

The role and approach of contingency planning¹ for a financial crisis

Introduction

I do not know about you, but to me the concept of contingency planning has always sounded quite boring and not challenging from an analytical point of view. My thoughts drift to issues such as having a back-up computer or maybe a back-up site for a payments system and a pair of extra telephone cables.

If nothing else, the events of September 11 clearly showed the crucial importance of planning for contingencies and since then planning for, in particular, **operational** contingencies has been very much in focus.

Planning for **financial** distress has existed since long but it has been patchy in its coverage. Some countries, primarily the US with its large number of banks and experience of a major systemic banking crisis, have established a framework of contingency measures, whereas other countries prefer to deal with problems on an ad hoc basis.

In fact, an argument for some countries not to plan ahead is their preference for what they call “constructive ambiguity” also in this field. They fear that by having contingency plans they will open the way for arbitrage and gaming by market participants, maybe also by the authorities. In my view, such fears are unfounded. Planning should lead to a set of measures for contingencies, but the measures should in themselves mitigate the risks mentioned and it should not be certain how the measures will be applied, for instance, whether the central bank will grant ELA and, if so, to whom and on what conditions. I would even argue the opposite: knowing which contingency measures may be applied, the financial agents can act in a more predictable and orderly fashion which will reduce the impact of a crisis.

Many countries have experienced that inadequate planning for a crisis led to suboptimal decisions on crisis resolution and hence to larger costs and dislocations. Time is often scarce in a crisis situation and if the ideal solution is not feasible – since there is no time to wait for legislation or other substantive arrangements – you must opt for the second-best.

As an example of comprehensive contingency planning I might mention the UK. They have tasked the Tripartite Standing Commission on Financial Stability to improve and test crisis management arrangements and more generally to assess and increase the resilience of the financial sector as part of the broader public sector initiatives to improve resilience of the UK’s critical functions. The Committee has folded into its

¹ This presentation is limited to planning for financial sector problems. My focus will be on distressed banks and the corresponding infrastructure.

contingency considerations all the relevant financial firms, trade associations, market infrastructure providers and the market liaison committees.

Why contingency planning?

The basic reason for contingency planning is obvious – the costs of problems in the financial sector are potentially large. There are different kinds of costs. The financial costs affecting shareholders, depositors, and other counterparts, maybe also the costs to the public purse of the government and central bank. But even more important are the macroeconomic costs in the form of shrinking economic values of assets and businesses, in production and in investments. I have read that the Indonesian financial crisis implied a set-back of some 20 years of poverty alleviation.

A comprehensive framework of contingency measures could, at best, prevent the crisis or, at least, reduce its harmful effects.

Of course, contingency planning cannot prevent a crisis on its own. It is part of a broader framework which, among other things, must include:

- Adequate preconditions. This encompasses for instance stable and sustainable fiscal and monetary policies. We also need a comprehensive and updated set of legislation and a well-functioning judicial system in order to maintain a culture based on law and discipline. We need good accounting and auditing standards, and people to perform them, to achieve discipline through transparency.
- Effective regulation and supervision. A prerequisite is that the responsible authorities have the necessary legal powers, the skills and resources to act to remedy problems at an early stage. I am well aware of my hosts' views on regulation so I hasten to add that I do not call for more of it, but rather that it is applied more intelligently. From what I have seen in various countries, there is still quite some room for improvements on this. In fact, I venture to state that good contingency planning may reduce the need for some parts of regulation.

Hence, ensuring adequate preconditions and effective regulation and supervision should be the first line of defence against crises. Coming from a country where snow is prevalent, I could say that the snowball of a minor weakness in a bank, if unattended, could turn into an avalanche.

Definitions

There is some confusion in the international debate on the meaning of contingency planning and it often gets mixed up with the concepts of crisis management and crisis resolution. This is how I see them:

- Contingency planning is an explicit act by the authorities, the financial industry and other interested parties to create legislation, policies, organisations,

structures and arrangements intended to prevent or to reduce the impact of a financial crisis.

- Contingency measures are the results of the planning – they could be laws, policies, organisations, structures or other arrangements.
- Crisis management takes place in or just before a crisis when the relevant parties meet to analyse, discuss and decide on applying contingency measures or other remedies.
- Crisis resolution takes place through the application of crisis measures

Let me exemplify this:

Contingency planning could, among other things, aim at preserving asset values in distressed institutions.

A contingency measure would be to create a “sleeping AMC”.

Crisis management would be to decide to awaken the AMC and to start its operations.

Crisis resolution would be to transfer assets from a distressed bank into the AMC.

Categories

As I mentioned, the main categories of contingency planning are operational and financial issues. A crisis in the financial system may stem from a failure in either category. They have generally different causes and implications but the underlying threat to financial system stability is common.

