



## Do depositors care about enforcement actions?

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### Abstract

Since 1990, federal bank supervisors have announced formal enforcement actions publicly. The change in regime provides a natural laboratory to test two propositions: (1) claims by economists that putting confidential supervisory information in the public domain will enhance market discipline and (2) claims by bank supervisors that releasing such data will spark runs. To evaluate these propositions, we measure depositor reaction to 87 Federal Reserve announcements of enforcement actions. We compare deposit growth rates and yield spreads before and after the announcements at the sample banks and a control group of peer banks. The data show no evidence of unusual deposit withdrawals or spread increases at the sample banks following the announcements of formal actions. These results suggest that public announcements of enforcement actions did not spark bank runs or enhance depositor discipline. Apparently, depositors did not care a great deal about our sample actions. © 2001 Elsevier Science Inc. All rights reserved.

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### 1. Introduction

As is well known, underpriced deposit insurance creates incentives for bankers to take excessive risk. Bankers can pursue high-risk ventures, confident of capturing the profits and shifting the losses, should failure occur, to the Federal Deposit Insurance Corporation

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(FDIC). Broadly speaking, two forces constrain this temptation: government supervision (Flannery, 1982) and discipline by bank claim-holders [see Flannery (1998) for a thorough review of the literature].

Theory and evidence suggest that discipline by bank claim-holders can constrain bank risk, in some cases better than bank supervisors. Bank claim-holders, with their own money on the line, have powerful incentives to monitor and punish excessive risk. Between 1987 and 1991, for example, holders of large certificates of deposit at thrift institutions responded to increases in the probability of failure by demanding higher yields and withdrawing funds (Park & Peristiani, 1998). Thrift supervisors, in contrast, responded to emerging problems slowly, hoping that troubled institutions would grow out of their problems. This regulatory forbearance significantly increased the ultimate cost of the cleanup (Kane, 1989; White, 1991).

Shifts in public policy over the last decade reflect the view that discipline by bank claim-holders can be an important check on bank risk. The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) limited insurance coverage on some classes of deposits and directed the FDIC to resolve failures in the least costly way. These provisions shifted more of the burden of failure to uninsured depositors, thereby strengthening their role as monitors (Benston & Kaufman, 1997). Moreover, the capital standards phased in under the Basle Accords were designed to mimic the discipline that depositors would impose in a world with no insurance by linking capital requirements to credit risk exposure (Berger et al., 1995).

In theory, greater disclosure of confidential supervisory information could further strengthen discipline by bank claim-holders. The Federal Financial Institutions Examinations Council (FFIEC) requires all depository institutions to submit quarterly Reports of Condition and Income, also known as call reports. Bank claim-holders, in turn, react when presented with evidence that an institution is taking on more risk (Hall, King, Meyer, & Vaughan, 1999 and 2000). Through on-site examinations, supervisors gather additional information about the quality of loan portfolios and the competence of bank management that does not appear in call reports. If bank claim-holders had access to this confidential information, they could, in theory, exert even more effective discipline on risky institutions.

Bank supervisors have, however, consistently opposed releasing confidential information for fear of sparking costly runs. Bank runs, supervisors argue, are not creatures of the 1930s. In the 1980s, for example, news reports questioning the solvency of state-run deposit insurance funds prompted runs at thrift institutions in Maryland and Ohio (Kane, 1989). More recently, a CNN report about the 1991 Rhode Island credit union crisis led to a brief run on Old Stone Bank, a safe and sound \$3.7 billion thrift, when a reporter elected to use the institution's impressive façade as a backdrop (Wilke, 1991; Leander, 1991). Supervisors fear that depositors will respond to negative information as Old Stone's depositors responded to the CNN report. Instead of evaluating the information carefully, depositors will panic and withdraw funds from named or other similar institutions. The failures of such institutions may, in turn, disrupt lending relationships that cannot easily be re-established with other banks. Disruption of these relationships reduces the value of bank-dependent firms (Petersen & Rajan, 1994; Slovin, Shushka, & Polonchek, 1993) and depresses local as well as national economic activity (Bernanke, 1983; Gilbert & Kochin, 1989).

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