

# Relationship between Bank Failure and Economic Activities: A Review of Literature

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## Abstract

The banks are very important institutions in any given economy due to their role of financing the economy. Banks if not properly regulated can fail and hinder their primary role. The main aim of the study was to carry out a literature review on the Relationship between bank failure and economic activities. The specific objectives of the study are; to review the theoretical literature that anchors the study that links bank failure and economic growth, to review the empirical literature on the channels that link bank failure and economic growth, to investigate the gaps in the theoretical and empirical literature on the channels that link bank failure and economic growth and to propose a theoretical framework for linking bank failure and economic growth. The study is anchored by the agency theory, the contagion and the theory of lemons. The study empirically reviewed past studies in similar area and established gaps. The result indicated that the essential cause of the banking crunch is a physical one. Deregulation made it conceivable for commercial banks to also achieve activities of speculation banks, and for investment banks to also achieve actions of commercial banks. This had the effect of letting these organizations to association liquidity and credit risks in an unrestrained way. Double liability disclosures shareholders of deteriorating banks to misplace not only the original amount capitalized but also an amount identical to the par value of shares periods the number of shares possessed. The bank channels have a precarious role in the determining of the economy in the following ways. In the direct wealth effect when the banks fail, the investors who did not have the credits insured will have reduced wealth. This will in turn affect the real economy due to abridged consumer expenditure. Conclusion was made that bank failure remains a major threat to consistent economic growth that leads to development. The impact caused by economic contraction prevalent during this phase originated due to several shocks resulting in liquidity preference increase among depositors who preferred holding more currency to demand deposits and other liabilities. To this

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end, capital squeeze created reduction in money supply that affected entrepreneurial financing leading to slowdown in economic activity.

**Keywords:** Bank failure, Economic growth, Bank failure channels.

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## Introduction

Bank failure has been an issue in the economies for a very long time. Studies such as (Calomiris & Mason, 2003) have postulated the consequences of the bank distress during the great depression. In the recent past the US economy suffered an economic crisis which was attributed to deregulation in the financial sector. The bank failure that followed caused a lot of harm in the economy (Dell, Detragiache, & Rajan, 2008). The bank failure has been a world-wide phenomenon as seen in the Asian markets (Haque & Brown, 2017), in Africa (Aka, 2011). The biggest problem is that there is always a ripple effect in to other economies as well (Fidrmuc & Korhonen, 2010). It is therefore very important to assess the problems that can emanate from these financial crisis. The root cause of this financial crisis is always the banking sector. If a bank failed, it would result into many other sectors failing as well.

The banks are very important institutions in any given economy due to their role of financing the economy. These banks if not properly regulated can fail and hinder their primary role. In Japan, the Japanese banks were considered to have failed when their ability to renew loans and extend new credit was hampered (Kang & Stulz, 2000). Failed banks are not necessarily illiquid banks as shown in a study by (Ashcraft, 2005). The FDIC botched performing banks owing to challenges with affiliates of the same multi-bank holding firms. During the financial crisis in the USA, Bear Stearns began having liquidity problems and other financial institutions followed forcing the regulator to set up a Troubled Asset Relief Program (TARP) to avert the too-many-to-fail problem. When banks are facing the financial problem, they are could be nationalized, acquired, given liquidity grants, privatized or have their management taken over before a decision to liquidate them is reached especially if there are too many weak banks in the economy. Some empirical literature included the acquired banks as failed institutions arguing that they are exited banks as well (Brown & Dinc, 2011). In a study conducted in Japan, Hokkaido Takushoku Bank was professed virtual insolvency on November 17, 1997 and proclaimed the handover its functioning rights in Hokkaido, Japan's northernmost island, to area North Pacific Bank (NPB) (Hori, 2005).

In this study we will look at failed banks as institutions that have been placed under receivership and those that are unable to meet their obligations when they fall due and are liquidated. Various economies have experienced a failure of their banks. In the US, 120, 132, and 84 commercial banks failed, respectively, over the years 2009–2011 (Ghosh, 2017). In Nigeria, Eight banks out of the Twenty-four operating banks failed were declared insolvent by the Central bank of Nigeria (CBN) (Elegbe, 2013a).

