>		
	Pedroni test statistics	$p$ -value
$v$ -statistic	0.184	(0.150)
$\rho$ -statistic (PP)	-1.593*	(0.094)
$t$ -statistic (PP)	-0.328	(0.139)
$t$ -statistic (DF)	-0.540	(0.111)

\*\*\*, \*\*, \* correspond to 1%, 5%, and 10% level of significance respectively for a two-tailed distribution.

In view of the non-stationary characteristics of the data series of liquidity risk spread and of credit risk and in order to avoid spurious regression problems, we move to a panel cointegration framework. The cointegration test proposed by Pedroni (1999) is utilised here to show whether there exists a long-run relationship between the variables under study. The cointegration technique of Pedroni has been a significant improvement over conventional cointegration techniques applied in a time series framework, as it allows the cointegrating vectors to vary across the members of the panel data set. Examining the null of no cointegration, the Pedroni test is basically a test of unit roots in the estimated residuals of the panel.

The within dimension approach of the Pedroni test relies on four statistics: the panel  $v$ -statistic, the panel Phillips-Peron (1988)  $\rho$ -statistic, the panel Phillips-Peron (1988)  $t$ -statistic, and the panel Dickey-Fuller (1979)  $t$ -statistic. These statistics account for common time factors and heterogeneity across the sample banking institutions. The results, which are summarised in Table 2 (Panel B), cannot reject the null of no cointegration between the examined variables. Hence, no long-run cointegration relationship can be established.

We now continue with the description of the right-hand side variables of our empirical analysis. We use three measures to describe the on-balance-sheet leverage of banks. These

measures refer to the so-called gross balance sheet leverage ratio, which is calculated as the ratio of bank's total assets to the book value of total equity capital (*LEVI*), the inverted Tier 1 leverage ratio (*LEV2*), and the ratio of total liabilities to book equity capital (*LEV3*). The latter two measures are utilised as instruments for *LEVI* in the instrumental variables regression model, which is analytically presented in the following subsection. In that subsection, we also discuss why all the on- and off-balance-sheet leverage measures which are presented in the current paragraphs are introduced in our model in first differences instead of levels.

Several various measures of banks' off-balance-sheet leverage which are complementary to each other are employed in our econometric analysis. More concretely, we capture derivatives leverage by using the on-balance-sheet asset equivalent component of the exposure implied by the off-balance-sheet derivative contracts. This measure is calculated by the ratio of credit equivalent amount of OTC derivatives outstanding to book equity capital (*DERLEVI*) and maps the off-balance-sheet derivatives positions of the sample banks onto their on-balance-sheet equivalents. We instrument *DERLEVI* with the credit exposure across all derivative contracts divided by the bank regulatory capital which is given by the sum of Tier 1 and Tier 2 capital requirements (*DERLEV2*), and with the ratio of trading revenue from derivatives activities to total revenue (*DERLEV3*).<sup>16</sup>

In addition to the derivatives activities of banks, we also measure loan securitisation through conduits and other special vehicles. As earlier discussed, numerous loans and other assets were securitised and sold to other institutions in the years preceding the crisis. The originating banks, however, retained the servicing rights to the bundle of securitised loans. We thus report the ratio of the outstanding principal amount of loans and other assets sold and securitised with servicing retained or with recourse or any other credit backstops provided to total assets (*SECLEVI*) to capture the magnitude of banks' off-balance-sheet leverage due to asset securitisation activity. *SECLEVI* is instrumented with the amount of credit exposure arising from recourse or other seller-provided credit enhancements to SIVs and other conduits divided by total assets (*SECLEV2*).

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<sup>16</sup> A detailed explanation of the derivation and the properties of *DERLEV2* can be found in Breuer (2002).

We further employ two versions of the OBS leverage ratio as proposed by the Bank for International Settlements (BCBS, 2009).<sup>17</sup> The first measure is given by the sum of commitments, direct credit substitutes, acceptances, and repurchase agreements divided by the book equity capital (*OBSLEV1*). The second measure (*OBSLEV2*) is employed as an instrument for *OBSLEV1* and is equal to the ratio of standby letters of credit and guarantees to the regulatory capital. Apparently, securitised assets and derivative contracts which are captured in the measures discussed above are neither considered in *OBSLEV1*, nor in *OBSLEV2*. This reveals the complementary nature of the off-balance-sheet leverage measures we employ in our analysis, which is confirmed by the relevant pairwise tests which are performed further below.

Following Angrist and Krueger (2001), Hausman (2001), and Murray (2006), the instruments we employ in our econometric analysis are all variants on the same theme. To give an example, *DERLEV1* is instrumented with *DERLEV2* and *DERLEV3* as already mentioned. Both these instruments express the activity of the sample banks in derivatives markets but from different perspectives. In particular, *DERLEV2* follows a regulatory approach of the exposure of banks in derivative contracts since its denominator is given by the sum of Tier 1 and Tier 2 capital. *DERLEV3*, on the other hand, reflects the revenue stream which is generated from derivatives trading activity. Hence, the economic relationship that holds between *DERLEV1* and its instruments is straightforward and this is also true for the other endogenous regressors of our model. Of course, economic intuition need not stand naked and alone; intuition must be tested and confirmed. For this reason, we also use a set of alternative instruments for *DERLEV1* which are again variants on the same theme, and we do the same with the rest of the endogenous variables. We add them one by one in our regression model and check the robustness of our results. Parameter estimates are not found to vary a lot, which provides justification to the economic criteria we apply to select our instruments.

In Table 3 that follows, we perform Pearson pairwise correlation tests for the two risk variables as well as for the on- and off-balance-sheet leverage measures and their instruments. The tests are performed for both the pre-crisis and the crisis periods (see Panel A and Panel B, respectively). We observe that the correlations between the same types of leverage are significant at 1% and 5% levels. However, no (or low) statistically significant correlations are reported

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<sup>17</sup> The BIS off-balance-sheet ratio is considerably similar to the one used by the Bank of Canada. The main difference between the two ratios is the values of transaction- and trade-related contingencies which are added in the numerator of the Canadian leverage ratio, but not in that of the BIS ratio.

between the different leverage types like, for example, between *LEVI* and *OBSLEVI*, or between *SECLEV2* and *OBSLEV2*. This verifies that the chosen off-balance-sheet leverage measures are indeed complementary to each other in the sense that do not overlap one another thus covering the broad spectrum of modern banking activities. We, moreover, observe that *CoVaR* is significantly correlated with *TOTRISK* only in the pre-crisis period.

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**Table 3**

Correlation tests. This table contains the Pearson correlations between the two risk variables of the empirical analysis and also between the leverage variables and their instruments. *P*-values are reported below the correlation coefficients. Panel A shows the correlations for the pre-crisis period that starts in 2002q1 and ends in 2007q2. Panel B presents the correlations for the crisis period that extends from 2007q3 to 2012q3.

<b>Panel A</b>	<i>TOTRISK</i>	<i>CoVaR</i>	<i>LEV1</i>	<i>LEV2</i>	<i>LEV3</i>	<i>DERLEV1</i>	<i>DERLEV2</i>	<i>DERLEV3</i>	<i>OBSLEV1</i>	<i>OBSLEV2</i>	<i>SECLEV1</i>	<i>SECLEV2</i>
	1.000											
<i>CoVaR</i>	0.234**	1.000										
	0.006											
<i>LEV1</i>	-0.089	-0.108	1.000									
	0.221	0.310										
<i>LEV2</i>	-0.408	-0.435	0.393**	1.000								
	0.187	0.261	0.040									
<i>LEV3</i>	-0.129	-0.182	0.198**	0.285*	1.000							
	0.341	0.411	0.034	0.056								
<i>DERLEV1</i>	-0.156	-0.090*	0.733	0.649	0.524	1.000						
	0.105	0.081	0.389	0.576	0.289							
<i>DERLEV2</i>	-0.341	-0.222	0.402	0.501	0.506	0.510**	1.000					
	0.129	0.183	0.219	0.253	0.210	0.043						
<i>DERLEV3</i>	-0.480	-0.504	0.537	0.529	0.589	0.672**	0.561**	1.000				
	0.206	0.278	0.333	0.275	0.302	0.005	0.034					
<i>OBSLEV1</i>	0.256	0.308	-0.521	-0.430	-0.481	0.071*	0.098	0.183	1.000			
	0.424	0.494	0.387	0.369	0.286	0.094	0.119	0.124				
<i>OBSLEV2</i>	0.306	0.279	-0.732	-0.556	-0.634	0.274	0.241	0.304*	0.386**	1.000		
	0.556	0.443	0.378	0.471	0.388	0.116	0.132	0.077	0.029			
<i>SECLEV1</i>	-0.023	0.073	-0.392	-0.431	-0.544	0.964	0.781	0.883	0.397*	0.402	1.000	
	0.101	0.135	0.251	0.229	0.340	0.199	0.143	0.194	0.096	0.131		
<i>SECLEV2</i>	-0.036	0.060	-0.430	-0.490	-0.413	0.504	0.463	0.560	0.733	0.670*	0.925***	1.000
	0.211	0.184	0.318	0.292	0.299	0.102	0.154	0.152	0.175	0.088	0.001	

\*\*\*, \*\*, \* correspond to 1%, 5%, and 10% level of significance respectively for a two-tailed distribution.



Panel B	TOTRISK	CoVaR	LEV1	LEV2	LEV3	DERLEV1	DERLEV2	DERLEV3	OBSLEV1	OBSLEV2	SECLEV1	SECLEV2
TOTRISK	1.000											
CoVaR	0.347	1.000										
LEV1	0.124	-0.167	1.000									
LEV2	0.201	0.205	0.515***	1.000								
LEV3	-0.304	-0.330	0.001	0.319**	1.000							
DERLEV1	0.140	0.217	0.411**	0.046	0.430	1.000						
DERLEV2	0.321	0.420	0.677	0.556	0.297	0.544**	1.000					
DERLEV3	-0.111	-0.143	0.280	0.310	0.186	0.017	0.187*	1.000				
OBSLEV1	0.121	0.129	0.212	0.277	0.145	0.433**	0.086	0.167	1.000			
OBSLEV2	-0.142	-0.397	0.197	0.265	0.274	0.033	0.128	0.862***	0.439	1.000		
SECLEV1	0.186	0.272	0.174	0.203	0.402	0.107*	0.101	0.000	0.480	0.480	1.000	
SECLEV2	-0.189	-0.420	0.387	0.349	-0.378	0.089	0.404	0.129	0.139	0.139	0.897***	1.000
	0.202	0.310	-0.484	-0.429	0.211	0.341	0.117	0.788	0.808	0.778*	0.089	0.000
	0.340	0.429	0.303	0.341	-0.432	0.130	0.893	0.231	0.199	0.187	0.199	0.089
	0.388	0.441	-0.681	-0.502	0.299	0.130	0.222	0.521	0.199	0.187	0.199	0.089
	0.322	0.301	0.360	0.410	-0.330	0.876	0.562	0.150	0.199	0.187	0.199	0.089
	0.489	0.510	-0.344	-0.398	0.204	0.214	0.150	0.150	0.199	0.187	0.199	0.089
	-0.039	0.106*	0.308	0.255	-0.438	0.454	0.110	0.110	0.199	0.187	0.199	0.089
	0.120	0.100	-0.483	-0.561	0.221	0.110	0.110	0.110	0.199	0.187	0.199	0.089
	-0.044	0.102	0.345	0.321	0.221	0.110	0.110	0.110	0.199	0.187	0.199	0.089
	0.128	0.231	0.345	0.321	0.221	0.110	0.110	0.110	0.199	0.187	0.199	0.089

\*\*\*, \*\*, \* correspond to 1%, 5%, and 10% level of significance respectively for a two-tailed distribution.

The combination of the recent financial stability literature (see, e.g., Berger et al., 2009; Uhde and Heimeshoff, 2009) and bank risk literature (see, e.g., Gonzalez, 2005) provides us with the basis for the selection of two metrics for possible alterations in the traditional services of banks. The first is banks' asset composition (*ASSETCOMP*) that captures the changes in bank lending activity. This is measured by the ratio of net loans and leases to total assets. The second is a measure for the composition of bank liabilities (*LIABCOMP*), which shows any changes in the traditional funding sources of banks and which is calculated as the ratio of demand deposits to total liabilities.

It is widely accepted that economic performance has a considerable impact on demand and supply of banking services. More precisely, high levels of banking activity are generally related to favourable economic conditions like price stability and economic development. In this context, the macroeconomic environment is largely considered to have an effect on the risk-taking behaviour of banks. We thus employ the quarterly change in the U.S. Consumer Price Index (*INF*) to control for fluctuations in the level of prices, and the GDP output gap (*GDP*) to control for variations in economic growth.

Importantly, we trace the history of each banking firm in our sample to investigate whether a bank has experienced some merger and/or acquisition (M&A) over the entire data period. To achieve this, we resort to the relevant information provided by NIC/FFIEC. We find that the great majority of our sample banks and, more specifically, 18 out of 20 banks have been involved in at least one M&A transaction over the examined period. However, it is important to mention here that none of these banks has been targeted from some other financial institution; to the contrary, all 18 banks have only been acted as acquirers in these M&A deals. This strengthens even further our choice of sample banks on the basis of their systemic importance, which has been analytically discussed earlier in the paper. We control for the possible impact of M&As with the purpose any spurious bursts of systemic risk and individual bank risk due to M&A transactions to be excluded from our sample. We introduce a dummy variable in our model (*MA*), which is equal to unity in the quarter  $q$  that bank  $i$  has been involved in some M&A transaction. For example, if a transaction has occurred on, say, April 15 2008, then this transaction is recorded in the second quarter of 2008, meaning that the binary variable *MA* takes the value of one in 2008q2.

Table 4 reports the summary statistics for all the variables we employ in our analysis for each of the two periods under examination. What mainly comes out from these statistics and is important for our research is the reported upsurge in the off-balance-sheet leverage activities of banks during the pre-crisis period, which is followed by a downward trend in all such kind of activities in the later time period. This supports the argument that banking institutions accumulated a high degree of leverage off their balance sheets during the economic upturn, whilst they moved to reduce their off-balance-sheet holdings by large after the eruption of the crisis in mid-2007. Moreover, total bank risk is found to be on average higher in the years before the outbreak of the crisis compared to the post-2007q2 period. The converse holds true for systemic risk, which shows an upward trend in the crisis era.

**Table 4**

Descriptive statistics. The summary statistics of all the variables employed in our baseline empirical analysis are reported in this table. Panel A shows the statistics for the pre-crisis period which extends from 2002q1 to 2007q2, while Panel B refers to the crisis period that commences in 2007q3 and ends in 2012q3. Variables are distinguished into four main categories: the left-hand side risk variables, the leverage variables, the bank-specific control variables, and those variables that capture the macroeconomic environment. The description of each variable together with the relevant data sources are provided in Appendix A.

