November 2012

Alarming Factors in predictability of failure of financial institutions

Mo Vaziri
University for Business and Technology

Rafiqul Bhuyan
University for Business and Technology

Ponkala Anand Vaseekhar Manuel
University for Business and Technology

Follow this and additional works at: https://knowledgecenter.ubt-uni.net/ijbte
Part of the Business Commons

Recommended Citation
DOI: 10.33107/ijbte.2012.1.1.01
Available at: https://knowledgecenter.ubt-uni.net/ijbte/vol1/iss1/1

This Article is brought to you for free and open access by the Publication and Journals at UBT Knowledge Center. It has been accepted for inclusion in International Journal of Business and Technology by an authorized editor of UBT Knowledge Center. For more information, please contact knowledge.center@ubt-uni.net.
Alarming Factors in predictability of failure of financial institutions

Mo Vaziri, Rafiqul Bhuyan, Ponkala Anand Vaseekhar Manuel

UBT-Kosovo

Abstract. The impact of failure of financial institutions is beyond just the failure of a public corporation. The failure of financial institutions in the USA, is a clear evidence that the greater macro impact is beyond just the failure of few financial institutions. It can bring down the entire economy and can have global devastating impact. By realizing the grave systemic risk of the failure, US government is forced to intervene and bail out many institutions for greater macro-economic reasons. It raises the view that perhaps the current regulating policies and methods are lacking efficiency in predicting the possibility of failure ahead of time and hence not effective in preventing that to happen. In this research we apply several existing methods of institutional failure and test the signaling ability of each method in predicting the bankruptcy well ahead of time. We apply Moody’s financial ratios, Standard and Poor’s financial ratio, vaziri’s financial ratio, Altman’s Z score and then applying logit model and discriminant analysis, we test each of these model’s predictive ability for future use. We analyze the reasons like changes in market, policy, economy, and political influence which have led to bankruptcy. Banks or financial institutions from Europe, United States and Asia are considered as samples. Samples are taken from same period to analyze the effect of different methods. The results from this analysis should help us find the most significant method that could be used to identify the risk, so that necessary action could be taken to prevent the effect or reject the project which could lead to bankruptcy in the future. This research would also offer policy recommendations for regulating agencies as to which factors should be analyzed deeply and how to implement a preventive measure ahead of any potential problems.

Keywords: Bank failure, prediction, logit, Z score. JEL Classification: G 17, G 21, F

1. Introduction

Banks and Financial Institutions are the backbone of a country. When banks go bankrupt it affects the economy of the country and risk of recession to the country and to integrated global economy. Asset markets would experience high level of volatility through huge movements in the exchange rates, interest rates and commodity prices. Banks and Financial Institution must add risk management to their investments decisions, as the level of risk is unpredictable. Financial risk cannot be forecasted as it does not rise by a single factor; it is a result of multiple exposures. If risk management system is implemented in the right way, it would help nullify systematic and market risks. However, if the bank does not follow zero tolerance for irresponsible speculation, the effect of risk management system would be nullified. Strategies for risk management should be revised with changes in market and requirements.

Many banks and financial institutions were affected in late 2000s due to Global Financial Crisis. Affected banks and financial institutions are merged, taken over by other banks or financial institutions, partly nationalized by the government, or liquidated. Some of the reasons behind this crisis include: sub-prime mortgages, collateralized debt obligations, frozen credit markets, and credit default swaps. The purpose of this study is to determine the causes for financial distress which lead to bankruptcy of financial institutions and banks in USA, Asia and Europe in late 2008. Understanding the causes would help the banks from taking projects that could lead to bankruptcy and increase capital for times of distress. Several models exist in the literature. We apply and compare the forecasting ability of each of those models. These models are: Moody’s, Standards & Poors, Z-score model, and Vaziri’s system. Using these models, we attempt to identify major signals and to find out if there is significance between their mean and deviations. The major signals include: Excessive loan/asset growth, Excessive lending concentrations, Deteriorating financial ratios, Tracking loan recoveries to gross loan charge-offs, Deposit rates higher than market rates, Off-balance sheet liabilities, Delayed financials, Change in auditors, Change in management, Use of political influence, Rumors in the money market, Share price volatility, and Deteriorating economy.
2. Literature Review

