Did the Financial Reforms of the Early 1990s Fail? A Comparison of Bank Failures and FDIC Losses in the 1986-92 and 2007-13 Periods

Eliana Balla
Federal Reserve Bank of Richmond

Ned Prescott
Federal Reserve Bank of Cleveland

John Walter
Federal Reserve Bank of Richmond

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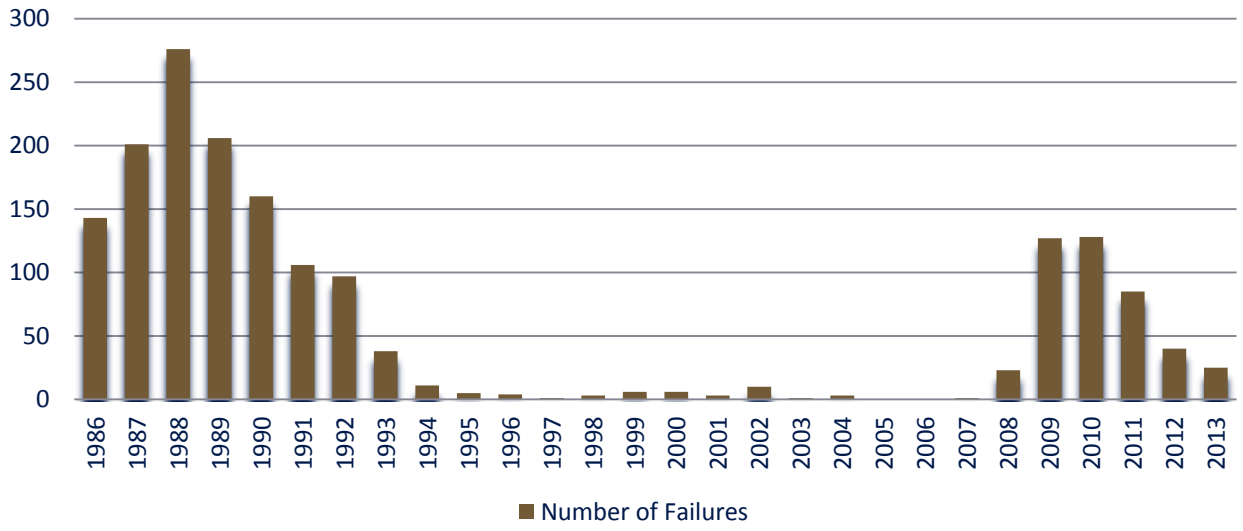
Commercial Bank Failures 1986-2013



Note: There are about twice as many banks in 1988 as in 2010, so failure rates are similar across the two crises.

FDIC Losses Compared

FDIC Losses Measured as a Percentage of Failed Bank Assets Net of Book Equity

	1986-1992	2007-2013
Average Losses	20.3	25.2
Weighted by Assets	13.2	18.4

Notes:

Losses are as reported by the FDIC as of December 2014.

Sample only includes banks that were in existence at the beginning of each period and that are not *de novo* banks.

Losses are higher for *de novo* banks, but they do not raise the averages much.

Structure of Presentation

- List three differences between the two periods
- Compare predictors of bank failures
- Compare predictors of losses to the FDIC
- Disentangle the relative importance of the three differences

Change 1: Increased CRE Concentrations for Small and Mid-Size Banks

	1985Q4	2006Q4
Securities	29	22
Ag loans	7	5
Consumer loans	12	5
C&I loans	12	10
Construction and land development loans	2	7
RE backed by 1-4 family properties	11	16
RE backed by nonfarm nonresidential properties	5	15

A small and mid-size bank is one with less than $14.8 billion in assets in 1985 Q4 and less than $50 billion in 2006 Q4. Each category of bank assets expressed as a percentage of total assets.

Change 1: Bank Balance Sheets

- Increased concentrations in:
  - commercial real estate lending
  - CLD lending
  - concentrations even bigger for failed banks

- But average capital higher
  - 1985 Q4 – 8.5%
  - 2006 Q4 – 11.0%

Change 2: Difference in Economic Performance

National recession

Change 2: Difference in Economic Performance

Early period: New England – real estate collapse; Texas – oil shock

Change 3: Regulatory Reforms in early 1990s

- Basel I Accord (1988)
  - implemented early 1990s
  - higher capital requirements
- FDICIA (1991)
  - FDIC must use least cost resolution
  - Prompt Corrective Action (PCA)
    - capital triggers that force supervisors to act
    - reduces forbearance
    - expected to reduce FDIC losses

Data

- Sample is comprised of established small/midsize commercial banks
  - Bank data - Call Reports
  - FDIC Losses – FDIC Historical Statistics on Banking

- Take characteristics of banks right before each of the 7 year periods
  - Balance sheet (loan concentrations, securities, deposits, capital)
  - Performance (size, non-performing loans, earnings)
  - Accounting (loan loss reserves, accrued interest receivable)
  - State-level economic conditions

Method

- Pool banks by period
  - Pre-FDICIA (1986-1992), Recent crisis (2007-2013)
  - Take bank characteristics in 1985Q4 and 2006Q4
- Heckman selection model
  - Predictors of failure and loss given failure evaluated in separate stages
- Use consistent variables across the two periods

