"NOTHING SERIOUS EVER HAPPENS"

By Mr N Hapuarachchy

What causes Bank failures?

The common belief or theory is that financial crises are due to macro-economic factors. This belief is based on the fact that the entire banking system depends on the ability to borrow and lend. This is what ensures a constant flow of liquidity into the economy. The borrowing and lending are not restricted to the consumers or businesses. Banks also borrow amongst themselves everyday in order to replenish their reserves. When a banker can no longer borrow the money it needs to cover the money it's loaned out, a failure is the result. Contrary to this popular belief, this paper attempts to discuss the role of the Management as a major cause in banking failures. This study is further based on a recent failure of a specialized Bank where evidence suggests that the role of bank management could be a major cause for failure.

Implications of Bank failures

A bank fails economically when the market value of its assets declines below the market value of its liabilities, so that the market value of its capital (net worth) becomes negative. At such times, the bank cannot expect to pay all of its deposits in full and on time. The perception of the public of bank failures will be unsatisfactory because such perceptions may spill over to other banks and possibly to banking system as a whole. Banks are therefore considered more fragile than other institutions unless properly managed in a transparent manner. Certain rumours, market information or perception can change the stability of a Bank abruptly and depositors may run "irrationally" on banks.

Poor management and ineffective supervision could make good banks bad banks within a short period. Of these banks which have gone down could have survived and regained, stability if Good Management prevailed while bad Management would lead to deeper crisis through compounding losses, misuse of resources and finally fraud. Such banks could be saved only by addressing the institutional remedies which have been proven to be ineffective or even counter productive. "Nothing serious ever happens" seems to be the assumption or the belief of the Management of troubled banks. In this scenario it is opportune to analyze, the management problems that lead to failure.

In USA bank regulators have a system to rate banks according to the CAMEL System which represents the quality of Capital, Assets, Management, Earnings and Liquidity. Each institution is given periodically marks by the regulators according to the performance in a series of aspects that make up each of those areas.

These ratings range from 1 to 5 from very good banks to failing banks. The elements used as a basis to rate the bank's management are;

:: Competence

:: Leadership

:: Compliance with regulations

:: Ability to plan

:: Ability to react to change in environment

:: Quality of policies and ability to control as they are applied.

:: Quality of the Management team and potential succession.

:: Risk of insider dealings.

A satisfactory response to these concepts can be good definition of Good Management. If all the banks are well managed, anyone could argue that there is no need for regulators to worry much. However, the fact that Banks are supervised and under regulatory framework may keep the Management of Banks on pins to follow the rules of good management. Traffic lanes and policemen would be necessary even in a country of good drivers. Both banking and driving are risky activities for third parties. Regulators cannot be expected to check the activities of the management of a bank, which is determined to run the place by hook or by crook. The very existence of such bank will be a threat sooner or later. However, Managers of a bank who are undergoing temporary set backs due to identified weaknesses will come back having put the house in order.

Handle with Greater Care

Banks are definitely more fragile than any other industry because they deal with money owned by the public. Availability of a regulatory framework has provided adequate confidence in the public to trust the banks to the letter. No questions asked. Yet failed banks have practically mismanaged their affairs causing erosion in public confidence in the banking system as a whole. A run on a bank depends on the perception of the depositors and will have a severe input on the solvency of other banks.

Banks which are falling within CAMEL rating of 3 and below could be considered as banks with good management. In the case of rating above 3, management of such banks have been classified into four categories.

a) Technical Mismanagement

b) Cosmetic Management

c) Desperate Management

d) Fraudulent Management

These activities may or may not occur in a sequence for a bank to fall apart. However, it appears that Technical mismanagement takes precedence in the process of the deterioration of the affairs in a troubled bank. The significant factor is that management is innocently ignorant that Technical mismanagement is taking place within the reach of their own team. Technical mismanagement is directly linked to the profitability of the bank. In an attempt to forcibly maintain a non existent profitability, it activates a chain reaction resulting in cosmetic and desperate management. The end result will be deliberate FRAUD carried out by “Good Manager” who become a “bad Manager”. Such banks may by this time have lost its capital with the consequence of severe a liquidity crisis. Then comes the run on the banks.

