COMMENTS BY KEITH HALL AT THE WORKSHOP FOR BANKING CRISIS MANAGEMENT AT THE RESERVE BANK OF NEW ZEALAND 3 MARCH 2005

Thank you for the opportunity to participate in this workshop and for the invitation to discuss the paper by Professor Kane and Daniella Klingebiel. They have produced a paper which provides us with a sobering reminder of just how prone we are to errors in this branch of public policy and at what enormous economic costs to society!

I am also very conscious that I am sharing the platform with Goran Lind, someone who is 'battle-hardened' from having experienced at first hand the challenges of managing a systemic crisis. I cannot hope to match Goran's insights and long may that remain so! Instead, I wanted to draw out just a few of the points made by Ed in his paper and cross reference them to the way we are thinking about some of these issues just now in Australia

Let me start by referring to Ed's analogy – that we should think about an efficient crisis management system in much the same way we would about the workings of the casualty and emergency facilities at a major hospital. In other words we need to recognise that:

- a systemic crisis, like a massive heart attack, can happen at anytime, anywhere and with little advance warning;
- like a heart attack, the damage will only be contained by timely and skilful treatment; and
- successful intervention ultimately requires that we have appropriately skilled emergency response teams in place.

Ed is making some important points here – that you need to recognise and plan for the worst, and it's hard to disagree with him on this. But as the paper notes elsewhere, systemic events are very infrequent events in many countries – they certainly are in Australia and New Zealand – and that does have some bearing on how government is

likely to resource up its regulator for the handling of very low probability events. Sticking to Ed's medical analogy, as the residents of many country towns know only too well, the occasional fatality often isn't seen to justify a hospital with the kind of staff and equipment that a busy city hospital takes for granted. So it will certainly be hard pressed to handle any once-in-a-generation train crash that occurs in its vicinity.

I suspect that Ed would say at this point that this does not absolve the authorities from preparing a 'crisis management plan' for low probability, but high impact events – and he would be right. But in drafting a crisis management plan for the financial system, I think we may need to be pragmatic about just how quickly many regulators can locate and deploy suitably trained appraisal teams.

I will return briefly to this issue of resources later on, but before doing so I want to pick up on the words 'without advance warning' and put in a plug for the type of financial stability analysis now undertaken by a growing number of central banks including the RBNZ. We all recognise that we can never 'fire proof' the financial system against occasional failures, and nor do we wish to. But there has been a shift among central banks to believing that it might be possible to do a better job than we have in the past when it comes to analysing and identifying potential vulnerabilities within our financial systems – that there might be some value to be derived from devoting more staff to crisis prevention. The RBA is one of a growing number of central banks that now has a department that focuses exclusively on financial stability. We also now go on the public record twice a year in a *Financial Stability Review* – the latest of which will be released in just a couple of weeks from now. It is an important step forward in raising public awareness of the issues and risks in the financial system.

Nonetheless, we all know that despite our best endeavours to prevent them, 'bad things will happen' and we all need to have contingency plans in place for dealing with them. How you construct these plans will vary from country to country depending on how you choose to balance various broad policy objectives including the protection of depositors and minimising moral hazard. But they will have some broad similarities in that they will seek to promote the stability of the financial system by preventing the failure of systemically important financial institutions.

So on that fateful day when we receive the unwelcome news that one of our banks may be about to default on its payment obligations what is the likely sequence of events? (And let me first reassure you that this particular bank has no operations in New Zealand so there are no trans-Tasman complications!)

Well, first up, we will need to determine whether we are dealing with a bank that is *systemically important and solvent*. If so, then under current policy, it will qualify for liquidity support from the Reserve Bank and, hopefully, the potential crisis will be quickly defused. It's worth emphasising, however, that might still involve us in some quite difficult judgement calls. How do we assess systemic importance? And since the Reserve Bank is no longer the bank supervisor in Australia – exactly what level of comfort can we reasonably expect to receive from APRA on questions of solvency, especially if the timetable for decision-making is very tight?

If the bank turns out to be *neither systemically important, nor solvent* then closure is the default outcome. That would involve an APRA-appointed administrator liquidating the institution's assets, paying off creditors in accordance with the priority provisions of the Australian Banking Act. This would see depositors being paid off before other creditors, but the payments may not occur for many months. To my mind, an outcome that denies depositors access to transaction balances for even a couple of days runs the risk of promoting social unrest and may not be credible. It will certainly increase the chances of an ad hoc government response, which is one of the reasons why the RBA is on the public record in support of some form of deposit insurance in Australia – a matter the Government currently has under consideration.

But what if the bank is apparently insolvent and 'closed resolution' is not the most sensible outcome? This may be because the administrator can see substantially more value in the bank from selling it off as 'going concern' than from breaking it up. But more importantly, it may be because we are dealing with an *insolvent but systemically important* bank whose failure would have a material impact on the financial system and the wider economy. I expect Bruce White and Peter Ledingham will be running us through the RBNZ 'haircut' approach later on – and I look forward to that. Putting to one side the legal impediments that currently exist to such an approach in Australia

(due to the depositor preference provisions in the Banking Act), I have to confess that my own experience as a bank supervisor in the early 1990s has left me with a somewhat jaundiced perspective on our ability to estimate the 'worth' of a distressed financial institution at speed. In some circumstances, I suspect that the only practical solution may well turn out to be the one in which government has to take on some credit risk, perhaps by providing the central bank with a guarantee on a line of credit to the troubled bank. Of course, any such support would be highly conditional with the pain of the subsequent restructuring falling squarely on the owners of the bank.

But what if we have a systemic crisis of the kind canvassed by Ed Kane? Here I think there is less scope to quibble over the merits or otherwise of government involvement. Once confidence in the entire banking system has been eroded and a large number of financial institutions are precariously balanced, there is no quick fix. The 'skilled treatment' that Ed advocates will take time and the 'skilled emergency response teams' – if they exist –will be very tightly stretched indeed. Ed emphasises the importance of practising 'triage' here – a willingness to let some 'patients' go in order to free-up the resources needed to save others. The problem with a systemic crisis, however, is that some institutions – the systemically important ones – need to be kept on life-support and nursed back to full-health regardless of their underlying condition, because their demise would jeopardise the prospects of otherwise healthy institutions.

This is an environment in which a blanket guarantee for depositors – normally an anathema to us all – may well be a sensible way to proceed if confidence in the banking system is to be upheld while the authorities set about the demanding task of restructuring the banking system. So the message that I take away from Ed's paper is not that one should categorically rule out liquidity support from government, or the use of government guarantees, 'in extremis', but that when you do, you need to make very sure that you use the breathing space wisely. For as the paper spells out all too clearly, the risks from postponing or delaying difficult restructuring decisions will be extremely high.

Thank you.