Reserve Bank of New Zealand

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Containing a Systemic Crisis: Relicensing vs Blanket Guarantees

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[Based on Empirical Research performed jointly with Daniela Klingebiel, World Bank]

Critical Distinction

Limited Guarantees
vs.
Blanket Guarantees
(Offer comfort indiscriminately to everyone exposed to the **cold chill** of bank losses)

Definition: A ***systemic crisis*** occurs when members of an important segment of a country's financial system are recognized to be economically insolvent at the same time and these institutions experience accelerating silent runs (or even open depositor runs). It ***externalizes*** a political struggle over when and how losses in bank and borrower balance sheets are to be unwound and allocated across society.

Three Phases of Crisis-Management Tax-Transfer Programs

1. Immediate Damage Containment
2. Medium-Term Restructuring of Insolvent Banks
3. Long Aftermath

- Containment and Restructuring are ***tax-transfer programs***. In both phases, heavy lobbying by politically influential sectors seeks to redistribute losses and risks away from the immediate victims of the crisis.

My Presentation has three goals:

1. To describe crisis-management options and how authorities deployed disaster-relief policy options in recent systemic crises.
2. To compare the effects of different disaster-relief programs on three dimensions: fiscal expenditures, macroeconomic disruption, and industry market structure.
3. To infer from this record what combinations of depositor-protection, bank-protection, borrower-protection and taxpayer-protection schemes are and are not economically efficient.

Dangers

- Taxpayers deserve accountable and time-consistent crisis-containment policies. Such policies are hard to devise amidst the turmoil and conflict a crisis generates.
- Infrequency of crises --and lack of planning and rehearsal for them-- shortens policymaking horizons and leads to copying uncritically policy responses recently employed elsewhere.
- What is being copied is a sequence of trial-and-error decisions after which policymakers deny or cover up their errors: systematically exaggerating the wisdom and success of their particular programs of loss and risk reallocation.

TIMELESS PARENTAL WISDOM

"Curtis" by Ray Billingsley, 6-9-02

Several Adages Help to Define Problem of Time Inconsistency

- Haste makes waste
- A stitch in time saves nine
- Well-begun is half-done

Commonsense analysis indicates that policy actions taken at the outset to contain a developing crisis--particularly the issuance of extensive liquidity support and government guarantees-- absorb off-budget fiscal resources and tend to inappropriately constrain policy options for dealing with insolvent institutions in the later phases.

A systemic crisis resembles a battlefield.

- Loss-generating banks wounded by open deposit runs resemble serious casualties.
- Supervisory personnel resemble emergency medical personnel ("paramedics") required to administer first aid to wounded banks under continuing hostile fire.
- Lobbying resembles pleas for help from wounded
- Containment strategy, like battlefield medicine, seeks to locate the wounded, alleviate their suffering, and temporarily stabilize their condition.
- The tools of a paramedic are preliminary treatments: kind words, painkillers, tourniquets, and bandages. Each is limited in amount available.
- Financial-sector restructuring resembles follow-up surgery that take place in a more sterile environment located some distance from the firing line.

1. Vital importance of **prior planning** and **staffing** to permit the proper sequencing of containment measures

1. **Not developing and rehearsing** a multistep benchmark disaster-management plan is <u>in practice</u> a plan to use blanket guarantees without stopping to undertake the **"valuation triage"** needed to identify and impose time-consistent restrictions on **hopelessly insolvent and borderline banks.**

Relicensing Procedures

1. Begins with a brief **timeout** for Preliminary Insolvency Assessment. Length of timeout depends on quality of supervisory skills and information systems.
2. Continues with strengthening insolvent institutions by imposing **preliminary haircuts** on all creditors other than very small depositors
3. Proceeds to sort out banks into **three categories** based on assessment values and the level of precision with which supervisors in a given country can compile their preliminary assessments.

