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Bank forbearance: A market-based explanation

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Abstract

Why does forbearance for insolvent banks occur? We offer an explanation based on stockholders' ability to appeal to the courts for reversal and monetary damages after the regulator has initiated a receivership action. Although this has always been theoretically possible, precedents and common law standards now exist. We calculate the market's perceived postponement of receiverships for banks thought to be insolvent. We explain the receivership delays with the regulator's reluctance to proceed when investors' pricing of the bank's stock and accountants' assessment of the bank's solvency do not support a receivership action. Our clinical evidence is consistent with this notion. © 2000 Bureau of Economic and Business Research, University of Illinois. All rights reserved.

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1. Introduction

Receivership delays, known as forbearance, for financial institutions thought to be insolvent are not uncommon. This raises the question of *why* forbearance occurs. Explanations provided in the literature are based on an incentive breakdown that causes the regulator to protect and defend the regulated (Kane, 1989, 1990; Boot & Thakor, 1993). We advance an alternative explanation: regulators may be deterred by the threat of a shareholder appeal to the courts to reverse the receivership and assess monetary damages against the regulator.[1] We provide clinical evidence consistent with this notion.

Prior to the closing of a financial institution and the liquidation of its assets, the regulator

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places the institution's assets into receivership.[2] The receivership decision is not mandatory but rather discretionary, even after the FDIC Improvement Act of 1991 (FDICIA).[3] Whereas a reversal of the receivership has always been a theoretical possibility, cases brought in the 1980s have established precedents for the return of an institution's assets and the assessment of damages against the regulator. Three examples illustrate the vulnerability of regulators to shareholder opposition: Franklin Savings, MCorp, and First City Bancorp of Texas.[4] In the Franklin Savings Case, though reversed at the appellate level, the court found for the stockholders and reversed the receivership decision.[5] In the MCorp case, the court ruled that the FDIC improperly seized 12 of the 20 MCorp banks. MCorp sought $250 million of actual damages and up to $1 billion of contingent and consequential damages. In the First City Bancorp of Texas case, the FDIC agreed to pay the stockholders damages of $380 million when the bank was found to have had a net worth of $60 million.

The caution the regulator must exercise is due to the possibility of being held accountable in court, and to the fact that the standards that are being established by the courts tend to be more demanding than what is required under banking law. Banking law allows the regulator wide latitude to judge insolvency based on "predictive judgment" when the accounting write-offs of a bank's assets notoriously lag their deterioration.[6] The courts, on the other hand, require the regulator to "produce and certify record upon which he relied *at the time of decision*, which record must contain *sufficient* data to allow reviewing court to determine whether Director had *rational* basis for appointment decision (italics added)" [Franklin Savings v. Director, Office of Thrift Supervision, 934 F.2n 1127 (10th Cir.1991), p. 1128]. The market's pricing of the bank's individual assets at the time of the receivership decision could best provide a rational basis for the decision, as the cumulative accounting write-down tends to lag actual asset values. Yet, a substantial portion of bank assets consists of business loans for which secondary markets don't exist. Hence, it is typically impossible to accurately price a bank's assets on the day its receivership is effective (Beaver, Datar & Wolfson, 1992).

To further complicate the regulator's problem, for banks that have publicly traded stock (and subordinated debt), the prices of these securities in the markets may suggest investors' assessment that the bank was solvent on the day the receivership was invoked. The market prices of the bank's securities may thus contradict the regulator's judgment and increase the regulator's burden to justify the receivership decision. When the bank's equity valuation in the stock market is inconsistent with evidence of insolvency, the regulator faces a dilemma. The equity value may reflect the market's assessment of future bank profitability, but it may also merely reflect the option value of the time the troubled institution is expected to receive to re-establish solvency. This problem is cited by a former FDIC Director: ". . . slow action by regulators and limited disclosure helped keep stock prices of troubled banks at unrealistically high values." (FDIC, 1997, Vol. II, p. 81).

To capture the countervailing influence of third-party judgments on the receivership decision, we introduce proxies for the valuation of bank assets by accountants and investors. In the empirical analysis, we use the market value of the institution's equity divided by its book value as a measure of investors' valuation relative to the accountants' valuation. For high market-to-book ratios of equity, the regulatory burden of proof is greater as investors assign a market value to the institution that exceeds the value reflected in the accounting