<b>Panel A: Pre-crisis period</b>	Mean	Median	Maximum	Minimum	St. Dev.	Obs
<b><i>Risk variables</i></b>						
<i>TOTRISK</i>	2.287	1.212	5.259	0.214	2.221	432
<i>CoVaR</i>	3.112	2.860	7.194	0.713	1.890	429
<b><i>Leverage variables</i></b>						
<i>LEV1</i>	7.879	7.174	12.121	5.732	0.256	436
<i>LEV2</i>	0.121	0.118	0.197	0.069	0.021	435
<i>LEV3</i>	7.123	6.875	10.564	4.784	0.598	436
<i>DERLEV1</i>	10.989	9.112	17.804	3.731	3.098	419
<i>DERLEV2</i>	1.865	1.775	3.122	0.484	2.883	427
<i>DERLEV3</i>	3.167	3.001	5.713	0.965	1.119	426
<i>SECLEV1</i>	7.005	6.603	11.434	1.740	1.794	431
<i>SECLEV2</i>	11.995	10.953	21.805	3.842	1.980	432
<i>OBSLEV1</i>	14.719	13.992	26.141	3.095	2.395	420
<i>OBSLEV2</i>	9.813	9.175	19.530	1.408	3.592	421
<b><i>Traditional banking variables</i></b>						
<i>ASSETCOMP</i>	0.522	0.513	0.798	0.185	0.178	438
<i>LIABCOMP</i>	0.223	0.208	0.421	0.063	0.063	439

<i>MA</i>	0.154	0.143	1.000	0.000	0.211	440
<b>Macroeconomic environment</b>						
<i>INF</i>	0.036	0.034	0.093	-0.035	0.086	439
<i>GDP</i>	0.026	0.023	0.067	-0.019	1.514	439
<hr/>						
<b>Panel B: Crisis period</b>	Mean	Median	Maximum	Minimum	St. Dev.	Obs
<hr/>						
<b>Risk variables</b>						
<i>TOTRISK</i>	1.989	1.897	4.342	0.089	1.341	401
<i>CoVaR</i>	6.959	6.794	10.853	2.805	1.852	392
<b>Leverage variables</b>						
<i>LEV1</i>	6.184	5.953	10.909	3.882	0.954	413
<i>LEV2</i>	0.110	0.107	0.174	0.041	0.017	413
<i>LEV3</i>	6.007	5.843	8.904	3.211	0.765	412
<i>DERLEV1</i>	5.999	5.755	12.004	0.653	4.783	400
<i>DERLEV2</i>	1.126	1.100	2.275	0.087	3.341	397
<i>DERLEV3</i>	1.605	1.509	3.009	0.252	3.006	404
<i>SECLEV1</i>	4.976	4.672	8.843	0.656	2.845	407
<i>SECLEV2</i>	8.784	8.432	14.734	1.956	2.165	408
<i>OBSLEV1</i>	9.643	9.462	19.943	1.134	2.742	389
<i>OBSLEV2</i>	7.683	7.459	15.629	0.747	4.131	392
<b>Traditional banking variables</b>						
<i>ASSETCOMP</i>	0.652	0.643	1.074	0.099	0.349	416
<i>LIABCOMP</i>	0.241	0.231	0.382	0.061	0.089	417
<i>MA</i>	0.127	0.119	1.000	0.000	0.087	420
<b>Macroeconomic environment</b>						
<i>INF</i>	-0.029	-0.032	0.121	-0.274	3.731	418
<i>GDP</i>	-0.034	-0.038	0.282	-0.341	4.174	418

As regards the data sources, all bank accounting variables are obtained from the FR Y-9C forms filed by U.S. Bank Holding Companies with the Federal Reserve. We also collect data from OCC's Quarterly Reports on Bank Derivatives Activities to develop the off-balance-sheet leverage measures employed in our analysis. The market interest rates used in the construction of total bank risk (*TOTRISK*) and of systemic risk (*CoVaR*) are obtained from Thomson Reuters Datastream, GFDatabase, and Moody's. As concerns the short-term interest rates, which are also needed for the production of *CoVaR*, these are taken from the Federal Reserve Board website

and the U.S. Department of the Treasury. To continue, data on M&As are collected from NIC/FFIEC, as previously mentioned. Finally, inflation data are obtained from the Bureau of Labor Statistics of the U.S. Department of Labor, whereas GDP data are taken from the Bureau of Economic Analysis of the U.S. Department of Commerce.

### 3.4. The model

To evaluate the effects of leverage and reverse leverage on individual bank soundness and on systemic risk, we estimate the following model:

$$\begin{aligned}
 Y_{iq} = & \alpha_{iq} + \beta_{1,iq}\Delta LEV_{iq} + \beta_{2,iq}\Delta DERLEV1_{iq} + \beta_{3,iq}\Delta SECLEV1_{iq} + \beta_{4,iq}\Delta OBSLEV1_{iq} \\
 & + \gamma_{1,iq}ASSETCOMP_{iq} + \gamma_{2,iq}LIABCOMP_{iq} + \gamma_{3,iq}MA_{iq} \\
 & + \delta_{1,q}INF_q + \delta_{2,q}GDP_q + \varepsilon_{iq}
 \end{aligned}
 \tag{11}$$

where:  $i=1, 2, \dots, N=20$

$q=2002q1, 2002q2, \dots, Q=2012q3$

In our model,  $Y_{iq}$  stands for either *TOTRISK*, or *CoVaR*;  $\Delta LEV1_{iq}$ ,  $\Delta DERLEV1_{iq}$ ,  $\Delta SECLEV1_{iq}$ ,  $\Delta OBSLEV1_{iq}$  are the average quarterly changes in *LEV1*, *DERLEV1*, *SECLEV1*, and *OBSLEV1*, respectively;  $ASSETCOMP_{iq}$ ,  $LIABCOMP_{iq}$ ,  $MA_{iq}$  are the three bank-specific control variables;  $INF_q$ ,  $GDP_q$  are the two macroeconomic variables;  $\varepsilon_{iq}$  is the regression error term, whereas the vectors  $\alpha$ ,  $\beta$ ,  $\gamma$ , and  $\delta$  contain the parameters of interest to be estimated. The reason why the on- and the off-balance-sheet leverage variables are introduced in the model in first differences rather than in levels is because we wish to capture the effects of increasing (positive) and declining (negative) trends of leverage on bank risk-taking and systemic risk.

It is likely that our model suffers from endogeneity bias as regressors may be endogenously determined along with the dependent variables. At a micro-level, *i.e.* when *TOTRISK* is considered to be the dependent variable of our model, the cause for this is, presumably, the endogenous character of leverage and risk-taking decisions, which are both taken from bank managers. Of course, we recognise that these decisions depend to some extent on the rules imposed on banking firms by regulatory and supervisory authorities. Nonetheless, even under

these constraints that managers face in their banks' profit maximisation problem, it is their own decisions that eventually affect the level of leverage and the degree of risk-taking.

From a macroprudential perspective, systemic risk -captured by *CoVaR*- is viewed as being dependent on the collective leverage behaviour of banks and, as such, is very likely to be endogenous. To be more specific, the leverage decisions of banks have an impact on the quantities transacted (e.g., borrowed and lent), the prices of financial assets, and, subsequently, on the soundness of the economy and the stability of the entire financial system. This, in turn, has powerful feedback effects on the health of banking institutions, which affects their ability to extend credit by leveraging their resources.

Parameter estimates from simple Ordinary Least Squares (OLS) regression might be biased in the case of endogeneity and this can lead to erroneous inference. To tackle the problem of potential endogeneity, we estimate the model by means of two-stage least squares instrumental variables (2SLS IV) regression for each of the two examined periods. Therefore,  $\Delta LEV1$  is instrumented with  $\Delta LEV2$  and  $\Delta LEV3$  in the first-stage OLS regressions. Similarly,  $\Delta DERLEV2$  and  $\Delta DERLEV3$  are used as instruments for  $\Delta DERLEV1$ , whereas  $\Delta SECLEV1$  is instrumented with  $\Delta SECLEV2$ , and  $\Delta OBSLEV1$  with  $\Delta OBSLEV2$ . The second-stage regressions of the 2SLS IV approach are then estimated with the predicted values of  $\Delta LEV1$ ,  $\Delta DERLEV1$ ,  $\Delta SECLEV1$ , and  $\Delta OBSLEV1$ .

To estimate eq. 11 we rely on a set of variables that we observe over time and which have been already described in Section 3.3. Nevertheless, there might exist some unobserved variables which are likely to have an impact on the examined relationship and are not incorporated in our model. Omitted variables in general can be either constant over time, or time-dependent. Regardless of their time dimension, omitted variables are difficult, or sometimes impossible to be measured and be controlled for. If we search to find instrumental variables, or proxies, for the likely omitted variables, a series of rather strong assumptions which are hardly met in practice has to be made. Moreover, it is necessary to know how to correctly model each omitted variable's influence on the dependent variable of the regression equation as well as the relationship that holds between the instruments and the possible omitted variables. Most importantly, it is hard to identify the specific variables which are correlated with the main model variables thus producing flawed estimates and which have been omitted from the model.

We include individual (bank-level) fixed effects in our regression analysis to account for the influence of the time-invariant factors which are correlated with our main variables. Fixed effects can control for these factors as they focus on within-bank variation. Further, a statistical test that unobserved bank heterogeneity does not drive the empirical findings is provided by the use of fixed effects. From this perspective, the choice of the fixed-effects estimator is based on the view that our sample banks are not drawn randomly from the entire population of U.S. banks; rather, as previously discussed, our sample consists of all the major U.S. banking companies, which have a systemically important role in the U.S. economy.

The fixed-effects model is more appropriate when differences across banks deemed to be substantial, time-invariant, and correlated with the explanatory variables. The random-effects model, on the other hand, is appropriate when correlated omitted variables are not an issue to be considered. Given the potential for omitted variables bias and the importance of bank-specific effects in our model setup, we anticipate the fixed-effects approach to be the most appropriate one. Indeed, we can easily reject the use of random effects on the basis of the Hausman (1978) test. At standard levels of statistical significance (*i.e.*, 1% and 5%), we reject the null hypothesis that the differences in coefficients obtained from the two estimation methods are not significant. Accordingly the fixed-effects model is our preferred estimator.<sup>18</sup>

Before moving to discuss the produced outcome of the regression analysis, we use the Maddala and Wu (1999) panel unit root test to examine the stationarity of our data set. The Maddala and Wu test is a Fisher-type test, which combines the  $p$ -values of the test-statistic for a unit root in each sample bank. This test does not necessarily require a balanced panel data set like most of the relevant tests do. We reject the null hypothesis of non-stationarity at the 5% significance level for all the variables of our model.

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<sup>18</sup> From a theoretical viewpoint, Hsiao (1986) argues that, when inferences are made about a population of effects from which those in the data are considered to be a random sample then the effects must be considered as random. As analytically explained in Section 3.1, our data set covers the 20 U.S. systemically important banking institutions and, as such, it cannot be considered as a small sample of a much larger population of systemically important institutions. That is, even from a conceptual viewpoint, the fixed-effects model is more appropriate than its random-effects counterpart.

## 4. Discussion of the empirical results

### 4.1. First-stage results

The results of the first-stage regressions of the 2SLS IV approach for both data periods are summarised in Tables 5a and 5b that follow. We resort to Sargan-Hansen test (or  $J$ -test for overidentifying restrictions) which relies on the studies of Sargan (1958) and Hansen (1982) to examine whether the chosen instrumental variables are correlated with the error term of the model. This is, in fact, the essential condition for an instrumental variable to be valid. The application of the Hansen  $J$ -test provides us with  $p$ -values which range from 0.264 to 0.464. We therefore fail to reject the null hypothesis that overidentifying restrictions are valid thus providing support to the validity of the selected instruments. We also examine the joint statistical significance of our instruments using a heteroskedasticity-robust  $F$ -statistic test. The results of the  $F$ -test confirm the validity of the instrumental variables used in our analysis.

It is important to mention at this point that, in practice, it is not easy to know whether an explanatory variable is endogenous or not. Apparently, if the OLS estimators are consistent, they should be preferred from those obtained with 2SLS IV regression. To deal with this in our baseline model (eq.11), we test the null hypothesis of no endogeneity against its alternative using the Hausman's (1978) test:

$$H_0: Cov(X_2, \varepsilon) = 0$$

$$H_1: Cov(X_2, \varepsilon) \neq 0$$

In essence, what the Hausman test does is to evaluate the significance of two estimators obtained with different econometric techniques: one with OLS, and the other with 2SLS IV. If a statistical difference is documented between the two estimators, then our concern of endogeneity is substantiated. The Hausman test we run examines the null hypothesis of no statistically significant difference between the OLS and 2SLS IV estimates. Table 5a and Table 5b show that the calculated Hausman  $p$ -values are all lower than the selected level of statistical significance ( $\alpha = 0.05$  or 5%). This is to say, our concern of endogeneity is substantiated and this provides support to the use of 2SLS IV instead of OLS.



**Table 5a**

First-stage regression results. This table presents the first-stage results obtained by the 2SLS IV fixed-effects regression model with total bank risk (*TOTRISK*) as the dependent variable of the second stage. Panel A reports the results for the pre-crisis period (2002q1-2007q2) and Panel B the results for the crisis period (2007q3-2012q3). The average quarterly change in on-balance-sheet leverage ( $\Delta LEVI$ ) is instrumented with  $\Delta LEV2$  and  $\Delta LEV3$ , the average quarterly change in derivatives leverage ( $\Delta DERLEVI$ ) is instrumented with  $\Delta DERLEV2$  and  $\Delta DERLEV3$ , the average quarterly change in leverage from securitisation ( $\Delta SECLEVI$ ) is instrumented with  $\Delta OBSLEV2$ , and the average quarterly change in off-balance-sheet leverage ratio ( $\Delta OBSLEVI$ ) with  $\Delta OBSLEV2$ . The exogenous control variables which are also included in the second-stage regressions are: asset composition of banks' balance sheets (*ASSETCOMP*), banks' liabilities composition (*LIABCOMP*), a dummy variable which accounts for M&A transactions (*MA*), the rate of inflation (*INF*), and the level of economic growth (*GDP*). A detailed description of each variable can be found in Appendix A. A constant term is included in the regression model, but is not reported in the table. The Hansen-J test of overidentifying restrictions tests the null hypothesis that the excluded instruments are uncorrelated with the error term of the model and are correctly excluded from the regression in the second stage. The *F*-test of instrumental variables reports the joint significance of identifying instruments. The Hausman test examines whether 2SLS and OLS coefficients are statistically different. Heteroskedasticity-robust *t*-statistics are reported in parentheses.

