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Bank Failure Prevention: Is there a Missing Link in Literature? A perspective from Nigeria

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Abstract

As rich and impressive as it is, the burgeoning banking literature misses out a vital link with bank failure prevention – and incredibly does not offer clue about it. As its purpose, this paper identifies the missing link and highlights its significance for sound, safe and successful banking.

The paper draws on the author's experience of bank failures as a practitioner, consultant and author on banking for more than a quarter of a century, starting 1991. There were interviews, discussions and interactions with several bank insiders. The literature, documentaries about bank failures, and regulatory publications were equally consulted.

The findings are instructive: banks fail in countries around the world despite elaborate literature, regulation and strict laws meant to guide their operations; the literature lacks a framework of practice that weaves the main themes of the banking theories in order to optimise their value towards prevention of bank failures; current theories tend to overemphasise moral hazard, giving erroneous impression that all banking wrongdoings derive from it – yet moral hazard is a symptom of a more deep–seated banking rot, ostensibly going on undetected; regulatory issues contribute to bank failures – often regulators are found wanting as the stakeholder watchdog.

Keywords: **Bank Failures, Prevention, Regulation, Supervision, Surveillance.**

Introduction

The literature is rich in research and theories of banking [1]. It has essentially evolved three dominant theories of banking at different times during the past century [2]. There has been the "currently prevalent" financial intermediation theory which the fractional reserve theory preceded, while the credit expansion theory was predominant a century ago [2]. The modern theory, personified by the intermediation theory, seeks to justify the existence of financial intermediaries, explain the dynamics of bank liability contracts, and situate the challenge of imperfect functioning of the financial contracts. The evidence came from a test in which, "a loan from a bank was booked in the bank's accounting IT system under controlled conditions that excluded unrelated transactions", and finding that "the credit creation theory of banking is consistent with the empirical observations, while the other two theories are not," throwing "doubt on the rationale for regulating bank capital adequacy to avoid banking crises, as the case study of Credit Suisse during the crisis illustrates".

The earlier theories were oriented to address particular challenges in specific banking risks, dynamics and problems. This orientation espouses a narrow, rather than holistic, view of the critical issues in attaining efficient, robust and successful banking. Shades of such views are seen in thoughts on assets and liabilities management and their related theories. Included in this mould are the popular liquidity management theories: commercial loan theory founded on the tenth century English monetary history when the real bills doctrine influenced banking; shiftability theory; anticipated income theory.

A common observation is that rather than always trigger the desired economic tendencies, regulation sometimes creates loopholes which banks exploit to gain some unfair advantages at the expense of customers, financial markets and the economy. For example, the real fallout from protection of banks through deposit insurance has been incidence of moral hazard which then, as though in a vicious circle, necessitates further regulation. This paradox defines the puzzle with which evolution of theories of financial intermediation contends. The starting point in addressing the puzzle would be a change of focus of regulation from institutions and products to functions and services. This is justifiable. The forces that impinge on effectiveness of banking institutions and products are still in a state of flux. Also, while institutions and products may change dependent on technological revolutions and policy directions of the authorities financial functions and services tend to be stable and immutable.

The observed decline in information asymmetries and transactions costs due to technological advances in transactions processing while intermediation is burgeoning equally demands a progressive paradigm shift in regulation. Regulation should be founded on a robust framework that departs from current tainted interventions that fail to address age old threats to banks such as insider abuse, distress and failure in concrete terms. The framework should give impetus for effective risk management based on functional rather than institutional rules.

In pursuit of this goal, adverse selection and moral hazard remain a critical challenge, completely antithetical to effective intermediation and, by implication, a threat to banks as going concerns. However, current research and theories tend to overemphasise adverse selection and moral hazard problems, giving erroneous impression that all banking wrongdoings derive from them. Yet such vices are simply symptoms of a more deep–seated banking rot, ostensibly going on undetected.

Perspective from Nigeria

The paper draws evidence on the authors' experiences of bank failures in Nigeria as practitioners, consultants and authors on banking for more than a quarter of a century – starting from 1991 – and seeing the agonies of bank failures first–hand in the course of these careers. It takes to experience the trauma of loss of deposit in a failed bank to truly appreciate the plight of victims of bank failures. As we observe, "in principle bank failures may seem no worse than other business failures, but in fact bank failures can do substantial damage in terms of interrupting profitable investment by bank customers" [3-5]. The problem, to all intents and purposes, is a worldwide phenomenon. The question that springs to mind with regards to this malaise is why banks still fail across the globe despite strict laws, rules and regulations meant to guide their operations. Apparently, many ponder this banking menace without a clear–cut clue to the answer. Meanwhile banking remains one of the most regulated sectors in the world [4]. Stumbling across the notion of organic banking, while juggling thoughts around on the issue, was purely fortuitous. With interest research on it started. There was a bit of anxiety, though. The anxiety stemmed from uncertainty as to the best approach to adopt and whether the approach would answer that all important question and, in doing so, address bank failures holistically. Nevertheless, the study forged ahead digging into facts, not myths, of bank failures [6].

