Bank failure causes and consequences

Experience, Failure

Banks are financial institutions that act as payment agents for customers in addition to borrowing and lendingmoney. In some countries, banks are the primary owners of industrial corporations while in others they are prohibited. Banks act as payment agents by conducting check or current accounts for customers , paying cheques and collecting deposited cheques. Banks provide various payment services, and a bank account is considered indispensable by most individuals and governments. Banks have adverse effects on the economy and its various sectors. The banksfailureare seen as more serious that any other type of business firm failure.

The seriousness given to banking institution is due to the consequences its failure may cause to other banks. When a bank fails, both solvent and insolvent banks are also affected. The adverse effects of failure by the banks demand public attention. Bank failures even in the current world continue to be a major public policy concern. This concern is seen in all countries all over the world. This also explains why banks are regulated more vigorously then other firms. A failed bank is said to be the one whose operations are suspended due to it'sfinancial difficultiesby the supervising banking authorities(Benton E. G. 1998.)

Discussion

Bank failures have their various causes one of them being failure due to the tight financial interconnection that banks develop between each other. The interconnections may result to the contagion effect(http://www. cato. org/pubs/journal/cj16n1-2html). Contagion in banking is more serious than in any other industry due to various factors . They include ; it occurs faster, it spreads more widely within the industry, result in large numbers of

failures, result to large losses to creditors and its spread beyond the banking industry These interconnections are encouraged by the banks continuous lending to and from each other and the need to pay other banks.

Established interconnections promote their dependence on each other. When one bank fails the shocks at one bank which they are interconnected with. The success of the banks that are interconnected with each other becomes dependent on the success of the others. Failure in one of the banks spreads the problem to other banks making them experience the failure.

Read which one factor causing businesses to vigorously enforce ethical standards

Dishonesty and illegal banking practices contribute greatly to failure in the banks. Example of dishonest practices include fraud. Fraud can be defined as the intent to deceive or an attempt to conceal. Illegal activities promote misuse of bank funds by the involved people. For example, the largest bank failures in United States was due to illegal banking practices . The USNB bank failure was due to fraud and internal irregularities while the HNB bank failure due to illegal channels of risky real estate loans (Lynne. P. D. 1975).

Lack of inexperienced workers is more likely to cause failure than when workers are skilled and experienced. Banks develop their management practices in a manner that seals any chance of funds misappropriation. The human labour in the banks is advocated to the honest and loyal to the bank and its activities. Workers who lack experience may fail to perform their

duties properly within the shortest time limit bank workers are expected to work efficiently to minimize any losses that may arise.

Lack of skills may result to performance bank that can make the bank system prone to opportunities for illegal activities. Though bank's management have attempted to have the best management practices that address fraud cases, illegal activities are still identified to take place in the banks in the present world, (http://www. cato. org/pubs/journal/cj16n1-2html) . Banks manage huge amounts of capital and public money. Embezzlement of the funds reduces the financial ability of the concerned bonus. Serious cases of fraud have led to the bankruptcy of some banks in the world over.

Violation of banking laws encourage illegal banking practices. Every country in the world has a banking Act that guides the banking laws. The laws stipulate what the laws mean and even penalties for those who defy these laws. The laws assist banking institutions to carry out their activities in the most acceptable way for the good of the bank, the country and the public. The bank undertakings promote maximization of profits while at the same time offering assistance to the clients or customers who may need financial assistance in one way or another. Violation of these laws result to very great loss to the bank. The bank may consequently fail to sustain itself and sooner or later close down.

Dishonesty of the bank officials which is also that involve obvious mistakes can make a bank fail in delivering its services as required. Bank officials work for the banks and provide their services for the success of the bank. However, sometimes bank officials get engaged in activities that channel the

bank funds to other sources illegally. Bank officials may either work together or even with outside forces to embezzle funds.

The bank workers are very familiar with the bank's activities and systems hence are conversant with the systems; they can easily manipulate the systems to enable them direct funds to the wrong people. External forces may also use bank officials to steal funds from banks. This is because they can be able to influence workers who have easy accessibility to bank systems that can be manipulated. Whether small or huge amounts, bank officials who are dishonest and disloyal may promote bank failure through loss of huge amounts of capital.

Failure of the banks to enforce repayment of loans poses a great risk to the collapse of banks. Where banks become unable to collect loans, loss of funds may be a possible risk. Consequently , later poor asset quality erodes a bank’s capital. Loans are normally lend to individuals or groups of people to cater for their immediate needs or business plans. Loans are issued out and have to be repaid within a given time limit. Banks are involved in huge amounts of money lending as loans, especially to large or growing organizations or companies.

The greatestmotivationin lending loans is the profits banks get from interest on the money lend out. However, in some instances some banks due to poor management on issues that concern loans may become unable to collect the loans as required. Loans may even be lend to individuals or organizations without following the right procedures. This puts the bank at the risk of losing the money because ways of getting it back may be undermined by previous non-procedural ways of lending it out.

The stability of the bank in terms of capital or assets is interfered with. Any bank that succeeds requires a stableenvironmentI which to work in and any instability that occurs affects the bank's efficiency and success. Loans need to be collected back on time and in full amount to promote increase in income while at the same time minimizing any losses through loans that were previously given out.

Depressed economic conditions or marginally depressed conditions where the banks operate from undermine their success.

For example, deterioration in agricultural , oil and gas or commercial estate economies . Thedepressionwill adversely affect small size banks. The bank's size of capital is a factor that affects its success. Capital is very important in establishing a business enterprise as well as supporting its business activities. Banks vary in size in relation to the capital with some banks being large and others smaller.

