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LESSONS REGARDING BANK FAILURES. AN OVERVIEW[1]

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Abstract

In this paper we evaluate the main causes and consequences of bank failures. Starting from the theoretical level and identifying traditional and modern causes, common and specific causes for bank failures, we continue with an analysis of the Romanian case. The Romanian banking system had several major problems, concentrated between the two World Wars and in the nineties, on different economic backgrounds.

Key words: banks, bank failures, causes, consequences
JEL classification: G21, E58

1. Introduction

Nowadays, banks are one of the main players in the financial systems, with an active role and thus being necessary to preserve the public trust in banks. Bank failures, even when isolated, have more important consequences, than compared with an ordinary company bankruptcy. When happens on a larger scale and affect the entire banking system, becoming a bank crisis, the consequences can be disastrous for the entire economy. This is why it is important to identify the main causes and costs of the bank failures, in order to prevent them, or to avoid at least partially their consequences.

2. Causes of bank failures - literature review

Taking into account the important consequences of the bank failures or bankruptcies, especially considering its implications for the economy's financial stability, of course both the scientific research and the surveillance authorities and the central banks focused preferentially on analysing the main causes and consequences of such events.

Most empirical studies on banking failures consider a bank to have failed if it either received external financial support or was directly closed [Marco, 2005]. Bongini, Claessens, and Ferri (2001) and Gonzalez-Hermosillo (1999) considered a bank to have failed if fitted in one of the following categories: a) the financial institution was recapitalized by either the

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central bank or an agency specifically created to address the crisis, and/or required a liquidity injection from the monetary authority; b) the financial institution's operations were temporarily suspended ("frozen") by the government; c) the government closed the financial institution; d) the financial institution was absorbed or acquired by another financial institution.

The bank failures have important consequences on the entire financial sector and on the entire economy. Thus, obviously, the financial literature analysed the *consequences of the bank failures for the financial stability*. Crocket distinguishes between the market's financial stability and the financial institution's financial stability [Crockett, 1997, p. 9]. In this approach, the financial institution's financial instability means that a bank's fall leads through contagion to other's bankruptcy, to periods of "bank run", the public lost of trust in the financial system, public expenditures for solving the crisis and macroeconomic disequilibrium with effects on the economic growth.

Blejer [1998, pp. 105-122] connects the financial instability with the insolvability risk; Allen and Gale [2000, pp. 1-33] connects the gravity of the financial instability with the interconnections between the banks, a higher connection (a bank being symmetrically dependent with other banks) meaning higher potential gravity.

Das, Quintyn and Chenard [2004, p. 44], analysing the financial crisis in East Asia, Ecuador, Mexico, Russia, Turkey and Venezuela concluded that a common cause was the *weak regulation and supervision*.

The risk of financial instability forces the states to prevent and to combat the phenomenon. There are two approaches: to let the market forces to solve the problem of financial stability (arguing that the bank, "on its own", will be more cautious and responsible), or the public authorities will interfere for preserving the financial stability, this becoming an objective of the political economy. The public authorities can a) create deposits guarantee schemes and can act as lenders of last resort, when necessary, or b) supervise and regulate the financial activity. According to Llewellyn (2006), supervising and regulating the financial activity targets a) the prudential regulation, focused on the financial stability of institutions, individually; b) systemic regulation and supervision, of the entire financial and payment system; c) the protection of clients against unfair practices and against incomplete and incorrect information; d) the assurance of a fair competition, without anti-competition practices. Another objective of the supervision activity is that of *maintaining the public trust* in the banking system and preserving the depositors' funds [Turliuc, 2002, p. 77].

Demirguc-Kunt şi Detragiache (2000), in an empirical study including 61 emerging and developing markets for the period 1980-1997, concluded that if the banking system is not *rigorously surveyed and regulated*, the bank crisis increase in number and intensity, correlated with the "generosity" of the fund insurance schemes.

