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WHY BANKS FAIL?

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ABSTRACT

Banks are very important institutions; they take a major role in the economic aspect. The thought of bank failure led to a concern for governments, shareholders, depositors, and the public. This research dissertation will clarify the most common reasons for financial problems or banks failure. In order to answer and resolve the research question, which is why banks fail? Explaining why banks failure is different than other businesses failure, and how that can impact the nation growth rates. Furthermore, examine the internal and external factors to know the most affective between them. However, it cannot be only one reason that causes the failure of banks. Using ratio and regression analysis methods to calculate and forecast risks before happening. Collecting quantitative data through online survey questionnaire, that allowed the author to view respondents' opinion, then analyze and interpret the responds. Presenting the reasons of bank failure as findings and discuss the most affective two, which are they: risk management from internal factors and clients from the external factors.

INTRODUCTION

Bank is a financial institution where businesses and people can keep their money safe and they can take it back at any time, which called deposits. Also making loan, which is borrowing money from the bank and repay it back with interest. These actions are called financial intermediation. Banks work on the customer's deposits to give others loans, so it can make money for itself. They provide financial products and service to their customers, such as: exchange currency, wealth management, safe deposit boxes and online banking. Banking traced back to the Roman Empire, on record the world's first bank was Taula de la Ciutat, established in 1401 in Barcelona [1].

The national government or central bank is responsible to control and monitor all the banks in their country. They all set polices, rules and regulations for banks to follow, in order to protect and prevent them and the nation from financial losses or failures. Banks's failure is common thing happens around the world, it is different and more serious than other businesses failure, it may affect the nation growth rate because the governments have to cover all banks losses. Generally, the safest places for people to keep their money are banks, even though from time to time they fail. It is hard to predict that banks will fail from outsiders, because it turns out of nowhere [2]. Banks are highly regulated because they run with a big leverage, which make them sensitive businesses; therefore, they are not able to perform many financial activities [3]. Also, they are special financial institutions and their failures cost the economy a highly prices, so banking should stabile to minimize the losses [4]. A failure could cause more than damage to financial development, related to public interests, earnings and employment [5]. In addition, there are other factors that may cause banks failure such as: lack of staff, rely only on one member of staff, poor management, and compensation linked to performance [6]. The key of developing the performance is to know and understand the hidden risks, to avoid problems and sometimes failing. Bankers who followed the rules of irrelevant banking, resulted by economic environment changes, were unable to keep away problems [7]

The most affective reasons for financial problems and banks failure are regulatory disagreement and mismanagement [8]. The key for any business to be successful is having good management, so they should focus on it and give it a main role in banking, there are many banks fail because of the mismanagement [9]. One of the underlying reasons for bank failures is poor or no risk management. That means the culture does not understand the risks clearly to avoid the changing and falling in the structure [10]. Regarding to the regulations the risk management has to change over time to protect banks from failing [11].

Banks should have more funds so they can minimize the probability of being bankrupt or having financial risk [12]. Some banks do not hold enough cash in hands from deposits, and that raise the risk of having financial problems or failures [13]. Non-performing loans are one of the reasons of bank failure because they are illiquid and long-term obligations, which loans are the deposits of other people, and in order to make the banks stay solvent, they must be able to give back depositors their money whenever they want [14]. Bank's low capital is one of the failure reasons, because it encourages the bank to take high-risk operations to survive, and to avoid that they should increase their capital ratio [15]. Systemic risk or market risk is one of the causes to banks failure, because of threats that banks exposed to, such as geographical limitations [16]. One of these geographical limitations that could affect banks investment activities, which lead to reduce the operation diversification, is branching restrictions because it limits the expanding of banks locations [17]. Clients rely on the government in order to protect their money when the banks fail, because it is the governments' responsibility to cover the failures [18]. Covering the losses for banks from governments could make depositors jump from bank to another and that is valuable [17] There are other reasons of bank

failure like: laws, mismanagement, deposit insurance, poor skills, and regulation lack [12]. According to Hempel and Simonson [18] they confirm that what causes banks failure are mismanagement, and regulatory conflicts. One of the common causes for bank failure is ineffective regulatory system [19]. Banks sometimes are not taking the regulation in serious way and ignoring the skill management because of the insurance deposit from the government [20].

The aim and object of this workis to know and examine the reasons of why banks have financial problems or sometimes failure. And clarify which of the factors either internal or external has the most impact on the situation. Internal factors mean the inside facts that could be strengths or weaknesses of the business, and external factors means the outside facts that could impact the business from opportunities or threats, in order to answer the research question.

METHODOLOGY

In this research the authors used an online survey questionnaire as a tool to examine and collect quantitative data, about the reasons of banks failure, if it caused by internal or external factors, and which of these affect the most. The structure of the survey questionnaire contains eight questions, seven of them were close-ended and one was open-ended. The authors started with personal information questions to know the respondents more, and then ask about respondents' opinion in several questions about the topic.

First, questioning the gender types of the respondents, and the results came out; the percentage of females (75%) was higher than males (25%).
The second one was about the age of the respondents, the ages were classified into three categories: 15 -20(27%), 21-39(69%) and 40-above (4%).