The essence bank failures hamper the money supply in the economy. Most firms in a bank-based financial system rely on these institutions for funding to expand their operations as well as their daily operations as working capital. When the banks fail, the firms lose the funding and are forced to cut back on their operations. This results to unemployment rates going up due to lay-offs, low profits, deep in the capital market prices and reduction in production by these firms. These are used as indicators of economic growth from various studies. (Ghosh, 2017), looks at measure of regional economic activity catalogue that is created on nonfarm workforce employment, the unemployment proportion, regular hours operated in business, and salaries and incomes, formed by the Federal Reserve Bank of Philadelphia. In Japan, (Hori, 2005) analyzes the productivity of customer firms of a unsuccessful organization in Japan.

Globalization caused a lot of transnational companies to use emerging markets as part of their production chain. This led to the wide web of interconnected countries, therefore the financial crisis caused an investment shift into the Asian economies. The effect of the worldwide economic crunch was felt in the Asian markets such as China and India as evidenced in a study by Fidrmuc & Korhonen, (2010). In this study, it shows the economic crisis in the OECD trickled down to China and India business cycles and brought them closer to OECD cycles. The low levels of the Asian Business cycles were caused by idiosyncratic shocks in former economies which were poorer than the OECD countries. The study does not show the direction of causality among the failure of the financial scheme and the financial growth.

The failure of HTD bank in Japan had gross negative impact on the client's market value on the day of pronouncement of the bank failure (Hori, 2005). The study however did not show significant loss of profitability of firms in the bank. It showed that the quality of the firms and the liquidation method would affect the firm. Another study (Dell et al., 2008) found out that the banking crisis in twenty two countries affected the growth of industrial segments that were more reliant on the outside funding. The adverse shocks caused poor economic performance and bank crisis had additional effect on growth. The impact was more severe in countries that were developing since they had less access to foreign funds and other alternative funds. In Nigeria twenty seven banks have been reported to have failed in 1998 and thirteen more in 2006 (Elegbe, 2013a). In Kenya there are several banks that have been placed under receivership in 2016. One being Imperial bank.

In most economies, bank failure can be linked to deterioration of economic growth and output. When the banks fail, they cause disruption of banking and credit relationships which may result to wider financial effects of attentiveness to policymakers, supervisors, and other shareholders (Kandrac, 2013). There has been the contention of the course of interconnection when the relationship amongst bank failure and economic growth is being established. In a study conducted in sixteen countries, a bi-directionality and reverse causality was established (Demetriades & Hussein, 1996). Establishing a constructive association between the bank credit to the reserved segment and the GDP of state was not sufficient without good regulation and some level of effectiveness (De Gregorio & Guidotti, 1995). The banking crisis and failure will eventually have an effect on output growth and private credit growth. In the recent financial crisis in the USA, banks began

experiencing defaults on their loan portfolios. The banks had those collateralized debt and mostly from the construction industry. When the schemes began to stand and the inventors could not find consumers, the houses were put out for sale. This caused an oversupply in the market and the prices of the houses fell. The drop in the price of real estate meant the decline in the worth of the collateral with the bank making it even more difficult to pay the loans. The banks then had a difficult time recouping their money and this resulted in the reduction of money supply and eventually slowed the economic growth (Berger, A. N., Imbierowicz, B., & Rauch, C., 2016). The contentious question emerges; do bank failures amplify the economic growth? The great depression gives a basis of research. The economic turmoil that prevailed during this phase resulted to several shocks resulting to having more depositors' preference to liquidity. In the end, this resulted in capital squeeze and therefore a reduction in money supply. Four channels that show the association among bank failure and economic development and the role of bank regulation and insuring deposits were established as; effect on direct wealth, illiquidity, relationship disruption and credit crunch due to reduced loan supply (Ramirez & Shively, 2012).

Direct wealth effect on the depositors is the first to be felt in the event of a collapsed bank. If the bank has not fully insured the deposits, the borrowers would likely suffer losses and have a reduction of their wealth. This is transmitted into the real economy through reduced demand for goods and services (Charles W Calomiris, 1993).

The other problem of bank failure is that local depositors and creditors tend to lose money due to illiquidity of deposits and therefore resulting to slower economic growth (Kandrac, 2014). Even though some or all deposits are not fully lost, the insured depositors' money remains illiquid and out of reach for the depositors. The spending by the borrower is then greatly reduced. During liquidation of banks, the assets sold off to repay the depositors. This could take very long and the loss of value for money. The time value of money if taken into consideration would therefore have adverse effects on the economic growth of a country. According to (Brownbridge, 1998), in 1993/94 Kenya experienced about 11 per cent of the entire assets of banks and NBFIs being held by the unsuccessful local banks.