If a major part of the payment system breaks down due to malfunctioning telecommunications or to the distress of its largest participant – it is equally disastrous.

A lot has been done in the field of operational contingency planning in recent years. Let me mention just a few examples:

- Creation of substitutes for IT-systems, other routines, telecommunications, and for staff and premises. This is not always as simple as it may sound. For instance, when some institutions tried to switch their activities across from Manhattan to the back-up sites in New Jersey on the 11 September 2001, they observed that almost all transportation of the staff moving to the back-up site must pass through the narrow Hudson tunnel – obviously a vulnerable point. They also learnt that the grid for the tele cables and server stations does not follow distinct geographical boundaries so two differently located sites may be dependent on the same tele cable.
- Creating a sleeping NewBank, which quickly can assume the duties to settle US government paper if two other settling banks such as BONY and JP Morgan Chase, which dominate in this role, would fail.

Much has also been done to plan for financial distress but some countries have certainly done more than others. The US stands out and has also the widest and

most publicized experience of applying their measures so I will start with them. This does not preclude that other countries apply similar measures.

- The famous Chapter 7 /Chapter 11 legislation aims to provide more time in a situation in which the solvency of the institution may be questioned. The extra time should be used to find solutions so that the destruction of asset and franchise values and disruptions generally in the financial sector and the macro economy are minimized.
- A huge organisation was created already in 1933 – the FDIC – with ample resources, skills and number of staff in different locations of the US and a strong legal mandate to deal with distressed bank in a (lowest) cost-efficient manner.

Planning for emergencies in the infrastructure should incorporate the systems as well as the institutions operating in them. Crises can emanate from failures in the infrastructure but exogenous crises can also be propagated by it. This calls for different kinds of contingency measures, operational as well as financial.

Systems need to be made more robust, for instance through:

- Back-up systems, sites and staff. Alternative routines.
- Organisational and legal arrangements to ensure rapid back-up of liquidity and collateral.

Also the owners of the infrastructure systems, often banks or other financial institutions, must be able to act as a source of strength.

When certain types of transactions are dominated by few institutions, alternative channels and agents need to be prepared.

Legal backing and practical arrangements must be prepared to ensure the orderly winding-up of existing commitments in a payment system. The same applies to a failed institution acting as a custodian, to facilitate the smooth transfer of assets it may hold on behalf of others.

To avoid gridlock in a payment system it may occasionally be appropriate for the central bank to grant ELA or to use its “good offices” as a mediator trusted by all counterparties. [Example from the US Fed] .

What needs to be protected?

Problems may erupt in financial institutions, markets and in the financial infrastructure, which itself includes institutions and systems. To be effective, contingency planning must include all possible crisis points. Since banks dominate the financial system in most countries, the bulk of financial contingency planning has been directed at them. Most of the operational contingency planning is directed at the infrastructural systems. Given developments and interlinkages in the financial sector, there is a clear need to broaden the scope of planning and contingency measures.

Although a crisis will manifest itself through certain channels, it does not automatically follow that the same channels need to be rescued. We should rather focus to ensure the necessary financial functions which are prerequisites for a continued stable and sustainable macroeconomic development, and indeed, a well-functioning society.

These key functions are well-known to us all:

1. Payment services. To me, this is the ultimate core function, because even the other important functions of the financial system are dependent on safe and efficient settlement and payment.
2. Transformation of savings into investments and consumption, including the intra-temporal aspect.
3. Assumption, management and channelling of risks.

The functions have different characteristics and hence need different contingency measures.

Payment services can be highly time-critical. Even very short disruptions may lead to large negative effects on other parties and on the macro economy.

The savings function is generally less time-critical. Even if savings are locked temporarily in a distressed bank, people usually have cash, credit cards and accounts in other banks, not to mention friendly relatives and shop-keepers, which will take them through a number of days. Sweden once had a bank staff strike for a month, without significant problems for the depositors.

Lending is also less time-critical. Normally, the borrower is not affected until the borrower needs a new loan, or wants to renew the current one. As is the case for the depositor, there are usually many alternatives open to the borrower.

Risk handling is to some extent time-critical. The distressed institution may have assumed various traded risks and the relevant markets may react to the uncertain situation, creating turbulence. Spreads for risk instruments may increase to the extent that it may not be financially feasible to protect against certain risks.

The functions could also be assessed by their vulnerability – for instance, by whom they are performed and how easy they are to replicate.

Payment services are in many cases centralised in a limited number of systems and participants. The systems are not easy to replicate without advance planning, e.g. on organisation and legal underpinnings. Saving and lending services are performed by a plethora of institutions and markets. “Plain vanilla” risks are managed and channelled by many institutions and markets, whereas some sophisticated risk instruments are more narrowly offered and traded.