In a sample of 24 systemic banking crises in emerging-market and developed countries, Dziobek and Pazarbasioglu (1997) found that *deficient bank management and controls* (in conjunction with other factors) were responsible in all cases. Also, they analysed the success of crisis' resolution policies and which type of responses were more appropriate. They found that resolution measures were more successful in improving the banking system's balance sheet (stock) positions than their profit (flow) performance: balance sheets could more easily be improved through an injection of equity or swapping bonds for bad loans, but improving profits was more difficult and took longer, because it requires operational restructuring. The most progress in restoring the banking system's financial strength and its intermediation role occurred when a) countries addressed crises earlier, b) lender of last resort was strictly limited, c) firm exit policies were used and d) owners and managers were given the right incentives.

Gavin and Hausmann (1996) argue that *systemic shocks* undermine the viability of banks and create a crisis, but they do not completely explain banking crises. Bank failures result from the interaction of vulnerability and systemic shocks, where the weakest banks are the ones most likely to fail. Oviedo (2003) presents a theoretical model where bank failures are due exclusively to *macroeconomic shocks*. In a study of 29 bank insolvencies, Caprio and Klingebiel (1996) found that a combination of *macroeconomic and microeconomic factors* was usually responsible.

Chinn and Kletzer (2000) and Dekle and Kletzer (2001) provide theoretical models of financial crises in emerging markets where the source of the crises is the interaction between the *microeconomics of private financial intermediation and government macroeconomic policies*. The role of regulators' politics and incentives on intervening with failing banks have been studied by Kroszner and Strahan (1996), Bongini et al. (2001), Hoshi and Kashyap (2001), Rosenbluth (1989), Kane (1996), Brown and Dinc (2005).

A working paper presented by the Basel Committee in April 2004, "Bank Failures in Mature Economies", considered that the thrift and banking crises of the 1980s and 1990s were effectively addressed by *increased supervisory scrutiny*, *risk-based capital requirements*, *new closure rules*, and perhaps most importantly, *lower interest rates and a very long economic expansion*. The U.S. financial system has proved to be very resilient during the recession and subsequent slow recovery.

In conclusion, major causes of bank failures, found in the literature are: inefficient financial supervision, macroeconomic shocks, inadequate regulatory capital, improper credit evaluation, poor selection of borrowers, non-performing loans, deterioration in bank's capital position, disproportionate operational costs, heavy expenditures on bank's fixed assets, excessive exposure to real estate industry, politics (government) interventions, insufficient provisioning, management frauds and foreign exchange risk.

From a certain point of view, we can identify "classic" or "traditional" and "modern" causes of bank failures. If the causes from the first category we can identify them in the entire history of the banking system, connected with the very beginning of the bank failures, the second category is connected with the modernisation of the financial system, being generated by the financial innovation and the appearance of new financial products, institutions or processes or connected with the financial disintermediation. There are also internal causes (from inside the bank) and external causes (situated outside the bank, in the national or even international environment), predictable and unpredictable causes.

In the process of financial innovation, the use (or abuse) of some new financial instruments on a different background compared with the original one, on a larger scale, without proper regulation and supervision, can generate problems. *The credit derivatives* for example, allow the bank to improve its image, similar to a "window dressing", but this arrangement could hide the reality. The derivatives (one of the most invoked examples of financial innovation, as response to the market's needs), generally, appeared as a reaction to risks, but their use can also be risky. The recent history of this instrument shows the risks of its "uncontrolled" use; it is the case of Barings Bank, Sumitomo Bank, Allied Irish Bank (AIB) and Société Générale, more recently; all of them registered enormous looses, hundreds of millions of US dollars, as result of assuming such positions on derivatives.

In the Barings case, in 1995 Nick Leeson „succeeded" to bankrupt the oldest bank in England, with over two hundred years of activity – being created in 1762 – after provoking looses over 1 billion pounds, through financial operations engaging derivatives that could bring, if successful, about 27 billion GBP). In June 1996, another trader, Yosuo Hamanaka, provoked to his employer, Sumitomo Bank, looses of 1.8 billion USD as result of unauthorised operations of 20 billion USD in the derivatives market. In 2002, the biggest Irish bank at that time, AIB, suffered 866 millions of euro looses, caused by a single currency trader, John Rusnak, having as starting point unhedged positions on the derivatives market.

