The Decline of Traditional Banking Activities

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Abstract: The decline of traditional banking activities raise the issue of efficiency of financial stability, in terms of quantitative and qualitative aspects – the increasing danger of banking failures as well as of susceptibility due to increased propensity of banking institutions to assume additional to risks either in the form of riskier loans offer or engaging in other “non-traditional” financial activities which give a promise for greater profitability, but also higher risks. Non-traditional activities of banking as financial products dealers (financial derivatives), generate an increasing risks and vulnerabilities in the form of moral hazard issues. That is the reason why and these activities should be regulated as well as are the traditional activities. Challenges posed by the decline of traditional banking activities is twofold: the stability of the banking system must be maintained, while the banking system needs to be restructured to achieve financial stability in the long run. One possible way is an appropriate regulatory framework to encourage a transition period of changing the structure of banking activity(reduction of traditional activities and expanding non traditional activities) to enable banking institutions to perform a deep methodic analysis of non traditional activities, oriented to the financial banking efficiency.

Keywords: traditional banking activities; quantitative aspects; qualitative aspects

1. Introduction

The new industrial economies witnessed post-1970 economic take off with GDP growing at a faster rate than the population. These economies shared 20% of global output and it is predicted that by the year 2015 these countries will be producing approximately one third of the output, which is virtually the same as the OECD countries.

There was not any single model that could be presented for such a success but there are some main reasons for such a huge and fast growth within these economies in this short period of time. The main reasons include culture: the people in these countries worked hard and importance was given to the literacy rate, i.e. being able to read and write; secondly, external factors, such as in some of the countries like Malaysia and South Korea which faced military threat from some communist countries; therefore these countries were financially supported by the US. Hence, this encouraged the political alliance among the countries of South East Asia and the growth of Japanese economy was emulated.
Also the financial markets in these countries were encouraged by the structural reforms within economies and foreign investors were assured that there would not be any control on their capital. Other reasons for such successes in these economies were: they provided industrial basis, there was increase in export growth, exchange rate policies, careful privatization and high savings rations. Such measures produced some economic benefits for these countries and they saw an increase in the mobilization of domestic savings. They removed reliance on external debt as a single source to finance economic and also the development of the stock markets reduced the cost of capital which resulted in increased shareholder value.

2. Financial Crisis and Risk Management

The Asian financial crisis was a big shock after so many years of outstanding performance. It did not break all of a sudden but there were numerous signs of gathering crisis. Macroeconomic indicators pointed to major imbalances such as real exchange rate appreciation, a slowdown in export growth and large persistent current account deficits that were financed mostly by portfolio investments and, also, the short term capital and the rising external debt. These problems were witnessed in the Thailand economy; the above-mentioned problems also exposed other weaknesses in the economy, such as unhedged foreign currency borrowings by the private sector, an inflated domestic property market and a weak over-exposed banking system. It is not that everything was realized afterwards but the market reflected its own warnings by declining property prices and mounting exchange rate pressure. However, the concerned authorities in Thailand and in the rest of the region did not realize this and were not ready to recognize such problems after so many years of success. This is the reason why there was a delay in taking necessary action and providing a convincing policy.

The question asked at this stage is: how did the crisis spread to other South East Asian countries that had less current account deficit and foreign investment was substantial? Since these countries are close trade competitors, the depreciation of one country’s currency will make other countries’ products less competitive; hence, the other countries will depreciate their currency as well. This depreciation in currency value will increase the cost of domestic–private debt servicing and it makes a country’s financial position vulnerable, so most of the foreign currency reserves go into debt servicing. Secondly, when the investors see the financial condition of one country as being vulnerable, they try to shift their investments from this particular country to another. In the case of the Asian financial crisis, most of these countries were running on the same policies, so when the investors saw Thailand’s financial position in trouble, they thought that, sooner or later, the other East Asian economies would go through the same problems as well, so they started to shift their investments from these countries, thus making their position weaker and spreading the problems from one country to another. Another reason for this contagion effect during the crisis period is that when the depositors of banks started to demand their money back, banks found it hard to provide the funds in order to fulfill the demand. Hence, banks must either borrow money from other financial institutions or transfer the funds from their branches in other countries. This transfer of funds from one country to another also makes the position of other country’s financial institutions weak and therefore the crisis spreads from one country to another.