The other cited problem of bank failure is that it can result to fiscal interruptions in the economy. One of the greatest disruptions is on the associations that banks and their debtors have created over the years. A study in Japan on the Hokkaido Takushoku Bank shows an effect of the botch of the bank on the customers' association (Hori, 2005). Banks establish close relationships with their customers and extend credit to these customers, there is an effect on them when the banks have a problem with liquidity (Campello & Gao 2017). These relationships cannot be easily replaced thus the bank failure leads to disrupted lending and thus worse economies outcomes. The termination of established bank-business relationship is detrimental to the economy. Before a borrower can establish new relationship with other banks, it would take a lot of time therefore the cost of capital would increase. The relationship-based source of funding reduces asymmetric information problem on both parties. The bank failure also affects adversely the bank's corporate borrowers especially those that do not have access to the public funds (Chava & Purnanandam, 2011). These relationship banking effects is especially so for those

economies which are bank-based. That is, those economies whose firms' funding comes from the banks.

When one bank fails, it creates other banks contraction of money supply (Minamihashi, 2011). The other bank may become more pessimistic about the economy and try to reduce their lending in the economy (Calomiris & Mason, 2003). The surviving banks could reduce their lending due to heightened uncertainty regarding depositor's redemptions. Therefore, to preserve their solvency, they reduce the loans to bank dependent borrowers. Businesses are therefore, forced to reduce investment and thus reduce GDP. The bank employees are also affected when banks fail. There is loss of flows and subsequent failure of the company. This leads to less demand for goods and services for those who are unemployed and creates slowed economic growth.

### **Problem Statement**

Bank failure has been linked to slowed economic growth in many studies presented evidence that bank failure had an effect on economic activities (Bernanke, 1983a) tried to show the influence of financial crisis of the US economy during the great depression. The research of (Anari, A. and Kolari, 1999) showed that negative shock in prices and money supply had negative impact of GDP Of a country. The study showed that repeated shocks from the banking sector eventually had adverse effect on the real economy. In usual conditions, when individuals have assurance in the banks, crunches do not happen. However, if the problems occur due to non-performing credits, bank innings are unavoidable. This can emanate from even one bank. When that bank fails to meet its obligations when they fall due, then other banks are hit in similar method as the bankrupt bank by shared movement of disbelief. This results in massive withdrawals that lead to fire sales that result in a decline in asset prices, dipping the price of bank assets. This in turn erodes the equity base of banks and leads to a solvency problem. The solvency problem fires up a liquidity crisis (de Grauwe, 2011).

There are also studies that show that economic decline causes bank failure. According to (Chang, R. and Velasco, 1999), bank runs could be brought about by demand depositors and foreign short-term debt exceeding bank liquidity value. The bank fragility has therefore a problem of external shocks. In his work, (Wheelock, 1992), find that bank failure rates were highest in counties suffering the greatest agricultural distress and where deposit insurance system membership was the highest. The mortgage assets based on nonprime loans, caused some financial institutions to be exposed that they were threatened with failure, and some failed because they were unable to raise capital or obtain liquidity as the value of their portfolios declined (Sander, 2008). Some other studies do not find significant relationship between bank failure and measures of local economic activities. (Stiglitz & Weiss., 1981).

There are studies show that as banks increase their interest rates to attract more saving; they generate a base in which they get a lot of money supply. This money supply in turn it is directed to more productive and innovative activities by the borrowers. This increases the real output of a country, (Aka, 2011). The direction of causality in the bank failure and economic growth has been a contentious issue in the banking sector studies. Many of

the studied having been done in area outside Africa. However, some studies have tried to show the direction of bank failure and its effects on the economic activities and economic growth. In Africa, we have a study by (Elegbe, 2013b) that tries to give an empirical connection between bank failure and economic development in Nigerian. Using the Granger causality test, the study concluded that monetary policy and macroeconomic channel serve as a venue of banking failure while increase in non-performing loans in the sector has undermined industrial production and Nigerian economic growth. In Nigeria, (Aye, 2013) found that financial development caused economic growth. In Kenya, (Odhiambo, 2009), showed that link economic development to financial development. These studies have shown the economic growth and relationship with financial development but the channel that links bank failure and economic growth. This study therefore comes to bridges this gap and to establish a deep literature review on these channels as outlined by (Ramirez & Shively, 2012) in their study where they established a bank channel.

