

## **Comments on Alternatives to Blanket Guarantees for Containing a Systemic Crisis**

*(Ed Kane and Daniela Klingebiel)*

I like this paper very much. This is not only a diplomatic way of saying that I share many of the views expressed in it, but also that I find the simple model ("simple" is a praise in my parlance as a practitioner!) in the paper to explain complex interlinkages in an elucidating way.

Although I agree with many of the views, this will of course not stop me from mentioning some issues where I have different experiences and thoughts.

### **Where I concur**

One of the most important underlying messages of the paper is that contingency planning and crisis management matters. If you are unprepared for a crisis situation (for instance such a simple thing as not having made clear to yourself and the public how to treat depositors and other counterparties to distressed banks) you may have to resort to solutions which are excessively drastic and have severe negative side-effects (as you have noticed, there is much medical language in the paper). Likewise, if you have not prepared crisis management, then scared and stressed supervisors, central bankers or politicians may select suboptimal solutions. Such experiences have made the Swedish central bank so interested in crisis simulations and in contingency planning.

Another important theme of the paper is the need to act sooner rather than later. This is more important than doing exactly the right thing. When I am speaking on the theme of crisis resolution I often end by saying – Do something! Do anything! One reason is that by doing nothing you will certainly exacerbate the crisis, partly in substance because you allow the bad banks and bad habits to continue, partly because you do not address the lack of confidence in the banking system, which is the underlying cause of the crisis. I regret to say that Japan is the most obvious showcase of the costs of doing nothing for an extended period.

Before turning to those issues where I will try to disagree with Ed, I want to say a few words about national bias. I think, truly, that we solved the Swedish banking crisis in a rather neat way and some of us involved have travelled around the world to spread the gospel of how we did it. To others this may merely sound like pompous chauvinism. Let me then explain how I see it: Firstly, there is a set of good practices which are universally applicable in a crisis situation. Secondly, these good practices, as well as individual solutions must be applied in accordance with the structures and traditions of the specific country. Take the example of transparency: In Sweden, where transparency is the norm, continuously disclosing all information about the

problems of the banks and the measures to be taken acted as a strengthening measure in itself and it had few side-effects because the recipients believed in the information and the depositors felt safe to be protected anyway. But in a country in which transparency is outside the normal culture you would need to be very careful not to worsen the crisis situation by informing about the problems. I still think that transparency is the correct way, but in such a culture you need to prepare gradually to make room for increased transparency in a crisis situation.

Thus, my conclusion is that some measures of crisis resolution will work better in some countries and that we should be a little humble about our successes. That being said, there is no doubt that some types of solutions are generally more effective than others.

### **Where I try to disagree**

To get some bite into this discussion I will present some non-concurring views on Ed's thesis that overriding solutions such as blanket guarantees and exceptional liquidity support are dangerous. Yes, I do agree that they distort the market and provide false incentives but I would argue that (i) there are situations in which you cannot avoid them and (ii) their negative side-effects depend very much on how they are applied and there are ways to reduce these effects.

In the Swedish crisis it was not enough to cover the depositors, even if we had had a limited protection system. The banks had a net debt to foreign counterparts (mostly Japanese and German banks) to the tune of 60 billion USD. Against this, the central bank held reserves of 20 billion. When the distrust in the banks and in the Swedish currency ran its deepest, we lost our 20 billion in ten days. Six of the seven major banks had liquidity and to some extent solvency problems. We had to stop the rot or face not only a banking crisis but also a major macroeconomic and currency crisis.

Being well aware of the adverse effects, we tried to construct the blanket guarantee in the best possible way. First of all, we did not guarantee the Swedish institutions, but only that the counterparties "would not suffer any losses from their claims on Swedish banks". Second, banks' shareholders were not included but suffered losses.

Simultaneously with the blanket guarantee (which as the paper notes was unlimited to its amount, which was important to restore confidence) the government also established a Bank Support Agency with the task to allocate, also unlimited, public resources to the ailing banks. Of course, this allocation was done according to strict rules; there was no give-away. Any bank which received support had to give up a corresponding amount of ownership control. In addition, the conditions of the support were harsh, less so in monetary terms but in terms of having to strengthen the bank's management, not least credit management. In those cases in which significant support was provided, the government placed their own man on the board of the bank, not to interfere in the daily running but to ensure that the conditions were complied with and that the bank did not engage in unsound practices due to the situation.

As mentioned in the paper, triage was applied. We focused very much on rescuing values rather than institutions. Thus we created good banks/bad banks and transferred bad assets to AMCs. If a bank was found not to viable even after these cleansing efforts, we merged it with another bank creating a sound institution.

Hence, I would argue that we had no choice to applying a blanket guarantee but we applied it in a way to minimize the side-effects. The most important thing is that you do not implement the guarantee and then do nothing. You must immediately supplement it by taking all the other measures to deal with the crisis. If not, you are running into the danger described in the paper – that banks and other market agents behave in accordance with the distorted incentives provided by the guarantee.

By the way, I have the same view about the AMC-solutions. Correctly applied, they can facilitate crisis resolution and save big money, but there are examples of abuse of the AMC-solution – for instance when they are used as a means to do accounting tricks so that the banks' losses remain hidden.

## **Conclusion**

In sum, I agree that you would prefer to avoid the overriding sweeping solutions to crises. To do this, you need to plan ahead of the crisis. You would also like to focus your solutions on securing the necessary financial functions rather than the institutions themselves. And if you do have to use the overriding solutions – do this in a way to minimise the side-effects. All this fits in very well with today's general theme – on the virtues of being prepared for a crisis.