Various studies have been attempted to analyze the reason behind the financial crisis and determine the type of risk management that banks can adopt to prevent heavy losses in the future. Various risk models like GARCH, GJR and EGARCH are used to measure Value-at-Risk to determine the requirement of capital (Michael McAleer, Juan ‘Angel Jimenez-Martin and Teodosio Perez-Amaral, 2009). Bank-level governance, country-level governance, country-level regulation, and bank balance sheet and profitability which could have also affected the performance of banks before late 2008 crisis (Andrea Beltratti and Rene M Stulz, 2009). Banks who took high risk were not well capitalized (Simon Kwan and Robert A. Eisenbeis, 1995) as they did not absorb any risk (George S. Oldfield and Anthony M. Santomero, 1997). Also method like EWMA (Riskmetric, 1996; Zumbauch, 2007) is used in a unified framework and notation. These research find that results from these models to reduce Daily Capital Charges (DCC) shows that GARCH is the best for the period of January 3, 2008 to June 6, 2008. Andrea Beltratti and Stulz discuss the reasons behind the poor performance of banks during the financial crisis. The authors analyze different reasons including ineffective regulations, difference in regulation of financial institution, governance of banks, difference in balance sheets and profitability to be one of the reason behind this crisis. Governance is taken as taken as one of the factor in analyzing the performance because it plays an important role in the performance of a bank (Kirkpatrick, 2008; Peong Kwee Kim, Devinanga Rasiah, 2010). Anti-Director index was used to measure shareholders role in pushing the banks to take more risk (La Porta, Lopez-de-Silanes, Shleifer, and Vishny, 1998). The allocation of capital based on the risk is affected by exogenous and endogenous factor (Shriives and Dahl, 1992 and Jacques and Nigro, 1995). Capital is increased based on the increase in risk due to regulatory pressure. In this paper, Bank Risk, Capitalization and Inefficiency by Simon Kwan and Robert A. Eisenbeis the authors discusses about the agency theory and models like bank leverage, risk taking and inefficiencies.

Managers when they act as agents to stockholders they do not give proper information and they take big risk by investing in inefficient project (Jensen, 1986). When the cash flow is high it could lead stockholders to inefficient investment as when there is low cash flow and absence of NPV for the investment project could led to efficient investment (Stulz, 1990). Choice of leverage could solve half of this problem (Jensen, 1986) When the company is in debt, the manager will work efficiently and the debt will reduce the free cash flow that was associated with agency cost. The purpose of this model was to show that inefficiency is associated with firm asset risk, growth of the firm and leverage, like the companies investing in negative net present value projects and banks investing in poor quality loans. This debt would push the managers to help grow the firm in size and try to make it an efficient firm.

If the wealth of the firm is related with the firm’s performance then the managers will be more risk averse (Hughes, Lang, Mester and Moon, 1994). As a result the managers will not take risk and they invest in less risky project. The loan taken to invest in these risk-less projects would be seen as inefficiency. Leverage decision for the bank depends on deposit insurance and regulation. If the deposit insurance is wrongly priced it would misguide in taking heavy risk. This model was not considered due to bankruptcy cost which would decrease the value of the firm (Kwan, 1990 and Keeley, 1988). The theory also suggests that the firm would take more risk to counterbalance the capital required instead of pushing the growth of the firm. Taking more risk would affect the safeness of the bank (Koehn and Santomero, 1980 and Kim and Santomero, 1988). Increasing the capital will help the debt holders from being exposed to high risk (Furlong and Keeley, 1990). It I observed that the firms whose growth is rapid tries to take more risk and tradeoff with loss of charter value and human capital. In Model Choice and Value-at-Risk Performance by Cris Brooks and Gita Persand the authors feel that internal risk management models help to reduce the risk by calculating the capital requirement. In this paper the authors discusses the agreement between the investment banking and regulatory communities. The authors use different methodologies to find the problem that exist in statistical modeling that are used to find market-based capital risk requirements. They find some drawbacks in all methods and conclude that simpler the method more accurate is the results. Highprofile derivates disaster suggests that there is a requirement for good risk management system (Jorion 1995). The authors compare the model suggest by Basle Committee with other methods to measure risk.