### **Theoretical Review**

This study is anchored by various theories which include the contagion theory, agency theory and the theory of lemons.

#### *Contagion theory*

Banks are interconnected to each other by virtue of their linked assets. There is heterogeneity in bank assets. When on bank fails or experiences liquidity problems, depositors rush to withdraw their money. Subsequently, if one bank fails, the others can be pretentious quickly and perhaps sternly even if the banks are not linked in any way to the indisposed bank. In effective capital markets, the fall over effect will be touched in negative irregular returns produced by hostile actions in the price of stock in all banks in the segment (Kanas, 2005). The negative stock revenues knowledgeable by other banks are known as infection effects. The origins of contagion effects was realised in the study (Diamond & Dybvig, 1983), representing that contagion effects can progress from casual shocks that persuade some investors to withdraw funds, even when no essential change in a bank's forecasts has happened.

There are various categories of the contagion effect as shown in different studies. In the study by (Schoenmaker, 1996) he talked about the pure contagion and noisy contagion. In the pure contagion, if one bank fails due to the internal factors that are only in that one bank such as fraud, reported losses etc., then other banks could be adversely affected in the long run. These other banks could be distinctly different from the failed banks, but since the banking sector is very volatile, then they would experience the same problems as the failed institution. The noisy contagion on the other hand is where when one bank fails, it gives a bad signal in relation to other banks with similar characteristics forcing them to face a run as well.

This occurs due to interconnectivity of banks from a global perspective. The stress in one country's banking sector can be transmitted to other geographical regions. The idiosyncratic shocks occur in specific countries in their banking sector presented due to

the 'herd behaviour'. This means those shocks that occur not due to interconnectivity of portfolio like the linked assets but the of depositors' perception. The volatility contagion occur when there is a spill over to other sectors of the economy due to the problems in the banking sector. We could have negative returns in the financial markets.

### *Agency Theory*

A study by (Jensen, M. C., & Meckling, 1976) talks about the origin of the agency theory began in the 1960's. It looked at the risk sharing element where the principal delegates work to another party (the agent) to perform the work. These two parties could have different objectives and goals thus leading to conflicting vision. This is known as the agency problem. In the banking sector the depositor deposits his money in the banks and trusts the bank will act in the best interest of the depositor, however sometime these banks fail due to indulging in risky activities. This creates the agency problem in the banking industry.

The agency problem arises when there is a conflict with the agent and the principal and when it is difficult or expensive for the agent to access information on what the agent is doing. According to (Mishkin, 1996) the banks avoid the 'free rider' problem where other banks do not participate in the gathering of information and do not have to incur costs in research and development. They only copy what others have done or are doing. The banks therefore do not disclose their activities to the third parties including the depositors that gave them the money. The above issues can be addressed by verifying if the agent acted in the best interest of the principal. Since this is elusive for the depositor, the regulator (the central bank) has the duty to verify and supervise the activities in the banks. The other way is to make sure there is risk sharing between the agent and the principal. The agency theory is therefore a mediating factor of deciding the best suitable contract between the two. According to a study by (Jensen, M. C., & Meckling, 1976), there are two broad agency theories, that is, the positivist theory and the agent- principal theory.

### *The positivist agency theory*

Here the agent maximizes his interest to the expense of the principal. It looks at the reduction of the self-serving interest of the agent. Several studies (Jensen, M. C., & Meckling, 1976) and (Fama, 1980) show the importance of governance mechanisms that reduce the agency problem such as, outcome based contracts are essential because they help transfer the risk to the agent who is assumed to be more risk averse to the principal. Information systems could also be put in place to reduce the information asymmetry between the agent and the principal.

### *The agent- principal theory*

This is a broader theory that covers all stake holders in the organisation. The main feature however, is the total asymmetric information for both parties. Most of the time the bank has the upper hand since they have more information than the agent in this case the depositor. We also have the borrowers from the banks amplifying the moral hazard

since the banks do not know the good borrowers from the bad borrowers. This theory is more abstract and mathematical based compared to the positivist approach (Harris, M., & Raviv, 1979).