	Panel A: Pre-crisis period				Panel B: Crisis period			
	$\Delta LEVI$	$\Delta DERLEVI$	$\Delta SECLEVI$	$\Delta OBSLEVI$	$\Delta LEVI$	$\Delta DERLEVI$	$\Delta SECLEVI$	$\Delta OBSLEVI$
$\Delta LEVI$		0.165* (1.71)	0.061* (1.68)	-0.154 (-1.19)		0.293** (1.88)	0.054 (1.39)	-0.184 (-0.97)
$\Delta LEV2$	0.088*** (2.99)	0.196** (1.89)	0.043 (1.58)	-0.131 (-1.01)	0.123*** (2.56)	0.223* (1.74)	0.047 (1.33)	-0.161 (-0.85)
$\Delta LEV3$	0.096*** (3.90)	0.213* (1.69)	0.069* (1.68)	-0.188 (-0.85)	0.134*** (3.59)	0.250* (1.67)	0.082 (1.56)	-0.228 (-0.76)
$\Delta DERLEVI$	0.218* (1.67)		0.260 (1.45)	0.275* (1.68)	0.187 (1.59)		0.295** (1.75)	0.243** (1.90)
$\Delta DERLEV2$	0.199 (1.43)	0.175** (1.87)	0.231* (1.66)	0.302** (1.92)	0.232 (1.54)	0.222** (1.83)	0.244** (1.82)	0.329** (1.87)
$\Delta DERLEV3$	0.256* (1.69)	0.254** (1.91)	0.288** (1.89)	0.267** (1.86)	0.203* (1.66)	0.294** (1.78)	0.304** (1.87)	0.351* (1.64)
$\Delta SECLEVI$	0.101 (1.22)	0.065** (1.76)		0.069* (1.61)	0.096 (0.93)	0.098* (1.65)		0.102* (1.63)
$\Delta SECLEV2$	0.089 (1.18)	0.053 (1.59)	0.088** (1.87)	0.080* (1.64)	0.089 (1.04)	0.112* (1.69)	0.131** (1.86)	0.110* (1.62)
$\Delta OBSLEVI$	-0.148 (-0.79)	0.158* (1.72)	0.160 (1.32)		-0.172 (1.11)	0.131 (1.59)	0.141 (1.28)	

<i>AOBSLEV2</i>	-0.132 (-0.80)	0.166* (1.70)	0.201 (1.44)	0.276*** (2.98)	-0.164 (-1.02)	0.112* (1.64)	0.189 (1.52)	0.303*** (3.64)
<i>ASSETCOMP</i>	0.261*** (2.65)	0.119 (0.88)	0.126** (1.79)	0.093 (0.94)	0.209** (1.91)	0.087 (1.41)	0.155* (1.64)	0.099 (1.24)
<i>LIABCOMP</i>	0.052 (0.83)	0.214 (1.00)	0.022 (0.99)	0.015 (1.15)	0.078 (1.27)	0.195 (0.94)	0.031 (1.02)	0.102* (1.60)
<i>MA</i>	0.009* (1.67)	0.015* (1.69)	0.021 (1.51)	0.009 (1.32)	0.016** (1.74)	0.028** (1.85)	0.018 (1.43)	0.017* (1.61)
<i>INF</i>	0.017*** (3.61)	0.029** (1.91)	0.009 (1.59)	0.023** (1.72)	0.039** (1.87)	0.051** (1.82)	0.024* (1.68)	0.084** (1.87)
<i>GDP</i>	0.032** (1.88)	0.053** (1.83)	0.041* (1.69)	0.057** (1.95)	0.086** (1.83)	0.54* (1.68)	0.063** (1.85)	0.097*** (2.13)
Observations	419	419	419	419	389	389	389	389
<i>R</i> <sup>2</sup>	0.182	0.214	0.192	0.177	0.224	0.232	0.281	0.209
<i>F</i> -statistic	14.89	16.42	15.01	13.41	17.62	19.06	18.76	16.31
<i>p</i> -value	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Hansen <i>J</i> -statistic	3.47	3.81			5.63	4.32		
<i>p</i> -value	0.324	0.351			0.464	0.398		
Hausman <i>p</i> -value	0.04	0.04	0.04	0.03	0.04	0.02	0.03	0.03

\*\*\*, \*\*, \* correspond to 1%, 5%, and 10% level of significance respectively for a two-tailed distribution.

**Table 5b**

First-stage regression results. This table presents the first-stage results obtained by the 2SLS IV fixed-effects regression model with systemic risk ( $CoVaR$ ) as the dependent variable of the second stage. Panel A reports the results for the pre-crisis period (2002q1-2007q2) and Panel B the results for the crisis period (2007q3-2012q3). The average quarterly change in on-balance-sheet leverage ( $\Delta LEVI$ ) is instrumented with  $\Delta LEV2$  and  $\Delta LEV3$ , the average quarterly change in derivatives leverage ( $\Delta DERLEVI$ ) is instrumented with  $\Delta DERLEV2$  and  $\Delta DERLEV3$ , the average quarterly change in leverage from securitisation ( $\Delta SECLEVI$ ) is instrumented with  $\Delta SECLEV2$ , and the average quarterly change in off-balance-sheet leverage ratio ( $\Delta OBSLEVI$ ) with  $\Delta OBSLEV2$ . The exogenous control variables which are also included in the second-stage regressions are: asset composition of banks' balance sheets ( $ASSETCOMP$ ), banks' liabilities composition ( $LIABCOMP$ ), a dummy variable which accounts for M&A transactions ( $MA$ ), the rate of inflation ( $INF$ ), and the level of economic growth ( $GDP$ ). A detailed description of each variable can be found in Appendix A. A constant term is included in the regression model, but is not reported in the table. The Hansen-J test of overidentifying restrictions tests the null hypothesis that the excluded instruments are uncorrelated with the error term of the model and are correctly excluded from the regression in the second stage. The  $F$ -test of instrumental variables reports the joint significance of identifying instruments. The Hausman test examines whether 2SLS and OLS coefficients are statistically different. Heteroskedasticity-robust  $t$ -statistics are reported in parentheses.

	Panel A: Pre-crisis period					Panel B: Crisis period				
	$\Delta LEVI$	$\Delta DERLEVI$	$\Delta SECLEVI$	$\Delta OBSLEVI$	$\Delta LEVI$	$\Delta DERLEVI$	$\Delta SECLEVI$	$\Delta OBSLEVI$	$\Delta LEVI$	$\Delta OBSLEVI$
$\Delta LEVI$		0.159** (1.82)	0.064* (1.65)	-0.149 (-1.14)		0.286** (1.91)	0.049 (1.35)	-0.179 (-1.04)		
$\Delta LEV2$	0.083*** (2.42)	0.191** (1.84)	0.041 (1.53)	-0.130 (-0.96)	0.101*** (2.33)	0.210* (1.76)	0.040 (1.25)	-0.159 (-0.90)		
$\Delta LEV3$	0.139*** (3.45)	0.206* (1.66)	0.074* (1.69)	-0.192 (-0.89)	0.150*** (4.00)	0.257** (1.73)	0.079 (1.50)	-0.237 (-0.86)		
$\Delta DERLEVI$	0.211** (1.79)		0.251 (1.52)	0.267* (1.66)	0.196 (1.51)		0.284* (1.66)	0.263*** (1.99)		
$\Delta DERLEV2$	0.204 (1.51)	0.202*** (1.99)	0.239** (1.79)	0.289*** (1.96)	0.224 (1.49)	0.198*** (2.11)	0.240** (1.79)	0.336** (1.91)		
$\Delta DERLEV3$	0.249* (1.65)	0.221** (1.85)	0.301*** (2.01)	0.257** (1.88)	0.212 (1.46)	0.255** (1.83)	0.311** (1.81)	0.362** (1.73)		
$\Delta SECLEVI$	0.092 (1.14)	0.061* (1.64)		0.072 (1.57)	0.105 (1.00)	0.103* (1.66)		0.096* (1.64)		
$\Delta SECLEV2$	0.081 (1.26)	0.050* (1.66)	0.082*** (2.04)	0.084* (1.65)	0.096 (0.92)	0.110* (1.67)	0.140*** (1.96)	0.121* (1.68)		
$\Delta OBSLEVI$	-0.159 (-0.90)	0.143 (1.58)	0.164 (1.26)		-0.160 (-1.03)	0.124 (1.55)	0.157 (1.14)			

<i>AOBSLEV2</i>	-0.139 (-0.87)	0.172* (1.69)	0.194 (1.48)	0.240*** (2.93)	-0.160 (-0.88)	0.103* (1.65)	0.202 (1.50)	0.287*** (3.45)
<i>ASSETCOMP</i>	0.250*** (2.44)	0.108 (0.94)	0.120** (1.83)	0.100 (0.91)	0.194* (1.68)	0.094 (1.32)	0.167* (1.63)	0.104 (1.21)
<i>LIABCOMP</i>	0.044 (0.78)	0.210 (0.96)	0.019 (1.06)	0.013 (1.21)	0.085 (1.21)	0.204 (1.03)	0.030 (0.96)	0.113* (1.63)
<i>MA</i>	0.010** (1.76)	0.013** (1.75)	0.022 (1.54)	0.011 (1.39)	0.014* (1.65)	0.024** (1.86)	0.015 (1.38)	0.019* (1.65)
<i>INF</i>	0.019*** (3.46)	0.027*** (1.98)	0.010* (1.65)	0.026** (1.76)	0.042** (1.80)	0.056** (1.89)	0.022* (1.66)	0.090** (1.90)
<i>GDP</i>	0.030*** (1.96)	0.047* (1.68)	0.044* (1.67)	0.059*** (1.97)	0.079* (1.66)	0.59** (1.73)	0.057** (1.81)	0.102*** (2.03)
Observations	406	406	406	406	375	375	375	375
<i>R</i> <sup>2</sup>	0.171	0.207	0.188	0.168	0.153	0.212	0.209	0.208
<i>F</i> -statistic	12.45	15.80	14.89	12.97	10.20	16.86	16.12	15.88
<i>p</i> -value	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Hansen <i>J</i> -statistic	3.02	3.76			2.83	4.01		
<i>p</i> -value	0.292	0.343			0.264	0.363		
Hausman <i>p</i> -value	0.04	0.03	0.04	0.03	0.04	0.03	0.03	0.03

\*\*\*, \*\*, \* correspond to 1%, 5%, and 10% level of significance respectively for a two-tailed distribution.

#### 4.2. Second-stage results

The estimation results of the second-stage regressions are presented in Tables 6a and 6b below. The former table shows the estimation output using *TOTRISK* as the dependent variable of the model; the latter relies on systemic risk (*CoVaR*) regressions. The left column in each table reports the empirical results for the time period preceding the emergence of the crisis, while the right column contains the results for the crisis period.

**Table 6a**

Second-stage regression results. This table presents the second-stage results obtained by 2SLS IV fixed-effects regression analysis for the pre-crisis period (2002q1-2007q2) and for the crisis period (2007q3-2012q3). The dependent variable is total bank risk (*TOTRISK*). The main explanatory variables are the average quarterly changes in: on-balance-sheet leverage ( $\Delta LEVI$ ), derivatives leverage ( $\Delta DERLEVI$ ), leverage from securitisation ( $\Delta SECLEVI$ ), and off-balance-sheet leverage ratio ( $\Delta OBSLEVI$ ). All explanatory variables are instrumented in the first stage; the instrumental variables are:  $\Delta LEV2$ ,  $\Delta LEV3$ ,  $\Delta DERLEV2$ ,  $\Delta DERLEV3$ ,  $\Delta SECLEV2$ , and  $\Delta OBSLEV2$ . The set of bank-specific control variables used in our analysis includes the asset composition of banks' balance sheets (*ASSETCOMP*), banks' liabilities composition (*LIABCOMP*), and a dummy variable which accounts for M&A transactions (*MA*). Two macroeconomic control variables are also used: the level of inflation (*INF*) and the level of economic growth (*GDP*). A detailed description of each variable can be found in Appendix A. A constant term is included in the regression model, but is not reported in the table. Heteroskedasticity-robust *t*-statistics are reported in parentheses.

	<i>TOTRISK</i>	
	Pre-crisis period	Crisis period
$\Delta LEVI$	0.089*** (5.07)	-0.009*** (-2.34)
$\Delta DERLEVI$	1.041*** (4.75)	-0.784** (-1.77)
$\Delta SECLEVI$	1.119** (1.87)	-1.005*** (-4.21)
$\Delta OBSLEVI$	0.834*** (2.52)	-0.193*** (-1.99)
<i>ASSETCOMP</i>	-4.767*** (-2.44)	-3.163** (-1.80)
<i>LIABCOMP</i>	-1.702** (-1.79)	-0.932** (-1.73)
<i>MA</i>	0.012 (1.21)	0.016 (0.98)
<i>INF</i>	-0.099** (-1.76)	-0.052*** (-2.07)
<i>GDP</i>	-1.165**	-0.865*

	(-1.86)	(-1.61)
Observations	419	389
$R^2$	0.163	0.179
$F$ -statistic	11.54	10.88
$p$ -value	0.00	0.00

\*\*\*, \*\*, \* correspond to 1%, 5%, and 10% level of significance respectively for a two-tailed distribution.

**Table 6b**

Second-stage regression results. This table presents the second-stage results obtained by 2SLS IV fixed-effects regression analysis for the pre-crisis period (2002q1-2007q2) and for the crisis period (2007q3-2012q3). The dependent variable is systemic risk (*CoVaR*). The main explanatory variables are the average quarterly changes in: on-balance-sheet leverage ( $\Delta LEV1$ ), derivatives leverage ( $\Delta DERLEV1$ ), leverage from securitisation ( $\Delta SECLEV1$ ), and off-balance-sheet leverage ratio ( $\Delta OBSLEV1$ ). All explanatory variables are instrumented in the first stage; the instrumental variables are:  $\Delta LEV2$ ,  $\Delta LEV3$ ,  $\Delta DERLEV2$ ,  $\Delta DERLEV3$ ,  $\Delta SECLEV2$ , and  $\Delta OBSLEV2$ . The set of bank-specific control variables used in our analysis includes the asset composition of banks' balance sheets (*ASSETCOMP*), banks' liabilities composition (*LIABCOMP*), and a dummy variable which accounts for M&A transactions (*MA*). Two macroeconomic control variables are also used: the level of inflation (*INF*) and the level of economic growth (*GDP*). A detailed description of each variable can be found in Appendix A. A constant term is included in the regression model, but is not reported in the table. Heteroskedasticity-robust  $t$ -statistics are reported in parentheses.

	<i>CoVaR</i>	
	Pre-crisis period	Crisis period
$\Delta LEV1$	0.165*** (2.31)	0.197** (1.69)
$\Delta DERLEV1$	0.078*** (4.31)	0.286*** (4.24)
$\Delta SECLEV1$	0.552*** (1.99)	0.669** (1.75)
$\Delta OBSLEV1$	0.834** (1.87)	1.275*** (2.03)
<i>ASSETCOMP</i>	1.304 (1.29)	0.899 (1.41)
<i>LIABCOMP</i>	0.868 (0.99)	1.103 (0.90)
<i>MA</i>	0.028 (1.32)	0.033 (1.14)
<i>INF</i>	-1.106***	-1.539***

	(-2.46)	(-1.97)
<i>GDP</i>	-1.883**	-2.376*
	(-1.89)	(-1.76)
Observations	406	375
$R^2$	0.144	0.129
<i>F</i> -statistic	14.12	12.76
<i>p</i> -value	0.00	0.00

\*\*\*, \*\*, \* correspond to 1%, 5%, and 10% level of significance respectively for a two-tailed distribution.

#### 4.2.1. The pre-crisis period

A positive and statistically significant impact of  $\Delta LEVI$  on both  $TOTRISK$  and  $CoVaR$  is reported. This implies that, before the outbreak of the crisis, the on-balance-sheet leverage exerted an increasing effect not only on the degree of total bank risk, but, most importantly, on the risk exposure of the entire banking system. Along the same lines, the risk profile of individual banks was deteriorated and the level of systemic risk was raised as a result of the expansion of the off-balance-sheet business of banking institutions. These are revealed by the significantly positive relationship we document between  $\Delta DERLEVI$ ,  $\Delta SECLEVI$  and  $\Delta OBSLEVI$  with  $TOTRISK$  and  $CoVaR$ . In fact, by comparing the coefficient values on  $\Delta DERLEVI$ ,  $\Delta SECLEVI$  and  $\Delta OBSLEVI$  with that on  $\Delta LEVI$ , we can argue that off-balance-sheet leverage played a relatively more harmful role for both the health of individual banks and for the stability of the entire system. To sum up, in the years before the onset of the crisis, the growth in bank leverage through derivatives in association with the increase in securitisation activity, and the expansion of other off-balance-sheet undertakings seriously hurt the health of individual banks and, at the same time, produced substantial instability to the system.

Consistently, over the past decade or more, banks responded to the increased demand for credit instruments with higher yield by developing financial engineering techniques and creating modern types of products.<sup>19</sup> Although these developments may have come about as a result of the wider financial advances aimed at increasing the profitability of banks, strengthening their risk profile, and improving the efficiency of the system, they also provided opportunities for

<sup>19</sup> The banking literature provides ample empirical evidence on the upsurge in the volume of modern activities of U.S. banking institutions before the crisis (see, e.g., Rogers and Sinkey, 1999; Stiroh, 2004).

growing off-balance-sheet leverage and for shifting risks amongst market participants in highly complicated ways. Consequently, according to our findings, most of the (then) new financial instruments were indeed opaque and masked the extent of leverage and interconnectedness of risk, which appeared to be spilled-over across a wide range of institutions and markets worldwide.

