When to Call It Quits

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During the unraveling of the 2008 financial crisis, 165 banks failed. They were ultimately bailed out at a cost of $8.9 billion. But the question on the minds of ordinary taxpayers, investors, regulators, and many others was: why didn’t the bank managers cut their losses, quit while they were ahead, run for the exit before the government pulled the plug?

Two researchers at Olin explore this question and the process of delaying the difficult decision of when to call it quits in a study of bank closures from 1984 to 1997.

Irrational vs. Rational Delays

The dominant theoretical explanation for this delayed exit is “escalation of commitment.” Escalation of commitment is a tendency to hold onto investments in spite of negative feedback when there is uncertainty about outcomes. Because this behavior is irrational, there is a presumption that making people more rational might solve the problem.

Elfenbein and Knott offer an alternative view. They argue that some delay is rational. When there is uncertainty about market demand or about your own ability, and when that gets coupled with variable profits, it doesn’t make sense to pull the plug at the first sign of losses. Those losses may merely reflect temporary setbacks—you don’t want to scrap all your investment if profits will ultimately rebound. In this view, some waiting is good, but too much waiting leads to more losses.

The question Elfenbein and Knott ask is: when do firms pull the plug relative to when they should pull the plug?

Quitting Time

The researchers use a formula for the optimal time to exit that was developed by operations professors who applied it to research and development projects. The formula had not been applied to whole firms prior to this study.

Elfenbein and Knott applied the formula to 7,800 banks and found that 25% of failed banks exit within a year of the optimum exit point but nearly 50% delay exit for three years beyond that.

This finding suggests some behavioral biases were coming into play. In order to explore how these biases might influence exit strategy, Elfenbein and Knott compared how firms responded to good news (profitable quarters) versus bad news (loss quarters).

In theory (using the formula), all news should be treated equally. However, the researchers found that firms were a thousand times more sensitive to good news—meaning it took $1,000,000 of losses to get an equivalent (but opposite) response to $1,000 of profits.

Since most of the banks in the study were entrepreneurial independent banks, it might be assumed that they are more irrational than bureaucratic firms—the idea being that bureaucracy rids the firm of emotion. Elfenbein and Knott actually found the opposite to be true. Independent banks exited sooner than banks belonging to large holding companies. The most likely explanation is: independent bank owners have their own money at risk and unnecessary losses directly affect their personal wealth.

Conclusions & Takeaways:

1. Some delay in cutting losses is rational, whether closing a failing firm or divesting underperforming divisions.

2. The good news is there’s an algorithm to help identify when a firm should cut losses and exit.

3. The algorithm is most effective when there is good information about the market—including information about rivals’ performance.

4. Banking has better information than any other industry because the FDIC publishes quarterly data (approximately 2,400 variables) for all insured banks (roughly 10,000), so delays in other industries are probably worse than the ones in this study.

5. Since banking remains highly competitive even with this level of disclosure, firms in other settings should lobby the government for greater disclosure of tax and economic census data.