



Decision-making during the credit crisis: Did the Treasury let commercial banks fail?☆



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ABSTRACT

Limited attention has been paid to the comparative fate of banks benefiting from Capital Purchase Program (CPP) funding and less fortunate banks subject to FDIC resolution. We address this omission by investigating two core issues. One is whether commercial banks that ended up being subject to FDIC resolution received CPP funds. The other is whether the non-allocation of CPP funds made FDIC receivership more likely for viable commercial banks. Our findings show almost no overlap between CPP-funded and FDIC-resolved commercial banks, but we provide evidence that a significant number of FDIC-resolved banks could have avoided receivership if they had been allocated CPP funding. By comparing estimated funding and resolution costs we also show that bailing out more banks would have been cost-efficient. While our results do not allow for any policy suggestion on the optimality of bailouts per se, they suggest that once a bailout program is already on the table, it is better to err on the side of rescuing too many rather than too few banks.

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1. Introduction

Since September 15, 2008, the day Lehman Brothers filed a petition seeking relief under Chapter 11 of the US Bankruptcy Code, the Federal Deposit Insurance Corporation (FDIC) has been appointed as receiver for almost 500 banks.¹ This is more than ten times the number of banks subject to FDIC receivership during the expansion period that preceded the credit crisis (40 banks failed between October 2000 and September 15, 2008). (See Fig. 1).

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¹ See FDIC, list of failed banks, available at fdic.gov (as of January 16, 2014).

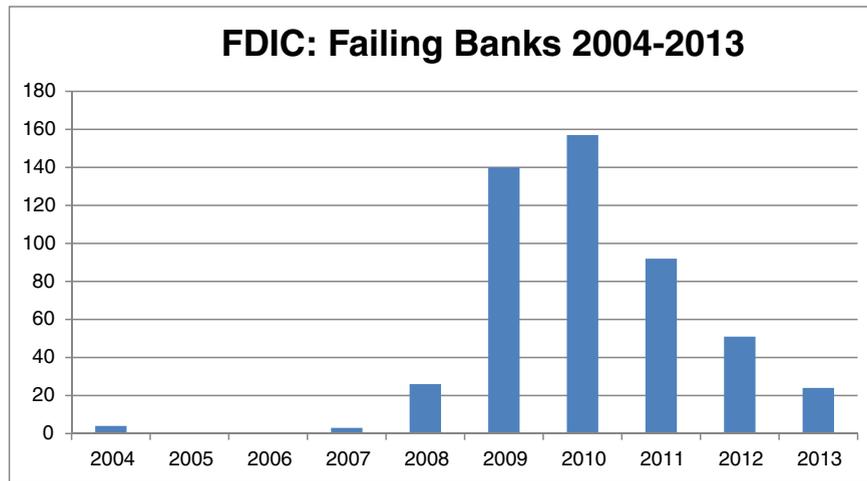


Fig. 1. Failing banks 2004–2013. The figure presents the time series of US commercial bank failures between 2004 and 2013. Data are from the FDIC website (<https://www.fdic.gov/bank/individual/failed/banklist.html>).

It is an open question whether this increase in FDIC interventions is related to the decisions taken during the 2007–2008 financial crisis by the US Treasury, and in particular by its management of the Capital Purchase Program (CPP) established under the Troubled Asset Relief Program (TARP). According to the Treasury, CPP “was launched to stabilize the financial system by providing capital to *viable* financial institutions of all sizes throughout the nation. Based on market indicators at the time, it became clear that financial institutions needed additional capital to absorb losses and restart the flow of credit to businesses and consumers”.² The Treasury did not explicitly define *viability* nor the market indicators suited to measure it, except to point out that: “Participation is reserved for healthy, viable institutions that are recommended by their applicable federal banking regulator”.³ It follows that the Treasury had to avoid two types of mistakes: (i) subsidizing banks that were not viable (type I error); and (ii) not assisting banks that were viable (type II error).

Ideally, the proper way to deal with a *viable* bank facing difficulties in a financial crisis situation is to have the government intervene and provide some form of temporary aid (as in the case of the CPP).⁴ Conversely, when providing temporary aid will not prevent a bank from failing during or after the crisis, it should be considered *non-viable* and restructured or wound-down. In the real world, however, insuring for the continuation of essential services can require the government to provide financial support to banks that may not be viable, especially if their failures could lead to a bank-run and result in the so-called *too-many-to-fail* effect (Brown and Dinc, 2011). In addition, non-viable banks may be bailed out due to pressures by politicians worried about the impact of bank failures upon their constituency (Blau et al., 2013), even though this kind of state aid is likely to merely delay resolution or liquidation. Such lobbying is not only increasing the costs of subsequent FDIC intervention (Liu and Ngo, 2014), but is also likely to lead to fire sales of bank assets that, in turn, affects the viability of additional banks (Caballero and Simsek, 2013).

These considerations highlight the practical importance of the decisions made by the Treasury during the credit crisis: (i) were CPP funds allocated to (ex post) non-viable banks? (ii) was the non-allocation of CPP funds a determinant factor of FDIC receivership for (ex ante) viable banks? Related to this, there is also the issue of whether the Treasury took optimal decisions once we properly account for the cost of FDIC interventions—in particular in view of the FDIC often carrying 80% of the losses resulting from the sale of resolved bank assets.⁵

This paper empirically investigates the decisions government officials took to accepting some banks into the CPP program and not supporting others that were thereafter subject to resolution. Our focus is on *commercial banks*, especially smaller ones, rather than on *bank holding companies* (BHCs). While many BHCs submitted applications to participate in the CPP program, they were usually under the control of their largest bank (Carnell et al., 2008). It follows that BHC-affiliated commercial banks were the most likely users of CPP funding, for two reasons. First, they were the legal entities in charge of lending to firms and individuals, and thus the intended recipients of CPP funding. Second, over half of the 707 applications approved and funded by the Treasury were submitted by institutions with less than \$500 million in assets (Cornett et al., 2013), within which funding is more likely to trickle down to banking subsidiaries rather than to remain at the holding level. In addition, the focus on commercial banks allows for a cleaner analysis. On the one hand, it makes it possible to directly compare CPP bailouts, which targeted BHCs as well as

² See <http://www.treasury.gov/initiatives/financial-stability/TARP-Programs/bank-investment-programs/cap/Pages/overview.aspx> (as of November 24, 2014).

³ See <http://www.treasury.gov/initiatives/financial-stability/glossary/pages/default.aspx> (as of November 24, 2014).

⁴ For a literature review, see Bolzico et al. (2007); Mishkin (2000).

⁵ During the crisis there was a serious risk that the Treasury would have to bail-out the FDIC. See e.g. FDIC-Insured Institutions Lost \$3.7 Billion in the Second Quarter of 2009, Press Release PR-153-2009, FDIC, <http://www.fdic.gov/news/news/press/2009/pr09153.html> (last accessed on April 23, 2014).

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