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Too-big-to-fail: Bank failure and banking policy in Jamaica

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Abstract

Research on the causes of bank failure has focused on developed countries, particularly the United States of America. Relatively little empirical work has examined developing countries. We examine the total population of banks in Jamaica between 1992 and 1998 and find that real GDP growth, size, and managerial efficiency were the most significant factors contributing to the failure of banks. Bank failure is defined to include bailout and regulator-induced or supervised merger. Our results suggest that there were implicit 'too-big-to-fail' policies during this period.

JEL classification: G21; G28

Keywords: Bank failures; Too-big-to-fail; Developing economies; Jamaica

1. Introduction

The last decade of the 20th century was unprecedented in Jamaica's financial history. Of a population of 37 banks, 21 were classified as failed, with 14 being so classified in 1 year—1998. However, few outright closures occurred. Most problem banks were merged with other banks, or continued to operate through financial support from the government. More than a half of domestic banks received some kind of financial support from the government, initiated voluntary bankruptcy proceedings or surrendered their licences.

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Explanations for such banking problems vary. Empirical research on bank failures separates the causal factors into bank-specific, industry-specific, macroeconomic and other. However, much of the debate on developing countries has neglected banks at the individual level, and has focused on the problems faced at the sector or industry level. Moreover, the (often conflicting) results of existing studies do not offer inferences about the factors that are particularly significant in developing countries, or to those that are significant to the failure of individual banks, or to the fate of problem banks. This paper addresses the following questions: what factors were significant in the banking crisis in Jamaica? What factors influenced how the crisis was handled and was there an implicit too-big-to-fail (TBtF) policy? What are the lessons for bank regulators in developing economies that can assist in better preparedness for the future?

To address these questions, the within-sample performance of a panel of Jamaican banks is examined. Some of the factors identified as contributing to failure include deterioration in the macroeconomic environment, rapid expansion and weakness in a range of bank-specific factors: capital, management, and liquidity. The size results are particularly significant and point to the operation of implicit 'TBtF' policies. Larger banks are more likely to fail, but are also more likely to be bailed out rather than closed.

The next section discusses the banking crisis in Jamaica. Section 3 reviews the literature on bank failures. Section 4 discusses data and methodology. Sections 5 and 6 present the results, and Section 7 concludes.

2. Bank failure in Jamaica

The term 'bank failure' has been interpreted varyingly. The more precise definitions have focused on accounting factors (for example, Martin, 1977; Benston and Kaufman, 1995), economic factors (Bell et al., 1990; González-Hermosillo et al., 1997), or legal factors (Meyer and Pifer, 1970). Conversely, more general definitions have attempted to be all-inclusive and have applied a 'catch-all' combination of specific definitions (for example, Thomson, 1992). Using a general definition of 'bank failure' embracing closure, bankruptcy, supervised merger, or direct government assistance, we assess the population of banks in Jamaica over the period 1992–1998.[1] Table 1 shows a comparative profile of the Jamaican banking sector before and after the crisis.

Three banks that had been subject to regulator-induced cessation saw the government discharging depositors' liabilities within the context of *de facto* deposit insurance; 90% of the deposits in one case and 100% for the others. The majority of bank failures occurred in 1997 and 1998. Four banks failed in 1997 and 14 failed in 1998. However, even in those years when a relatively greater number of banks failed, there were survivors.

3. Bank failure literature

Studies attempting to empirically identify the causes of bank failures in developing countries have focused mainly on macroeconomic factors (Rojas-Suárez, 1998; Bongini et al., 2000). It is common for banking crises to occur in periods of macroeconomic downturn (Benston and Kaufman, 1995; Gavin and Hausman, 1996; González-Hermosillo et al., 1997; Demirgüç-Kunt

[1] An involuntary merger initiated by a central bank or other regulatory authority may be considered evidence of failure if the merged bank was seen as unable to survive on its own (see, for example, Martin, 1977; Altman et al., 1981). Moreover as noted by Altman et al. (1981), to ignore such mergers could result in bank groups that are not entirely discrete and may result in misspecification of the results of predictive models.