Companies that practices risk management are more tolerant to volatility than companies that do not have risk management. Risk management allows the companies to take big risk (Stulz, 1996). Considering the theoretical studies done by Smith and Stulz they find that companies with large equity stake are more risk averse. In-order to better understand the behavior of the management and incentives with risk the author describes that we must consider factors like: Liquidating a company will not cause any economic harm to shareholders who are well-diversified in the perfect market but not in the real world there is lot of complications. Filling a bankruptcy will cost 3% to 25% of their total market capitalization (Gilson,1990). Second, a financially distressed company
can use U.S. Bankruptcy code which states that the companies can reorganize itself by filling bankruptcy protection instead of filling bankruptcy. As this code buys some more time for the companies to get relief from the financial pressure. The firm get a duration of two years under bankruptcy protection (Eberhart,A., E. Altman and R. Aggarwal, 1999) Companies that are in the financial distress can file for Chapter 7 which is for or Chapter 11 which is for reorganization. Most of the companies choose Chapter 11 over Chapter 7.Entering Chapter 11 has some benefits like: the business operates, it avoids pre-filing of certain transfers, and it negotiates with creditors with single plan. The investor do a prepackage bankruptcy which allows the company to talk with creditors before filing for Chapter 11 so that they can continue with normal operation (Jorion,P.,1997). Most corporations have hedging and insurance to reduce their risk, but hedging only diversifies the risk. As these risks are transferred into another form of risk like, market risk transferred to credit risk (Kimball, 2000).Nearly 40% of the firms that were used as sample in 1979-1988 were not able to get back (Hotchkiss, 1995). This risk management tool is liked by the top management even though it might some people might be dropped during reorganization (Smith Jr., C.W. and R. Stulz, 1985). When a management acts as a agent it results in a conflict of interest and try to find benefit from filing Chapter 11 (Stulz, R, 1996). Stockholders lose a lot from their prepayment investments as the firm pays a small percentage in order to speed up the bankruptcy process (Trottman, 2003). Bankruptcy not only affects the stockholders but also the creditors and employees.

3. Data and Methodology

The financial institutions selected for this study are from USA, Asia and Europe. Hundred banks are selected as samples of which 3 of them are acquired banks, 17 of them were helped by the government after the crisis, 20 of them have claimed bankruptcy and 60 of them are active banks. The banks are studied for 10 years (2001 to 2010). The reason for choosing this period was that most banks went bankrupt at this time. There was less information about bankrupt banks as they were not acquired or merged.

We choose 5 following methodologies to investigate financial distress and bankruptcy which are Moody’s, Standard and Poor’s, Vaziri’s, Z-score Model, and Logit Model. Different financial ratios required for the models were calculated and analyzed. To find if there were any risk management system in place the policies and procedures for lending were studied and the bank’s liquidity was identified using risk management models. To find if there were any government regulations that influenced the failure of banks, secondary data was collected and studied.

