Fiji Sun
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Saturday, March 1 2014

Why bank failures happen

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"If you owe the bank $100, that's your problem.
If you owe the bank $100 million, that's the bank's problem!"

That famous quip from one of the world's richest men ever, late Jean Paul Getty sums up the tragic story of any bank that failed.

At the launching function of the new Home Finance Company Bank last week, Prime Minister reminded the nation of "the debacle of the National Bank of Fiji (NBF) in the 1990s, the first ever 100 per-cent Fijian-owned financial institution".

NBF had a F$220 million problem. As it could not recover its loans, it failed.

More failures in 21st century

In 2009, many American banks failed.

The latest news from India is that many public sector banks have bad loans. The Kolkata based, United Bank of India (UBA), has an "acute Paul Getty problem". The Reserve Bank of India got its Chairman and Managing Director sacked and the Board superceded, with severe restrictions on its lending.

The Indian government is ever ready to re-capitalize, since most of the bad loans are reported to be owed by powerful politicians.

India is known for *melas* (fiestas). Frequent bank melas in each town, after the 1969 bank nationalization, were famous. It was regular Diwali at somebody's expense! Loans, regardless of collaterals were disbursed at low rate under the "quit poverty programs", in the 1970s and 1980s. It went on until the economic crisis hit India in 1989.

The German author of the 1940s, Bertolt Brecht in utter disgust observed:

"It is easier to rob by setting up a bank than by holding up a bank clerk".

Today, in Europe, things are no different. The February 2014 study by the Paris-based think tank, the Organization of Co-operation and Development on *Economic Challenges and Policy Recommendations for Euro Area* identifies Greece, Ireland, Portugal and Spain with high non-performing assets (ratios ranging from 10 to 28 percent), affecting the euro's future.

The solutions are: raise capital requirements, strengthen regulations and enforce strict supervision.

NBF Saga

Fiji's NBF Saga is documented by USP academics Michael White, Roman Greenberg and Doug Munro in their 2002 book: *Crisis: The Collapse of the National Bank of Fiji*.

Reckless lending was its undoing. NBF bosses knew it was not their money.

In his foreword to the book, the then Vice-Chancellor Savenaca Siwatibau, a former central banker, wrote that the bulk of the money lent out by the NBF to borrowers "came from the thousands of depositors, many of them small ones, who deposited hard-earned savings with the bank".

The government introduced an amendment in the NBF Act in the early 1980s. That enabled NBF to lend more than 25 percent of its capital to any one borrower.

"This led to the concentration of lending to one big borrower prior to the events of 1987. This borrower, when it ran into difficulties, started the bank on its irreversible downward path to ultimate collapse", Siwatibau observed.

R**isks faced by banks**

Every bank, which accepts deposits, creates deposits and lends under fractional reserve system, knows it is the depositors' confidence that keeps a bank strong and helps to grow stronger.

Depositors do not withdraw money all the time. They do so only when needed. So, banks transform deposits of different size and maturity into interest earning assets of different size and maturity. Banks earn interest income, pay interest to depositors and make profits. Known as "borrowing in the short and lending in the long", banks transform their liabilities into assets.

Banks face two kinds of risks: credit risk and market risk.

Credit risk is given rise to when a bank's borrower fails to meet the obligations in accordance with agreed terms.. Market risk arises from movements in market prices including changes in interest rates, foreign exchange rates and equity and commodity prices.

When depositors withdraw funds, and if the bank cannot satisfy them, rumours start floating about its "health. The liquidity troubles begin.

The crisis-hit bank exhausts all possibilities: ranging from borrowing from central bank to selling its assets at a lower price than its market value for getting cash to satisfy its depositors on demand.

A bank panic ensues if more depositors try to withdraw cash. Bank failure eventually follows.

What is more dangerous is the fear of *spillover* effects.

It leads to failure of other banks, whether they are solvent or otherwise.

The latest measures, which were internationally agreed upon after the 2009 global financial crisis, include raising the capital and liquidity ratios for the banks. When implemented by 2017, they will impose greater capital requirements for the banks. They will facilitate quicker access to liquidity.

The purpose is to force shareholders, instead of taxpayers, to absorb losses.