#### 4.2.2. *The crisis period*

Let us now turn to analyse the regression output for the crisis period. During that period, the off-balance-sheet holdings of banks were largely reduced as earlier shown in the relevant summary statistics. When asset prices and liquidity started falling in mid-to-late 2007, the collateral values of assets held by financial institutions deteriorated. This made it difficult for banking institutions to raise funds and, hence, the majority of banks were forced to decrease leverage. The shrink of leverage (deleveraging), though probably led to further asset price reductions, occurred mainly off the balance sheet of banks improving their risk profile by lowering their overall risk-taking, as revealed by the significantly negative link between  $\Delta DERLEVI$ ,  $\Delta SECLEVI$  and  $\Delta OBSLEVI$  with  $TOTRISK$ . For example, by focusing on the impact of  $\Delta SECLEVI$  on  $TOTRISK$ , we can argue that the low-quality subprime loans offered by U.S. banks to their conduits and other relevant financial vehicles before the onset of the crisis put an upward pressure on their overall risk-taking. The collapse of those financial organisations when the crisis erupted led to the decrease in the off-balance-sheet leverage of banks and, hence, to the reduction of the stand-alone bank risk.

Equally strong in terms of statistical significance, but not that strong in terms of the estimated coefficient value if compared to the corresponding coefficient values of the off-balance-sheet leverage variables, is the effect of the traditional leverage of banks (as captured by  $\Delta LEVI$ ) on  $TOTRISK$ . On the whole, we can maintain that both the on- and off-balance-sheet deleveraging process which commenced immediately after the outbreak of the crisis has strengthened the soundness of banking institutions on an individual basis. To the contrary, a serious threat to systemic stability was formed after the beginning of the crisis by the large number of bad assets that SIFIs used to hold (and still do, though to a decreased extent) in their portfolios as a result of the above-described deleveraging process. This is reflected in the positive link we report between the on- and off-balance-sheet leverage measures and  $CoVaR$ .



#### 4.2.3. Across the two periods

Both *ASSETCOMP* and *LIABCOMP* are found to have a significantly negative effect on *TOTRISK* across the two data periods under study. By contrast, the impact of these two variables on *CoVaR* is not statistically significant in any of the two periods. We can therefore postulate that the banks which concentrate on traditional bank lending activities contribute less to the overall individual bank risk, even though the business mix of traditional banking services is not statistically related to the stability of the whole banking system.

We can make an effort to combine the above-described positive impact of traditional banking products on total risk with the negative effect of off-balance-sheet business on risk as reported in the pre-crisis period. Evidently, the relationship that holds between the diversification of bank output through the production and release of modern financial items with risk can be either negative or positive. In the former case, there are at least two channels through which product diversification leads to a reduction in the overall bank risk-taking. The first, which is largely related to the conventional wisdom among banking scholars (see, e.g., Papanikolaou, 2009) and practitioners, shows that non-interest (fee) income, which is produced by innovative financial assets, is less sensitive to changes in the economic and business environment than interest income, which is produced by traditional assets like bank loans. This is to say that banks which rely more on the former type of income are typically exposed to less risk as they manage to reduce the cyclical variations in profits and revenues. Turning to the second channel, in case there is a negative or a weak correlation between the above two sorts of income, then -according to the traditional banking and portfolio theories (see, e.g., Diamond, 1984)- any observed increase in the share of fee-generating business in the overall portfolio of banking items reduces the volatility of total earnings via diversification effects. As a consequence, risk is again reduced.

Nevertheless, every coin has two sides: in line with our empirical findings for the pre-crisis period, DeYoung and Roland (2001) argue that non-interest income is less stable compared to its interest counterpart, implying that non-traditional products and services increase bank riskiness, while the converse holds true for the traditional banking operations. This happens mainly due to the following three reasons: the nature of bank-customer relationships, the particular input mixes, and the lower capital requirements for fee-generating activities.

To start with the first reason, traditional activities like loan issuance generate relatively stable relationships between the banks and their customers in that the switching and information costs

for both lenders and borrowers are high and, hence, it is not in the interest of either side to walk away from this sort of stable relationships. To the contrary, the aforementioned costs are lower in the case of modern financial products and this renders the demand for the latter lines of business far from solid and continuous. Accordingly, where interest income appears to be rather stable, non-interest income is highly likely to fluctuate over time.

Second, a banking institution can extend a lending relationship only with a burden on its variable cost (*i.e.*, interest expenses). However, if the bank takes the decision to increase the volume of non-traditional services offered to its customers, it will have to hire additional fixed labour inputs and this will inevitably lead to an increase in its operating leverage. A higher operating leverage, in turn, is expected to amplify revenue volatility into higher profit volatility. That is, the involvement in modern banking activities that produce off-balance-sheet leverage is again related to a higher degree of risk.

Finally, the banking regulatory environment, as described in Basel I and II, allowed banks to hold just a small amount of capital against fee-based activities in comparison with the amount they were required to hold for traditional items and which was significantly higher than the former one. These differences in capital adequacy requirements suggest an enhanced degree of financial leverage, which is related to higher earnings volatility for non-traditional banking business.

An additional finding that remains unchanged across the two periods under scrutiny is that *GDP* and *INF* are significantly negatively related with both *TOTRISK* and *CoVaR*. This suggests that economic growth which, as expected, is accompanied by a higher price level, boosts banking soundness and contributes to the establishment of safer financial systems regardless of the state of the economy (upturns *vs.* downturns). In this context, the macroeconomic environment is largely considered to have an impact on the risk-taking behaviour of banks as well as on the stability of the entire financial system. Lastly, we find that M&As do not significantly affect *TOTRISK* and *CoVaR* regardless of the time period under consideration.

## 5. Robustness analysis

To test the robustness of our results, we replace *TOTRISK* and *CoVaR* with two alternative metrics of individual bank soundness and of systemic risk. These are the *ZSCORE* and the Marginal Expected Shortfall (*MES*), respectively.

*ZSCORE* is a measure of bank insolvency risk and is calculated as follows:

Let failure occurs when the total equity capital (*TE*) of a bank is smaller than its losses where  $-\pi$  stands for negative profits:

$$TE < -\pi \quad (12)$$

Then, the bank's probability of failure can be written in the following way:

$$p(TE < -\pi) = p(\pi < -TE) = p\left(\frac{\pi}{TA} < -\frac{TE}{TA}\right) = p(ROA < -\frac{TE}{TA}) \quad (13)$$

where  $p(\cdot)$  is a probability and  $ROA(Returns\ On\ Assets) = \pi/TA$ , with  $\pi$  is measured with bank's Net Income After Taxes and  $TA$  stands for Total Assets. Suppose that  $r = ROA$  and  $\lambda = -\left(\frac{TE}{TA}\right)$ , where  $r$  and  $\lambda$  are two random variables. We can then write that:

$$p(r < \lambda) = \int_{-\infty}^{\lambda} \psi(r) dr \quad (14)$$

where  $\psi(r)$  is a density function. If  $r$  is assumed to follow a normal distribution, we can rewrite the likelihood of bankruptcy in terms of the standard normal density  $\Psi(\cdot)$  as follows:

$$p(r < \lambda) = \int_{-\infty}^z \Psi(\zeta) d\zeta \quad (15)$$

where  $\zeta = \frac{r-\rho}{\sigma}$  and  $z = \frac{\lambda-\rho}{\sigma}$  with  $\rho$  being the true mean and  $\sigma$  the standard deviation of  $r$ .<sup>20</sup> *ZSCORE* is the sample estimate of  $-z$  (since  $z < 0$ ) and is defined in the following way for each sample bank and for each sample quarter:

$$Z_{iq} = \frac{ROA_{iq} + (TE_{iq} / TA_{iq})}{\sigma(ROA_{iq})}, \quad i = 1, 2, \dots, N=20; \quad q=2002q1, 2002q2, \dots, Q=2012q3 \quad (16)$$

<sup>20</sup> Normality is a rather strong assumption for the distribution of  $r$ . Nevertheless, because of Chebyshev's inequality, we know that regardless of the distribution of  $r$ , the upper bound to the bankruptcy probability is:

$$p(r \leq \lambda) \leq \left(\frac{\sigma}{\rho - \lambda}\right)^2 = \frac{1}{z^2}$$

where  $ROA_{it}$  stands for the Return On Assets of bank  $i$  calculated by the ratio of net income to total assets ( $TA_{iq}$ );  $(TE_{iq} / TA_{iq})$  is the ratio of total equity to total assets; and  $\sigma(ROA_{iq})$  is the period standard deviation of  $ROA$  which captures the volatility of bank returns. Hence,  $ZSCORE$  combines profitability, capital risk, and return volatility in a single measure. Evidently, it is increasing in banks' average profitability and capital strength and decreasing in return variability. Overall, larger values of  $ZSCORE$  imply lower probability of default and, hence, greater bank soundness. Since  $ZSCORE$  is highly skewed, we follow the recent literature (see, e.g., Laeven and Levine, 2009; Schaeck et al., 2012) and use its log transformation in our analysis.

The alternative measure of systemic risk which we construct is  $MES$  as proposed by Acharya et al. (2012).  $MES$  measures how bank  $i$ 's risk exposure adds to the system's overall risk and, as such, it can be viewed as a straightforward alternative of  $CoVaR$ . It is based upon the established in the banking literature measure of Expected Shortfall ( $ES$ ).  $ES$  is defined as the expected loss of a financial institution conditional on the loss being larger than  $VaR$ :

$$ES_{\alpha} = -E(R \mid R \leq -VaR_{\alpha}) \quad (17)$$

where  $VaR$  is the maximum value loss with confidence  $1-\alpha$ , that is,  $Pr(R < -VaR_{\alpha}) = \alpha$ . If we decompose banking sector's return  $R$  into the sum of each sample bank  $i$ 's returns  $R_i$ , we get that  $R = \sum_i y_i R_i$  where  $y_i$  is the weight (in terms of size) given to bank  $i$ .<sup>21</sup> We use the formula of  $ES$  (see above) to get that:

$$ES_{\alpha} = -\sum_i y_i E(R_i \mid R \leq -VaR_{\alpha}) \quad (18)$$

By calculating the first order conditions with respect to the weight  $y_i$ , we obtain the sensitivity of the risk of the entire system to the risk exposure of bank  $i$ :

$$\frac{\partial ES_{\alpha}}{\partial y_i} = -E(R_i \mid R \leq -VaR_{\alpha}) \equiv MES_{\alpha}^i \quad (19)$$

<sup>21</sup> The notation followed here is the same with that used in the construction of  $CoVaR$ .

We estimate *MES* at a risk level of  $\alpha = 0.05$  or 5% using daily data of Credit Default Swaps (CDS) returns from Bloomberg. Specifically, we first pick up the 5% worst days for an equally-weighted portfolio of CDS returns on the banks of our sample in every quarter, and then compute the CDS return for any given sample bank for these particular days.

In our robustness checks, apart from replacing *TOTRISK* and *CoVaR* with *ZSCORE* and *MES* respectively, all bank leverage variables are instrumented with their past realisations under the thought that the latter are given before the current leverage values are realised. Lagged values of bank leverage are not expected to be systematically correlated with changes in the current levels of leverage, especially when these changes are due to some unforeseen event like the global financial crisis.<sup>22</sup> Admittedly, selecting the number of lagged differences to be smaller than the correct ones may distort the size of the tests, while selecting orders which are larger is likely to result in a significant loss of power. We thus consider all possible lag orders as these selected by two of the most popular model selection criteria, namely the Akaike Information Criterion and the Schwarz-Bayesian Information Criterion. We instrument leverage variables with their second- and third-period lags since their first-order lags are not selected by the aforementioned criteria as valid instruments. The use of longer lags is based on the supposition that they can provide better instruments as they can potentially reduce the possible correlation between the instruments and the disturbances in the error term of the original regression.

In addition, we incorporate time (quarterly) dummies in our model to allow for common factors that may have an influence on individual bank risk and on systemic risk over time. By doing so, we can capture the unobserved as well as the non-measurable time-varying characteristics of the likely omitted variables, and also those of the other variables included in our model. Before estimating the model, Maddala and Wu (1999) unit root tests are carried out to ensure the stationarity of our panel data sets. All data series are found to be stationary.

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<sup>22</sup> A number of studies in the banking literature use lagged values of the endogenous variables in their instrumental variable analysis. Two of the most recent studies which follow this approach are those of Elsas et al. (2010) and Cornett et al. (2011).

**Table 7a**

Robustness tests. This table presents the second-stage results obtained by 2SLS IV fixed-effects regression analysis for the pre-crisis period (2002q1-2007q2) and for the crisis period (2007q3-2012q3). The dependent variable is bank insolvency risk (*ZSCORE*). The main explanatory variables are the average quarterly changes in: on-balance-sheet leverage (*ΔLEVI*), derivatives leverage (*ΔDERLEVI*), leverage from securitisation (*ΔSECLEVI*), and off-balance-sheet leverage ratio (*ΔOBSLEVI*). All explanatory variables are instrumented in the first stage. The instrumental variables are given by the two- and three-period lags of *ΔLEVI*, *ΔDERLEVI*, *ΔSECLEVI*, and *ΔOBSLEVI* according to the Akaike Information Criterion and the Schwarz-Bayesian Information Criterion. The set of bank-specific control variables employed in our analysis includes the asset composition of banks' balance sheets (*ASSETCOMP*), banks' liabilities composition (*LIABCOMP*), and a dummy variable which accounts for M&A transactions (*MA*). Two macroeconomic control variables are also used: the level of inflation (*INF*) and the level of economic growth (*GDP*). A detailed description of each variable can be found in Appendix A. A constant term with time (quarterly) dummies is included in the regression models, but is not reported in the table. Heteroskedasticity-robust *t*-statistics are reported in parentheses.

	<i>ZSCORE</i>	
	Pre-crisis period	Crisis period
<i>ΔLEVI</i>	-0.164*** (-3.21)	0.032** (1.79)
<i>ΔDERLEVI</i>	-0.332*** (-4.78)	0.050** (1.86)
<i>ΔSECLEVI</i>	-0.847*** (-2.90)	0.208*** (3.44)
<i>ΔOBSLEVI</i>	-0.834** (-1.85)	0.372*** (2.13)
<i>ASSETCOMP</i>	4.402** (1.88)	4.175** (1.78)
<i>LIABCOMP</i>	2.004*** (3.21)	2.389*** (3.98)
<i>MA</i>	0.002 (0.79)	0.008 (0.90)
<i>INF</i>	0.904* (1.62)	0.673** (1.87)
<i>GDP</i>	0.976** (1.86)	1.153* (1.58)
Observations	413	382
<i>R</i> <sup>2</sup>	0.148	0.129
<i>F</i> -statistic	11.04	12.88
<i>p</i> -value	0.00	0.00

\*\*\*, \*\*, \* correspond to 1%, 5%, and 10% level of significance respectively for a two-tailed distribution.