3.1 Moody’s Financial Ratios

Moody’s system helps a bank to find out the probability of defaulting and if default occurs how much would be the loss. Moody’s model helps to identify if a bank is efficient to pay of its debt. It also helps investors to find if the bank is capable of asset and shareholders’ equity into profit. It helps to identify if the banks are liquid enough to pay off their short term debt. Ratios used in this paper to analyze it are as follows: Interest Coverage Ratio (EBIT/Interest Expense, EBITDA/ Interest Expense) and Asset Coverage Ratio could be used to find if the financial institutions are capable of paying their leverage. If there is excess cash available for interest payment it shows that there is less risk involved. Leverage Ratios (Total Liability/Total Asset, Equity/Total Liability, Short Term Debt/Equity Book Value) is used to determine how debt the financial institution is in. Higher the ratio, higher is their debt and more risky it is. Liquidity Ratios (Current Asset/Current Liability, Intangible Asset/Total Asset, Cash/Net Sale, Working Capital/Total Asset, Cash/ Total Asset) can be used to determine if banks have enough liquid assets to meet their short-term debt obligation. Ratios must be higher to reduce the risk. Profitability Ratio (ROA) determines if banks have some earnings after their expence to estimate how profitable the institution is. High percentages are indicators that the bank is doing well.

3.2 Standards & Poors Financial Ratios

S&P’s system can be used to determine the probability that a bank will default or not. It helps to find, how much debt banks are in and to find if they can pay of their debt. This method shows if the banks have made profit with the money they borrowed. It includes ratios like Coverage ratios (EBIT/ Interest Expense, EBITDA/Interest Expense, Net Operating Income/Total Debt) which could be used to find if the financial institution are capable of paying their leverage. If there is excess cash available for interest payment it shows that there is less risk involved.
Leverage Ratio (Total Debt/EBIT, Total Debt/EBITDA, Total Debt/Capitalization) is used to determine how debt the financial institution is in. Higher the ratio, higher is their debt and more risky it is and Profitability Ratios (ROE, Net Operating Income/Sale) which helps to determine if the bank is doing an idle investment with the shareholders’ investment by generating profit.

3.3 Vaziri Model
Vaziri’s system includes all most all ratios in Moody’s and S&P system and other financial ratios like efficiency ratio which could be used to determine if the bank is stable or at high risk. Vaziri’s Model identifies how heavily the banks are leveraged and if they can pay of their debt. It also helps to identify if the banks are efficient and if they are able to make profit with the money they borrowed. Vaziri’s model helps to identify the reason for the bankruptcy of banks in long run. Ratios for this method includes: Coverage Ratios (Current Ratio, Quick Ratio, Cash Velocity, Time Interest Earn), Leverage ratios (Total Liability/Total Asset, Short Term Debt/Equity Book Value, Equity/Total Liability), Profitability Ratios (ROE, Net Income/ Sale, Retained Earnings/ Total Asset, EBIT/Total Asset, Net Income/Total Asset), and Efficiency Ratios ( Asset Turnover, Fixed Asset Turnover, Inventory Turnover, Inventory to Net Working Capital).

3.4 Z-Score Model
For Z-Score, we developed the model which is established by Edward I. Altman. Altman’s applied the statistical method of discriminant analysis to a dataset of publicly held manufactures. The estimation was originally based on data from publicly held manufacturers, but have since been re-estimated based on other databases for private manufacturing, non-manufacturing and service companies. In this paper, we use Z-Score models for predicting bankruptcy which was developed by Altman (1968, 1983, 1993) for non-manufacturing industries.

Z-Model: 
\[
Z=6.56X_1+3.26X_2+6.72X_3+1.05X_4
\]
Where, \(X_1\)=working capital/total assets, \(X_2\)=retained earnings/total assets, \(X_3\)=earnings before interest and taxes/total assets, \(X_4\)=book value equity/book value of total liabilities,
\(X_1\), working capital/total assets (WC/TA). This ratio measures the net working capital relative to the size of the assets used in the business. It is used as a measure if liquidity standardized by the size of the firm. \(X_2\), retained earnings/total assets (RE/TA). This variable relates the total retained earnings of the firm to the total assets employed. It is able to capture the cumulative profitability of the firm since inception. Also, since young firms tend to have low RE/TA ratios, this variable may capture the age of the firm as well. \(X_3\), earnings before interest and taxes total assets (EBIT/TA). The operating profitability in relation to total assets measures the productivity of the assets or the earning power. \(X_4\), book value equity/ book value of total liabilities (BE/TL). This differs from \(X_1\) in that it uses the book value rather than the market value of equity. This ratio is appropriate for a firm that is not publicly traded, and hence the Z-model with this variable definition is called the Z’-model or the private firm model. Bank was considered bankrupt if value is less than 1.1 Zone of ignorance if values fall between 1.1 - 2.6 and is considered non-bankrupt if values are greater than 2.6.