According to (Eisenhardt, 1988) both theories are good but the important part is for the organisation but the positivist approach looks at the different types of contracts and the agent-principal theory looks at the most efficient contract in a given situation such as risk, uncertainty etc. Once a bank collapses the relationship between the banker and the depositors is hampered and the borrowers as well. The depositors would be very sceptical when getting into another relationship with another bank. The borrowers in the failed bank will also have a problem securing loans from other banks especially if they have not been in the bank for a very long time. The new bank would first take a while and learn about the new borrower. This is brought about by the information asymmetry.

### *Theory of lemons*

This theory by (Akerlof, 1970), tries to show a relationship between the quality of a product and the uncertainty in the market. This theory can be applied in the banking sector where we have the banks accepting deposits from the public. The banks offer deposit services (the car market) to the public and the depositors choose which bank to bank their money. The banks do not disclose their activities to the public to avoid the 'free rider' problem. The free rider problem in the banking sector is where the banks spend a lot in research and acquiring information about a market, then the other banks just copy without having incurred any expense. The banks therefore tend to hide their dealings to avoid this. This also affects the depositor since they have no knowledge on what the banks are doing with their money (asymmetric information). The bank can either be a good bank or a failing bank (the lemon). The depositor will not know whether he has deposited in a good bank or a lemon until it is too late. Once one bank collapses, the depositors even in the good banks will tend to withdraw their cash as well. This drives the good banks out of business because the failed banks (lemons) are offering bad service and since the depositors are not able to differentiate the two they do the mass withdrawals in all banks good or bad.

### **Issues arising from the Reviewed Theories Leading to Knowledge Gaps**

Contagion theory posits that if one bank fails due to the internal factors that are only in that one bank such as fraud, reported losses etc., then other banks could be adversely affected in the long run. These other banks could be distinctly different from the failed banks, but since the banking sector is very volatile, then they would experience the same problems as the failed institution. The failure of one bank will spill over to the other banks and other sectors due to the heterogeneity of assets. This theory does not put into consideration government safety nets that tend to boost depositors' confidence. The agency problem arises when there is a conflict with the agent and the principal and when it is difficult or expensive for the agent to access information on what the agent is doing. This theory relies on the asymmetry of information. However, this can be ironed out through more research on declaration of information and information transparency be sort. The theory links quality of the product with market uncertainty. The bank customers



will not know a good bank from a failing bank. Therefore when one bank fails, the good banks will also be affected. The theory talks about quality but has no gauge for quality and relies on trust in the market place. These uncertainties can be further explored in game theory.

## **Empirical Review**

This study looks closely at the various studies that have been done to establish the relationship between bank failure and economic growth. It is a critical review on the bank failure channels; the direct wealth, illiquidity of funds, disrupted relationships and credit crunch. (Ramirez & Shively, 2012) explained the extent to which the regulatory variables, such as minimum capital requests and deposit insurance (deliberate or obligatory) increase the harshness of the bank failure channel.

### *Direct Wealth*

The main findings of the study are the following. First, bank failures decline the customer firms' savings by around 30%. Hence, as foretold by theory, we established bank failures' effects on their customer companies or businesses and explained one avenue through which large bank failures can reason/amplify collapses. Second, the data propose that possibly high investment development/level firms indicate/are chosen by corrupt banks. Failing to interpret for this conduct causes a 30–80% lesser bias in normal level approximations. The results of this paper indicate that in a collapse corrupt banks allow their customers to invest at high rates to recuperate. Therefore, the bank failures' effect on customer firms is superior than foretold in the preceding literature, which does not discourse this assortment behaviour (Minamihashi, 2011).

### *Illiquidity of Funds*

The credit formation procedure in the most significant service in the banking business, however, it is attached on an intrinsic breakability of the banking system. If investors are not content with the actions of a bank and have some form of suspicion they could remove their deposits at the similar time (Jefferis, 2017). This is what we had previously denoted to as the herd attitude in this paper.. The banks would therefore go into surprise because they would be incapable to satisfy these removals as their assets are illiquid. A liquidity crunch vents (De Grauwe, 2008)

A study carried out in the USA banking scheme after the Russian crisis in 1998 intended at manipulating an exogenous agitation of the supply-shock purpose for U.S. banks during the Russian crisis. Since the crisis was sensibly exogenous to the U.S. borrowers' request shocks, it unsettled the supply of credit disproportionately more for the bank-dependent firms as likened to their rated complements. This exogenous shock to the supply-side function allows us to approximation the fundamental effect of banks' aptitude to supply funds on their debtors' performance. The regression model indicated that bank-dependent firms received 3.61% lower return than companies with admission to the public-debt market after regulatory for firm size, influence, and market-to-book ratio. The study also exhibited those superior firms that had less debt implemented better.