After that, the problem seemed to be solved, after strengthen the regulatory framework in the main financial system, but later a new case started again the polemics about the need of a *closer regulation and surveillance*: thus, in 2007, Société Générale registered looses over 4.9 billion EUR, provoked by a rogue trader, Jérôme Kerviel.

One year later, *at international level*, in the context of the international financial crisis, the discussions about *regulation and surveillance* for the derivatives market were renewed. As result of the stronger regulation, actors from the market complained that the regulation became too severe and there is the danger to suffocate the market. In fact, sometimes, at least in the regulatory framework, it happens to pass quickly from one extreme to another, from a very lax regulation and supervision, toward a very severe one.

Those new kind of risks, with impact also on bank failures, determined the financial surveillance authorities to react, through new regulations, for avoiding such events.

3. Romanian bank failures. An historic overview

One of the first bank failures in the Romanian banking system is connected with its early beginning. The National Bank of Moldova was the name of the first ever created bank in Romania, in the period 1856-1857. Friederich Ludwig Nulandt, a German investor, president of the Bank of Dessau, started his activity as director of the nwe created Romanian bank in March 1957. In less than one year, the bank became bankrupt. The causes of the failure, as it were identified, are: insufficient capital (substantially less, compared to the one declared initially: instead of 10,000,000 thalers, only 513,570); loans granted on long terms to rich real estate owners, discount operations granted to insolvent traders, well known by all the bankers for years, granting a huge loan to the state, without any chances for being reimbursed, involvement in speculations (including stock market speculations) and adventurous operations, like buying camels for the British army in India (unsuccessfully) and the concession of collecting taxes in a province of Minor Asia.

The world economic crisis in the thirties had major implications on the Romanian banking system. The lack of trust in the Romanian economy generally leaded to difficulties for banks in obtaining external credits and also to lower internal deposits. The failure of Oesterreichische Kredit-Anstalt Bank from Wien generated a crisis in the entire Central Europe in 1931. Thus, three Romanian credit institutions were bankrupt: "Banca Generală a Țării Româneşti" (June 1931), Berkovitz Bank (July 1931) and Marmorosch, Blank & Co Bank (October 1931). In order to save the banking system, the National Bank of Romania granted important discount credits [Kirițescu, 1997, p. 407], however a significant number of small and medium banks were forced to cease their activity. The evolution of the number of banks in the period 1928-1934 suggests this phenomenon: in 1928, were 1,122 banks with 10 billion lei in capital, and in 1934 only 873, with the same capital.

Table no. 1 The evolution of the number of banks in the period 1928-1934 (billions lei)

Year	Number of banks	Capital
1928	1,122	10.0
1929	1,097	11.2
1930	1,102	11.6
1931	1,037	11.9
1932	955	10.5
1933	893	10.0
1934	873	10.0

Source: [Pintea, 1995, p. 162]

Between 1934 and 1941, the bank failures and concentrations become even more important (mainly due to the state's intervention, the small banks being forced to merge or close) the number of banks falling to 275, with approximately the same bank capital [Turliuc, 2009, p. 229].

In a synthesis, the main causes of the bank bankruptcies in that period were: the systemic risk (due to the fall of some major banks abroad), failures in bank management, disregarding a minimum of prudential rules, granting big loans without warranties, long term loans with fix interest rate, the state interference, obtaining important loans never returned, hazardous investments, fake accounting, lack of adequate bank control, regulation and supervision.

4. Modern Romanian bank failures. Causes and consequences

After 1990, during the transition to the market economy, on a background including lack of experience, insufficient legislation and a mix between public and private property, with the predominance at the beginning of the state property in the entire economy, the banking system had to face also financial problems. Some of the banks with financial problems were officially declared bankrupt and several others were reorganised or supported by the state, without an official judge decision of bankrupt, even if some of them were unable, at a certain moment, to pay their debt.