Soon it was realised that it is usually challenging and, in general, delicate to obtain data for research or case study on banks. As a researcher facing this situation, especially in developing and emerging economies, the ideal prayer is that the odds are overcome. The researcher begins to make progress only when the required data are obtained from and about the banks earmarked for study. A combination of discreet, sensitive and confidential modes of operation in banking complicates the problem. In overcoming the odds, the author tapped experience in working for five different banks in Nigeria in various capacities from 1991 to 2003, rising through the ranks to become divisional director, corporate banking, and member of executive management [7,8]. Two of the banks failed while the third became distressed, managed to survive, but was ultimately acquired by another bank. There were also interviews, discussions and interactions with several bank insiders with a view to following sundry issues in the operations of other banks heading for a fall and those that failed. Some use was made of data from the literature and documentaries about bank failures. Publicity about sundry banking issues, most of which were strongly perceived to be factors of bank failures in Nigeria, over the last quarter of a century equally came in handy. Relevant publications of the Central Bank of Nigeria (CBN) and Nigeria Deposit Insurance Corporation (NDIC), especially on failed banks in Nigeria, were also consulted [9-12].

36 banks altogether failed between 1991 and 2003, representing 30% of the 120 banks in Nigeria at the time. It shows the 25 banks that failed or were heading for a fall from 2004 to date. The 25 banks altogether represented about 27% of the 89 legacy commercial banks in Nigeria, pre–banking sector consolidation, as at December 31, 2005. Some of the 25 banks eventually went into mergers while others were either acquired or rescued by the Central Bank of Nigeria (CBN). Three of the banks Spring Bank, Bank PHB and Afribank were nationalized and rechristened “bridge banks” in August 2011, while the same fate befell Skye Bank in September 2018. The new (in parenthesis) and original names of the banks were (Enterprise Bank) Spring Bank, (Keystone Bank) Bank PHB, (Mainstreet Bank) Afribank and (Polaris Bank) Skye Bank. Interestingly, while Skye Bank whose operating license was later revoked by the CBN in 2018 acquired Mainstreet Bank in 2014, Heritage Bank acquired Enterprise Bank in October 2014, while Sigma Golf–Riverbank Consortium acquired Keystone Bank in March 2017. The acquisitions were conducted as sale under the auspices of Asset Management Corporation of Nigeria Limited (AMCON) to which the banks were transferred following the revocation of operating licenses of the original banks. There were 21 commercial banks in Nigeria as at December 31, 2018 at the end of the regulatory interventions, mergers, and acquisitions [13].

Instability and failures on account of inadequate capitalisation, mismanagement, over-trading, lack of regulation and unfair competition from the foreign–owned banks characterized early history of banking in Nigeria; 21 out of 24 of the indigenous banks established during that period up to 1954, failed. The industry and its stakeholders got a reprieve as regulatory intervention took centre stage and restored stability after the establishment of the Central Bank of Nigeria in 1959. However, the impact of regulation began to wane from the late 1980s due to unanticipated banking explosion. With the number of banks increasing to 120 in 1992 from 40 in 1985, poaching became the order of the day. The perceived banking boom turned out a fluke as it became truncated in the face of subsequent rampant bank failures. This round of failures came on the heels of skills gaps and professional misconduct of the practitioners. The available few experienced employees moved to the highest paid jobs, with dire consequences for the industry as it created a situation in which “inexperienced personnel and even misfits were appointed or promoted into sensitive positions,” with the implication that “honesty and integrity were relegated to the background,” which resulted in “decline in standards and breach of banking ethics…” and a loss of confidence in the banking system” [14]. The Nigeria Deposit Insurance Corporation aptly captured the precarious economic and financial fallout from this experience when it estimated that over 50 percent of money supply in Nigeria in 1998 was outside the banking system due to the uncertainty of bank failures. It becomes hard to sell the sense that banks are a haven for savers, investors, and businesses. Ironically, this sense which ordinarily should be incontrovertible nowadays no longer holds water for many. It identifies weak regulatory and supervisory framework, weak management practices, and the tolerance of deficiencies in the corporate governance behaviour of banks as some of the factors that necessitated banking reforms in Nigeria [15].