In addition, all firms were graded in percentile and ranks allocated in the regression model to reduce skewed data. The approximation of the bank credits then drops to 3.10% and is significant at 1%. Other firms would sell their stocks to create cash flows when there is a disaster as is shown by the high instability and superior value drops (Chava & Purnanandam, 2011).

### *Disrupted relationships*

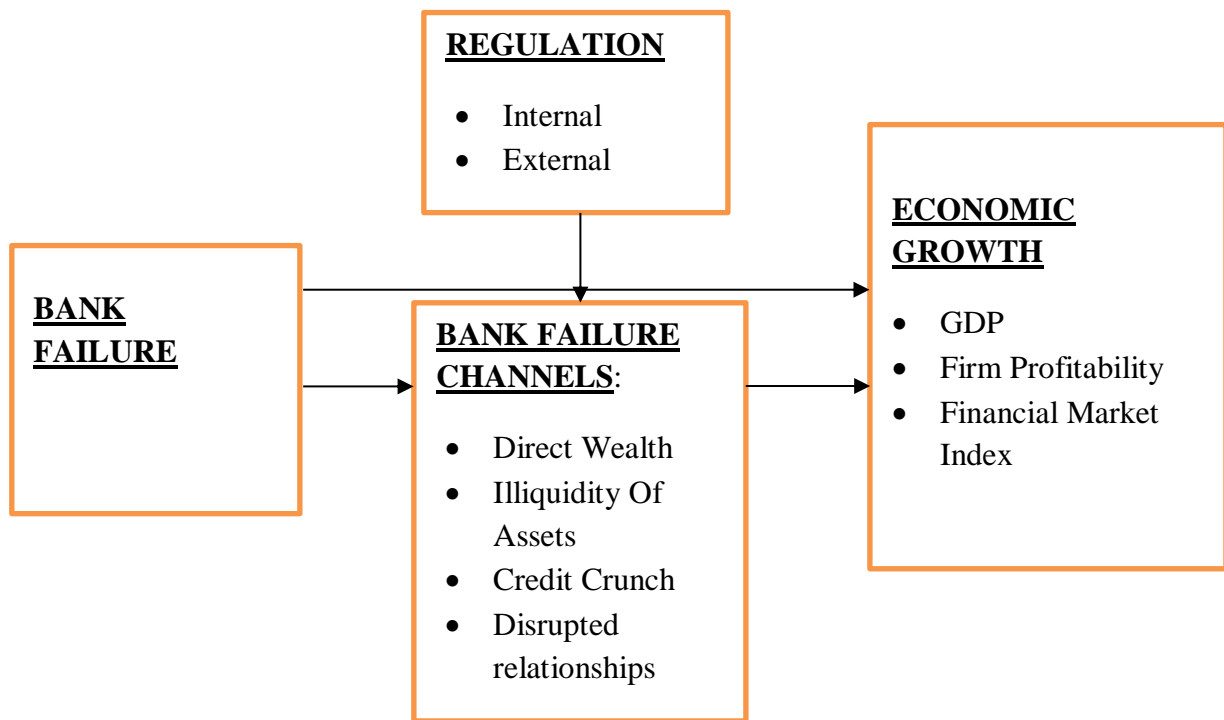
Relationships between banks and their customers is very essential for the economy to grow. (Ghosh, 2017) shows that bank failures negatively and significantly affect changes in state GDP in both construction and finance sectors, with a 100 basis point rise reducing state-level construction and finance sector output by 0.29 and 0.09%, respectively. However, Bank failure rates are not statically significant in affecting the manufacturing and real estate sector. GDP. The study also shows bank failures significantly reduce employment in construction industry, finance, manufacturing, real estate and insurance industry the negative coefficient in all the of employment in all the five sectors shows there is a direct link between the bank failure and the GDP. The results amplify the evidence that when a bank fails the businesses connected to it will have cash flow problems and this trickles down to the GDP of a country. This was however refuted by (Minamihashi, 2011), where the study showed there was no evidence that if a bank collapsed, the firms that access funding from it will lack alternative sources of funding. The firms' financing will however be abruptly cut off resulting to decreased investments.