Table no. 2 Romanian banks declared bankrupt after 1990

No.	**Bank name**	**Authorised**	**Radiated**	**Observations**
1	Credit Bank S.A.	24.12.1991	23.04.1999	authorisation withdrawal, starting the bankruptcy procedure
2	Banca Comercială Albina S.A.	05.02.1996	18.05.1999	authorisation withdrawal, starting the bankruptcy procedure
3	Banca Columna S.A.	08.09.1994	29.06.2000	authorisation withdrawal, starting the bankruptcy procedure
4	Bankcoop-Banca Generală de Credit şi Promovare S.A.	01.11.1990	27.09.2000	authorisation withdrawal, starting the bankruptcy procedure
5	Banca Internațională a Religiilor S.A.	02.03.1994	18.06.2001	authorisation withdrawal, starting the bankruptcy procedure
6	Banca Română de Scont S.A.	17.09.1996	11.03.2002	authorisation withdrawal, starting the bankruptcy procedure
7	Banca Turco-Română S.A.	02.03.1994	15.05.2002	authorisation withdrawal, starting the bankruptcy procedure

Source: [Turcu, 2004, pp. 410-412]

All of the bank failures are after 1995, but most of them (including the bankruptcies) are between 1998 and 2002. In fact, during the early nineties, the number of banks in Romania was relatively small, some of them with entirely or majority state-owned capital. For example, in 1995, among the 24 banks authorised in Romania, 7 were entirely on majority state-owned, 9 had entirely or majority Romanian private capital and 8 had entirely or majority foreign owned capital and in 1998 were 36 banks: 7 were entirely on majority state-owned, 13 had entirely or majority Romanian private capital and 16 had entirely or majority foreign owned capital.

Most of the bank indicators, aggregated for the entire banking system were not very favourable, especially in 1998 and 1999, reflecting the macroeconomic environment; thus, the credit risk rate in 1998 was 58.51% and 35.39% in 1999.

Beside this, the surveillance capacity of the National Bank of Romania according to its first Statute, Law 34/1991, was limited and did not included the possibility to start the juridical procedure in case of ceasing payments. *The procedure for bans bankruptcy was similar to any ordinary company* (Law 64/1995) *and the central bank did not had any role*, except if it was the main creditor. As consequence, some of the financial problems in the Romanian banking system in the nineties were solved without an official bankruptcy decision or being decided several years later. In other cases, the National Bank of Romania (NBR) withdraw the authorisation for some banks, that did not respected the banking regulations (like Commercial Bank Unirea in July 2001 or Nova Bank S.A. in August 2006), without being declared bankrupt. A particular case was Dacia Felix Bank, where, for three months, between March and June 2001, the NBR withdraw the authorisation, but the Cluj Court of Law obliged the NBR to give back the authorization of functioning.

Those bank failures have *multiple causes*, common ones and specific ones. As *common causes* for the majority of bank failures in the nineties, we can highlight: the unfavourable macroeconomic environment, the state's intervention in bank's operations (in some majority state owned banks), inadequate regulation and supervision.

In Romania, in the nineties, the macroeconomic environment was mainly instable and dominated by the recession and with important inflation rates, connected in the second part with high interest rates that concretised in non-performing credits and insolvability.

Sometimes, *the banks did not respected the banking legislation and NBR's prudential rules*; this was also connected with the low social capital and low liquidities, specific to the early beginning of the private capital in banking.

A long period of time, *the legislative framework* was favourable to the debtor, offering the possibility to avoid the payments. The mechanisms for forced executions in order to recuperate the loans were very complicated and disadvantaged the creditor, in a period with hyperinflation (that overpasses 200% in certain years). As result, the banks registered looses even as result of some credits that seemed to be well provisioned [Isărescu, 2003, p. 193].