Technical Mismanagement

It has been observed that Technical mismanagement could occur in the following situations.

When a new bank is set up and managed by a new management. On many occasions, bankers who leave an existing bank to promote a new bank, try to introduce new methods of banking which are sometimes not “ethical”. They would go to the extent of adopting wrong techniques and criteria in order to maintain their image and entice the innocent public to begin relationships. New banks are always faced with the problem of gaining public confidence without which they cannot exist. In their desire to achieve this overnight, they adopt policies and practices which are technically outside accepted management principles.

QUICK GROWTH

Seeking growth for the sake of growth is a fundamental error committed by troubled banks. Growth is very often connected with “Over extension” or lending large sums of money that are not in proportion to the Bank’s capital. Similarly such have diversified in a very short period to business areas they are not familiar with or not well equipped to manage well. Absence of adequate capital to cushion potential losses become a major constraint for troubled banks to accommodate write-offs while maintaining a reasonable growth of Income generating assets. In the process of image building management may commit a major portion of the capital to non-income generating assets thereby further restricting the growth. Floating of subsidiaries, which are not adequately capitalized, in order to display a“Group” image to unsuspecting clients will further add to the already strained capital base.

POOR LENDING

Lending policies, which are not consistent and strong enough to avoid possible losses due to poor lending, may prove that, in the long run Management tends to forget that the funds are owned by the depositors who expect the bank to keep, manage and return such deposits, on maturity or on demand. Inability of the management to adopt policies to ensure that funds are lent in a manner so as to yield a proper remuneration with comfort of recovery on due dates, will be a poor reflection on the management of the Bank.

a) Risk Concentration

One good example of poor lending is Risk Concentration. This means making loans representing a high proportion of the Bank’s capital to one single borrower or group or a sector or industry. Despite regulations and limitations banks may violate this fundamental rule to gain quick benefits but inevitable disaster. Sometimes, due to inadequacy of competence, Bank Management may be compelled to surrender to irresistible pressure from borrowers who sometimes are unable to service their debt or even pay their operational overheads. Not all concentrations lead to failure, but many bank failures are the result of serious loan concentrations.

b) Connected Lending

This is a situation where the bank lends money to companies or businesses owned by the bank or major shareholders. This type of connection compels the Bank Management to consider requests for poor lending proposals which are outside the lending criteria. Connected lending may be done but within limits. This kind of lending is risky because management’s lending to use the bank as an instrument to finance own businesses irrespective of their ability to repay. Such concentrations are very often rolled over to keep them in the regular portfolio. This type of lending is common in development banks or specialized banks. There is nothing wrong in

this type of lending provided effective controls and proper evaluation criteria are applied as in the case of lending to third parties.

However, in practice, such loans are usually made on less rigorous criteria and highly geared to small or no equity. In view of the connection and the necessity to accommodate this type of lending the attitudes of the management become lenient in approving and monitoring of such lending. The key people who represent the bank in such businesses will not only go along the stream of activities desired by the bank and try to supervise and control for the mutual benefit of both parties. The parent bank will hesitate classifying such loans as non-performing despite evidence of deterioration.

MISMATCHING

This is a situation where lending terms are out of proportion with those of deposits. It is an accepted fact that deposits stay longer with the Bank. But, if and when terms of lending are over stretched far beyond those of liabilities or become un-collectible due to forced roll over serious liquidity problems may arise causing mismatch of maturities of Deposits and Advances. In such a situation, any attempt to maintain liquidity will result in paying excessive rates for new funding. If such deposits are with fixed rates, substantial losses will occur in the transformation due to interest rate risk. If the bank solves its liquidity crisis by offering rates well above the market disregarding market valuation, the losses are inevitable. Continual borrowing at high rates without correcting mismatches and recovering the loans has been a major cause for the deterioration of troubled banks.

INEFFECTIVE RECOVERY

Banks funding faces severe strains due to accumulation of NPLs resulting in ineffective recovery. NPLs created through poor lending will dent the cost structure of the bank compelling the bank to mobilize more funds to maintain the holding cost of NPLs and continue with new lending. NPLs sometimes get stuck due to conflicts of interest between the bank and companies owned by the bank.

