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The effects of resolution methods and industry stress on the loss on assets from bank failures☆

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ABSTRACT

In this paper, we examine how the value of failed bank assets differs between two types of FDIC resolution methods: liquidation and private-sector reorganization. Our findings show that private-sector reorganizations do not deliver the expected cost-savings from 1986 to 1991, a period of industry distress. On a univariate basis, the net loss on assets is lower for a private-sector reorganization than for a liquidation in both a period of industry distress and of industry health. However, institutions with higher quality assets and higher franchise values are more likely to be resolved using a private-sector resolution. Once we control for this selection bias, we find that institutions that are resolved during periods of industry distress result in higher resolution costs than liquidation. During periods of industry health, private-sector resolutions are less costly than liquidations. We show that if a bank that failed during the post-crisis period instead failed during the crisis period, its net loss as a percent of assets would have been 3.232 percentage points higher. Given that the average net loss on assets ratio is 21.42 percent during our sample period from 1986 to 2007, the increase in costs is economically significant.

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1. Introduction

In this new era of bank failure resolutions, a careful analysis of the past is warranted. To provide useful guidance for an efficient resolution process, we undertake a thorough analysis of the resolution methods and loss on assets of 1213 of the 1244 banks that failed and were resolved by the FDIC from 1986 to 2007.

Our primary objectives are to examine how the value of failed bank assets differs between resolution methods and how it is affected by the condition of the banking industry. Our focal variable, the net loss on assets, is the difference between the book value of assets at time of sale and the proceeds received from the sale of assets, adjusted for premiums received for the deposit franchise.

Prior to a bank closing, the FDIC determines the resolution structures that it offers to potential bidders, markets the failing bank to these bidders, and evaluates the bids it receives. Two primary options are available to the FDIC. One option is to liquidate the assets and pay off the insured depositors. In this case, any value related to banking relationships and of deposit franchise is destroyed. Alternatively, the FDIC can sell all or part of the assets to an acquirer together with all or part of the deposits in a private-sector reorganization. In this case, customer relationships continue and are transferred to another institution. An FDIC liquidation is analogous to a Chapter 7 bankruptcy and a private-sector reorganization is analogous to a Chapter 11 bankruptcy. We define a private-sector reorganization method as one where more than 25

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percent of the assets are purchased by an acquirer that is approved by the FDIC. When less than 25 percent of the assets are purchased by the acquirer we call this method an FDIC liquidation.[1]

James (1991) proposed the "differential cost hypothesis" to explain the cost differences between resolution structures. According to this hypothesis the value of failed bank assets is less in an FDIC liquidation than a private-sector reorganization. The argument for this hypothesis is that a private-sector reorganization can preserve some of the franchise value. Given that the franchise value is non-negative, a private-sector reorganization should always be equally or less costly than a liquidation. This prediction is also consistent with the recent theoretical model developed by John et al. (2013) who show that firms in financial distress that are privately resolved have higher values than firms that go through liquidation. James (1991) finds empirical support for his hypothesis and shows that purchase and assumption resolutions are less costly than liquidations. Bovenzi and Murton (1988), and Brown and Epstein (1992) examine losses in bank failures during the period from 1985 to 1988 and also provide similar findings that support the differential cost hypothesis.

However, the differential cost hypothesis does not consider frictions that can arise in private-sector reorganizations. If there are costs associated with private-sector reorganization that exceed the franchise value that is preserved, then liquidation will result in lower costs. Shleifer and Vishny (1992, 2011) argue that these frictions and their associated costs can arise from a lack of investment capital in the industry due to distress. In situations where the degree of industry distress is severe, an asset sale may result in a price lower than its value in best use. In the context of resolving failed banks, this can occur because during a period of industry stress there are fewer qualified bidders available to bid on failed bank assets. As the volume of non-performing loans and defaulted loans increases, bidders may be more risk-averse which results in lower bids. Those firms that bid on failed bank assets know that during periods of industry distress they face less competition and therefore offer lower bids. Furthermore, the FDIC may prefer to pass assets because they are concerned that the accumulation of failed bank assets during a crisis would lead to a decline in liquidity of the deposit insurance funds.[2] Therefore, if the FDIC finds itself in a situation where a liquidation is not tenable because there are impediments to liquidating assets and paying off depositors in an orderly manner, a private-sector reorganization would result and might prove to be costlier than liquidation. We refer to this outcome as the "industry distress" hypothesis.