This study will now focus on banks in East Asian countries, as these banks are also partly blamed for the crisis. The economic growth of the South East Asian region concealed the banking practices in this region. Against the background of strong regional growth lending of dubious quality was both
concealed and accommodated. But these practices were making these banks more and more vulnerable and this is what had been witnessed over the period of time.

3. Bank Failures

Bank managers, investors and regulators are all concerned with bank failures because all of them have their own vested interests. Managers are concerned because they might lose their jobs, investors might lose their investments and regulators have to make sure that there is no know-on effect from such a failure since a failing bank may put costs on the taxpayers. An attempt will be made to identify some reasons that cause these banks to fail. Also, a recent example of bank that failed to identify the risks and consequently suffered heavy losses is cited.

Banks fail when liabilities outweigh assets of the bank. The assets are the IOUs of its customers and the liabilities are their deposits. If the customer borrows a million pounds from the bank and has given the IOU to the bank for this borrowed amount then the bank has assets worth that amount. If the customer is unable or refuses to pay the amount by the due date this means that the IOU that he signed is worthless, but if the borrowed amount by the customer is in the same bank then the liability of the customer remains there. Many banks can absorb such losses but if the borrower was a sovereign government and the amount of the borrowed money was high then this creates serious problems for banks.

Bank failures are perceived to have greater adverse effects as compared with other firms’ failures in other industries. One of the reasons why they are given more importance is that their failure can spill the effect over to other banks and thus can cause problems for the whole system. This means that the systemic risk can be triggered if the bank fails. When history is examined, it may be noticed that it is not only one country or region that has suffered from bank failures but, regardless of political and economic culture, virtually every country at some point has suffered. This is the reason why banking industry as compared with other industries has been subject to heavy regulations throughout the world. The explanation to this is that in the 14th century, the Bardi family of Florentine bankers was ruined owing to the failure of Edward III to meet outstanding loan obligations. This is the only time in British history that the government failed to honor its debts. From this it may be concluded that bank failures are not a new thing. Some of the bank failures seriously damage the financial system of the country, as witnessed in the UK in 1886 and in the USA in 1993. In England there were two major failures: one was over end, Gurney and Company Ltd. In 1866 and the other was Barings Brothers in 1890. Over end Gurney was a financial firm that dealt in bill broking and banking. Until 1856 it was running smoothly but in 1857 after the change in management, it began to lend money with poor collateral. It also started to take bills of dubious quality. Soon the bank started to report losses and was floated in the summer of 1865. In 1866 it went to Bank of England for assistance but this was refused and therefore it was declared insolvent. Similarly Barings Brothers was a merchant bank that made loans to the governments of Argentina and Uruguay. These loans made up three quarters of the total loan portfolio. The value of the securities provided dropped and also there was a drop in the loan repayments. Barings reported the problem to the Bank of England. Barings was put into liquidation but was refloated as a limited liability company; capital was provided from the Barings family and friends. The collapse of the bank was largely the result of the mismanagement of assets that led to a weak loan portfolio and, in the case of Gurneys, poor quality finance bills (Shelagh, 1998, p.267). In the USA there was a series of bank failures between 1930 and 1933. The main cause of bank failure was the stock market crash of 1929. This created uncertainty and resulted in a severe depression in the
During the first US banking crisis in November 1930 the number of US banks which failed was 256; this had a contagious effect and the whole of the US fell under its grip, with 352 more banks failing in December. Apart from the market failure another reason for the bank failures was the poor quality of loan books and bad investments, according to Friedman and Schwartz. After the 1930’s the main causes of bank failures were bank runs that forced banks to sell their assets at a discount (Shelagh, 1998, p.268).

The main causes and reasons for the bank failures and problems will be examined.

3.1. Causes of bank failures/problems

The main reasons for bank failures or the banks facing problems in running operations are:

a. Expansion

One of the reasons for bank failure is the rapid expansion of its operations. This creates problems in managing the bank, as the management does not have enough expertise. This was the main reason why Credit Lyonnaise has faced problems: in order to see the French bank rival Deutsche Bank, the president of France strongly endorsed the expansion of the bank throughout the world. Owing to the lack of management experience in dealing with problems that arise during the rapid expansions the bank ended up with heavy loses.

b. Liberation

Liberation is also one the reasons why banks have faced problems in the recent past. Liberation should go hand in hand with the supervision and adequate internal controls. If there is no adequate supervision and no internal controls then this will compel bankers to take unnecessary risks and they will try to make most out of the opportunities available to them. Therefore, it is important to have internal controls that are compatible with government policies.

c. Fraud

Corruption and fraud in banks are also reasons for bank closures. In many countries politicians influence banks and therefore loans are given to those private firms that politicians have interest an in. BCCI is a prime example of criminal involvement and massive fraud; the loans were given without any collateral to the Dubai based shipping corporations because of the personal relations involved. These frauds forced this bank to close its operations and the management of the bank was punished, although some of the people involved have still not been punished.