OVER OPTIMISTIC ASSESSMENT

Many NPLs are created involving borrowers who have long relationships with the Bank on a personal level. They may be well known to many key officers or sometimes are in and out of the bank on a day to day basis. Requests for facilities do not go through the normal evaluation criteria but allowed over the counter without any documentation. Such customers are used to writing cheques for what ever amount with confidence because they know very well that the bank will honour such cheques whether limits are exceeded or not. This type of face lending end in a dead lock situation where the customer suddenly finds that the party is over for him. The bank, by having extended unlimited credit has ruined a customer and is left with unsecured loans, the recovery of which is a remote possibility. Now begins the turn for the banker to go behind the customer pleading for security cover and repayment. The cordial relationship that existed between bank officers and the customer is no more, causing further strains on the bank. Banks which fail to assess all possible risks and resort to name lending or face lending , face severe consequences of their folly. But it may be too late.

Lending officers who get carried away by the importance and the long relationship of the customer and also by other benefits may try to paint a nice picture to the approving officers in

order to get their proposal passed. This over optimistic assessment invariably misses the test good evaluation.

LACK OF INTERNAL CONTROLS

Absence or inadequacy of internal control could be disastrous in many areas of operations. However, shortcomings in the core business areas which involve income generating assets are vulnerable and cause more damages than in other areas.

LENDING

Absence of regular credit reviews by credit officers could reduce the effectiveness of the monitoring process, due to reliance on the skills and the ability or competence of the credit officers in making decisions. A formal review procedure should be in place to ensure awareness of the staff of any adverse trends and through such trends to draw the attention of the management for corrective action.

MANAGEMENT INFORMATION

Non-availability or insufficient feed back is another cause for deterioration of the assets. A good information system will help management to promptly analyze the trends and identify warning signals well in advance. Lack of knowledge of what is happening in the core business area prevents risk management process in minimizing the losses.

INTERNAL AUDITS

Failure to ensure that both regulations and internal policies are properly applied at all levels will result in gradual failure of controls to prevent failures. Many failures could have been avoided, if the internal auditors were sharp enough to pick evident signals of impending crisis or if management was receptive to the reports by the auditors. A CEO cannot afford to ignore vital areas unless CEO himself manipulates the internal operations for obvious reasons.

POOR PLANNING OR “NOTHING SERIOUS EVER HAPPENS”

Ability to foresee is a very rare gift, which can be developed with adequate techniques. But poor planning is not only a matter of technique but a matter of attitude. It has a close relationship with the age or interests of top management, with the absence of team work, and with the wishful thinking that banking has always been a very safe business that needs no sophistication nor adaptation to change. We have always done very well, “Nothing serious ever happens,” “Problems are solved by time” are typical attitudes. In a context of economic upheavals, growing competition, financial “menageries” etc. it is easy to understand what are the consequences of poor planning. On the contrary, if a bank follows its own trends closely, if it tries to capture what is ahead in he economy and on the markets, it can adapt its strategy so as to suffer limited damage and survive even in the midst of serious upheavals. Together with quick growth and bad lending policies, this aspect of mismanagement is the most frequent cause for a bank deterioration.

THE CROSSROAD

As a result of technical mismanagement and/or other macro or micro factors, a bank may find itself in a situation where equity is increasingly eroded by hidden losses, real profits decrease

(if not their disappearance) and dividends, of course, are in danger. This would be the typical situation where good supervision or a good board would have the bank declare the real situation, change management and inject new capital. But lack of proper supervision and/or good boards lead to a very different situation. A drop in dividends is the key signal to the market that the bank is deteriorating and bankers will tend to do everything in their power to avoid lack of confidence and to keep control of ownership and management. This is the key crossroad. If the banker does not take the right road, the bank is doomed to be engulfed in "cosmetic management" and "desperate management", either one after the other or simultaneously. Management will get worse and worse, the culture of the organization will deteriorate very quickly, the market will be distorted and a spiral of losses will soar. This is probably the point of no return. From then on, liquidation or restructuring is the only effective solution to a situation of insolvency that may grow in geometric progression.

COSMETIC MANAGEMENT

What is called "cosmetic management" consists of hiding past and current losses so as to buy time and remain in control, while looking and/or waiting for solutions.