The third question was about the professional or employment status of the respondents, which shows that 63% of them were students, 27% were Employees, 7% non-employees and 3% retired.

The fourth question was to check if respondents have background about what banks are, by asking if they own any bank account. The results show that a high number of them do (91.92%).

The fifth one was depending on respondents' opinions, it questioning which of the reasons are more affecting banks failures, either they are internal (73%) or external causes (27%).

The sixth question was also about respondents' opinions, if they think that the reason is internal which factor affects the most: management plan, strategy or employees. And the results showed that 52.58% think that management plans is more affecting, 26.80% think it is strategy and the last percentage 20.62% showed it is employees.

In addition, the seventh question asks for respondents' opinion, if they think the reason was external which factors affect more: government, competitors or

clients. There were two answers resulted the same percentage 35.71% government and competitors. The third answer was clients with a 28.57% percentage.
The last and the eighth question was asking for respondents' opinions, in what strategy banks should follow to avoid failing. Most of the responds were about management and clients' services, both have the same average of answers.

RESULTS AND DISCUSSION

Banks's failures are more serious than other institutions failures, because governments get involved to pay their losses, which could affect the growth rate of the country. There are many reasons lead to a bank's financial problems or sometimes failures. The failures of banks can be classified into two major parts, internal and external.

INTERNAL FACTORS

Poor Management

Poor management is classified as an internal because banks are responsible to manage their own. Basically, management is the major role for any business; it works to manage everything related to it, especially risks. The most important part that helps the banks to grow and expand is good management, although the perception of it is changing day to day according to the market changes, but banks should develop their own and following these changes. Management helps banks to run and perform in right way if they have good plans and avoid any type of risk that may occur. However, there are different types of risks that banks are exposed to, some of them could be forecasted and managed by the analysis calculations I clarify previously. These risks may have negative effects on the bank performance and financial statements. So they should have good risk management plans, which works to identify, analyze, measure and assess the risk. After that responding, controlling and monitoring to make sure it is gone. Furthermore, understanding the problem is part of finding the solution and minimizing the risk's negative impact on the bank capital and financial results. Managers are responsible to aware the bank's staff of any risk that could happen and to prepare them to deal with any problems, too.

Bad Loans or Credit Risk

Bad loans and credit risk should be managed as a part of the banks' management, so it classified as an internal. Basically, credit risk is one of the major risks that any bank could face; it is the inability of borrowers to pay back their obligation for banks, or also the bonds issuer to repay when it is required. One of the most common banks failure causes are bad loans; loans mean that an amount of money given by the lender to the borrower with an agreement to repay. When a person takes a loan from a bank, he must sign a contract agreement, which determine the amount of payment that should be repaid in certain date of each month. If these payments do not go as they were planned for, the bank will lose money from their provision. In these cases, they called it bad loans or non-performing loans. Loans and deposits covered a big part of the traditional banking business, because most of the bank's money

is from the depositors. Banks work on investing these deposits, some of it in simple way like loaning other bank clients and some in other complicated ways. Giving loans to individuals or businesses help them to develop and expand. The bank must check the borrowers credit score to make sure that they are able to repay, to avoid the risk of default and losing that money. So, the credit analysis skills are important in this type of business, therefore banks have huge training programs to develop the skills of their lending office employees. These programs help to save and protect the bank's profitability and assets, by teaching the employees how to understand and value the risks of borrowers. These bad or non-performing loans are major cause that leads to serious banks problems or sometime failure.

Ineffective Employees and Operational Risk

Ineffective employees and operational risk are classified as an internal because it is related to banks' performance. Employees are important to run any business, choosing the right one to the right position will minimize problems. The risk of ineffective employer is too high for the bank, because it has sensitive performance. Banks should improve their employees' performance, skills and knowledge by providing training programs, and motivate them from time to time. Operational risk occurs due to losses or failing in banks internal process, such as systems, procedures and employees' tasks. Huge losses are resulted from these failures, so banks should be careful in using systems, performing procedures and hiring employees.

Liquidity Risk

Also called funding issues, classified as internal because banks are responsible to manage it. This risk occurs when banks have no liquid assets that can easily converted to cash, which means inability to meet their short-term obligations. This could lead to huge financial problems or failures, because banks cannot repay their debt such as: credits, bonds and equities. They should keep more cash or liquid assets to avoid this risk, because they do not know when their obligations will be required.

Asset and Liability Mismatch

Assets means everything owned by the bank from money or property, it gives a future benefit in economy. Liabilities are everything the bank owes to others like customers deposits, which offer future obligations. These two should be matched in a particular way, to support each other in the balance sheet. The mismatch occurs when assets are matched incorrectly to liabilities, this related to asset and liability management in the banking world. If unmatched situation happened the bank will face serious problems, which have to be fixed by balancing these two. However, balancing does not mean equality, but means matching. Increasing the available assets to match with the raising liabilities will protect the banks form any mismatching situations. A good asset and liability management can rescue the bank from huge loss. Otherwise, the bank will have serious issues or failures, if a big part of the portfolio is unmatched.