3.5 Logit Analysis
Logit Analysis was developed and established by James Ohlson which uses discriminant analysis to identify bankruptcy. This model predicts the probability of occurrence of an event. The model used for this analysis is:

\[
y = -1.32 - 0.407(\text{size}) + 6.03(\text{Total Liabilities} / \text{Total Assets}) - 1.43(\text{Working Capital} / \text{Total Assets}) + 0.0757(\text{Current Liabilities} / \text{Current Assets}) - 2.37(\text{Net Income} / \text{Total Assets}) - 1.83(\text{Working Capital flow from Operations} / \text{Total Liabilities}) + 0.285(1 \text{ if net income was negative for the last two years}; 0 \text{ if Net Income was not negative for the last two years}) - 1.72(1 \text{ if Total Liability exceed Total Assets}; 0 \text{ if Total Liability do not exceed Total Assets}) - 0.521(\text{Change in Net Income} / \text{Sum of absolute values of current and prior years’ net incomes}).
\]
Size is the natural logarithm of (total assets / GNP implicit price deflator) with a base of 100. Y value which is calculated from this equation is then transformed into a probability, which is the calculated as: Probability of bankruptcy = 1 / (1+e^-y) e = 2.718282
4. Findings and Results

Subprime mortgage loan was the main reason for the bankruptcy of all banks and financial institution. Nearly 80% of the mortgage that was given out was adjustable-rate mortgages. The price of housing went up in mid-2006 and fell after that which made it impossible to refinance. Securities that used subprime mortgages lost their values and led to failing economy. They started taking more risk by financing to everyone even people with damaged credit history. This type of loan rose from $100 billion in 1999 to $625 billion by 2005 (Bloomberg, 2011). Government wanted more home owners and they were more interested in revising more regulations than implementing them, such as Basel II (Michael McAleer, Juan-‘Angel Jimenez-Martin and Teodosio P’erez-Amaral, 2009). Feds oversight was also one of the reason behind bankruptcy of so many banks (Bloomberg, 2011). Other than government regulations that led to bankruptcy, some banks also had internal problems. American International Group, Inc. (AIG) had change in management in 2005 when Greenberg was replaced by Martin J.Sullivan then he was got in a scandal. AIG’s credit rating was reduced a lot leading to liquidity crisis in September 16, 2008. Sumitomo Trust & Banking Co. Ltd., was affect by the changes that occurred in Japanese banking financial structure. Abbey National bank gave out many mortgage loans in 1980’s for 15 years. With the fluctuation in interest rates the bank extended loan payments which led to the downfall with the subprime mortgage crisis. Northern Rock was greatly affected by the U.S. subprime mortgage crisis. To liquidate the assets and to pay back their loans Amcore Financial Inc filed bankruptcy. Results of each models are shown in the following tables.