While there are almost infinite ways to hide the economic reality of a bank, some of the can be grouped in a model; the "upside down income statement" technique. In a typical income statement, the first item is interest income and the last one is dividends, dividends being the result of additions and deductions of all the items in between. But when dividends are in danger, the banker may decide that they cannot be considered a variable, but a fixed element, that is taken as a basis to construct the remainder of the statement down the ladder, through manipulation of figures, no matter what the reality is. The "upside down income statement" would therefore tend to read as model A, as against a standard one, as shown in model B.

Model A	Model B
Dividends	Interest/ Income
+ Undistributed Profits	- Financial Cost
+ Taxes	= Spread
= Net Profits	+ Fees
+ Provisions	- Overhead
± Sundry Income/ Expenditure	= Operational Profit
= Operational Profit	± Sundry Income/ Expenditure
+ Overhead	- Provisions
- Fees	= Net Profits
= Spread	- Taxes
+ Financial Cost	- Undistributed Profits
= Interest Income	= Dividends

Once dividends have been predetermined, the first area a banker will touch upon in order to maintain the same dividend is undistributed profits. This is not yet an accounting gimmick but the threshold to cosmetics. The bank is sacrificing its capital adequacy for the sake of a "good image" that no careful analyst should believe. Still, investors will receive the remuneration they were accustomed to.

The next problem arises when a further reduction in undistributed profits is no longer possible. Then, the banker will think of manipulating the net profits in order to increase them on paper, even if that means having to pay more taxes. How? The banker will have four main resources to achieve his purpose.

a) to make provision less than required, through "evergreening" procedures, or collaterialization

b) to consider un-collectable accruals as income

c) to revalue assets

d) to advance accrual of income and postpone accrual of expenditures.

"EVERGREENING"

The most serious problems of a bank are not in loans classified as overdue. They are smaller loans and are being dealt with. The worst losses of a bank are hidden in the portfolio that is classified by the banker as current portfolio or "good portfolio". This means that when a banker wants to adapt provisions to a given level of profits and dividends, he will not classify a bad loan as overdue, doubtful or a write off. Instead, he will automatically reschedule the loan over long periods of time, which will avoid classifying it as overdue.

Interests will be refinanced. This is a snowball process that may lead to disaster because those loans become more and more difficult to collect, and the borrower's bargaining position is strengthened because of the bank's failure to take effective recovery action. The culture of non-payment develops. Those practices are very typical of loans to companies where the bank or the bankers have stock, or where the bank has concentrated disproportionate sums of money. A very significant example of the latter is that of banks substantially involved in large lending to one or two customers, when they keep rescheduling the debt over and over again without making the necessary provisions.

Another typical way of reducing the need for provisions is to make a bad loan look good by obtaining collateral, even if that is economically insufficient to cover the debt or is impossible to foreclose on. For instance, loans with prior mortgages, factories with ongoing business and labour problems, real estate with limited or no development potential. However, the banker will account for the collateral as being worth the principal and the interest to be accrued over a period of time. The borrower will again be very happy about it.

In any case, the borrowers may still have negative equity, current losses or even negative cash flow, but the banker will argue that he does not need to provide for those loans, and that time will solve the stressed situation of the borrowers. He may even go as far as to say that such borrowers are going concerns with no need for provisioning.

The practices described above not only lead the banker to make provision less than he should, but will also lead him to capitalize interest i.e. to account for refinanced interest (which in fact will be increased losses or principal) as income. So, looking back to the income statement, the banker has achieved better "profits" not only because provisions are lower, but even more important, because interest income is higher, thanks to procedures that make loans look like "evergreens".

Suppose that "evergreening" is not enough to keep profits at the desired level. The banker still has a way out: to revalue fixed assets, be they real estate or stock. Some legislation permits banks to periodically revalue their assets in times of inflation without additional tax implications. Some banks use this advantage to increase the book value of their assets beyond their economic value, thus creating artificial additional income (the difference between the previous book value and the new one) and reserves (as a counterpart of the asset revaluation).

Worst of all, some bankers may revalue their assets by selling them to companies that are connected with the bank, on credit for a price above the book value and account for the positive differences as income. The negative difference will not appear on the buyer's balance sheet, or, if it does, it will not be consolidated with the bank's balance sheet, as it should. Another type of "revaluation"; banks may receive foreclosures that are insufficient to cover the loan in question but account for them at the loan value.