**Table 7b**

Robustness tests. This table presents the second-stage results obtained by 2SLS IV fixed-effects regression analysis for the pre-crisis period (2002q1-2007q2) and for the crisis period (2007q3-2012q3). The dependent variable is systemic risk (*MES*). The main explanatory variables are the average quarterly changes in: on-balance-sheet leverage ( $\Delta LEVI$ ), derivatives leverage ( $\Delta DERLEVI$ ), leverage from securitisation ( $\Delta SECLEVI$ ), and off-balance-sheet leverage ratio ( $\Delta OBSLEVI$ ). All explanatory variables are instrumented in the first stage. The instrumental variables are given by the two- and three-period lags of  $\Delta LEVI$ ,  $\Delta DERLEVI$ ,  $\Delta SECLEVI$ , and  $\Delta OBSLEVI$  according to the Akaike Information Criterion and the Schwarz-Bayesian Information Criterion. The set of bank-specific control variables employed in our analysis includes the asset composition of banks' balance sheets (*ASSETCOMP*), banks' liabilities composition (*LIABCOMP*), and a dummy variable which accounts for M&A transactions (*MA*). Two macroeconomic control variables are also used: the level of inflation (*INF*) and the level of economic growth (*GDP*). A detailed description of each variable can be found in Appendix A. A constant term with time (quarterly) dummies is included in the regression models, but is not reported in the table. Heteroskedasticity-robust *t*-statistics are reported in parentheses.

	<i>MES</i>	
	Pre-crisis period	Crisis period
<i>ΔLEVI</i>	0.202** (1.88)	0.243*** (2.04)
<i>ΔDERLEVI</i>	0.709*** (3.67)	0.791*** (3.54)
<i>ΔSECLEVI</i>	0.988** (1.83)	1.197** (1.79)
<i>ΔOBSLEVI</i>	0.754*** (2.64)	0.830*** (2.27)
<i>ASSETCOMP</i>	0.489 (1.44)	0.786 (0.63)
<i>LIABCOMP</i>	0.818 (0.89)	1.178 (0.59)
<i>MA</i>	0.027 (1.02)	0.039 (1.15)
<i>INF</i>	0.830 (1.32)	0.938* (1.63)
<i>GDP</i>	1.794* (1.67)	1.754* (1.59)
Observations	402	361
$R^2$	0.116	0.148

<i>F</i> -statistic	9.64	8.18
<i>p</i> -value	0.00	0.00

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\*\*\*, \*\*, \* correspond to 1%, 5%, and 10% level of significance respectively for a two-tailed distribution.

Tables 7a and 7b summarise the results of the 2SLS IV second-stage regressions, which are very similar to those obtained from the baseline regression analysis.<sup>23</sup> In particular, all types of leverage are found to significantly increase both insolvency risk and systemic risk in the years before the outbreak of the crisis (recall here that larger values of *ZSCORE* are related with lower probability of default and, hence, greater bank soundness). In fact, the impact is stronger for the off-balance-sheet banking business. After mid-2007, reverse leverage activity is found to be harmful for the entire system, albeit it reduces individual bank risk. As we can further see, the deleveraging process that takes place off the balance sheet of banks is more harmful compared to the corresponding process that occurs on the balance sheet. To continue, even though the level of statistical significance of the estimated coefficients of *ASSETCOMP* and *LIABCOMP* on *TOTRISK* are slightly reduced when compared to the results of the main regressions, the signs of the coefficients remain largely unchanged. This is to say, traditional activities like the issuance of loans and the taking of deposits reduces individual risk and renders banking organisations more resilient to shocks. Lastly, no statistically significant relationship is documented between *ASSETCOMP* and *LIABCOMP* with *MES*. In summary, the reported results are robust to the use of *ZSCORE* and *MES* as the dependent variables of the econometric analysis.

Since our sample of banks has been selected on the basis of several bank-specific criteria on systemic importance, it might suffer from some sort of selection bias. Therefore, a second robustness test investigates whether our empirical findings have been influenced by selection bias induced by the non-randomness of our sample. To account for this bias, we apply the traditional Heckman (1979) two-stage methodology. In the first stage, we construct a dummy, which plays the role of the selection variable in the model. This variable is named *SCAP* and is

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<sup>23</sup> The results of the first-stage regressions are not shown here for the sake of brevity, but are available upon request. It is important to mention though that the application of the Hansen *J*-test provides us with *p*-values which belong to the closed interval [0.153, 0.377]. These values mean that we fail to reject the null hypothesis that overidentifying restrictions are valid and, hence, we can provide support to the validity of the selected instrumental variables. A robust *F*-statistic test further confirms the validity of our instruments. Furthermore, the Hausman test supports the use of 2SLS IV estimation methodology as it was the case in our main regression analysis.



equal to unity if bank  $i$  has taken part in the *SCAP* exercise, and zero otherwise. *SCAP* is linked to one of the six criteria we applied to select our sample of banks as analytically discussed in Section 3.1.

The first-stage (selection) model is a probit model where *SCAP* is run on  $\Delta LEVI$ ,  $\Delta DERLEVI$ ,  $\Delta SECLEVI$ ,  $\Delta OBSLEVI$ , and on a constant term using maximum likelihood estimation. The Inverse Mills Ratio (*IMR*) is obtained, which represents the selection control variable of the first-stage regression. The *IMR* is a monotonically decreasing function of the probability that an observation is selected into the sample. Moving to the second stage, we estimate our baseline model (eq. 11) by OLS incorporating the obtained *IMR* in the set of explanatory variables to correct for possible sample selection bias. In case *IMR* is not found to be statistically significant, then the null hypothesis of no sample selection bias cannot be rejected. The first- and second-stage results of the Heckman sample selection model for the two examined time periods using *SCAP* as the selection variable in the first-stage regressions are reported in Table 8.

**Table 8**

Sample selection bias. This table reports the marginal effects of first- and second-stage regression results of the Heckman's sample selection model. The results for both the pre-crisis period (2002q1-2007q2) and the crisis period (2007q3-2012q3) are reported. The selection variable in the first stage regression is *SCAP* that takes the value of one if a bank has taken part in *SCAP*. The selection regression includes the following control variables: *ΔLEVI*, *ΔDERLEVI*, *ΔSECLEVI*, and *ΔOBSLEVI*. The selection parameter obtained from the first-stage maximum likelihood regression is *IMR*. In the second stage, we estimate our baseline model (eq. 11) by OLS incorporating the *IMR* in the set of explanatory variables to correct for sample selection bias. A constant term is included in the model of each stage, but is not reported. A description of each variable can be found in Appendix A. Heteroskedasticity-robust standard errors are in parentheses.

	Pre-crisis period		Crisis period		Pre-crisis period		Crisis period	
	Stage 1	Stage 2	Stage 1	Stage 2	Stage 1	Stage 2	Stage 1	Stage 2
	( <i>SCAP</i> )	( <i>TOTRISK</i> )	( <i>SCAP</i> )	( <i>TOTRISK</i> )	( <i>SCAP</i> )	( <i>CoVar</i> )	( <i>SCAP</i> )	( <i>CoVar</i> )
<i>ΔLEVI</i>	0.392** (1.86)	0.110** (3.88)	0.404** (1.81)	-0.014** (-1.89)	0.372*** (2.03)	0.098*** (2.13)	0.344** (1.86)	0.213** (1.71)
<i>ΔDERLEVI</i>	0.854*** (2.67)	0.949*** (4.34)	0.815*** (2.43)	-0.713** (-1.83)	0.289*** (2.90)	0.138*** (4.12)	0.252*** (2.31)	0.307*** (4.12)
<i>ΔSECLEVI</i>	0.765*** (2.43)	1.005*** (1.99)	0.803*** (2.78)	-0.956*** (-4.10)	0.712*** (2.65)	0.489** (1.88)	0.709*** (2.45)	0.702*** (1.97)
<i>ΔOBSLEVI</i>	0.934** 1.82	0.798*** (2.28)	0.892** 1.78	-0.208** (-1.76)	0.802** 1.79	0.829*** (1.98)	0.833** 1.84	1.211** (1.88)
<i>ASSETCOMP</i>		-3.964*** (-2.90)		-3.443*** (-1.99)		1.208 (1.33)		0.954 (1.49)
<i>LIABCOMP</i>		-1.598*** (-1.96)		-1.086** (-1.78)		0.890 (1.04)		1.072 (0.83)
<i>MA</i>		0.018 (1.14)		0.009 (0.87)		0.021 (1.23)		0.031 (1.04)
<i>INF</i>		-0.153** (-1.72)		-0.092** (-1.86)		-1.027** (-1.91)		-1.410** (-1.78)
<i>GDP</i>		-1.290*** (-2.05)		-0.874** (-1.84)		-1.730*** (-2.00)		-2.299** (-1.97)
<i>IMR</i>		0.083 (1.21)		0.076 (1.14)		0.053* (1.61)		0.059 (1.43)
<i>Observations</i>	419	419	389	389	419	419	389	389
<i>R</i> <sup>2</sup>	0.154	0.188	0.137	0.163	0.190	0.178	0.142	0.172

\*\*\*, \*\*, \* correspond to 1%, 5%, and 10% level of significance respectively for a two-tailed distribution.

The first-stage results reveal that those banks which participated in the SCAP exercise in 2009 have been largely involved in on-balance-sheet leverage activities but, especially, in off-balance-sheet activities. This can be inferred from the positive and statistically significant relationships that we document between  $\Delta LEVI$ ,  $\Delta DERLEVI$ ,  $\Delta SECLEVI$ , and  $\Delta OBSLEVI$  with *SCAP*. This sort of relationships remains strong and unaffected for both periods under examination. Hence, we can argue that the SCAP banks were highly leveraged before the crisis, meaning that, after the outbreak of the crisis, they would be among the first ones to start deleveraging their portfolios. If we consider that the SCAP banks are of the biggest banks in the U.S. market (size has been the main criterion for a bank to participate in SCAP), then the reported results are perfectly in line with the positive relationship that holds between size and off-balance-sheet leverage exposure of banking organisations as discussed in Section 3.1.

As regards the second-stage regression results, these broadly confirm the findings of our baseline empirical analysis. The Inverse Mills Ratio is not statistically significant at the 5% level in any of our regressions, indicating that selection problems are marginal in our context. Therefore, controlling for potential sample selection bias does not have an impact on our empirical findings. Additionally and more importantly, the estimates of the Heckman-type regression models are consistent with those obtained from our baseline analysis.

## **6. Concluding remarks and policy implications**

In this paper we examined how modern banking that gave birth to the off-balance-sheet leverage business affected the risk profile of U.S. banks as well as the level of systemic risk before and after the onset of the late 2000s financial crisis. To achieve this, we employed a very representative data set of 20 U.S. SIFIs that covered both the pre-crisis period and the period after mid-2007 when the crisis erupted. We appropriately modelled the relationship between individual bank soundness and systemic fragility with on-balance-sheet leverage variables but, most notably, with several complementary measures of off-balance-sheet activities which have never been used in the relevant literature. Markedly, we paid special attention to the deleveraging process that occurred after the outbreak of the crisis, which comprises an additional innovative feature of our study.

Our formal evidence reliably indicates that leverage largely contributes to both total bank risk and systemic risk thus corroborating the findings that appear in the relevant literature (e.g., see

Wu et al, 2011) as well as in the popular press. To put it in a more detailed way, we lend support to the view that, before the onset of the crisis, banks accumulated leverage both on and, especially, off their balance sheets. Indeed, banks were able to expand leverage in ways that were previously impossible: by largely relying on new financial products, they managed to extend the short-term funding of their medium- and long-term assets. This increased maturity mismatch and raised the probability of bank runs and, in turn, the levels of the overall risk thus forcing the system to either fail or consider large-scale bailouts.

Accordingly, in the pre-crisis era, the positive relationship that we document between the off-balance-sheet leverage and risk shows that leverage was one of the main factors responsible for the fragility of the banking system. Nevertheless, a much more tangible threat to systemic stability was formed after the beginning of the crisis when banks started to dispose the large number of bad assets they used to hold either in their portfolios or out of them. The deleveraging process, which mostly took place off the balance sheet of banks, is found to be virtuous for individual banks' health, but harmful for the stability of the system.

We postulate that the expansion of derivatives trading associated with the increased securitisation activity was disregarded by national and supranational regulatory and supervisory authorities in the years running up to the crisis. The direct link between off-balance-sheet leverage and systemic risk provides the necessary condition to the current debate on stricter bank regulations through the imposition of an explicit off-balance-sheet leverage ratio as it is the case in Canada for many years now (see Bordeleau et al., 2009). A leverage ratio that does not consider off-balance-sheet items encourages banks to either further expand such kind of activities, or to innovate other products that can also take place off their balance-sheets. Put differently, the failure to incorporate off-balance-sheet items in a measure of leverage exposure provides additional incentives to banking firms to shift these items off their balance sheets so as to avoid the traditional on-balance-sheet leverage restrictions.

We should always bear in mind that traditional capital requirements were one of the chief reasons that turned banks to hide part of their assets and, hence, part of their risk off their balance sheets. Therefore, two different, complementary leverage ratios need to be imposed in our view: one that targets on the on-balance-sheet items and one that aims in restricting implicit leverage (both embedded and off-balance-sheet leverage). And, in fact, the new Basel rules (*i.e.*, Basel III) are moving towards this direction.

What we also document is that the banks which concentrate on traditional activities typically carry less risk compared to those involved with modern financial instruments. To be more specific, on the asset side of banks' balance sheets, the replacement of traditional loans with tranches of Asset Backed Securities (ABS), Collateralised Debt Obligations (CDOs) and other associated derivatives is found to increase total bank risk. Although such tranches are often AAA-rated and thus of low risk, the newer assets originated by banks are down-the-quality-curve. And, in fact, this seems not to have been taken into serious consideration by rating agencies before the crisis. Turning to the liability side of the balance sheets, the traditional business of taking deposits from households, which has been relatively declined compared to the non-interest income business is found to decrease individual bank risk.

All things considered, the aforementioned findings could play a role in the current discussion about a possible revival of the Glass-Steagall Act, which had banned commercial banks from underwriting, holding or dealing in corporate securities, hence essentially separating investment from commercial banking activities.

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### Appendix A: Variables and data sources

The following table presents all variables that we use in the econometric analysis. The abbreviation of each variable and the sources we use to collect the data are also reported.