Shocks may occur which affect the banks. The effects of occurrences that result to negative outcome in the banks can be referred to as depression effects. The large banks due to their large size of capital can cope with the depression much better than small capital banks. Large banks can be able to utilize their capital to improve on areas that become adversely affected.

However, small banks may lack the much needed capital to invest in improving its activities and areas in order to recover from the depression . For example in 1930s , banks in Nebraska experienced economic depression due to farmers lacking money to spend. The banks experienced failure at alarming rates causing people to lose their money, (Lynne. P. D. 1975). Small

banks are more likely to fail in case of depressions compared to larger banks that can cope with it.

Poor management in banks guarantees the failure of banks because it lacks proper activities or practices within the institution and outside the institution. Poor management translates to poor coordination poor organization, poor objectives andgoalsand poor methods of minimizing and preventing fraud or embezzlement of funds. An institution that lacks well-laid objectives and goals looses focus.

The direction towards success cannot be well defined. The activities within the institution lack good organization and coordination and this lowers the productivity of the workers. Workers cannot work together and lose a sense ofresponsibilityand commitment towards their work. This opens loopholes for fraud or illegal activities where workers may turn into embezzling of funds

The deficiencies within the bank’s board of directors and management are primary internal problems that result to failure. The experience, capability, judgment and integrity of the directors and the management officials determine the quality of a bank. The bank’s affairs are conducted under the board of directors orders. Uninformed and inattentive board of directors, lack of necessary banking knowledge, overly aggressive activity by the board or management are factors that contribute to failure. The management might be excessively growth-minded or may follow liberal credit views, which include inappropriate lending policies and poor judgment in the decision making process. Poor management affects all aspects of the bank that enhance success.

The human resource department is very important in a bank's management. Issues that are related to workers and the working environment are addressed and solutions provided for any arising problem. When the department becomes poorly managed the guidelines that ensure recruitment of qualified and skilled workers are undermined. Qualified, skilled and experienced employees encourages high worker productivity and prevents recruitment of poor skilled workers.

Lack of motivation to the workers (incentives) poor payment, laziness, absenteeism and lack of discipline undermine a bank's ability to succeed. All of the above mentioned can be attributed to poor management. Illegal activities of stealing bank funds hugely contributed to indiscipline on the side of the employees . Poor management in the banks hinders the development of measures that address problems that arise in its day-to-day operation. Management incompetence is no doubt one of major contributors in bank failure.

Banks face stiff competition from each other, triggered by the fact that every bank wants to triumph over the other (Benton E. G. 1998). This has seen great competition in the bank industry in all countries all over the world. Competition promotes better services for customers by the banks, and improved marketing strategies, which consequently result to growth (economically) and management wise.

Competition in the market though good can become tragic to the banks in its success. Bank's failure can be attributed to excessive competition among numerous banks. Stiff competition result to closing down of banks that could not survive the tough environment created by higher competitive rivals.

Excessive competition causes a tough environment for the banks to work within. Unfortunately where a given bank's operations bear very little income, it is most likely to fail if it does not improve.

Bank failures also have their effects, which include adverse effects to economic activity in the communities near the location of the failed banks. Local communities are involved in bank's activities and investments. The bank failures depress local sales, and local employment. Banks provide funds to allow businesses to purchase inventory and support small businesses capital. When banks fail the local businesses lack capital and funds to run the businesses.

Bankruptcy of one bank affects other banks also-contagion effect.. A large bank bankruptcy may cause the loss of public confidence in the whole banking system which is more likely to set off runs on the other banks. Consequently this causes losses to the banks and their stockholders, which then disrupts the monetary system and the stability of the general economy. Bank failures are said to have contagion effect where one bank failure spreads over to the other bank too.

Banks failure causes the market value of its asset to decline below the market value of its liabilities. Consequently the banks market value of its capital becomes negative causing the bank to become unable to pay all of its depositors in full and also on time. Informed depositors may withdraw their funds and strip the bank of its valuable assets. The less informed depositors and holders of longer dated deposits bear the entire loss.

Bank's losses due to failure accrue to shareholders, depositors, unsecured creditors and deposit insurer. Small loan customers are affected by changes in their own officers, loan standards and other aspects of their bank relationship. All these effects will then affect the national economy in a given country where economic development is undermined. The effects on small businesses, the depositors and other banks will hinder growth of economic activities.

Bank failure prediction is important for both the banks and regulators of the banking industry. The collapse of a bank has devastating consequences to the entire banking system and other financial institutions one way in which bank failure can be predicted is by constructing an integrated early warning system (IEWS) which can be used as a decision support tool in bank examination. Supervision process for banks that are experiencing serious problems also help in the prediction.

Banks that are operating in depressed economic conditions can be able to foresee their collapse if the economy fails to change . Deterioration of other sectors that support the economy (oil, agriculture and commercial real estate economies) may be a catalyst towards the banks collapse.

Where banks detect poor management issues they can be able to predict the likelihood of the bank to collapse. Detection of fraud cases act as a sign of failure if such activities are not stopped on time. Excessive competition from other banks and financial institutions that is developing will assist banks to predict how well they will operate in future. They can collapse if no measures are put into place to counter the competition.

Conclusion

To reduce the possibility of banks’ failure , the board of directors need to be active coupled with working together within well-specified roles. This enhances the establishment of realistic goals and strategic plans for the banks. More importantly , banks need to establish and maintain strong internal policies, systems and controls , to cope with fluctuations that may cause failure in banks.

References

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