In many cases when the bank is already facing some problems the top management tries to take one last risk, but this last risk does not work and therefore the bank goes deeper into trouble.

d. Economic sector

In many countries banks have made a mistake by investing heavily in one particular sector. This has been witnessed in many countries of Asia such as Japan, Thailand, Malaysia and many more Asian economies where banks have given loans to the real estate sector without having properly followed the rules. In many banks the loan books were not maintained properly and therefore banks would incur heavy losses through bad loans. Recently in Europe, it has been seen that banks have given many loans to the telecom sector. If the authorities do not take any quick action, this could create a bubble that could burst at any time, causing many banks and firms to fail as a result. Recently, the Bank of England warned banks in the UK to limit their investment in the telecom sector. If all the regulatory authorities were to take similar action then banks would not get into such serious problems.
e. Derivatives

Many people think that derivatives are an abolition of risk. Derivatives do not abolish risk they just shift the risk. The example of Allied-Lyons can be mentioned here where the company reported a loss of L150 million. The treasury was speculating in options and even when it thought it was reducing its risks, it was increasing them. Another reason is that the top management may be unaware of the mechanism of derivatives. Peter Barings, a descendant, did not know anything about derivatives so never paid any attention towards what his colleagues were becoming involved in. Therefore it is important for the top management to have sound knowledge of its products and services.

f. Too many banks

The problem that banks are facing these days is of shrinking profit margins. This is the result of excessive competition; because of this competition banks have started to give loans at lower margins and without any collateral. This is done in order to buy the market share.

g. Deposit insurance

Deposit insurance has also made it easier for bankers to take unwanted risks. As both the depositors and the bankers think that the deposits are safe the depositor therefore does not care what the bank management is implicated in and similarly the bank management takes high risks as they think that the deposits are safe even if the investments that they are making fail.

h. Complexity of financial conglomerates

In the recent past it has been seen that the companies have merged and because of these mergers bankers require sophisticated management control techniques. Those banks that do not maintain their systems accordingly and do not invest in information technology cannot keep up with this pace and therefore fail.

i. Rogue traders

Rogue traders have been the major reason for recent bank failures and bank losses. The biggest example is that of Barings Bank which collapsed in 1995 as a result of rogue trading. One way of reducing rogue trading is by eliminating the bonuses.

j. Regulators/Auditors

One of the questions being raised these days is: who are regulators accountable to? Another reason for regulators not performing their jobs properly is that the salaries paid to them are not as good as that paid to traders. Also, banks should have their own internal controls and they should not rely totally on these auditors and regulators.

These are some of the reasons why banks have failed in the past and now the implications will be considered.

4. Conclusions

In some cases bank failures have put a heavy burden on the taxpayers. This is the reason why regulators are often believed to be the reason for bank failures as they have increased the probability of bank failures and also their cost. Regulators are partly blamed because they try to socialize the cost of the failure by shifting the costs from private depositors to taxpayers. A matter for debate is why
these costs must be socialized, whereas when the bank makes profits these go to only a few private pockets.

Banks, as compared with other firms, are considered to be more fragile and also the banking industry as a whole is considered to be more susceptible to contagion than other industries. This greater fragility is believed to lead to greater failures for three reasons. 1. Low capital asset ratios, which means that they are highly leveraged. 2. Low-cash-to-asset ratios, which may require sale of earnings assets to meet deposit obligations. 3. High demand debt and short term debt-to-total debt (deposits) ratios, which may require sale of assets and even sale of non-liquid assets in order to pay off depositors (Kaufman, 1996).

Since banks are more closely intertwined financially through lending and borrowing from each other, the failure of one bank is believed to spill the effect over on another bank. Therefore the banking system is more susceptible to systemic risk. The contagious effect in banking occurs faster, spreads widely within the industry, results in a large number of bank failures, results in larger losses and can even spread to other countries, which might have a macroeconomic impact.

5. References