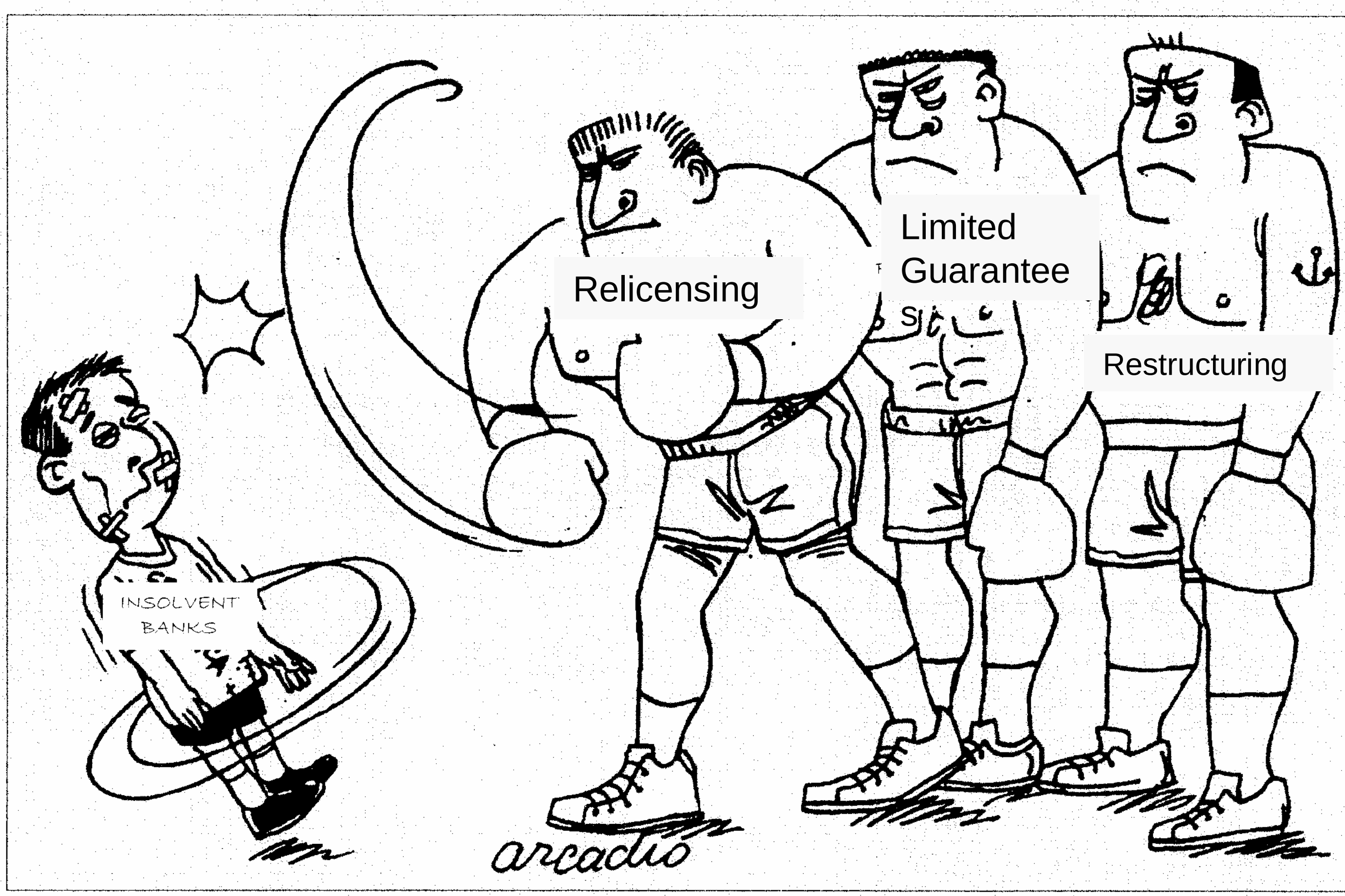
Three Categories of Relicensed Banks

1. <u>Fully Accredited Institutions</u>
2. <u>Hopelessly Insolvent Zombie Institutions</u>: Queued for prompt "restructuring"
3. <u>Borderline Institutions</u>: To be given an opportunity to prove solvency or raise new capital. Post-haircut deposit balances are guaranteed, but new deposit taking and new lending prohibited until viability is restored either by owners or by restructuring.