Variable	Abbreviation	Definition	Data source
<b>Risk variables</b>			
Total bank risk	<i>TOTRISK</i>	The quarterly standard deviation of each bank's daily stock market returns	Thomson Reuters Datastream
	<i>ZSCORE</i>	The sum of returns on assets and book equity ratio divided by the standard deviation of returns of assets	FR Y-9C forms
	<i>CoVaR</i>	The Value at Risk ( <i>VaR</i> ) of a financial institution conditional on the other institutions of the financial system being in distress	See <i>CoVaR components</i>
Systemic risk	<i>MES</i>	First pick up the 5% worst days for an equally-weighted portfolio of CDS returns on all sample banks in every quarter of a year, and then compute the CDS returns for each sample bank for these particular days	Bloomberg
<b>CoVaR components</b>			
Implied Volatility Index		An index of market return volatility	Chicago Board Options Exchange Market
Liquidity risk spread		The quarterly difference between the 3-month LIBOR rate and the 3-month U.S. T-bill rate	Federal Reserve Board & GFDatabase
Yield curve		The change in the quarterly difference between the 10-year U.S. T-bill rate and the 3-month US T-bill rate	Federal Reserve Board & U.S. Department of the Treasury
Interest rate risk		The quarterly standard deviation of the day-to-day 3-month U.S. T-bill rate	Federal Reserve Board & Moody's
Credit risk		The quarterly change in the credit spread between the 10-year BAA-rated bonds and the 10-year U.S. T-bill rate	Federal Reserve Board & Moody's

**Leverage variables**

	<i>LEV1</i>	The ratio of total assets to book equity capital	FR Y-9C forms
On-balance-sheet leverage	<i>LEV2</i>	The inverted Tier 1 leverage ratio	
	<i>LEV3</i>	The ratio of total liabilities to book equity capital	
	<i>DERLEVI</i>	The ratio of credit equivalent amount of OTC derivatives outstanding to book equity capital	OCC Quarterly Report on Bank Derivatives Activities & FR Y-9C forms
Derivatives leverage	<i>DERLEV2</i>	The credit exposure across all OTC derivative contracts divided by regulatory capital	
	<i>DERLEV3</i>	The ratio of trading revenue from OTC derivative activities to total revenue	FR Y-9C forms
	<i>SECLEVI</i>	The outstanding principal amount of loans and other assets sold and securitised with servicing retained or with recourse or any other credit backstops provided divided by total assets	FR Y-9C forms
Securitisation leverage	<i>SECLEV2</i>	The amount of credit exposure arising from recourse or other seller-provided credit enhancements to SIVs and other conduits divided by total assets	
OBS leverage ratio	<i>OBSLEVI</i>	The sum of commitments, direct credit substitutes, acceptances, and repos divided by total equity	FR Y-9C forms
	<i>OBSLEV2</i>	The sum of standby letters of credit and guarantees, acceptances, and repos divided by regulatory capital	

<b>Bank-specific control variables</b>			
Asset composition	<i>ASSETCOMP</i>	The ratio of net loans and leases to total assets	FR Y-9C forms
Liability Composition	<i>LIABCOMP</i>	The ratio of demand deposits to total liabilities	FR Y-9C forms
M&A deals	<i>MA</i>	A dummy variable which is equal to unity in the quarter $q$ that bank $i$ has been involved in some M&A transaction	NIC/FFIEC
<b>Macroeconomic environment</b>			
Inflation rate	<i>INF</i>	The quarterly change in U.S. Consumer Price Index (CPI)	Bureau of Labor Statistics, U.S. Department of Labor
Economic growth	<i>GDP</i>	GDP output gap	Bureau of Economic Analysis, U.S. Department of Commerce
<b>Heckman-type model</b>			
Supervisory Capital Assessment Program	<i>SCAP</i>	A dummy variable that is equal to unity if bank $i$ has been taken part in the SCAP	U.S. Department of Treasury
Inverse Mills Ratio	<i>IML</i>	A monotonically decreasing function of the probability that an observation is selected into the sample	Obtained by first-stage regression of Heckman

## Appendix B: Quantile vs. OLS regressions

The purpose of this Appendix is to explain the main reasons why we use quantile regression techniques instead of standard OLS techniques to estimate the return equations (eq. 7, 8, 9, and 10) in the context of *CoVaR* measurement. We focus on the following five reasons:

a) In the framework of *CoVaR* analysis, we can make the assumption that the return equation (say eq. 8) has the following linear factor structure:

$$R_q^{system|i} = \lambda_0 + M_{q-1}\lambda_1 + R_q^i\lambda_2 + (\lambda_3 + M_{q-1}\lambda_4 + R_q^i\lambda_5)\varepsilon_q^{system|i} \quad (8a)$$

where  $R_q^{system|i}$  is the quarterly growth rate of total assets of all  $N=20$  banks that comprise our banking system conditional on bank  $i$  being financially distressed;  $R_q^i$  is the quarterly growth rate of bank  $i$ 's total assets conditional on bank  $i$  being distressed;  $M_{q-1}$  is the one-quarter lag vector of the state variables that influence bank soundness as described in Section 3.3; and  $\varepsilon_q^{system|i} = \eta_q\sigma_q$ , with  $\eta_q \sim \text{i.i.d. } N(0,1)$ , where  $\eta_q$  is independent of  $M_{q-1}$ , i.e.,  $E[\varepsilon_q^{system|i} | M_{q-1}, R_q^i] = 0$ .

Both the conditional expected return  $E[R_q^{system|i} | M_{q-1}, R_q^i] = \lambda_0 + M_{q-1}\lambda_1 + R_q^i\lambda_2$ , and the conditional volatility  $Vol[R_q^{system|i} | M_{q-1}, R_q^i] = \lambda_3 + M_{q-1}\lambda_4 + R_q^i\lambda_5$  depend on  $M_{q-1}$  and  $R_q^i$ . The coefficients  $\lambda_0, \lambda_1$ , and  $\lambda_2$  can be consistently estimated by running an OLS regression of  $R_q^{system|i}$  on  $M_{q-1}$  and  $R_q^i$ . However, in order the *VaR* and *CoVaR* measures to be estimated by OLS, we need to also estimate the coefficients  $\lambda_3, \lambda_4$ , and  $\lambda_5$ . This implies that we need to make a prior distributional assumption about the error term  $\varepsilon_q^{system|i}$  of our model (eq. 8a). On the other hand, quantile regression analysis incorporates estimates of the conditional mean and the conditional volatility, which are needed to produce conditional quantiles without having to make any prior distributional assumptions about the error term (see Boyson et al., 2010; Chan-Lau, 2010; Adrian and Brunnermeier, 2011; Girardi and Tolga Ergun, 2013; Rubia and Sanchis-Marco, 2013).

b) Quantile regression models can be estimated for a large range of possible quantiles (see Boyson et al., 2010; Adrian and Brunnermeier, 2011). We can therefore run a set of different quantile regressions to estimate eq. 8a for different percentiles.

c) Quantile regression techniques capture the possible non-linearities, which can be found in the default risk of some banking institutions as well as in the relationships that hold between the default risk of different banks and that of the entire banking system (Chan-Lau, 2010). In this or similar contexts, Engle and Manganelli (2004) study a large group of non-linear quantile regression models, called Conditional Autoregressive Value-at-Risk (CAViaR).

d) Quantile regression extends the OLS intuition beyond the estimation of the mean of conditional distribution of the default risk of a bank, allowing the conditional distribution to be sliced at the quantile (percentile)  $p$  of interest thus obtaining the corresponding cross-section of the conditional distribution (Chan-Lau, 2010).

e) Quantile regression techniques allow for heteroskedasticity (Boyson et al., 2010).

**Highlights**

- We examine the relevance of on- and off-balance-sheet leverage of banks in the crisis.
- Attention is paid to the deleveraging process which occurred after the onset of the crisis.
- Both on- and off-balance-sheet leverage increase individual bank risk and systemic risk.
- Deleveraging is found to be beneficial for banks' health, but harmful for the system.
- Traditional lines of banking business carry less risk compared to modern products.

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**Table 1**

Sample of banks. This table reports the 20 U.S. banks which are employed in our empirical analysis.

<b>Bank name</b>	
1. BANK OF AMERICA CORP.	11. JP MORGAN CHASE & CO
2. BANK OF NY MELLON CORP.	12. KEYCORP
3. BB&T CORP.	13. NORTHERN TRUST CORP.
4. CAPITAL ONE FINANCIAL CORP.	14. PNC FIN. SERVICES GROUP INC.
5. CITIGROUP INC.	15. REGIONS FINANCIAL CORP.
6. CITY NATIONAL CORP.	16. STATE STREET CORP.
7. COMERICA INC.	17. SUNTRUST BANKS INC.
8. FIFTH THIRD BANKCORP	18. US BANK CORP.
9. FIRST HORIZON NATIONAL CORP.	19. WELLS FARGO & CO
10. HUNTINGTON BANKSHARES INC.	20. ZIONS BANKCORP.

**Table 2**

Panel unit root test and cointegration test. Panel A reports the values of  $W$ -statistic from the panel unit root test of Im-Pesaran-Shin (2003) and the corresponding  $p$ -values. All data series included in the return equations (eq. 7, 8, 9 and 10) in the  $CoVaR$  measurement are tested for stationarity. The null hypothesis under study is that of a unit root against the alternative of stationarity. Panel B summarises the results of the Pedroni cointegration test, which examines the null hypothesis of no cointegration between the variables of interest. The Pedroni test relies on four statistics: the panel  $v$ -statistic, the panel PP  $\rho$ -statistic, the panel PP  $t$ -statistic, and the panel DF  $t$ -statistic. These statistics account for common time factors and heterogeneity across the sample banking institutions.

<b>Panel A: Panel Unit root test</b>		
Variables	Im-Pesaran-Shin $W$ -statistic	$p$ -value
<i>Growth rate of total assets</i>	-2.345**	(0.031)
<i>Market return volatility</i>	-3.519**	(0.028)
<i>Liquidity risk spread</i>	-1.810	(0.341)
<i>Yield curve</i>	-3.109***	(0.007)
<i>Interest rate risk</i>	-2.930***	(0.005)
<b>Panel B: Cointegration test</b>		
	Pedroni test statistics	$p$ -value
$v$ -statistic	0.184	(0.150)
$\rho$ -statistic (PP)	-1.593*	(0.094)
$t$ -statistic (PP)	-0.328	(0.139)
$t$ -statistic (DF)	-0.540	(0.111)

\*\*\*, \*\*, \* correspond to 1%, 5%, and 10% level of significance respectively for a two-tailed distribution.

**Table 3**

Correlation tests. This table contains the Pearson correlations between the two risk variables of the empirical analysis and also between the leverage variables and their instruments.  $P$ -values are reported below the correlation coefficients. Panel A shows the correlations for the pre-crisis period that starts in 2002q1 and ends in 2007q2. Panel B presents the correlations for the crisis period that extends from 2007q3 to 2012q3.

<b>Panel A</b>	<b>TOTRISK</b>	<b>CoVaR</b>	<b>LEV1</b>	<b>LEV2</b>	<b>LEV3</b>	<b>DERLEV1</b>	<b>DERVEL2</b>	<b>DERLEV3</b>	<b>OBSLEV1</b>	<b>OBSLEV2</b>	<b>SECLEVI</b>	<b>SECLEV2</b>
<b>TOTRISK</b>	1.000											
<b>CoVaR</b>	0.234**	1.000										
<b>LEV1</b>	0.006	-0.108	1.000									
<b>LEV2</b>	0.221	0.310	0.393**	1.000								
<b>LEV3</b>	-0.408	-0.435	0.040	0.285*	1.000							
<b>DERLEV1</b>	0.187	0.261	0.198**	0.056	0.524	1.000						
<b>DERLEV2</b>	-0.129	-0.182	0.034	0.649	0.289	0.510**	1.000					
<b>DERLEV3</b>	0.341	0.411	0.733	0.576	0.506	0.043	0.561**	1.000				
<b>OBSLEV1</b>	-0.156	-0.090*	0.389	0.501	0.210	0.672**	0.034	0.098	1.000			
<b>OBSLEV2</b>	0.105	0.081	0.402	0.253	0.589	0.005	0.071*	0.124	0.386**	1.000		
<b>SECLEVI</b>	-0.341	-0.222	0.219	0.529	0.302	0.071*	0.098	0.183	0.029	0.402	1.000	
<b>SECLEV2</b>	0.129	0.183	0.537	0.275	0.481	0.094	0.119	0.194	0.397*	0.131	0.925***	1.000
	-0.480	-0.504	0.333	-0.430	-0.413	0.274	0.241	0.560	0.733	0.670*	0.001	
	0.206	0.278	-0.521	0.369	0.299	0.388	0.132	0.175	0.096	0.088		
	0.256	0.308	0.387	-0.556	0.286	0.116	0.781	0.152	0.175			
	0.424	0.494	-0.732	0.471	-0.634	0.964	0.143	0.152				
	0.306	0.279	0.378	-0.431	0.388	0.199	0.463					
	0.556	0.443	-0.392	0.229	-0.544	0.504						
	-0.023	0.073	0.251	-0.490	0.340							
	0.101	0.135	-0.430	0.292	-0.413							
	-0.036	0.060	0.318	0.292	0.299							
	0.211	0.184	0.318	0.292	0.299							

\*\*\*, \*\*, \* correspond to 1%, 5%, and 10% level of significance respectively for a two-tailed distribution.

Panel B	TOTRISK	CoVaR	LEV1	LEV2	LEV3	DERLEV1	DERLEV2	DERLEV3	OBSLEV1	OBSLEV2	SECLEV1	SECLEV2
TOTRISK	1.000											
CoVaR	0.347	1.000										
LEV1	0.124	-0.167	1.000									
LEV2	0.201	0.205	0.515***	1.000								
LEV3	-0.304	0.217	0.001	0.319**	1.000							
DERLEV1	-0.541	-0.503	0.411**	0.046	0.430	1.000						
DERLEV2	0.321	0.420	0.677	0.556	0.297	0.544**	1.000					
DERLEV3	-0.111	-0.143	0.280	0.310	0.186	0.017	0.187*	1.000				
OBSLEV1	0.121	0.129	0.212	0.277	0.145	0.433**	0.086	0.167	1.000			
OBSLEV2	-0.142	-0.397	0.197	0.203	0.274	0.033	0.128	0.862***	0.439	1.000		
SECLEV1	0.186	0.272	0.174	0.349	0.402	0.107*	0.101	0.000	0.480	0.480	1.000	
SECLEV2	-0.189	-0.420	0.387	-0.429	-0.378	0.089	0.404	0.129	0.139	0.139	0.897***	1.000
	0.202	0.310	-0.484	0.341	0.211	0.341	0.117	0.788	0.808	0.778*	0.089	0.000
	0.340	0.429	0.303	-0.502	-0.432	0.130	0.893	0.231	0.199	0.089	0.000	
	0.388	0.441	-0.681	0.410	0.299	0.876	0.222	0.521	0.199	0.199	0.000	
	0.322	0.301	0.360	-0.398	-0.330	0.214	0.562	0.187	0.199	0.199	0.000	
	0.489	0.510	-0.344	0.255	0.204	0.454	0.150	0.187	0.199	0.199	0.000	
	-0.039	0.106*	0.308	-0.561	-0.438	0.110						
	0.120	0.100	-0.483	0.321	0.221							
	-0.044	0.102	0.345									
	0.128	0.231										

\*\*\*, \*\*, \* correspond to 1%, 5%, and 10% level of significance respectively for a two-tailed distribution.

**Table 4**

Descriptive statistics. The summary statistics of all the variables employed in our baseline empirical analysis are reported in this table. Panel A shows the statistics for the pre-crisis period which extends from 2002q1 to 2007q2, while Panel B refers to the crisis period that commences in 2007q3 and ends in 2012q3. Variables are distinguished into four main categories: the left-hand side risk variables, the leverage variables, the bank-specific control variables, and those variables that capture the macroeconomic environment. The description of each variable together with the relevant data sources are provided in Appendix A.