All these aspects – the character of the function itself, if it is time-critical and how it can be substituted for – are important when constructing contingency measures.

Let us look at some examples of needed contingency measures related to each of the core functions:

Payment services:

In the event of distress of a participant of a payment system, gridlock may occur. In order to clear existing obligations and claims liquidity support may be needed to the failed institution or to other participants. This support may come from the owners of the system, from other participants, or from the central bank. There have been cases where a central bank has used “its good offices” and reputation to facilitate clearing.

Customers may use other financial agents for future payment services. The problems are enhanced when there are a few or dominating participants in a payment system or when the system itself is affected and there are few alternate systems.

Savings:

The existence of an adequate deposit guarantee system ensures low losses to depositors, reduces the risk of runs and makes it easier for the authorities to close banks. Having a deposit insurance system implies an obvious moral hazard risk, which has to be mitigated in the construction of the system. Deposits can also be transferred to a healthy bank, for instance in a purchase and assumption transaction. This requires legislation, for instance so that the purchasing bank is not required to ask for formal acceptance from each individual depositor.

Lending:

Existing credits could stay in the distressed bank as long as the bank does not have a severe problem. The bank could choose to sell individual or groups of loan assets in order to improve its liquidity and capital adequacy position. When he needs a new loan, the borrower could turn to another bank and there would be some delay during which the bank gets acquainted with the borrower and assesses his prospects. In a systemic crisis situation, every bank tends to become more cautious towards lesser known borrowers, which may restrict quick access to funds even for creditworthy ones. But this should not be exaggerated. The experience from the deep Swedish systemic crisis is that most of the borrowers, whose loan applications were legitimately rejected on factual grounds of being less creditworthy in the prevailing situation. You could also pose yourself the question: Why should a bank decline to take over the loan business with a good borrower?

The loan portfolio in a distressed bank may be sold to another bank or investor, a good bank/bad bank solution may be sought, or, impaired loans may be transferred to an AMC. All such solutions require careful planning ex ante. There must be legal backing for transferring assets in various ways and for the valuation of such assets. The organisational structure for managing and selling bad loans and bad banks must be prepared to the extent feasible. In a major crisis, the sheer logistical magnitude of the problem is staggering – I heard that the documentation for the bad loans of only

one of the Swedish banks in our crisis covers two miles of shelves. Luckily, Sweden is a vast country.

The US have prepared a large number of arrangements to deal with bank assets, including to let a bridge bank take over the assets and liabilities of a distressed bank while a more lasting solution is being sought.

Risks:

Normally, there are many agents willing to assume risks – at a price. The short-term problem in a crisis is that rapid divestment and unwinding of positions of a distressed bank can cause volatility and higher spreads in markets with possible knock-on effects. (compare the feared consequences of an LTCM-type failure). Various preventative measures, including legislation and pre-agreed sets of documentation, with legal opinions, for various risk instruments, could be taken to facilitate a rapid but orderly unwinding of risk positions. In addition, well-balanced, coordinated and considered transparency measures from the industry but also from the authorities will be of great help.

Indirect measures may aim at the operations of the markets themselves. For instance, circuit-breakers stopping trading temporarily may provide a little more time for orderly sales and for the situation to cool down.

There are several sound arguments why contingency planning should focus on ensuring the key functions:

- The focus will be on the overriding objective of macro economic development and stability and not on a lower-level objective.
- It reduces moral hazard risk since owners and other stakeholders in individual institutions will never know if and how they will be rescued. For instance, ELA may be granted to other parties than the distressed one, or not at all.
- The functional approach will provide better incentives to the crisis survivors rather than to the failed institution.
- The functional approach makes it easier for the authorities to close non-viable institutions and systems.
- The functional approach will make it easier for authorities to withstand undue interference from interested parties.

The Riksbank has analysed the effect on a major bank failure using the functional approach. Our conclusion was that no bank can be seen à priori as having systemic importance in a functional sense so there is no need to rescue the bank itself. However, if two or more major banks were in serious trouble, the situation could sometimes, but not always, have systemic repercussions. Our analysis presupposes that certain crisis measures will work smoothly, such as early payments from the deposit guarantee fund, and that a panic is avoided.

Going from individual to systemic distress

The basic framework of contingency measures is in principle applicable to all kinds of relevant institutions, large or small. But the measures may partly have different aims. The main objective when dealing with a small bank in distress may be to protect depositors and the franchise value of the bank. In this case, the threat to key functions may be small but it can still be regarded as appropriate to apply contingency measures. On the other hand, measures applied in relation to a large institution could include systemic aspects.