Restructuring entails careful diagnosis and a prioritized queuing for conclusive treatment.

- Restructurers use sophisticated methods to estimate asset values and seek lasting methods for restoring salvageable institutions’ profitability and reputation. Their task is to identify, clean up, and consolidate the portfolios of insolvent banks and to see that the capital positions of the reconstituted firms is adequately patched up by financial surgery.
- How much good supervisory surgeons can accomplish depends very much on how well the battlefield medics have done their jobs.

IMPORTANCE OF PROPER SEQUENCING IN KNOCKING INSOLVENT INSTITUTIONS OUT OF THE GAME



Adapted from a cartoon drawn by Arcadio/*La Nación*/San José, Costa Rica
Cartoonists & Writers Syndicate

Issuing blanket guarantees (rather than limited ones) distorts the government's intertemporal budget restraint by deferring all triage activity to the restructuring phase.

- By issuing blanket guarantees, a government hopes to avoid designating the liabilities of even the most severely wounded institutions as unworthy of government support.
- Whatever political and administrative benefits blanket guarantees may generate, our data show that keeping moribund institutions on life support is a costly strategy over the crisis as a whole.
- Governments that try to contain a spreading financial crisis by guaranteeing the liabilities of hopelessly insolvent banks paint themselves into a corner. Because such guarantees cede control over future restructuring costs in part to the machinations of the country's weakest institutions, the loss tends to increase the longer the guarantees are kept in place.

Containment treatments consist of standstill requirements, loans, credit lines, and guarantees.

1. Standstills put the claims of various private parties on hold for a specified period of time.
2. Other treatments create immediate or deferred government obligations which absorb fiscal resources.
3. The credibility of these obligations depends on the government's ability to service them from tax revenues.
4. A government's fiscal capacity depends in turn on officials' ability to scale back other planned expenditures and to collect new taxes.