In 1995, like in the previous years, the majority of short term credits were granted to majority state owned companies (62.5%). However, at that moment, the weight of non-performant credits for private companies in total credits were 34.17%, due to some banks like Dacia Felix, Credit Bank, Bankcoop and Bancorex, that granted credits very easily.

The state influence and involvement in the banking sector materialised in Government's decisions for preferentially crediting companies from the energetic and agricultural sectors, disregarding their economic and financial situation [Banca Națională a României, 1998, pp. 81-82], thus *inducing distortions in the banking system*, discouraging the competition and worsening the financial situation of some state-owned banks, like Bancorex and Banca Agricolă.

The bank failures after 1989 in the Romanian banking system had *major negative effects*, generating private costs (for the stockholders, clients and creditors), as well as important social costs and an impact on the entire economy.

The cost of credibility for the Romanian banking system, due to the loose of trust, is illustrated by the savings' trend; it was noticed a descendent trend between 1999 and 2003. After that, due to correlated legislative measures, the banking system consolidated, in connection with a better macroeconomic environment and regained the depositors' trust. This behaviour was correlated with an important reduction of the nongovernmental loans, from 16.04% of GDP in 1998 to 9.42% of GDP in 2002, compared with 79.81% of GDP in 1990 [Stoica, 2005, p. 116].

Table no. 3 Population' savings in the period 1998-2003 (%)

	1998	1999	2000	2001	2002	2003
Savings	33,5	29,3	24,1	23,6	23,8	31,6

Source: [Banca Națională a României, 2003]

The *macroeconomic environment* had an important role in some bank failures; between 1996 and 1999 it was a period of recession and Bancorex, Banca Internațională a Religiilor, Credit Bank, Banca Agricolă registered financial problems. In that period, the unemployment rate at national level increased from 6.6% in 1996 to 11.8% in 1999. As result of the financial difficulties of Bancorex and Banca Agricolă (both state banks), because most of the non-performing loans from their portfolio were transformed in public debt, the quasi-fiscal deficit increased substantially. In fact, this was not the first time: through the Government Decision 447/2001, approved by Law 7/2002, 90% of the non-performing credits from the banking system were covered by the state (155 billion lei) and 10% by the commercial banks; in 1994, the state approves to cover 210 billion lei, increasing the public debt [Lăzărescu, 1998, p. 115]; in 1997, the state had to cover over 1 billion USD for Bancorex and Banca Agricolă; in year 2000, the cost covered by the state for the same two banks, was approximately 5,636 billion lei, meaning non-performing loans transferred to the Agency for Valorising the bank Assets (Government Ordinance 39/1999) and treasury bills issued in order to increase the capital for Banca Agricolă [Banca Națională a României, 2000, p. 92].

After year 2000, slowly, connected with the macroeconomic environment improvements, due to reforms, privatisation and increasing competition, together with a better legislative framework, in the context of European integration and correlated with a better financial supervision and with the preponderance of foreign banks, the Romanian banking system became more and more stable and trustful, without any failures, allowing to overpass even the international financial crisis without the state aid and without major problems.

5. Conclusions

In the last decade, the Romanian banking system became stronger and stronger. After 2002, on sound basis, with a modern (European) regulation, with enhanced supervision and taking advantage of the favourable economic background, beside the increasing competition, the Romanian banking system consolidated its position as centre of the financial system. The stronger regulation and supervision, connected with a sound and cautious monetary policy, avoided the overheating of the banking system and allowed to face the international financial crisis without major internal problems. The soundness of the Romanian banking system is proved, in the international turbulent environment, by the lack of severe financial problems or failures; no bank needed the state's financial support or faced major liquidity problems. In conclusions, nowadays the Romanian banking system became a modern one, developing on sound basis and taking advantages of the "catching-up" phenomenon at least in the financial field; the presence of the foreign capital and of the international banks allowed its modernisation. Without being one of the most performant or a European model, the Romanian banking system continues to be the main pillar of the financial system, supporting the national economic development.

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