Why does the FDIC sue?☆

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ABSTRACT

Cases the Federal Deposit Insurance Corporation (FDIC) pursues against the directors and officers of failed commercial banks for (gross) negligence are important for the corporate governance of U.S. commercial banks. These cases shape the kernel of bank corporate governance, as they guide expectations of bankers and regulators in defining the limits of unacceptable behaviour under financial distress, such as risk shifting. We examine the differences in behaviour of all 408 U.S. commercial banks that were taken into receivership between 2007 and 2012. Sued banks had different balancesheet dynamics relative to those who are not sued in the three years prior to failure. These banks were generally larger, faster growing, obtained riskier funding and tended to underprovision. We find evidence that boards of failing banks respond to litigation by reducing the use of riskier funding in an out-of-sample set of banks. Our results suggest the FDIC does set corporate governance standards for all banks by suing negligent directors and officers.

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1. Introduction

What can regulators do to change the risk shifting behaviour of bank management? Fahlenbrach et al. (2012) show that some banks perform more poorly in crises. Banks that performed poorly during the Russian debt crisis of 1998 also performed poorly in the Global Financial Crisis of 2008 and 2009, showing long-run persistence in bank risk taking behaviour or cultures. In both crises, banks that are more reliant on short term financing and experienced higher asset growth are more likely to be a “bottom” performer. While the regulators can circumscribe the behaviour of banks through rules and regulations ex ante, it would appear that they are unable to change persistent risk taking behaviour or cultures at banks. Our contribution is to show that the FDIC, on an ex post basis, does punish bank managements who have engaged in risk shifting behaviour. When banks fail and they are placed in FDIC receivership, the FDIC is entitled to pursue bank directors and officers for professional liability claims for negligence. If the FDIC pursues bank management in negligence claims in a predictable fashion based on easily observable

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We contribute to the empirical corporate governance literature on commercial banks by focusing on an important mechanism for disciplining directors: the threat of legal action. Corporate governance is concerned with the actions of the board of directors and their alignment with the interests of the shareholders. The institutional framework of corporate governance extends as far as shareholder litigation against directors and officers. Over 400 U.S. commercial banks failed during and after the Global Financial Crisis of 2008 and 2009. Just over a third of them saw Federal Deposit Insurance Corporation (FDIC) litigation against directors and officers, a far higher percentage than during the last major period of failures of federally guaranteed institutions, the S&L Crisis from 1986 to 1989, of 24%.

This paper empirically investigates the litigation strategy of the regulator (FDIC) when pursuing the bank directors and officers of failed U.S. commercial banks. Is the FDIC primarily interested in pursuing excessively risk taking banks? If the FDIC does indeed see value in improving banks’ governance, it will pursue directors in a systematic fashion reflecting poor governance. The directors and officers of U.S. commercial banks who are pursued for “negligence” are indeed those who have engaged in risky behaviour such as risk-shifting. In order for litigation to serve as a deterrent to poor corporate governance, it must be possible ex ante for directors and officers to be aware of potential financial distress. Therefore, we focus on a list of financial indicators, the “directors’ dozen” (see Table 1) from the FDIC’s guide for new directors, for evidence that the FDIC sues directors and officers for negligence that could have been foreseen. In our robustness tests, we find that in out of sample banks that fail after 2012 Q2, the behaviour of banks appears to change, with less evidence of risk shifting such as a reliance on riskier financing.1

Collecting data from the FDIC’s professional liability lawsuit list and professional liability settlement agreements for banks that failed between 2007 and June 2012 we identify cases of (gross) negligence that the FDIC chooses to pursue. The FDIC provides a list of failed banks, 408 banks failed in this time period and 161 are subject to litigation against directors and officers for (gross) negligence. We combine these bank failures and litigation cases with data from the Federal Financial Institutions Examination Council quarterly reports for the fundamental financial data to replicate the “directors’ dozen” and other control variables.

The control variables fall into three categories: income statement ratios, balance sheet ratios, and balance sheet dynamics. We employ three methods to analyse whether the directors of banks that fail who are sued should be aware of the greater risk being taken. We visualize dynamic, univariate comparisons of individual financial measures, contrasting banks that fail and whose directors are sued with all other banks that fail. Second, we compare sued banks to other failed banks using a multivariate logistic regression including the “directors’ dozen” with other control variables such as bank size and the size of the loss reported by the FDIC. Thirdly, we run a Cox Proportional Hazard model to predict banks that merely failed and those whose directors are sued from within the wider population of all banks using ex ante available information.

All three methods concur that directors and officers of banks who are sued for (gross) negligence should have been aware of the relatively greater risk taken by their institutions. Banks subject to litigation are engaged in faster total asset growth, utilize more net non-core funding (short term riskier deposits and loans) and appear to have underprovisioned. We also find regardless of the recovery potential, there is no “too-small-to-get-sued”.2 We find that the FDIC pursues a litigation strategy that penalises directors and officers of banks that fail exhibiting risk shifting behaviour. Specifically, banks with higher asset growth and reliant on short term riskier financing in the three years prior to failure. These are characteristics that are found in the “bottom” performers of Fahlenbrach et al. (2012)

The subsequent Section 2 discusses corporate governance and shareholder litigation. Section 3 describes the underlying bank level data. The next Section 4 discusses our three empirical methods. After that we present our empirical results in Section 5 and a range of robustness checks in Section 6. Finally, we conclude in Section 7.

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1 See Table 7.

2 A “too-small-to-get-sued” effect represents the idea that the FDIC, limited in its resources, does not choose to pursue smaller banks as the return on investment is low.

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