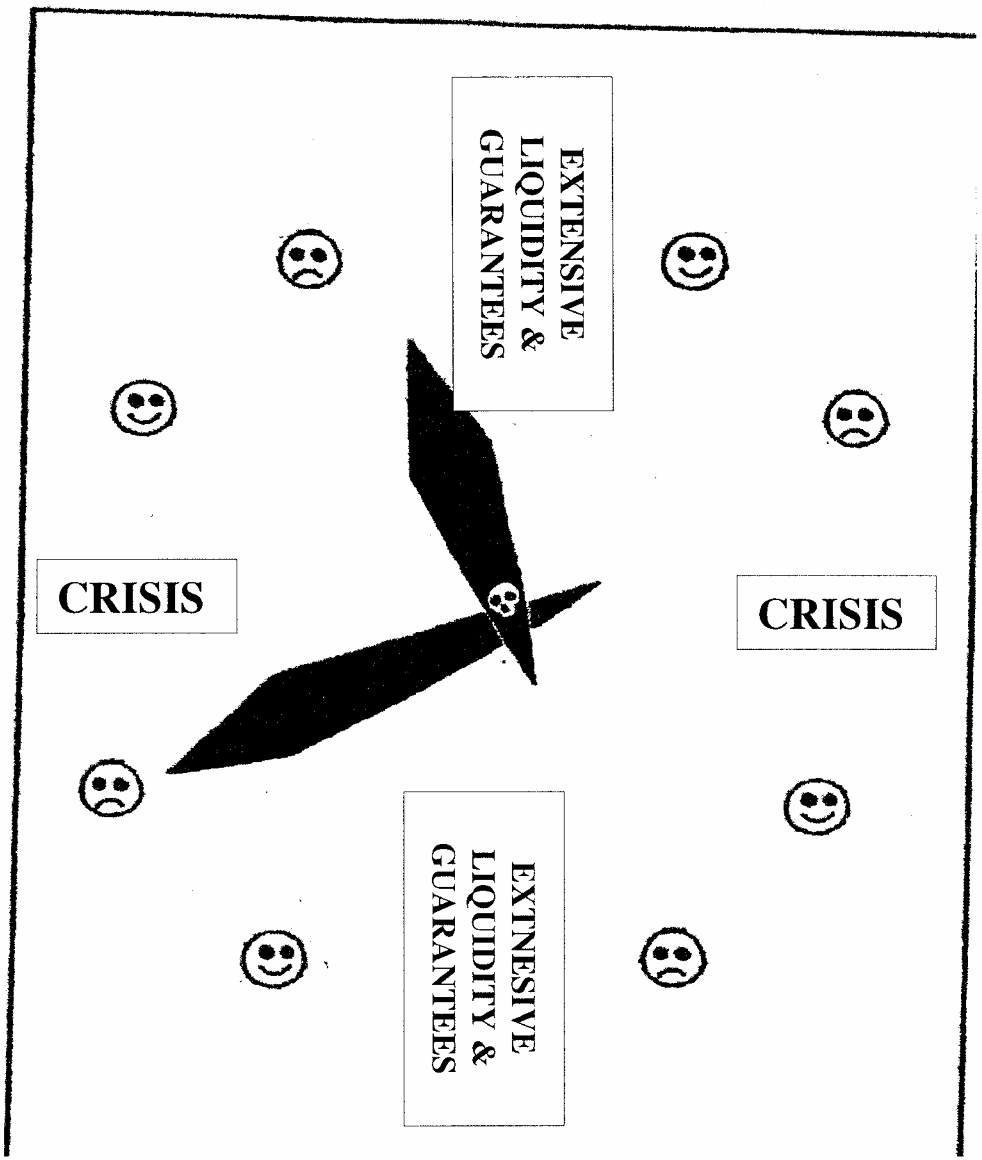
SUBSIDIES/ TRANSFERS

- To the extent that government loans and credit lines are written at a below-market interest rate, the government is implicitly transferring free equity capital to the recipient.
- Similarly, unless the government requires banks to fully compensate it for the costs of supporting the credit enhancement, free equity capital is also transferred from taxpayers to recipient banks.

- Many crisis governments cannot issue credible guarantees without outside help. (Say, from the IMF)
- If credible blanket guarantees are issued, the government faces **three new challenges**: 1) to control the amount of **new debt** that wounded institutions load onto the balance sheet of the government, 2) to control **how prudently guaranteed institutions invest the funds** they receive, and 3) to **cut back or eliminate** the guarantees once the restructuring process goes forward.
- The third challenge is particularly tricky. Once blanket guarantees have been employed, it is hard to convince the public that guarantees won't be renewed at the first sign of another panic.

•Banks whose credit is fully guaranteed can issue the **functional equivalent of new government debt** as long as they remain open. This is what tempts managers of insolvent banks to abuse their access to government assistance by taking on inordinately high-risk projects.

•Although abusive “gambles for resurrection” reduce the nation’s capital stock, they make great sense to owners and managers of insolvent banks.



Blanket-Guarantee Crisis-Management Clock

Time-Honored Form of Standstill: A longer timeout taken to allow government forensic analysts and private auditors to assess the depth and character of troubled banks' wounds is called a "banking holiday."

- It allows supervisory medics time to diagnose individual-bank insolvencies and to recommend and impose preliminary "haircuts" on formally uninsured depositors and nondeposit creditors before these parties can liquidate or collateralize their exposure in the bank.
- In the U.S. today, resolutions are usually completed over a weekend. But beginning on March 6, 1933, the entire U.S. system was shut down indefinitely for relicensing.
- Each haircut reduces the depth of a bank's insolvency by cutting back the size of its debts. This protects taxpayers by lessening the extent to which restructuring has to use taxpayer-financed loans, credit lines, and guarantees.

