

APCTP SEMINAR

Survival of the Un-fittest: A Distribution-to-Distribution Analysis of Pre-Crisis Bank Risk Buildup

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September 21 (Mon) 19:00~
ZOOM Webinar

A large body of literature on pre-crisis analysis suggests that there are evolving stages and phases in bank risk buildup. Based on banking sector z-scores and distribution-to-distribution analyses, we document the dynamic evolutionary processes of bank risk buildup in stages and phases. We empirically identify the period 2003Q2–2007Q4 as the pre-crisis period that led to the financial crisis of 2008–2009. In an environment of low-interest rates and macro risk, and fertile ground with flush liquidity, the seeds of the crisis in terms of financial innovations were sowed in 2003Q2. The evolutionary risk–build led by large banks started in 2003Q2. In the period of 2003Q2–2005Q4, the scale and scope of the risky asset balance sheet financed by short-term debt has expanded and extended to the aggregate banking sector, as too many banks adopted similar strategic and endogenous risk-taking choices. In the period of 2006Q1–2007Q2, the banking sector appears to be stable and solvent with stagnant returns on investment (ROA), but with low volatility dubbed as the “volatility paradox.” The sign of weakness in the banking sector triggered banks’ “race to the bottom” with the expectation of bailout and the financial crisis started in 2007Q4. Regression results corroborate the banks’ correlated risk-taking. The empirical analysis of the distribution of z-score, size, and leverage support a great deal of research on theoretical models on the channels of banks’ risk-taking permeating the entire banking sector and the financial crisis of 2008–2009. Investigating the probability of insolvency (measured by z-score) of aggregate banks, together with a distribution-to-distribution analysis of the z-score of individual banks, provide valuable insights about the dynamic evolution of financial (in)stability.

* This seminar will be given in Korean.

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The APCTP is supported by the Korean Government through the Science and Technology Promotion Fund and Lottery Fund and strives to maximize social value through its various activities.
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