The United Kingdom's small banks' crisis of the early 1990s: what were the leading indicators of failure?

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Bank failure has fortunately been a rare event in the United Kingdom. Even more infrequent has been the simultaneous failure of a number of banks that potentially threatens the stability of the financial system. This study uses as a backdrop the period, known as the small banks' crisis of the early 1990s, when failure was last widespread and the system faced a potentially systemic threat. It was also the most recent occasion on which the Bank of England provided emergency liquidity support to UK banks.

Using a logit model this study examines the balance sheet characteristics of the small and medium-sized UK banks at two points prior to the crisis period to see whether the banks that would go on to fail had any distinctive features compared with those that would survive. Its goal is to identify leading indicators of failure. This may assist the Bank of England and the Financial Services Authority (FSA) in crisis prevention policy prescriptions before a future crisis has had a chance to develop. In some senses it is analogous to the early warning systems employed by banking regulators in some jurisdictions, most notably the United States.

The study initially focuses on the small and medium-sized UK banks' balance sheet characteristics in 1991 Q2, the quarter prior to the announcement of BCCI's closure. This news accelerated the rate at which wholesale deposits were withdrawn from the small banks. At this point the most important leading indicators of failure were a high dependence on net interest income, low profitability, low leverage, low short-term assets relative to liabilities and low loan growth. Taken together, these indicators suggest that the banks that failed over the following three years were already weak by the early 1990s (reflecting the recession at the time).

While they may be helpful in identifying subsequent failures, these indicators cannot be used by regulators or central banks to take pre-emptive policy action. The interval between the signal and failure is too short, so by then, it may have been difficult for regulators to do anything more than manage down the scale of the problems. Indicators of future failure with a longer lead-time would be more useful.

Data from the pre-recession period were therefore analysed. The results suggest that rapid loan growth in the late 1980s boom was a good longer-term indicator of failure. A cyclical comparison indicates that the banks that subsequently failed tended to exhibit a pronounced boom and bust cycle in lending growth, unlike those banks that survived.