Our sample period allows us to test the validity of these two hypotheses utilizing two distinct economic and regulatory environments. The six-years from 1986 to 1991 represent a banking crisis period, when 1020 FDIC insured banks failed. In contrast, 224 FDIC insured banks failed during the sixteen years from 1992 to 2007, which represent a more stable period of time for the banking industry. If the differential cost hypothesis holds then private-sector reorganizations should be less costly than FDIC liquidations in both time periods. If the industry distress hypothesis holds then the private-sector reorganizations are more costly than liquidation during the crisis period.

An important consideration when we compare the cost effectiveness of resolution methods is whether the FDIC receives viable bids from the private sector for the failed-bank assets. Institutions that have higher quality assets and a higher franchise value associated with their deposits are likely to attract more bidders with the result that more assets will remain in the private sector. Therefore, it would be misleading to compare costs between the private-sector reorganization and the FDIC liquidations without controlling for the selection bias implicit in the resolution process. Our multivariate regressions control for this selection bias using a treatment regression.

In the first stage of our analysis, the probit regression, we model the outcome of the resolution process, which is either a private-sector reorganization or an FDIC liquidation. We posit that two objectives play a role in the resolution method outcome. One is the FDIC's regulatory mandate to minimize the cost to the insurance fund, and the other is to minimize the disruption to the community that the failed bank serves. Liquidating bank assets and paying off depositors can have a profound impact on a community because bank failures can lead to the destruction of relationship lending and a severe contraction in bank lending (Bernanke and Blinder, 1992; Bernanke et al., 1996; Ashcraft, 2005). We use factors that are proxies for the community disruption, such as business activity and personal income at the state level, as our instruments in the first-stage regressions.

Our tests show that these variables affect the outcome of the resolution process but not the loss on assets. We observe that FDIC liquidations are less likely in communities with low income and high unemployment rates. This outcome holds even during the 1992 to 2007 period when the FDIC was required to resolve banks in a manner that is least costly to the deposit insurance fund. One possible explanation of this result is that there is no conflict between minimizing the disruption to the community and minimizing the cost of the resolution.

In the second stage, we estimate equations for the net loss on assets, after we control for the selection bias in the resolution process. Our findings show that during the crisis period, private-sector reorganizations yield a higher loss on assets. This evidence refutes the differential cost hypothesis of James (1991), and other previous research which finds that the Purchase and Assumption (P&A) is a less costly method during the crisis period. We show that the lack of controls for the selection bias in the earlier research causes the difference in the findings.

Our results for the crisis period support the arguments of Shleifer and Vishny (1992, 2011) that in situations when industry distress is severe, an asset sale may result in a price lower than its value in best use. We corroborate this argument and show that at a time when investment capital is scarce due to industry distress and that FDIC finds itself in an environment where there are impediments to a liquidation, a private-sector reorganization proves to be costlier than liquidation. Additional support for the Shleifer and Vishny (1992, 2011) comes from the results for the stable period of 1992–2007. We show that the net loss on assets is lower for private-sector reorganizations when the industry is not in distress. In other words, once the industry regained its health, the FDIC received bids for failed bank assets that were more advantageous. However, we cannot attribute the cause of this finding entirely to the change in industry conditions. During this period the enactment of FDICIA brought a new regime for failed bank resolutions, including the least cost test and changes to failed bank marketing strategies, which may have contributed to lower costs. Because the FDICIA period and the non-crisis periods overlap, we are unable to disentangle the effects of FDICIA from those of improved industry health.

[1] Our definition of private-sector reorganization is closely related to the FDIC's purchase and assumption (P&A) classification of resolutions. The difference is that our definition classifies P&As that transfer less than 25 percent of assets to an acquirer as an FDIC liquidation. In our robustness checks, we vary this cutoff point between zero and 50 percent.

[2] As noted on p. 21 of FDIC (1998b) former FDIC Chairman L. William Seidman stated that when bank failures increase during a crisis holding assets uses up cash quickly, and that during the crisis forecasts indicated that the deposit insurance fund would be depleted by the end of 1990.

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