<b>Panel A: Pre-crisis period</b>	Mean	Median	Maximum	Minimum	St. Dev.	Obs
<i>Risk variables</i>						
<i>TOTRISK</i>	2.287	1.212	5.259	0.214	2.221	432
<i>CoVaR</i>	3.112	2.860	7.194	0.713	1.890	429
<i>Leverage variables</i>						
<i>LEV1</i>	7.879	7.174	12.121	5.732	0.256	436
<i>LEV2</i>	0.121	0.118	0.197	0.069	0.021	435
<i>LEV3</i>	7.123	6.875	10.564	4.784	0.598	436
<i>DERLEV1</i>	10.989	9.112	17.804	3.731	3.098	419
<i>DERLEV2</i>	1.865	1.775	3.122	0.484	2.883	427
<i>DERLEV3</i>	3.167	3.001	5.713	0.965	1.119	426
<i>SECLEV1</i>	7.005	6.603	11.434	1.740	1.794	431
<i>SECLEV2</i>	11.995	10.953	21.805	3.842	1.980	432
<i>OBSLEV1</i>	14.719	13.992	26.141	3.095	2.395	420
<i>OBSLEV2</i>	9.813	9.175	19.530	1.408	3.592	421
<i>Traditional banking variables</i>						
<i>ASSETCOMP</i>	0.522	0.513	0.798	0.185	0.178	438
<i>LIABCOMP</i>	0.223	0.208	0.421	0.063	0.063	439
<i>MA</i>	0.154	0.143	1.000	0.000	0.211	440
<i>Macroeconomic environment</i>						
<i>INF</i>	0.036	0.034	0.093	-0.035	0.086	439
<i>GDP</i>	0.026	0.023	0.067	-0.019	1.514	439
<b>Panel B: Crisis period</b>	Mean	Median	Maximum	Minimum	St. Dev.	Obs
<i>Risk variables</i>						
<i>TOTRISK</i>	1.989	1.897	4.342	0.089	1.341	401
<i>CoVaR</i>	6.959	6.794	10.853	2.805	1.852	392
<i>Leverage variables</i>						
<i>LEV1</i>	6.184	5.953	10.909	3.882	0.954	413
<i>LEV2</i>	0.110	0.107	0.174	0.041	0.017	413

<i>LEV3</i>	6.007	5.843	8.904	3.211	0.765	412
<i>DERLEV1</i>	5.999	5.755	12.004	0.653	4.783	400
<i>DERLEV2</i>	1.126	1.100	2.275	0.087	3.341	397
<i>DERLEV3</i>	1.605	1.509	3.009	0.252	3.006	404
<i>SECLEV1</i>	4.976	4.672	8.843	0.656	2.845	407
<i>SECLEV2</i>	8.784	8.432	14.734	1.956	2.165	408
<i>OBSLEV1</i>	9.643	9.462	19.943	1.134	2.742	389
<i>OBSLEV2</i>	7.683	7.459	15.629	0.747	4.131	392
<b><i>Traditional banking variables</i></b>						
<i>ASSETCOMP</i>	0.652	0.643	1.074	0.099	0.349	416
<i>LIABCOMP</i>	0.241	0.231	0.382	0.061	0.089	417
<i>MA</i>	0.127	0.119	1.000	0.000	0.087	420
<b><i>Macroeconomic environment</i></b>						
<i>INF</i>	-0.029	-0.032	0.121	-0.274	3.731	418
<i>GDP</i>	-0.034	-0.038	0.282	-0.341	4.174	418

**Table 5a**

First-stage regression results. This table presents the first-stage results obtained by the 2SLS IV fixed-effects regression model with total bank risk (*TOTRISK*) as the dependent variable of the second stage. Panel A reports the results for the pre-crisis period (2002q1-2007q2) and Panel B the results for the crisis period (2007q3-2012q3). The average quarterly change in on-balance-sheet leverage ( $\Delta LEVI$ ) is instrumented with  $\Delta LEV2$  and  $\Delta LEV3$ , the average quarterly change in derivatives leverage ( $\Delta DERLEVI$ ) is instrumented with  $\Delta DERLEV2$  and  $\Delta DERLEV3$ , the average quarterly change in leverage from securitisation ( $\Delta SECLEVI$ ) is instrumented with  $\Delta OBSLEV2$ , and the average quarterly change in off-balance-sheet leverage ratio ( $\Delta OBSLEVI$ ) with  $\Delta OBSLEV2$ . The exogenous control variables which are also included in the second-stage regressions are: asset composition of banks' balance sheets (*ASSETCOMP*), banks' liabilities composition (*LIABCOMP*), a dummy variable which accounts for M&A transactions (*MA*), the rate of inflation (*INF*), and the level of economic growth (*GDP*). A detailed description of each variable can be found in Appendix A. A constant term is included in the regression model, but is not reported in the table. The Hansen-J test of overidentifying restrictions tests the null hypothesis that the excluded instruments are uncorrelated with the error term of the model and are correctly excluded from the regression in the second stage. The *F*-test of instrumental variables reports the joint significance of identifying instruments. The Hausman test examines whether 2SLS and OLS coefficients are statistically different. Heteroskedasticity-robust *t*-statistics are reported in parentheses.

	Panel A: Pre-crisis period				Panel B: Crisis period			
	$\Delta LEVI$	$\Delta DERLEVI$	$\Delta SECLEVI$	$\Delta OBSLEVI$	$\Delta LEVI$	$\Delta DERLEVI$	$\Delta SECLEVI$	$\Delta OBSLEVI$
$\Delta LEVI$		0.165* (1.71)	0.061* (1.68)	-0.154 (-1.19)	0.293** (1.88)	0.054 (1.39)		-0.184 (-0.97)
$\Delta LEV2$	0.088*** (2.99)	0.196** (1.89)	0.043 (1.58)	-0.131 (-1.01)	0.223* (1.74)	0.047 (1.33)		-0.161 (-0.85)
$\Delta LEV3$	0.096*** (3.90)	0.213* (1.69)	0.069* (1.68)	-0.188 (-0.85)	0.250* (1.67)	0.082 (1.56)		-0.228 (-0.76)
$\Delta DERLEVI$	0.218* (1.67)		0.260 (1.45)	0.275* (1.68)	0.295** (1.75)			0.243** (1.90)
$\Delta DERLEV2$	0.199 (1.43)	0.175** (1.87)	0.231* (1.66)	0.302** (1.92)	0.222** (1.83)	0.244** (1.82)		0.329** (1.87)
$\Delta DERLEV3$	0.256* (1.69)	0.254** (1.91)	0.288** (1.89)	0.267** (1.86)	0.294** (1.78)	0.304** (1.87)		0.351* (1.64)
$\Delta SECLEVI$	0.101 (1.22)	0.065** (1.76)		0.069* (1.61)	0.098* (1.65)			0.102* (1.63)
$\Delta SECLEV2$	0.089 (1.18)	0.053 (1.59)	0.088** (1.87)	0.080* (1.64)	0.112* (1.69)	0.131** (1.86)		0.110* (1.62)
$\Delta OBSLEVI$	-0.148 (-0.79)	0.158* (1.72)	0.160 (1.32)		0.131 (1.59)	0.141 (1.28)		

<i>AOBSLEV2</i>	-0.132 (-0.80)	0.166* (1.70)	0.201 (1.44)	0.276*** (2.98)	-0.164 (-1.02)	0.112* (1.64)	0.189 (1.52)	0.303*** (3.64)
<i>ASSETCOMP</i>	0.261*** (2.65)	0.119 (0.88)	0.126** (1.79)	0.093 (0.94)	0.209** (1.91)	0.087 (1.41)	0.155* (1.64)	0.099 (1.24)
<i>LIABCOMP</i>	0.052 (0.83)	0.214 (1.00)	0.022 (0.99)	0.015 (1.15)	0.078 (1.27)	0.195 (0.94)	0.031 (1.02)	0.102* (1.60)
<i>MA</i>	0.009* (1.67)	0.015* (1.69)	0.021 (1.51)	0.009 (1.32)	0.016** (1.74)	0.028** (1.85)	0.018 (1.43)	0.017* (1.61)
<i>INF</i>	0.017*** (3.61)	0.029** (1.91)	0.009 (1.59)	0.023** (1.72)	0.039** (1.87)	0.051** (1.82)	0.024* (1.68)	0.084** (1.87)
<i>GDP</i>	0.032** (1.88)	0.053** (1.83)	0.041* (1.69)	0.057** (1.95)	0.086** (1.83)	0.54* (1.68)	0.063** (1.85)	0.097*** (2.13)
Observations	419	419	419	419	389	389	389	389
$R^2$	0.182	0.214	0.192	0.177	0.224	0.232	0.281	0.209
$F$ -statistic	14.89	16.42	15.01	13.41	17.62	19.06	18.76	16.31
$p$ -value	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Hansen $J$ -statistic	3.47	3.81			5.63	4.32		
$p$ -value	0.324	0.351			0.464	0.398		
Hausman $p$ -value	0.04	0.04	0.04	0.03	0.04	0.02	0.03	0.03

\*\*\*, \*\*, \* correspond to 1%, 5%, and 10% level of significance respectively for a two-tailed distribution.

**Table 5b**

First-stage regression results. This table presents the first-stage results obtained by the 2SLS IV fixed-effects regression model with systemic risk (*CovAR*) as the dependent variable of the second stage. Panel A reports the results for the pre-crisis period (2002q1-2007q2) and Panel B the results for the crisis period (2007q3-2012q3). The average quarterly change in on-balance-sheet leverage (*ALEVI*) is instrumented with *ALEV2* and *ALEV3*, the average quarterly change in derivatives leverage (*ADERLEV1*) is instrumented with *ADERLEV2* and *ADERLEV3*, the average quarterly change in leverage from securitisation (*ASECLEV1*) is instrumented with *ASECLEV2*, and the average quarterly change in off-balance-sheet leverage ratio (*AOSLSLEV1*) with *AOSLSLEV2*. The exogenous control variables which are also included in the second-stage regressions are: asset composition of banks' balance sheets (*ASSETCOMP*), banks' liabilities composition (*LIABCOMP*), a dummy variable which accounts for M&A transactions (*MA*), the rate of inflation (*INF*), and the level of economic growth (*GDP*). A detailed description of each variable can be found in Appendix A. A constant term is included in the regression model, but is not reported in the table. The Hansen-J test of overidentifying restrictions tests the null hypothesis that the excluded instruments are uncorrelated with the error term of the model and are correctly excluded from the regression in the second stage. The *F*-test of instrumental variables reports the joint significance of identifying instruments. The Hausman test examines whether 2SLS and OLS coefficients are statistically different. Heteroskedasticity-robust *t*-statistics are reported in parentheses.

	Panel A: Pre-crisis period				Panel B: Crisis period			
	<i>ALEVI</i>	<i>ADERLEV1</i>	<i>ASECLEV1</i>	<i>AOSLSLEV1</i>	<i>ALEVI</i>	<i>ADERLEV1</i>	<i>ASECLEV1</i>	<i>AOSLSLEV1</i>
<i>ALEVI</i>		0.159** (1.82)	0.064* (1.65)	-0.149 (-1.14)		0.286** (1.91)	0.049 (1.35)	-0.179 (-1.04)
<i>ALEV2</i>	0.083*** (2.42)	0.191** (1.84)	0.041 (1.53)	-0.130 (-0.96)	0.101*** (2.33)	0.210* (1.76)	0.040 (1.25)	-0.159 (-0.90)
<i>ALEV3</i>	0.139*** (3.45)	0.206* (1.66)	0.074* (1.69)	-0.192 (-0.89)	0.150*** (4.00)	0.257** (1.73)	0.079 (1.50)	-0.237 (-0.86)
<i>ADERLEV1</i>	0.211** (1.79)	0.251 (1.52)	0.251 (1.52)	0.267* (1.66)	0.196 (1.51)	0.284* (1.66)	0.284* (1.66)	0.263*** (1.99)
<i>ADERLEV2</i>	0.204 (1.51)	0.202*** (1.99)	0.239** (1.79)	0.289*** (1.96)	0.224 (1.49)	0.198*** (2.11)	0.240** (1.79)	0.336** (1.91)
<i>ADERLEV3</i>	0.249* (1.65)	0.221** (1.85)	0.301*** (2.01)	0.257** (1.88)	0.212 (1.46)	0.255** (1.83)	0.311** (1.81)	0.362** (1.73)
<i>ASECLEV1</i>	0.092 (1.14)	0.061* (1.64)	0.082*** (2.04)	0.072 (1.57)	0.105 (1.00)	0.103* (1.66)	0.140*** (1.96)	0.096* (1.64)
<i>ASECLEV2</i>	0.081 (1.26)	0.050* (1.66)	0.082*** (2.04)	0.084* (1.65)	0.096 (0.92)	0.110* (1.67)	0.140*** (1.96)	0.121* (1.68)
<i>AOSLSLEV1</i>	-0.159 (-0.90)	0.143 (1.58)	0.164 (1.26)	0.164 (1.65)	-0.160 (-1.03)	0.124 (1.55)	0.157 (1.14)	



<i>AOBSLEV2</i>	-0.139 (-0.87)	0.172* (1.69)	0.194 (1.48)	0.240*** (2.93)	-0.160 (-0.88)	0.103* (1.65)	0.202 (1.50)	0.287*** (3.45)
<i>ASSETCOMP</i>	0.250*** (2.44)	0.108 (0.94)	0.120** (1.83)	0.100 (0.91)	0.194* (1.68)	0.094 (1.32)	0.167* (1.63)	0.104 (1.21)
<i>LIABCOMP</i>	0.044 (0.78)	0.210 (0.96)	0.019 (1.06)	0.013 (1.21)	0.085 (1.21)	0.204 (1.03)	0.030 (0.96)	0.113* (1.63)
<i>MA</i>	0.010** (1.76)	0.013** (1.75)	0.022 (1.54)	0.011 (1.39)	0.014* (1.65)	0.024** (1.86)	0.015 (1.38)	0.019* (1.65)
<i>INF</i>	0.019*** (3.46)	0.027*** (1.98)	0.010* (1.65)	0.026** (1.76)	0.042** (1.80)	0.056** (1.89)	0.022* (1.66)	0.090** (1.90)
<i>GDP</i>	0.030*** (1.96)	0.047* (1.68)	0.044* (1.67)	0.059*** (1.97)	0.079* (1.66)	0.59** (1.73)	0.057** (1.81)	0.102*** (2.03)
Observations	406	406	406	406	375	375	375	375
<i>R</i> <sup>2</sup>	0.171	0.207	0.188	0.168	0.153	0.212	0.209	0.208
<i>F</i> -statistic	12.45	15.80	14.89	12.97	10.20	16.86	16.12	15.88
<i>p</i> -value	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Hansen <i>J</i> -statistic	3.02	3.76			2.83	4.01		
<i>p</i> -value	0.292	0.343			0.264	0.363		
Hausman <i>p</i> -value	0.04	0.03	0.04	0.03	0.04	0.03	0.03	0.03

\*\*\*, \*\*, \* correspond to 1%, 5%, and 10% level of significance respectively for a two-tailed distribution.

**Table 6a**

Second-stage regression results. This table presents the second-stage results obtained by 2SLS IV fixed-effects regression analysis for the pre-crisis period (2002q1-2007q2) and for the crisis period (2007q3-2012q3). The dependent variable is total bank risk (*TOTRISK*). The main explanatory variables are the average quarterly changes in: on-balance-sheet leverage ( $\Delta LEVI$ ), derivatives leverage ( $\Delta DERLEVI$ ), leverage from securitisation ( $\Delta SECLEVI$ ), and off-balance-sheet leverage ratio ( $\Delta OBSLEVI$ ). All explanatory variables are instrumented in the first stage; the instrumental variables are:  $\Delta LEV2$ ,  $\Delta LEV3$ ,  $\Delta DERLEV2$ ,  $\Delta DERLEV3$ ,  $\Delta SECLEV2$ , and  $\Delta OBSLEV2$ . The set of bank-specific control variables used in our analysis includes the asset composition of banks' balance sheets (*ASSETCOMP*), banks' liabilities composition (*LIABCOMP*), and a dummy variable which accounts for M&A transactions (*MA*). Two macroeconomic control variables are also used: the level of inflation (*INF*) and the level of economic growth (*GDP*). A detailed description of each variable can be found in Appendix A. A constant term is included in the regression model, but is not reported in the table. Heteroskedasticity-robust *t*-statistics are reported in parentheses.