Using the holiday to prepare a **program of limited guarantees** and to **write down insolvent banks' uninsured deposits** to values that their earning assets can **genuinely service** promises to simultaneously restore public confidence both in the government and in the banking system.

- Examining the aftermaths of pre-1992 systemic crises in which governments assigned losses to depositors of insolvent banks, Baer and Klingebiel (1995) find that the positive benefits of the reducing depositor uncertainty relatively quickly overcame the negative effects that surviving banks experience from the deposit writedown.

Blanket guarantees usually entail two other schemes for systemic protection

- Blanket guarantees
  - Government guarantees all of financial sector liabilities
  - Often extended at onset of crisis to stem loss of confidence
- Open-ended liquidity/solvency support
  - Government provides open-ended liquidity support to financial institutions regardless of institution’s financial standing
  - Often prior to crisis outbreak to delay crisis recognition and to avoid intervening in de facto failed institutions
- Forbearance policies
  - Government allows insolvent banks to continue to operate and/or does not enforce prudential regulatory norms
  - Often put in place during onset of crises to allow financial institutions to recapitalize from retained earnings

Have these policies been successful?

- JBF paper by Honohan and Klingebiel looks at fiscal and economic cost implication of such policies
- Sample
  - 34 countries that have experienced banking crises during 1970s-2000; 9 industrialized, 25 developing countries
  - 6 countries two distinct experiences; thus 40 distinct country experiences
- Dependent variable
  - Estimated total fiscal cost of banking crisis in percentage of GDP
  - Estimated duration of crises and output loss
- Average fiscal cost of financial crisis: 14 percent of GDP
- Average output loss: 12 percent of GDP

Regression results

- Model Validity: Variables, mainly policy variables, can explain 35 to 75 percent of cross-country variation in fiscal costs
- Blanket guarantees, open-ended liquidity support, and regulatory forbearance **increase** costs of banking crises
- Estimated benefits of better policies
  - Not issuing blanket guarantees reduces fiscal costs by 36 percent
  - Not extending liquidity support reduces fiscal costs by 63 percent in sample countries
  - Not engaging in forbearance reduces fiscal costs by 53 percent
- Costs are higher in countries with weak institutions

The issuance of blanket guarantees does not speed up economic recovery

- Dependent variable: speed of economic recovery and output loss
- Regression results
  - The issuance of blanket guarantees does not speed up economic recovery nor does it reduce extent of output loss
  - Liquidity support seemed to actually **prolong** crises as economic recovery took longer

Conclusion from empirical analysis

- Blanket guarantees add substantially to fiscal costs of crises
- They are not necessarily successful in restoring public confidence
- And they add little to the recovery process
- Therefore indiscriminate guarantees should be avoided

How to avoid issuance of blanket guarantees

- Do disaster planning exercise and be prepared
- Move early and comprehensively
  - Do not close individual banks without an overall plan
  - Deal with all insolvent and marginal solvent banks at the same time
- Prevent bad financing and looting
  - Have limits in place (conservator, contractual arrangements); use simple tools, e.g., reserve-requirements, to prevent weak banks from gambling
  - Avoid large, costly liquidity support

How to be more selective in issuance of guarantee

- Require banks to go through relicensing process
- Identify and support the better banks with
  - Liquidity support
  - And capital support
- Do not impose long deposit freezes

Other supporting policies

- If asset management companies are set up transfer assets at market prices and outsource management to private sector
- Structure capital support such that
  – There is a co-sharing arrangement with private capital
  – Try to do once-for-all recap
  – Do not recap on flow basis
  – Link bank- and corporate restructuring
- Have supporting macro policies

Conclusion

- Blanket guarantees, unlimited liquidity support and forbearance policies fiscally costly policies that provide little economic benefit
- Alternative mechanisms include
  – Intervene early and comprehensively in weak and insolvent institutions
  – Restrict activities of weak and insolvent banks
  – Relicense banks to signal to depositors that banks allowed to remain fully open are sound
  – Support (capital and otherwise) financial institutions that have strong franchise value