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Contribution of macroeconomic factors to the prediction of small bank failures

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ABSTRACT

Microprudential regulation is an integral part of any banking supervisory framework. By analysing the link between economic conditions and the survival of small co-operative banks, this study sheds light on the importance of the economic environment after assessing individual bank stability over time. The results show that bank failure is better captured when we account for the state of the economy both at the national and the regional level. Moreover, voluntary closures and acquisitions across provinces appear to be related with bank distress. Our findings have important policy implications. First, using a wider spectrum of information increases the accuracy of default prediction models, improving the supervisory toolbox used to monitor the health of small banks. Second, economic downturns increase a co-operative bank's default risk, supporting the introduction of countercyclical capital buffers to lessen the negative effects associated to bank instability.

1. Introduction

The regulatory reforms enacted in several countries following the 2007–2009 financial turmoil have attempted to correct major systemic weaknesses that caused the crisis. Policy makers and commentators have advocated the need to develop frameworks able to address the financial stability of the banking sector and increase the resilience of individual banking institutions during periods of stress. Despite this call, few studies have analyzed the financial stability of small banks. Microprudential regulation can help reduce the risk of system-wide shocks. Consequently, it is paramount to further explore the causes of bank distress with a particular focus on local and regional retail banks.

This paper analyses the determinants of failure among small banks, which are driving forces of the economic development in rural areas. In several countries, small banks are characterized by the mutual form of ownership. In particular, co-operative banks are mutual banks owned by their members that tend to have strong local roots. A change in economic conditions can have a profound impact on bank performance and profitability, especially when clients are members/owners of the same financial institution. For these banks, the incentive to keep lending during periods of financial distress is high, triggering

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