	<i>TOTRISK</i>	
	Pre-crisis period	Crisis period
<i>ΔLEVI</i>	0.089*** (5.07)	-0.009*** (-2.34)
<i>ΔDERLEVI</i>	1.041*** (4.75)	-0.784** (-1.77)
<i>ΔSECLEVI</i>	1.119** (1.87)	-1.005*** (-4.21)
<i>ΔOBSLEVI</i>	0.834*** (2.52)	-0.193*** (-1.99)
<i>ASSETCOMP</i>	-4.767*** (-2.44)	-3.163** (-1.80)
<i>LIABCOMP</i>	-1.702** (-1.79)	-0.932** (-1.73)
<i>MA</i>	0.012 (1.21)	0.016 (0.98)
<i>INF</i>	-0.099** (-1.76)	-0.052*** (-2.07)
<i>GDP</i>	-1.165** (-1.86)	-0.865* (-1.61)
Observations	419	389
<i>R</i> <sup>2</sup>	0.163	0.179
<i>F</i> -statistic	11.54	10.88
<i>p</i> -value	0.00	0.00

\*\*\*, \*\*, \* correspond to 1%, 5%, and 10% level of significance respectively for a two-tailed distribution.

**Table 6b**

Second-stage regression results. This table presents the second-stage results obtained by 2SLS IV fixed-effects regression analysis for the pre-crisis period (2002q1-2007q2) and for the crisis period (2007q3-2012q3). The dependent variable is systemic risk (*CoVaR*). The main explanatory variables are the average quarterly changes in: on-balance-sheet leverage ( $\Delta LEV1$ ), derivatives leverage ( $\Delta DERLEV1$ ), leverage from securitisation ( $\Delta SECLEV1$ ), and off-balance-sheet leverage ratio ( $\Delta OBSLEV1$ ). All explanatory variables are instrumented in the first stage; the instrumental variables are:  $\Delta LEV2$ ,  $\Delta LEV3$ ,  $\Delta DERLEV2$ ,  $\Delta DERLEV3$ ,  $\Delta SECLEV2$ , and  $\Delta OBSLEV2$ . The set of bank-specific control variables used in our analysis includes the asset composition of banks' balance sheets (*ASSETCOMP*), banks' liabilities composition (*LIABCOMP*), and a dummy variable which accounts for M&A transactions (*MA*). Two macroeconomic control variables are also used: the level of inflation (*INF*) and the level of economic growth (*GDP*). A detailed description of each variable can be found in Appendix A. A constant term is included in the regression model, but is not reported in the table. Heteroskedasticity-robust *t*-statistics are reported in parentheses.

	<i>CoVaR</i>	
	Pre-crisis period	Crisis period
$\Delta LEV1$	0.165*** (2.31)	0.197** (1.69)
$\Delta DERLEV1$	0.078*** (4.31)	0.286*** (4.24)
$\Delta SECLEV1$	0.552*** (1.99)	0.669** (1.75)
$\Delta OBSLEV1$	0.834** (1.87)	1.275*** (2.03)
<i>ASSETCOMP</i>	1.304 (1.29)	0.899 (1.41)
<i>LIABCOMP</i>	0.868 (0.99)	1.103 (0.90)
<i>MA</i>	0.028 (1.32)	0.033 (1.14)
<i>INF</i>	-1.106*** (-2.46)	-1.539*** (-1.97)
<i>GDP</i>	-1.883** (-1.89)	-2.376* (-1.76)
Observations	406	375
$R^2$	0.144	0.129

<i>F</i> -statistic	14.12	12.76
<i>p</i> -value	0.00	0.00

\*\*\*, \*\*, \* correspond to 1%, 5%, and 10% level of significance respectively for a two-tailed distribution.

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**Table 7a**

Robustness tests. This table presents the second-stage results obtained by 2SLS IV fixed-effects regression analysis for the pre-crisis period (2002q1-2007q2) and for the crisis period (2007q3-2012q3). The dependent variable is bank insolvency risk (*ZSCORE*). The main explanatory variables are the average quarterly changes in: on-balance-sheet leverage ( $\Delta LEVI$ ), derivatives leverage ( $\Delta DERLEVI$ ), leverage from securitisation ( $\Delta SECLEVI$ ), and off-balance-sheet leverage ratio ( $\Delta OBSLEVI$ ). All explanatory variables are instrumented in the first stage. The instrumental variables are given by the two- and three-period lags of  $\Delta LEVI$ ,  $\Delta DERLEVI$ ,  $\Delta SECLEVI$ , and  $\Delta OBSLEVI$  according to the Akaike Information Criterion and the Schwarz-Bayesian Information Criterion. The set of bank-specific control variables employed in our analysis includes the asset composition of banks' balance sheets (*ASSETCOMP*), banks' liabilities composition (*LIABCOMP*), and a dummy variable which accounts for M&A transactions (*MA*). Two macroeconomic control variables are also used: the level of inflation (*INF*) and the level of economic growth (*GDP*). A detailed description of each variable can be found in Appendix A. A constant term with time (quarterly) dummies is included in the regression models, but is not reported in the table. Heteroskedasticity-robust *t*-statistics are reported in parentheses.

	<i>ZSCORE</i>	
	Pre-crisis period	Crisis period
$\Delta LEVI$	-0.164*** (-3.21)	0.032** (1.79)
$\Delta DERLEVI$	-0.332*** (-4.78)	0.050** (1.86)
$\Delta SECLEVI$	-0.847*** (-2.90)	0.208*** (3.44)
$\Delta OBSLEVI$	-0.834** (-1.85)	0.372*** (2.13)
<i>ASSETCOMP</i>	4.402** (1.88)	4.175** (1.78)
<i>LIABCOMP</i>	2.004*** (3.21)	2.389*** (3.98)
<i>MA</i>	0.002 (0.79)	0.008 (0.90)
<i>INF</i>	0.904* (1.62)	0.673** (1.87)
<i>GDP</i>	0.976** (1.86)	1.153* (1.58)
Observations	413	382
$R^2$	0.148	0.129

<i>F</i> -statistic	11.04	12.88
<i>p</i> -value	0.00	0.00

\*\*\*, \*\*, \* correspond to 1%, 5%, and 10% level of significance respectively for a two-tailed distribution.

**Table 7b**

Robustness tests. This table presents the second-stage results obtained by 2SLS IV fixed-effects regression analysis for the pre-crisis period (2002q1-2007q2) and for the crisis period (2007q3-2012q3). The dependent variable is systemic risk (*MES*). The main explanatory variables are the average quarterly changes in: on-balance-sheet leverage ( $\Delta LEVI$ ), derivatives leverage ( $\Delta DERLEVI$ ), leverage from securitisation ( $\Delta SECLEVI$ ), and off-balance-sheet leverage ratio ( $\Delta OBSLEVI$ ). All explanatory variables are instrumented in the first stage. The instrumental variables are given by the two- and three-period lags of  $\Delta LEVI$ ,  $\Delta DERLEVI$ ,  $\Delta SECLEVI$ , and  $\Delta OBSLEVI$  according to the Akaike Information Criterion and the Schwarz-Bayesian Information Criterion. The set of bank-specific control variables employed in our analysis includes the asset composition of banks' balance sheets (*ASSETCOMP*), banks' liabilities composition (*LIABCOMP*), and a dummy variable which accounts for M&A transactions (*MA*). Two macroeconomic control variables are also used: the level of inflation (*INF*) and the level of economic growth (*GDP*). A detailed description of each variable can be found in Appendix A. A constant term with time (quarterly) dummies is included in the regression models, but is not reported in the table. Heteroskedasticity-robust *t*-statistics are reported in parentheses.

	<i>MES</i>	
	Pre-crisis period	Crisis period
<i>ΔLEVI</i>	0.202** (1.88)	0.243*** (2.04)
<i>ΔDERLEVI</i>	0.709*** (3.67)	0.791*** (3.54)
<i>ΔSECLEVI</i>	0.988** (1.83)	1.197** (1.79)
<i>ΔOBSLEVI</i>	0.754*** (2.64)	0.830*** (2.27)
<i>ASSETCOMP</i>	0.489 (1.44)	0.786 (0.63)
<i>LIABCOMP</i>	0.818 (0.89)	1.178 (0.59)
<i>MA</i>	0.027 (1.02)	0.039 (1.15)
<i>INF</i>	0.830 (1.32)	0.938* (1.63)
<i>GDP</i>	1.794* (1.67)	1.754* (1.59)

Observations	402	361
$R^2$	0.116	0.148
$F$ -statistic	9.64	8.18
$p$ -value	0.00	0.00

\*\*\*, \*\*, \* correspond to 1%, 5%, and 10% level of significance respectively for a two-tailed distribution.

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**Table 8**

Sample selection bias. This table reports the marginal effects of first- and second-stage regression results of the Heckman's sample selection model. The results for both the pre-crisis period (2002q1-2007q2) and the crisis period (2007q3-2012q3) are reported. The selection variable in the first stage regression is *SCAP* that takes the value of one if a bank has taken part in *SCAP*. The selection regression includes the following control variables: *ΔLEVI*, *ΔDERLEVI*, *ΔSECLEVI*, and *ΔOBSLEVI*. The selection parameter obtained from the first-stage maximum likelihood regression is *IMR*. In the second stage, we estimate our baseline model (eq. 11) by OLS incorporating the *IMR* in the set of explanatory variables to correct for sample selection bias. A constant term is included in the model of each stage, but is not reported. A description of each variable can be found in Appendix A. Heteroskedasticity-robust standard errors are in parentheses.

	Pre-crisis period		Crisis period		Pre-crisis period		Crisis period	
	Stage 1 ( <i>SCAP</i> )	Stage 2 ( <i>TOTRISK</i> )	Stage 1 ( <i>SCAP</i> )	Stage 2 ( <i>TOTRISK</i> )	Stage 1 ( <i>SCAP</i> )	Stage 2 ( <i>CoVar</i> )	Stage 1 ( <i>SCAP</i> )	Stage 2 ( <i>CoVar</i> )
<i>ΔLEVI</i>	0.392** (1.86)	0.110** (3.88)	0.404** (1.81)	-0.014** (-1.89)	0.372*** (2.03)	0.098*** (2.13)	0.344** (1.86)	0.213** (1.71)
<i>ΔDERLEVI</i>	0.854*** (2.67)	0.949*** (4.34)	0.815*** (2.43)	-0.713** (-1.83)	0.289*** (2.90)	0.138*** (4.12)	0.252*** (2.31)	0.307*** (4.12)
<i>ΔSECLEVI</i>	0.765*** (2.43)	1.005*** (1.99)	0.803*** (2.78)	-0.956*** (-4.10)	0.712*** (2.65)	0.489** (1.88)	0.709*** (2.45)	0.702*** (1.97)
<i>ΔOBSLEVI</i>	0.934** 1.82	0.798*** (2.28)	0.892** 1.78	-0.208** (-1.76)	0.802** 1.79	0.829*** (1.98)	0.833** 1.84	1.211** (1.88)
<i>ASSETCOMP</i>		-3.964*** (-2.90)		-3.443*** (-1.99)		1.208 (1.33)		0.954 (1.49)
<i>LIABCOMP</i>		-1.598*** (-1.96)		-1.086** (-1.78)		0.890 (1.04)		1.072 (0.83)
<i>MA</i>		0.018 (1.14)		0.009 (0.87)		0.021 (1.23)		0.031 (1.04)
<i>INF</i>		-0.153** (-1.72)		-0.092** (-1.86)		-1.027** (-1.91)		-1.410** (-1.78)
<i>GDP</i>		-1.290*** (-2.05)		-0.874** (-1.84)		-1.730*** (-2.00)		-2.299** (-1.97)
<i>IMR</i>		0.083 (1.21)		0.076 (1.14)		0.053* (1.61)		0.059 (1.43)
<i>Observations</i>	419	419	389	389	419	419	389	389
<i>R</i> <sup>2</sup>	0.154	0.188	0.137	0.163	0.190	0.178	0.142	0.172

\*\*\*, \*\*, \* correspond to 1%, 5%, and 10% level of significance respectively for a two-tailed distribution.



### Appendix A: Variables and data sources

The following table presents all variables that we use in the econometric analysis. The abbreviation of each variable and the sources we use to collect the data are also reported.

Variable	Abbreviation	Definition	Data source
<b>Risk variables</b>			
Total bank risk	<i>TOTRISK</i>	The quarterly standard deviation of each bank's daily stock market returns	Thomson Reuters Datastream
	<i>ZSCORE</i>	The sum of returns on assets and book equity ratio divided by the standard deviation of returns of assets	FR Y-9C forms
	<i>CoVaR</i>	The Value at Risk ( <i>VaR</i> ) of a financial institution conditional on the other institutions of the financial system being in distress	See <i>CoVaR components</i>
Systemic risk	<i>MES</i>	First pick up the 5% worst days for an equally-weighted portfolio of CDS returns on all sample banks in every quarter of a year, and then compute the CDS returns for each sample bank for these particular days	Bloomberg
<b>CoVaR components</b>			
Implied Volatility Index		An index of market return volatility	Chicago Board Options Exchange Market
Liquidity risk spread		The quarterly difference between the 3-month LIBOR rate and the 3-month U.S. T-bill rate	Federal Reserve Board & GFDatabase
Yield curve		The change in the quarterly difference between the 10-year U.S. T-bill rate and the 3-month US T-bill rate	Federal Reserve Board & U.S. Department of the Treasury
Interest rate risk		The quarterly standard deviation of the day-to-day 3-month U.S. T-bill rate	Federal Reserve Board & Moody's
Credit risk		The quarterly change in the credit spread between the 10-year BAA-rated bonds and the 10-year U.S. T-bill rate	Federal Reserve Board & Moody's

**Leverage variables**

	<i>LEV1</i>	The ratio of total assets to book equity capital	FR Y-9C forms
On-balance-sheet leverage	<i>LEV2</i>	The inverted Tier 1 leverage ratio	
	<i>LEV3</i>	The ratio of total liabilities to book equity capital	
	<i>DERLEVI</i>	The ratio of credit equivalent amount of OTC derivatives outstanding to book equity capital	OCC Quarterly Report on Bank Derivatives Activities & FR Y-9C forms
Derivatives leverage	<i>DERLEV2</i>	The credit exposure across all OTC derivative contracts divided by regulatory capital	
	<i>DERLEV3</i>	The ratio of trading revenue from OTC derivative activities to total revenue	FR Y-9C forms
	<i>SECLEVI</i>	The outstanding principal amount of loans and other assets sold and securitised with servicing retained or with recourse or any other credit backstops provided divided by total assets	
Securitisation leverage			FR Y-9C forms
	<i>SECLEV2</i>	The amount of credit exposure arising from recourse or other seller-provided credit enhancements to SIVs and other conduits divided by total assets	
OBS leverage ratio	<i>OBSLEVI</i>	The sum of commitments, direct credit substitutes, acceptances, and repos divided by total equity	FR Y-9C forms
	<i>OBSLEV2</i>	The sum of standby letters of credit and guarantees, acceptances, and repos divided by regulatory capital	

<b>Bank-specific control variables</b>		
Asset composition	<i>ASSETCOMP</i>	The ratio of net loans and leases to total assets FR Y-9C forms
Liability Composition	<i>LIABCOMP</i>	The ratio of demand deposits to total liabilities FR Y-9C forms
M&A deals	<i>MA</i>	A dummy variable which is equal to unity in the quarter $q$ that bank $i$ has been involved in some M&A transaction NIC/FFIEC
<b>Macroeconomic environment</b>		
Inflation rate	<i>INF</i>	The quarterly change in U.S. Consumer Price Index (CPI) Bureau of Labor Statistics, U.S. Department of Labor
Economic growth	<i>GDP</i>	GDP output gap Bureau of Economic Analysis, U.S. Department of Commerce
<b>Heckman-type model</b>		
Supervisory Capital Assessment Program	<i>SCAP</i>	A dummy variable that is equal to unity if bank $i$ has been taken part in the SCAP U.S. Department of Treasury
Inverse Mills Ratio	<i>IML</i>	A monotonically decreasing function of the probability that an observation is selected into the sample Obtained by first-stage regression of Heckman