Predictors of Failure

- Increases failure probability
  - Lending concentrations – CLD, CRE, C&I
  - Performance – Non-performing loans
  - Economic shocks – HPI drop, unemployment increase
  - Accrued interest receivable

- Decreases failure probability
  - Capital, securities holdings, earnings, core deposits
  - Residential mortgage and size (earlier period)

Predictors of FDIC Losses

- Most variables do not explain the variation in losses
- Increases losses in both periods
  - Accrued interest receivable
- Decreases losses in both periods
  - Size

Comparison of the Crises

- For small and mid-size banks
  - Crises look very similar
  - Same variables predict failure
  - Main difference is size of effects

- Some caveats
  - Policy actions to reduce failure rates in later period, e.g. TARP, expanded deposit insurance

Counterfactuals: failures

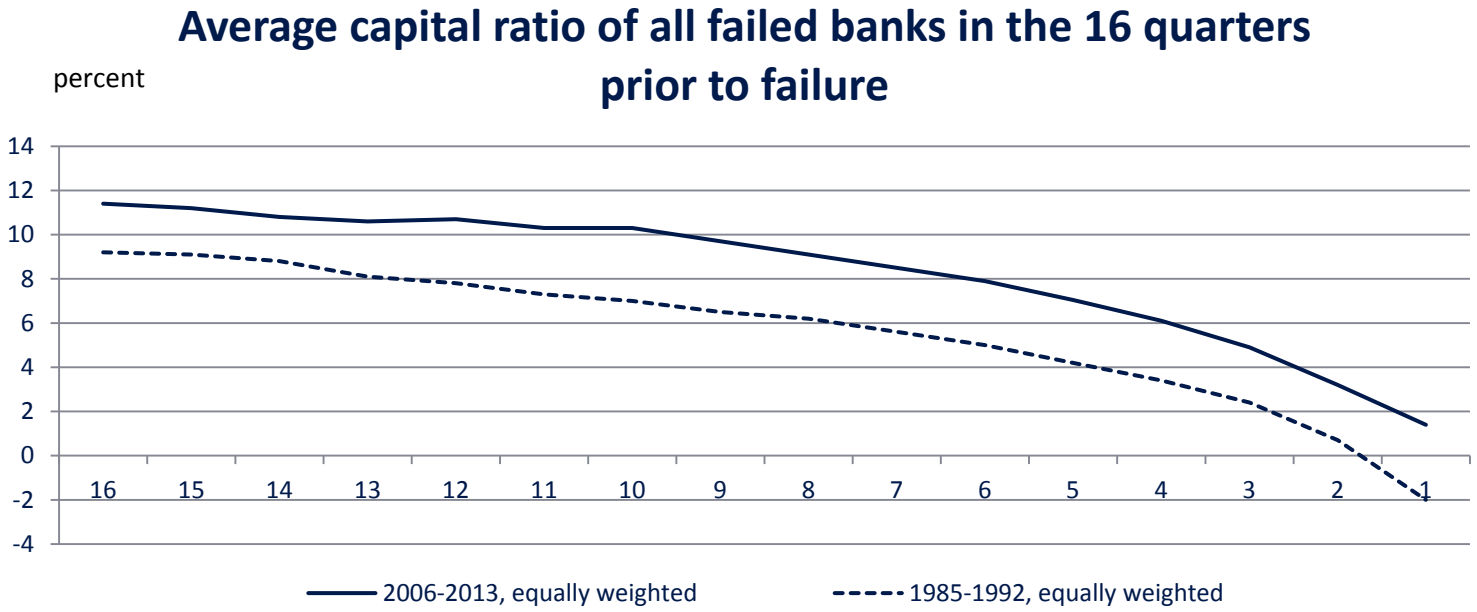
- Actual failure rates
  - 1986-1992: 5.7%
  - 2007-2013: 4.7%

- Switch size of economic shocks (HPI, unemployment)
  - 1986-1992: 11.6%
  - 2007-2013: 1.4%

- Move 2006 banks to 1985
  - 1986-1992: 3.3%
  - drop driven by higher capital of 2006 banks

- Size of economic shocks more important than CRE concentrations
- Higher capital from financial reforms helped

Capital Ratio of Failed Commercial Banks



In general, supervisors followed PCA.

Counterfactuals: losses

- Similar approach as with failures counterfactuals
- Economic shocks do not explain the size of losses
  - Unless constant term is picking that up
- If a bank gets to FDIC receivership, losses are going to be high
  - Suspect more valuable banks are bought before failure

Conclusions

- Two crises look very similar for small/mid-size banks
- Differences in failure rates
  - Biggest factor - size of economic shocks
- Balance sheet changes
  - Increased CRE concentration was risky
  - But higher capital was a mitigant

Conclusions (cont.)

- Higher capital requirements as a tool to reduce losses given failure:
  - Helped to reduce failure probabilities
  - No evidence of direct effects on losses to FDIC

- If a bank fails, losses are usually large
  - Accounting numbers lagged economic value
    - Suggested by finding on accrued interest receivable

Thank you

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