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Do Financial Crises Cleanse the Banking Industry?

Evidence from U.S. Commercial-Bank Exits

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Numerous studies highlight the large costs of financial crises in terms of financial instability and the decline of economic growth. While these costs are indisputable, more controversial is the possibility that some benefits might arise from these crises, such as the exit of less-productive firms. The proponents of these benefits see crises as a selection process that accelerates the removal of the least-productive firms, with an overall positive effect at the industry level. This argument is formalized in the cleansing view of real and financial shocks dating back to Joseph Schumpeter and his concept of creative destruction.

We evaluate whether the cleansing view applies to the exit of U.S. commercial banks during the major episodes of financial crises that occurred between 1984 and 2013. Understanding whether there is a cleansing effect in the banking industry during financial crises has important implications for regulators and policymakers. For instance, in the absence of a cleansing effect, government policies intended to reduce the short-term impact of crises are not in conflict with the longer-term objective of maximizing the productivity of the banking industry.

The literature does not investigate the cleansing effect of financial crises in the banking industry but focuses on nonfinancial firms with conflicting findings. A first group of studies looking at economic recessions offer support to the cleansing view and conclude that firms that do not keep up with innovations eventually fail. A second group of studies examining financial shocks show that financial crises destroy firms regardless of their degree of productivity and lead to a scarring effect.

Our analysis departs in two key respects from the existing studies on nonfinancial firms. First, we examine and compare the exit of commercial banks during two major crises—the Savings and Loans (S&L) crisis of the mid-1980s and the Global Financial Crisis (GFC) of 2007–2010. These crises show key differences in terms of the exit of firms. While the number of commercial banks that failed during the S&L crisis was greater than during the GFC, the latter crisis involved a much larger proportion of failed bank deposits. This is in line with the widely accepted view that the GFC was the most severe systemic shock that has hit the banking industry since the Great Depression. Therefore, analyzing these two different crises allows us to understand whether it is possible to reach general guidelines on crisis management in banking.

Second, we account for two bank exit mechanisms: failure and acquisition. The consideration of acquisitions is critical in any study of bank exit because weak banks are more likely to be acquisition targets. Furthermore, regulators often favor the takeover of troubled institutions by healthier ones (especially during periods of distress) to contain the spread of

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panic. Hence, ignoring acquisition as an exit mechanism of unproductive banks might result in misleading conclusions in terms of bank exit via failure.

To identify the least-productive banks, we follow a strand of the literature that examines the effects of bank productivity (measured in terms of efficiency) on bank exit without a specific focus on crisis periods. Accordingly, we measure bank productivity using cost efficiency, thus quantifying how effectively resources are used to produce bank outputs.

We find that the S&L crisis accelerated the removal of the least-efficient institutions via both exit mechanisms, as suggested by the cleansing view. In contrast, the GFC increased the probability of failure for all banks regardless of their levels of efficiency and favored the acquisition of banks with the highest degrees of efficiency. Furthermore, the cleansing effect that materialized during the S&L crisis disappeared in the group of young banks, whereas the findings for the GFC remain consistent with a general scarring effect independently of bank age. This indicates that crises might overly penalize young institutions that do not fully achieve their potential.

Next we examine two potential (but not mutually exclusive) explanations for the differences we observe across the two crises. First, it is likely that more widespread crises, such as the GFC, affect healthier and more-productive institutions by generating panic among uninformed depositors or by amplifying contagion risk via the interbank market. In line with this interpretation, we document that when the magnitude of a systemic shock is larger, the average efficiency of exit banks is also higher. Second, the GFC was characterized by a widespread government intervention via the Troubled Asset Relief Program and the Capital Purchase Program, which might have contributed to sheltering some inefficient banks from exit. Along these lines, we document that supported banks were less efficient than other surviving banks before the crisis.

Following our analysis of the explanations for the differences between the two crises, we examine broader effects of the two crisis periods. First, focusing on the crises' effects on the market share of surviving banks, we find that only the S&L crisis negatively affected the market share of the least-efficient institutions. Second, for acquiring institutions that might have benefitted from cheap deals during periods of systemic distress, we show a deterioration of acquiring-bank efficiency levels postacquisition.

In a final step, we examine whether there are postcrisis industry benefits to both surviving and new-entry firms due to the resources released from the failing institutions, as suggested by the cleansing view. We do not find any support for this conjecture and show instead that bank efficiency after the two crises remained significantly below the respective precrisis levels. Nevertheless, we do find some evidence that banks entering during crisis periods benefit from efficiency gains after those periods.

Overall, our findings highlight the importance of regulatory requirements that strengthen banks during good times in anticipation of future systemic distress. These rules play a role in safeguarding the long-term productivity of the banking industry.

NOTE:

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