**McKinsey Paper:**

*Research Question:*

Are higher capital and leverage ratios related to the chances of bank distress?

What are the most relevant capital ratios that indicate a bank distress?

*Contribution to literature:*

*Methology:*

They examined individual bank balance sheets including their level and composition of capital as of December 31, 2007, and estimate the relationship between initial capital and leverage ratios with subsequent bank performance. To estimate this relationship they used logistic regression. And to compare the results of the regressions, they used a statistical metric called Gini coefficient.

*Main Results:*

* In the 2007-2009 crisis, institutions with higher capital and with higher leverage ratios pre-crisis have had less chance of becoming distressed during the crisis. Our findings on recent distress rates are also supported by previous work on U.S. bank distress during the banking crisis in 1989-93 (e.g., Estrella, Park, and Peristiani, 2000).
* Capital ratios based on higher-quality forms of capital (e.g., TCE, Tier 1) have been more important predictors of bank distress than ratios based on broader measures of regulatory capital (Tier 1 plus Tier 2). TCE to risk-weighted assets (RWA) is the most predictive of the ratios we examined, and the data suggests that this ratio is a significantly better predictor than the second best – the ratio of Tier 1 to RWA.
* While leverage ratios on a stand-alone basis are related to the probability of distress, they do not appear to provide any additional information about the likelihood of future bank distress over and above what is already contained in the risk-based capital ratios

**Adrian-Shin 2011**

*Research Question:*

How do banks manage their balance sheet positions especially equity and assets under different market conditions?

*Contribution to literature:*

Key insights that financial firms/banks have different balance sheet behavior than non-financial firms*.*

*Methology:*

*Main Results:*

* Leverage patterns are countercyclical for the U.S. non-ﬁnancial sector, as expected, but this is not the case when they focus on particular institutions within the ﬁnancial sector, namely broker dealers.
* Leverage of investment firms rises during booms and falls during downturns; i.e., the leverage of investment banks is procyclical.
* This procyclicality ampliﬁes the business cycle, potentially leading to systemic risk if asset prices do not properly reﬂect fundamental values (“bubbles”).
* Instead of passive letting different market conditions passively control their balance sheet, investment banks actively manage their balance sheet. For example by reducing assets when the overall values of assets fall, they counter the effect of reduced equity, leading to a procyclical effect.