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Study delves into regulators' decision-making in bank closures

July 17 2015

Dr. Malcolm Wardlaw is an assistant professor of finance in the Naveen Jindal School of Management at the University of Texas at Dallas. Credit: UT Dallas

A new study from The University of Texas at Dallas found that commercial bank regulators consider much more than monetary cost when determining whether to close a troubled bank.

According to the study, published in a recent issue of the *Review of Financial Studies*, regulators show a desire to defer costs into the future and appear to resist closing very large and very small banks. The study also found political influence affected their decisions.

Dr. Malcolm Wardlaw, assistant professor of finance in the Naveen Jindal School of Management, said that instead of modeling the economic forces that cause a company to go bankrupt, the researchers wanted to model the regulator itself and determine what leads to its decision to close a bank.

"A regulatory agency is made up of people—people who have their own preferences and needs and wants and desires, and even if those agencies are free of corruption, people still are influenced by other things," Wardlaw said.

The study used data from the Federal Deposit Insurance Corp. (FDIC), the government agency that insures deposits in banks, to examine two time periods of bank closures—1986-1992 and 2008-2012.

The researchers used a technique typically used in labor economics called conditional choice probability estimation. Wardlaw said this is the

first time a finance paper has used these tools, which measure how people make decisions.

"If I'm a bank regulator, I can string this troubled bank along and hope it gets better, but the moment I decide we're done and we need to close up shop, then I'm done making decisions about this bank," Wardlaw said. "That bank is no more. Its assets get acquired by someone else or it's dissolved.

"A bank doesn't fail on its own in the same way a corporation files for bankruptcy. A bank gets shut down by a regulator."

In the first time period, the study found:

- Regulators had an aversion to closing the largest and smallest troubled banks.
- If a bank was sitting on a lot of property, regulators chose not to close them.
- Regulators may have faced political pressure to leave certain banks open.
- Regulators were somewhat shortsighted, placing too much weight on costs today vs. potentially higher costs in the future.

Those issues were gone in the 2008-2012 period, a testament to the efforts of regulators like the FDIC, Wardlaw said.

"U.S. banking regulators went through a lot of handwringing and self-examination after the '90s," he said. "They recognized that closure policy had often been mismanaged, and they made a massive attempt to fix the problems. It appears they succeeded on many levels."

Wardlaw said bank closures recently have come back to the public's attention. Bank failures were numerous in the 1980s and early 1990s, but

largely halted from 1994 to 2006. Since 2007, it's become an important issue again.

"You always have to pay close attention to what your regulatory bodies are doing, and not just in times of crisis. There are a number of important regulatory bodies in the U.S., and you can't just treat them as a cog in a machine. It's important to make sure that you know exactly what influences these regulators."

More information: *Review of Financial Studies*, rfs.oxfordjournals.org/content/28/4/1060.abstract

Provided by University of Texas at Dallas

Citation: Study delves into regulators' decision-making in bank closures (2015, July 17) retrieved 23 April 2024 from https://phys.org/news/2015-07-delves-decision-making-bank-closures.html

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