### *Credit Crunch*

The findings from (Ghosh, 2017) show that when the banks fail, credit courses are interrupted, latent borrowers like building companies contractors may not be able to protected funds to assume investment actions, leading to a weakening in engagement and production growth. A study done in Nigeria presented that non-performing loans (NPLs) and the interest rate (INR) are important in explanation the difference practiced by the GDP growth rate. In this study, null hypothesis was that non-performing credits did not affect financial development. The P-value was 3.21% which is less than 5% which offers a foundation to reject the insignificant. Ceteris paribus, we can honestly accomplish that in Nigeria banking sector effects economic growth (GDP) destructively but the sign of the coefficient is positive and significant (Aye, 2013).

### **Formulation of Research Conceptual Framework**

The conceptual framework illustrates the link between the independent variable and the dependent variable which is bank failure and the economic growth respectively. The moderating variable being the regulation and the mediating variable being the bank channels.



*Bank Failure and Economic Growth*

Theoretically, the relationship between economic growths may take diverse forms. On the one hand, the economic sector may affect development through the amassing channel and the distribution channel. The accumulation channel stresses the finance-induced development effects of physical and human capital accretion (Ndako, 2017). The allocation channel emphasizes on the financed-induced competence gains in resource distribution that enhances development (Luo & Zhang 2016; King & Levine, 1993). Following these deliberations, causality runs from economics to growth. On the other hand, financial development may also be inspired by economic development. For instance, in a developing economy, the private sector may request new financial tools and an enhanced access to outer finance.

### *Role of regulation*

The essential cause of the banking crunch is a physical one. Deregulation made it conceivable for commercial banks to also achieve activities of speculation banks, and for investment banks to also achieve actions of commercial banks. If the subprime crisis had not vented, another creditworthiness problem would have done the fake of setting in gesture the devilish communication between affluence and liquidity disasters (De Grauwe, 2010). A focus of the efficient market theory was that financial markets were accomplished of self-regulation, making government regulation dismissed. And since administrators lack the knowledge and the inducements to control, government guideline was seen as harmful. In doing so, it shaped the delusion in the banking system that the possessions on their balance sheets approved no or a very little risk. This curved out to be mistaken. The reason again has somewhat to do with inadequacies in monetary markets. Financial replicas used to price CDS are based on the supposition that returns are usually dispersed. There is one overall feature in all monetary markets, however, and that is that

revenues are not usually dispersed. The insinuation of this is that replicas based on normal deliveries of returns intensely undervalue the probability of big shocks, (Charles W Calomiris & Gorton, 1991)

### *External regulation*

Previous research proves that branch-banking regulation partial the occurrence of bank failures (Mitchener 2005). Hence, this regulatory characteristic may also affect the degree to which bank failures ostentatious economic conditions in the real sector. Thus, to internment the effect of splitting legislation, we use the normal number of years over the illustration period a state acceptable branching. (Ramirez & Shively, 2012)

### *Role of Bank channels on the economic growth*

The bank channels have a precarious role in the determining of the economy in the following ways. In the direct wealth effect when the banks fail, the investors who did not have the credits insured will have reduced wealth. This will in turn affect the real economy due to abridged consumer expenditure.

If the bank remains shut for a while, the investor will not have contact to the funds. Even if the bank revives the era in which it remains shut will have affected the liquidity of the investor. If the investors' funds were uninsured, the investor will wait until the bank's assets are discharged to contact their funds. This would cartel their expenditure and in turn unfavourably affect the GDP (Ashcraft, 2005).

Banks create close links and grounded relations with their clients. Therefore, when the bank fails it will upset these relations. The bank reliant on firms will practice a shortage in the funding of their daily actions. It would take a while to found another association with another bank and if they do the cost of borrowing would be advanced. This would upsurge the cost of production and reduction the GDP of a country (Bernanke, 1983).

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### **Conclusions**

Bank failure remains a major threat to consistent economic growth that leads to development. The impact caused by economic contraction prevalent during this phase originated due to several shocks resulting in liquidity preference increase among depositors who preferred holding more currency to demand deposits and other liabilities. To this end, capital squeeze created reduction in money supply that affected entrepreneurial financing leading to slowdown in economic activity.

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