Another type of manoeuvre to hide losses is to advance accrual of income and postpone accrual of expenditures. Let us mention a couple of examples. Fees should normally be spread over the operation term. However, bankers in trouble will account for them the very day the fee is received. On the expenditure side, the banker may postpone accounting for commitments (for example, the payment of the price of a purchase) to the time of actual payment, instead of making the entry on the day the contract is signed.

DESPERATE MANAGEMENT

"Desperate Management" is an expression that seeks to describe a situation where bankers see themselves in danger of "having to declare" a capital loss or having to pay fewer or no dividends. At that stage, the banker, besides indulging in cosmetics, will also look for businesses which may permit him to buy time, and if lucky, make up for the previous deterioration. The main practices followed under these attitudes are (a) speculation (b) paying rates above market rates for deposits and (c) charging high interest rates to borrowers.

When a distressed economic environment, bitter competition, and/ or technical mismanagement lead you to have current losses and a high proportion of non-performing assets, the banker will look for alternative sources of income, and indulge most of the time, in speculative activities. A few typical examples; buying real estate in times of inflation, in the hope that prices will keep increasing forever and a profit will be made when the property is sold; buying land as a basis for real estate development through loans from the bank; buying stock under the assumption that you are making short term profit. Frequently, profit does not materialize because of a change in the market trends or because of inaccurate estimates. Think of a situation where a tight monetary policy brings in deflation and adjustment, the market becomes narrower and the value of real estate drops dramatically.

What happens through the whole process is that the bank's proportion of non-performing assets becomes higher and higher, and the yield (that is supposed to be the income to cover deposit, interest rates, overhead and profits) continues to diminish. No matter how the cosmetics are applied, the problem is now the real cash flow, which suffers damage and the bank begins to experience liquidity difficulties.

When in liquidity difficulties, the banker will go out to the market and offer very high interest rates to potential depositors. He needs to maintain an image of growth, he hopes that he can charge similar high interest rates to borrowers and have growth absorb its problems; and above all, he is just in need of cash. What for? In order to cover interest to his depositors and even be able to physically pay the payroll and other fixed expenditures. Their deposit principals may no longer be entirely allocated to making new loans but to pay staff or suppliers. At this stage, the banker is taking deposits knowing they are unlikely to be repaid to depositors.

To the extent that the banker can still make new loans with a part of his deposits increase, he will try to make up for the high remuneration he pays to the deposits by charging interest rates to his borrowers that are beyond the market price. What happens is that he is now involved in a perverse process, because the quality of borrowers that can accept high interest rates is not likely to be the best. They are, typically, cases of stressed borrowers or borrowers connected to the bank or the bankers, who are not sure they will have to severe their debt. The borrowers have small or negative equity. The connected borrowers have connections. Through this practice, the banker may have high spreads on its income statements, but only on paper.

FRAUD

Fraud may have been one of the causes of losses for a bank at an earlier stage. That is frequently the case when a bank is set up or acquired by speculators or businessmen having their own business interests. Also, fraud is involved in "cosmetic" management, to the extent it is a way of hiding the truth to the public, in a business that is based on confidence. However, fraud is dealt with at the end of the process, in order suggest that a former good manager may become a fraudulent manager, through a deterioration process, such as the one described in this paper. In fact when illiquidity approaches and the banker feels the end may be near, he may feel the temptation to divert money out of the bank. The most typical channel is self lending, i.e. lending to companies that are owned by or connected with the banker. This may be done through special formal procedures that would make it very difficult for the bank to foreclose on him when he is no longer there. Another fraud that is typical of his last minute situation is "swinging ownership" of companies that are partly owned by the bank and the banker; if the company is prosperous, the banker may buy it from the bank at a low price. If the company is in poor shape, the banker will have the bank buy it from him at a high price. After all, he is in charge. Of course, all those operations are "properly" materialized through fiduciaries, paper companies and other similar methods, so as to escape supervision.