<table>
<thead>
<tr>
<th>Table 1. Moody’s Model</th>
</tr>
</thead>
<tbody>
<tr>
<td>Failed Banks correctly Predicted</td>
</tr>
<tr>
<td>Non-Failed Banks correctly Predicted</td>
</tr>
<tr>
<td>Type I Error</td>
</tr>
<tr>
<td>Type II Error</td>
</tr>
<tr>
<td>Incorrectly Predicted in Total</td>
</tr>
<tr>
<td>Correctly Predicted in Total</td>
</tr>
</tbody>
</table>

Moody’s model predicted that 11 banks would be bankrupt a year before the bank filled for bankruptcy and 10 banks before two years of bankruptcy. Of 20 banks that filled bankruptcy 18 of them filled in 2010 and 2 of them in 2011. Studies suggest that models can predict perfect bankruptcy two years before the file for it. The percentage of correct prediction ranges from 69% to 76%. This shows that this model is 72.5% reliable on average. This model also shows that most of the banks had high leverage and has less liquidity.
Table 2. S & P Model

<table>
<thead>
<tr>
<th>Year</th>
<th>Failed Banks correctly Predicted</th>
<th>Non-Failed Banks Correctly Predicted</th>
<th>Type I Error</th>
<th>Type II Error</th>
<th>Incorrectly Predicted in Total</th>
<th>Correctly Predicted in Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Failed Banks correctly Predicted</td>
<td>1</td>
<td>1</td>
<td>7</td>
<td>7</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>Non-Failed Banks Correctly Predicted</td>
<td>79</td>
<td>78</td>
<td>62</td>
<td>76</td>
<td>76</td>
<td>77</td>
</tr>
<tr>
<td>Type I Error</td>
<td>19</td>
<td>19</td>
<td>13</td>
<td>13</td>
<td>15</td>
<td>15</td>
</tr>
<tr>
<td>Type II Error</td>
<td>1</td>
<td>2</td>
<td>18</td>
<td>4</td>
<td>4</td>
<td>3</td>
</tr>
<tr>
<td>Incorrectly Predicted in Total</td>
<td>20</td>
<td>21</td>
<td>31</td>
<td>17</td>
<td>19</td>
<td>18</td>
</tr>
<tr>
<td>Correctly Predicted in Total</td>
<td>80</td>
<td>79</td>
<td>69</td>
<td>83</td>
<td>81</td>
<td>82</td>
</tr>
</tbody>
</table>

| % of Failed Banks Correctly Predicted | 5.00% | 5.00% | 35.00% | 35.00% | 25.00% | 25.00% | 30.00% | 10.00% | 20.00% | 80.00% |
| % of Non-Failed Banks Correctly Predicted | 98.75% | 97.50% | 77.50% | 95.00% | 95.00% | 96.25% | 95.00% | 80.00% | 98.75% | 58.75% |
| % of Total Incorrectly Predicted | 20.00% | 21.00% | 31.00% | 17.00% | 19.00% | 18.00% | 18.00% | 34.00% | 17.00% | 37.00% |
| % of Total Correctly Predicted | 80.00% | 79.00% | 69.00% | 83.00% | 81.00% | 82.00% | 82.00% | 66.00% | 83.00% | 63.00% |

S & P model, though shows that percentage of correct prediction is 80% it lacks to predicts the failure of banks in advance. The correct prediction of failed banks is only 5% in 2010 and 2009 and only 35% in 2008 and 2007, which shows that it is not reliable in predicting bankruptcy.

Table 3. Vaziri’s Model

<table>
<thead>
<tr>
<th>Year</th>
<th>Failed Banks correctly Predicted</th>
<th>Non-Failed Banks Correctly Predicted</th>
<th>Type I Error</th>
<th>Type II Error</th>
<th>Incorrectly Predicted in Total</th>
<th>Correctly Predicted in Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Failed Banks correctly Predicted</td>
<td>10</td>
<td>8</td>
<td>9</td>
<td>13</td>
<td>6</td>
<td>9</td>
</tr>
<tr>
<td>Non-Failed Banks Correctly Predicted</td>
<td>72</td>
<td>74</td>
<td>75</td>
<td>71</td>
<td>76</td>
<td>71</td>
</tr>
<tr>
<td>Type I Error</td>
<td>10</td>
<td>12</td>
<td>11</td>
<td>7</td>
<td>14</td>
<td>11</td>
</tr>
<tr>
<td>Type II Error</td>
<td>8</td>
<td>6</td>
<td>5</td>
<td>9</td>
<td>4</td>
<td>9</td>
</tr>
<tr>
<td>Incorrectly Predicted in Total</td>
<td>18</td>
<td>18</td>
<td>16</td>
<td>16</td>
<td>18</td>
<td>20</td>
</tr>
<tr>
<td>Correctly Predicted in Total</td>
<td>82</td>
<td>82</td>
<td>84</td>
<td>84</td>
<td>82</td>
<td>80</td>
</tr>
</tbody>
</table>