Missing Links and Prospects

The contemporary theories are headed for the fate of the earlier scholarship in lacking the ability to forestall bank failures. Perhaps the Basel Committee (1988; 1996; 2004; 2006; 2010) recognised this fact and, accordingly, enacted the Basel I (1988 & 1996), Basel II (2004 & 2006) and Basel III (2010) Accords to, respectively, deal with bank capitalisation; minimum capital requirements, supervisory review process, market discipline; and liquidity risk. It should be noted, though, that each of the Basel Accords came hard on the heels of financial crisis and money panic that jolted banking regulators across the globe: the experience of financial crisis in the 1970s and 1980s informed the enactment of Basel I Accord, while the Basel II Accord resulted from the 1990s financial crisis; it was equally in the aftermath of the global financial crisis of 2007-2009 that the Basel III Accord was enacted. While the three Accords seek to strengthen regulatory framework for the supervision of global banks, their underlying intent is to stem liquidity crisis, distress, and failure of banks. The spirit of the Accords favours adoption of specific risk management criteria, policies, and models as a means of shielding banks from crisis and failure [16].

However, the Basel Accords like the banking theories have hardly resolved bank failures. For example, empirical evidence suggests that liquidity risk measures which Basel III Accord introduced have low power of bank failure prediction compared with the traditional approaches to measuring liquidity risk, and that higher rates of bank failures were associated with Basel III–advised liquidity measures using liquidity coverage and net stable funding ratios. The outright or technical failure of many banks in some of the industrial countries that subscribe to the Basel Accords, e.g. the US and UK and in countries within the BRICS fold, e.g. China and Russia attests to the seriousness of the problem. The spate of bank failures around the world shows that current theories, like their forerunners, have failed to, or have been inadequate to address bank failures. The reason is simple. As rich and impressive as it is, the burgeoning banking literature misses out a vital link with bank failure prevention offering no clue about it. The missing link is organic banking. Few literature references to “organic” in relation.

Organic banking is not a panacea. It does not deal with issues such as force majeure, acts of God, uncertainty, and similar or related events that are beyond prevention or control but, in general, affect expected outcomes in business. For this reason, organic banking pivots on and is closely aligned with the goals of and need for banking regulation. In this way, the theory it underlies comes to fruition when its adoption is integrated with compliance with the banking laws and rules. Although organic banking touches general issues in banking, bank management and banking regulation, and has many practical applications in banking, the theory of it is limited to devising a means of preventing bank failures. It is necessary to put the phrase “bank failures” into perspective. Its import is limited to banks failing under abnormal circumstances often as a result of deliberate, self–serving, or negative actions of bank insiders, usually directors, management and employees in positions of trust. Incidentally, this category of failures accounts for most of the observed cases. Otherwise it will not be much strange that a bank, like any other business, could fail in the course of normal business operation.

Conclusion

Banks fail in countries around the world despite elaborate theories, rich empirical literature and strict laws meant to guide their operations. Unknown to many perhaps, everyone undetected causes curiously underlie the failure of banks. To make matters worse, bankers are clever at getting around banking rules. In doing so, they render banking regulation ineffectual.

It is doubtful whether there are existing theories, models or studies that directly identify the missing link with prevention of bank failures – ostensibly implying there is nothing strange about bank failures. Apparently this neglect builds on assumption that banks, like other businesses, could and do fail for sundry reasons. However, due to the high stakes in banking a major reason banking is such a highly regulated industry-failures in banking should cause many raised eyebrows and be unacceptable, to say the least. Ideally banks should not fail in the first place. Where failure is inevitable, it should be in the course of legitimate operations, unblemished and untainted by sundry abuses. Sadly, most of the observed bank failures were really avoidable.

What the literature lacks is a practical framework that weaves the main themes of the divergent, complex and robust banking theories, scholarship and accords in order to optimise their value towards prevention of bank failures. This paper identifies organic banking as the missing link with bank failures prevention. Organic banking should redress the sad reality that banks fail right under regulators' watch, often in avoidable circumstances despite the large literature and regulations meant to guide their operations. As the follow up articles show, organic banking identifies, defines and tackles sundry issues in banking rot and regulations. It furnishes a new approach to banking that addresses bank failures in concrete terms and in a novel way too.

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