EXTERNAL FACTORS

Bank Run

Bank run is classified as an external because clients are the reason. Bank run happens when huge number of clients decided to withdraw their deposits from the bank in a short time. That could happen due to a bad reputation or worries about the bank solvency. Banks do not hold enough money on hand. So, in order to increase their money quickly, they sell their assets in low prices, which lead to insolvency. And to avoid this risk banks should raise the amount of money they hold and keep more deposits without investing in it.

Market Risk

Market risk is classified as an external, because it happens outside banks, also it called systematic risk. It is the chance of the factors to affect the total financial markets performance in which banks involved to. Like the possibility of decreasing the investment value due to factor that affects all investment in the market, which

leads to losses in the expected returns. It cannot be removed or minimized through diversification, but still it can be hedged against or applying asset allocation strategy in the right way. The market risk could be physical damages also. Generally, the sources contain: interest rates changes, recessions, political disorder, natural disasters, wars, terrorist attacks and other events that cannot be avoided or planed for. In addition, the regulation of geographical limitations, which control the bank's branches spreading, lead to limits the bank's clients and encourage them to involve in high-risk investment.

Regulatory Issues

Regulatory issues are classified as an external because governments and central banks set the regulations. The Regulatory is responsible to manage the day-to-day operations also the long-term planning of the bank, in order to the current regulations and government policies. It depends on the bank's financial statements and the marketplace. Regulators are concerned also about performance management, employees' levels, training programs and compensation structures. Regulatory issues occur when a bank dispute or conflict with one of the rules or policies of regulators. For example: they set interest rates, how much banks can loan to clients and how much capital and deposits they should hold in hand. These regulatory provide protection for banks, from having serious financial problems and failures, also the nation economic growth rate from falling.

Competitors

Competitors are classified as an external because they are other similar financial institutions in the same business field. Competitors are other banks in the financial market competing against each other to be the best, by offering more products and better services, such as: reducing the interest rate for a loan to attract customers. The risk of competitions occurs when one bank takes advantage over the other, which leads to decrease in a bank's competitiveness. It may affect the bank reputation and causes financial losses. Therefore, banks should avoid that by understanding the market’s needs and wants, improving their performance, and adding value by using the newest technologies.

OVERALL DISCUSSION

The authors found that from searching in this topic, that poor management is important and sensitive internal factor. It protects the bank from having problems and risks by managing everything related to it. The process of the risk management works to identify, analyze, assess and respond to the risks. After that they have to control and monitor so it will not happen again. Understanding the risk and knowing how to deal with it, could be part of the solution. However, banks are paying a lot of money to have a good management plan and to attract skilled managers, in order to manage everything in a correct way. Also having employees training programs can minimize financial problems, reduce operation failures and develop the performance of the bank. Risk management plan should be improved regarding to the risk exposures, also it must follow the regulation. On the other hand, clients are important to the banking institutions; they are the most affective external factor. Without their money the bank will not be able to function, because they invest in the client’s deposits by lending others and making interest rates to themselves. Banks should attract customers, by following the market’s needs and wants. Providing a good offer, great customer services and having healthy financial reputation may help in attracting new clients. Basically, banks should follow their government and central bank; they are in control

of any financial institution. They protect them from losses and failures, and manage the nation economy. If any bank conflict or deregulate their rules or polices, they will be lost and sometimes close.

These factors are important in banking institutions, to be understood and managed through time. Banks must be concerned about the internal structure before the external, because if the operations and performances go well, that means the bank is healthy and following the regulations, then will attract the external factors. Management control and cover a large area of any businesses, so managing everything in the right way will be a benefit for the bank itself. Consequently, the key for any business success is to have good management, to win the competition in the market and to avoid any type of risk or failures.

CONCLUSION

Banks are important financial institutions; they play big role in the economic aspect. They are the safest places for people to keep their money, which banks

used to invest in, by giving this deposit as loans to other borrowers so they repay it back with interest. Although they fail out of nowhere from time to time, but depositors will not lose their money, because the losses will be covered. Therefore, banks should avoid failures by understanding the risk of it, and the reasons behind it. This research has discussed the most common reasons of why banks fail, and the affective factors from internal and external sides. The risk of bank failing is different than other businesses, because it is not only affecting bank, but also governments and the nation growth rates. The losses of failing have to be covered by governments or central banks, because they are responsible. Their job is to set polices and regulations for all banks to protect and keep them away from financial problems or failures. It is a common thing for banks to fail around the world, and there is no specific reason for that. But from what I found in this research that management is the most effective factor, because if the inner structure of the bank was healthy then everything will perform in the right way. Managing credit and liquidity risk could rescue banks from having financial problems; also managing clients' products and serveries for their satisfaction and competitive advantages are important for the bank's reputation. However, implement and respect the regulations must be the first concern of the bank's manager. Consequently, banks have to aware their staff of failing risk, to make them understand and feel more responsible. Also, one of the ways to avoid risk is using the methods of analysis calculations to forecast any risk before happening. The authors suggestions for the future researches are to look more for new reasons of banks failure that could appear after this period, because the market is developing so the risks are increasing and changing. Also trying to find new methods to forecast the risks.

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