| % of Failed Banks Correctly Predicted | 50.00% | 40.00% | 45.00% | 65.00% | 30.00% | 45.00% | 45.00% | 25.00% | 50.00% | 15.00% |
| % of Non-Failed Banks Correctly Predicted | 90.00% | 92.50% | 93.75% | 88.75% | 95.00% | 88.75% | 87.50% | 93.75% | 91.25% | 96.25% |
| % of Total Incorrectly Predicted | 18.00% | 18.00% | 16.00% | 16.00% | 18.00% | 20.00% | 21.00% | 20.00% | 17.00% | 20.00% |
| % of Total Correctly Predicted | 82.00% | 82.00% | 84.00% | 84.00% | 82.00% | 80.00% | 79.00% | 80.00% | 83.00% | 80.00% |

Vaziri’s model predicts much better than Moody’s and S&P model. Percentage of correct prediction is almost 80% for all years and percentage of correctly predicted failed banks is 45% before two years of actual failure.
Percentage of correct prediction of Logit is almost same as Vaziri’s model. Both the models show that they are 50% reliable.

Of all the models Z Score gives the best prediction. It’s prediction percentage of failed banks is 80% and shows 75% correct prediction before two years. Shareholders can relay more in this model.

5. Conclusion

In this research we apply several existing methods of institutional failure and test the signaling ability of each method in predicting the bankruptcy well ahead of time. The financial institutions selected for this study are from USA, Asia and Europe. Hundred banks are selected as samples of which 3 of them are acquired banks, 17 of them were helped by the government after the crisis, 20 of them have claimed bankruptcy and 60 of them are active banks. The banks are studied for 10 years (2001 to 2010). We apply Moody’s financial ratios, Standard and Poor’s
We consider financial ratios, Altman’s Z score and then applying logit model and discriminant analysis, we test each of these model’s predictive ability for future use. Moody’s model predicted that 11 banks would be bankrupt a year before the bank filed for bankruptcy and 10 banks before two years of bankruptcy. Of 20 banks that filled bankruptcy 18 of them filled in 2010 and 2 of them in 2011. Studies suggest that models can predict perfect bankruptcy two years before the file for it. The percentage of correct prediction ranges from 69% to 76%. This shows that this model is 72.5% reliable on average. This model also shows that most of the banks had high leverage and has less liquidity. S & P model, though shows that percentage of correct prediction is 80% it lacks to predicts the failure of banks in advance. The correct prediction of failed banks is only 5% in 2010 and 2009 and only 35% in 2008 and 2007, which shows that it is not reliable in predicting bankruptcy. Vaziri’s model predicts much better than Moody’s and S&P model. Percentage of correct prediction is almost 80% for all years and percentage of correctly predicted failed banks is 45% before two years of actual failure. Percentage of correct prediction of Logit is almost same as Vaziri’s model. Both the models show that they are 50% reliable. Of all the models Z Score gives the best prediction. It’s prediction percentage of failed banks is 80% and shows 75% correct prediction before two years. Shareholders can rely more in this model. We analyze the reasons like changes in market, policy, economy, and political influence which have led to bankruptcy. Banks or financial institutions from Europe, United States and Asia are considered as samples. Samples are taken from same period to analyze the effect of different methods. The results from this analysis should help us find the most significant method that could be used to identify the risk, so that necessary action could be taken to prevent the effect or reject the project which could lead to bankruptcy in the future.

References

International Journal of Business and Technology