CULTURE DETERIORATION

Deterioration of the management culture is one of the consequences of keeping problems unsolved as well as a source of the long lasting problem. The attitude and the example of top management permeate middle management and other organizational layers. A bad management culture is very difficult to change. Changing a deteriorated culture may take a new management at least as long as it took the culture to deteriorate, unless, several layers of management, are changed. This is one of the reasons why mergers are advocated as a solution to crises. Some features of a deteriorated management culture are;

- Paper is mistaken for facts. Figures are mistaken for money. Hiding and cheating becomes normal.
- Speculators become the ideal kind of managers, since speculation becomes the ideal business because it is one of the few hopes for recovery.
- Promotion of managers is based on loyalty, not on competence. Management information and teamwork disappear gradually.
- Internal audit activities are cut or confined to investigation of minor problems in branch offices.
- Branch managers become one-legged professionals. They receive instructions to concentrate on the collection of deposits and stop lending, since the whole lending gradually concentrates in the bank's headquarters and main branch office.
- The fact that money is the raw material of the bank and the "need for prestige" lead to inflation in staff, salaries and over heads. Luxury premises become a rule.
- As a counterpart of the culture of non payment among borrowers of banks in distress, the banker develops the culture of non-recovery.

LESSONS TO BE LEARNED

1. Many of them are expressed or implicit in the foregoing text, but the risk of repetition is worth running for the sake of synthesis. Regulation and supervision are not panaceas, but they

are necessary pillars to have a strong financial system and limit the damages caused by mismanagement and make macro policies effective.

2. Good Management and supervision may prove no good if there are no mechanisms in place to solve insolvency cases. This situation may even lead to the corruption of the CEO who, for lack of remedies, may find himself forced to tolerate hiding.

3. Bad management is an essential ingredient of all banking crises. Only in cases of complete economic upheavel can a good management be overwhelmed by the context; but even in this case, there are good managers and bad managers. Good managers can limit the damages to a considerable extent.

4. The quality of management is dynamic. Once the bank loses a considerable portion of its capital without properly reacting or having new capital injected, an accelerated process of deterioration is likely to take place.

5. The perpetuation of bad management is likely to multiply losses not only from the need to finance the previous ones but also through damage caused by a deteriorating culture and new loss making activities or practices.

6. Capital adequacy requirements are no good, unless a proper system of assets classification and provisioning is regulated, enforced and verified.

7. Overdue loans on the balance sheet may be negligible to judge a bank's solvency, if compared to big bad loans that are classified as current The bigger the bad loan, the more likely it is to be kept as current.

8. As a result of the above, rescheduled and rollover loans are the ideal hidden place for losses and the ideal way to have fake capital and income, is by avoiding provisions and accruing uncollectable interest as income.

9. A bank may remain liquid while being in the process of (losing its capital or its equity) several times, because of hiding practices. In other words, when illiquidity presents itself in a bank, you are in front of sheer bankruptcy, which may have eaten up not only own funds but also a considerable part of the depositors funds.

10. Identifying losses and acknowledge them on the books create problems but work a miracle, and prompting remedial reactions from all levels concerned.

11. This assertion is particularly important in case of state ownership, where loss of equity is considered by some to have a different meaning. In these cases, identification and disclosure of losses are essential. The money of the taxpayer is involved and, through disclosure, not only managers but also politicians may become more cautious.

12. Management deterioration and illiquidity resilience as described above, should prompt the authorities to react to a bank's insolvency as quickly as possible; otherwise, losses may increase in geometrical progression and new deposits will be allocated to bankrupt activities instead of productive ones. This is not only a danger for each particular instruction but for the whole financial system.

13. High remuneration of deposits, expensive lending and high spreads on books, are not necessarily due to relaxation on the part of the bad banker because of confidence in bailout operations. On the contrary, those practices are normally due to the need to compensate for high overhead, the wish to hide the bank's real situation and, in may cases, the fight for survival through new deposits that would cover financial costs and even overheads.

Background Papers

:: World Bank – Working Papers on Policy Planning & Research

:: Finance fragility by Andrew Sheng

:: IDI Ireland – Seminar on Bank restructuring

:: IDI Seminar on Banking and Development in 1990s

:: Bank Failure – Stability – Market Harmonics

:: Bank Failures & Systemic Risk – George & Kaufman

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