Since it is not possible, neither desirable, to define ex ante which is a systemically important institution or system, the basic level of contingency planning must be aimed at individual institutions and systems. Nonetheless, there also need to be specific contingency measures for addressing systemic situations. Such measures are more potent and may have negative repercussions (similar to a medicine prescribed when you are very ill) so there should be careful consideration before they are being applied. This is sometimes regulated in the legislation – for instance in special provisions which may be enforced only in a major crisis.

Typical measures for systemic crises are ELA and government solvency support. I will not discuss these in detail, just note that we are in a better position if we have carefully discussed the application of these measures long before the onset of the crisis. Another measure is to apply a blanket guarantee. This is a rather dangerous step and careful planning is necessary to reduce its potentially harmful effects.

Well-thought out disclosures are key in a systemic crisis because the crisis partly feeds on uncertainty. All parties need to know about the actual crisis situation and about the aims and intended actions of the authorities and other financial agents. Secrecy may sometimes be needed, at least temporarily, to avoid gaming and panic situations, but my experience is that we as authorities can be more transparent than is usually regarded as prudent. Ex ante planning is clearly needed for any information efforts to ensure that the information is well coordinated in substance and time between the parties. Authorities and the industry must have identified the optimal channels for receiving the information as well as arrangement for coordinating information with other parties. (Uncoordinated information will likely worsen the crisis. I heard about a former – note the word “former” – head of supervision in a South American country. When a certain bank CEO issued a press release to deny the rumours of problems in the bank; the supervisors issued another statement confirming such problems. A major crisis followed).

Cross-sector and cross-border implications

In recent years we have witnessed the development of large cross-sector and cross-border groups, sometimes called LCFIs. What do they mean for contingency planning?

Obviously, to the extent measures have been construed for small or medium-sized institutions, they may be inadequate to deal with distressed behemots. An obvious example: Citibank's credit portfolio is far too large to be purchased quickly even by a

consortium of big banks. You are familiar with the expression “Too big to fail”. Maybe, there are also institutions “too big to save”.

A major challenge in cross-border planning for contingencies is that different countries sometimes have opposing interests in a crisis. The host authorities may want to rescue an institution which for them is systemic, but the subsidiary is not systemic seen from the home authorities’ point of view. Such divergences can lead to actions (e.g., ring-fencing of assets) which make it more difficult and expensive to solve the crisis than if the authorities cooperated – the famous “prisoners’ dilemma”. But it is also ex ante more difficult to agree on cross-border measures. As an example, legislation, or even the legislative doctrine, may be different as well as the structure and mode of governance of a country.

Hence, contingency planning for cross-border incidents is the big challenge for the immediate future and for a long time. This work has started in Europe and, in particular between the Nordic countries, which is easier because of our tradition of similar legislation and public structures.

Conclusions

Operational contingency planning has been much discussed in recent years, also under the term of business continuity, but financial contingency planning has not been in focus to the same extent. Crisis management receives a lot of attention and rightly so, but it will not be effective without careful contingency planning. Lacking a well thought out framework of contingency measures, crisis management will have fewer options and less time to implement optimal solutions to the erupting crisis situation.

By focussing on the critical functions of the financial system, and not on the institutions, we avoid red herrings and make it easier for politicians and the general public to understand and support contingency planning.

The increasing presence of cross-sector, cross-border LCFIs call for more potent and more controversial contingency measures. However, we can not avoid those because the implications of a crisis involving a major LCFI are potentially more severe.

Contingency planning should start nationally, benefiting from other countries experiences. As a parallel but equally important step, we need harmonisation between national arrangements. This is admittedly a long-term project but we need to start now.

I am generally optimistic about the development of contingency planning. The trend of consolidation in the financial sector nationally as well as globally makes the financial agents and the public authorities increasingly aware of vulnerabilities and of the negative implications of crises. Preparing for contingencies is a low price to pay.

What to do

If you agree on the importance of contingency planning, what could be a realistic way of approaching the issue?

- First, to analyse what framework of contingency measures are needed in your own country, given the structure of your financial system and how your “key functions” are performed. Here, inspiration could come from measures and experiences in other countries. The analysis could start between the supervisors, the central bank and the financial industry but when the work is ripe we must continue on matters of legislation, new organisations and arrangements. The government must, of course, be closely involved.
- Second, to discuss contingency measures bilaterally with countries with which you have close financial ties.
- Third, and probably in parallel with the other approaches, to participate in a broad global discussion aiming at harmonisation to facilitate cross-border crisis resolution.

This will no doubt take a lot of time and effort, but it is worth the price, which otherwise could be steep.