Bank Failures in Economics

Snehal Phadke

A well-organized and efficient banking system is an essential pre-requisite for overall economic growth of country. Banks play an important role in the functioning of organized money market. They act as a conduit for mobilizing funds and channelising them for productive purposes. In order to meet the banking needs of various sections of the society, a large network of bank branches is established in all highly developed countries. But it has been observed during the past 30 years that even the sophisticated markets and long functioning banking systems have had significant bank failures and bank crisis. Bank failures are a direct threat to the economy of any country and hence regulatory changes are required to be designed to decrease the probability of future bank failures and lessen the cost of bank failures.

A number of recent official working groups and academic studies have analyzed the causes to bank failures across the world. The working paper presented by the Basel Committee is the analysis carried out by the experts on the same issue.

Major causes of Bank Failures:-

- **Foreign Exchange Risk**: -Banks may get into trouble if they undertake large and risky foreign exchange business. Losses may result if the bank has incurred liability in terms of a foreign currency and there is an unanticipated appreciation in that specific currency. The risk is higher especially in the environment of floating exchange rates. If the transactions are entered into with a fixed currency exchange rate the future liability is known in advance.

  For Example;- A bank has a future obligation to pay $10,000 say 3 months later.
  Present rate of exchange =Rs45=$1
  Present liability= Rs 4,50,000
  Rate of exchange 3 months hence =Rs47=$1
  Liability after 3 months:-

Fixed rate of exchange	Floating rate of exchange
Rs 4,50,000	Rs 4,70,000

  The banks should therefore hedge their risks in foreign exchange through forward contracts both for their pay ins and pay outs in the environment of floating exchange rates. Also the management should periodically review the open foreign exchange positions and close or hedge them accordingly.

  Similar were the circumstances in case of Herstatt bank in Germany. They got into trouble because of their large and risky foreign exchange business In the environment of floating rates of exchange Herstatt became over indebted as the bank suffered exchange losses of around DM 470 Million.

- **Excessive exposure to real estate industry**:-One of the types of securities banks accept is the Immovable Property. Once the property is mortgaged in the bank's name, the bank enjoys an exclusive control over it in case the borrower defaults in repayment of the loan. But real estate in itself has limitations such as the liquidity problem and risk of decline in the prices. Banks tend to give more and more loans against real estate when the market is at boom. Over a period of time the market stabilizes, real estate prices fall thereby reducing the value of collaterals in bank's commercial loan portfolios.

  In case of Sweeden banking crisis, around 1990 the period of strong economic growth ended. Significant problems developed in the housing market and rents started to fall.

Decreasing demand for premises resulted in substantial fall in real estate by about 50%. It caused large credit losses for financial institutions They had typically provided loans against the upper range of the value of assets pledged as collateral. As the banks were heavily exposed to real estate related industry declining real estate prices created significant amount of Non Performing Assets after the burst of bubble economy.

- **Improper credit evaluation, poor selection of borrowers**: - If the credit evaluation is poor, loans are given to borrowers not having enough repayment capacity. As a result the volume of loans disbursed increases which may initially strengthen the asset portfolio of the bank. But at the same time it carries with itself the risk of Non Performing Assets. If there are no stringent regulations regarding specific provisioning of NPAs, provisioning made is insufficient. Hence the impact is that banks do not address the problem of NPAs until it is reached an alarming level.

  One of the major aspects of Japan's banking crisis also was the length of time it took to address the problems of Non Performing Assets and later faced liquidity problems

- **Deterioration in bank's capital position**:- Although it is recognized that bank's capital position should be improved:-
  a) in order to resolve the problem of NPAs and
  b) to increase bank's capacity to extend new loans,
  it is not always possible. The reason being inadequate retained earnings, which actually should be the primary source for strengthening bank's capital position A faulty dividend policy and insufficient provisioning for bad debts results into reduced retained earnings.

  Reference: Bank failures in Spain

- **Heavy expenditure on bank's fixed assets**:- Heavy expenditure on assets especially on the office building requires huge investment. This may endanger the liquidity of bank funds.

- **Huge operating costs** :- Sometimes banks open deposit counters which are a Cost Unit but not definitely a profit center. Due to excessive number of branches not only the time and demand liabilities of the bank increase, but also operating costs like staff salaries. Maintenance are pushed up.

  Reference: CBK and Fokus banks in Norvay

- **Management Frauds**:- Managerial personnel is in whole charge of the bank's funds and is responsible for proper channelisation of the same. But in cases managers divert bank funds from banks to businesses owned by them or the main shareholders. Also in cases the latter acquires assets of the banks for less than true value or sells assets to banks at excessive prices. In addition finance extended by the banks is used for speculative real estate or industrial projects by the firms of the bank's own groups.

  A Classic example of this is found in Bank crisis in Spain. On occasions some banks had more than 50% of their balance sheet invested in loans to their own group. The lending criteria in these cases were always much more relaxed than for other borrowers. As a result NPAs increased deteriorating the banks' profitability and hence the capital position.

- **Importance of Supervision:-** In July 1991 the Bank of Credit and commerce International failed because of wide spread fraud. BCCI had a very complex structure involving branches over 70 countries. Its complex group structure made it difficult to conduct effective supervision and audit.It is believed that BCCI's financial statements had been falsified from its establishment in 1972. A scheme of deception was developed to conceal lending losses. To achieve this BCCI failed to record deposit liabilities and created fictitious loans that generated substantial but fictitious profits. Frauds also took place in BCCI's treasury position.

BCCI''s failure was attributable to wide spread fraud that was at least initially undertaken to conceal loan losses. In circumstances such as this where financial statements do not reflect true financial health, reporting capital ratios will also be misleading to investors. Hence in such cases the process of ongoing supervision may encourage banks to assess and improve their systems and controls.

- **Inadequate regulatory capital**:- The regulatory capital should be in line with the economic capital. It will help to strengthen the solvency of banks. The correct measurement of risk would enable it to be better managed. It is also important that capital requirements should cover operational risks including fraudulent operations. This risk is nearly always present in banking crisis of some size and its coverage with capital should help reduce it.
  The banks should be required to maintain sufficient control over the risks associated with their business such that their survival is not jeopardized.

- **Capital Adequacy Ratio**:- Basel committee has recommended that the banks should maintain a ratio of equity to total assets of 8% minimum. Also capital requirements should be based on capital adequacy ratio defined as the ratio between own funds and borrowed funds. In fact it is a leverage ratio bearing little relation to the risk incurred by the institutions.