The Causes, Costs and Resolution of Financial Crises

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Introduction

a) Systemic banking crises of unprecedented scale: Argentina, East Asia, Ecuador, Mexico, Turkey and Venezuela

b) These crises were due to a mixture of macro and micro economic factors

c) Recent crises introduced new challenges not seen in the Asian banking crises of the late 1990s

Outline of Presentation

1. What are systemic banking crises?
2. Origins of a crisis
3. Costs of banking crises
4. Standard model of crisis management
5. Complicating factors for the standard model
6. Conclusions and lessons

1. What are systemic banking crises?

- A loss of confidence in a ***substantial portion*** of the banking system

- Serious enough to generate ***significant negative effects on the real economy***

- Disruptions to the payments system, to credit flows, and from the destruction of asset values

2. Origins of crisis

- Irrespective of origin, a crisis first emerges as a **liquidity problem** in one, or some, or all banks
- Liquidity problems and deposit withdrawals are **symptoms of underlying problems**
- Causes can be **microeconomic** or **macroeconomic**, or a combination of both

2. Origins of crisis

Microeconomic

- Typically a result of poor banking practices in combination with poor regulatory/supervisory practices:
    - Lax lending practices
    - Weak risk control systems
    - Lead to balance sheet deficiencies (mismatches, poor asset control)

[Banks with such deficiencies are vulnerable to any shock]

2. Origins of crisis

Macroeconomic

- Macroeconomic imbalances build up strains in the banking system

- Impact depends on balance sheet structure:
  - Large exposure to government
  - High degree of dollarization
  - Unhedged borrowers
  - High and volatile interest rates

3. Costs of Banking Crises

- Fiscal cost of restructuring
- Impact on lending and deposits
- Impact on economic growth

Fiscal Costs Of Selected Banking Crises. (In Percent Of GDP)

	Crisis Period	Gross Outlay	Recovery	Net Cost	Assets 1/
Chile	1981–1983	52.7	19.2	33.5	47.0
Ecuador	1998–2001	21.7	0.0	21.7	41.3
Finland	1991–1993	12.8	1.5	11.2	109.4
Indonesia	1997–	56.8	4.6	52.3	68.1
Korea	1997–	31.2	8.0	23.1	72.4
Malaysia	1997–2001	7.2	3.2	4.0	130.6
Mexico	1994–1995	...	...	19.3	40.0
Norway	1987–1989	2.5	...	...	91.9
Russia	1998	...	...	Small	24.9
Sweden	1991	4.4	4.4	0.0	102.4
Thailand	1997–	43.8	9.0	34.8	117.1
Turkey	2000–	31.8	1.3	30.5	71.0
United States	1984–1991	3.7	1.6	2.1	51.4
Venezuela	1994–1995	15.0	2.5	12.4	28.3

Methodology, sources and important country-specific information are discussed below.
"..." to indicate that data are not available.
1/ Assets of deposit money banks in the year before the first crisis year.

Why Real Impact Differs Across Countries?

- On-going debate and no clear answer

- Some suggestions:
  - Speed of addressing the crisis
  - Coherence of policy framework
  - Political unity
  - Luck

- More research is needed.

4. "Standard Model" of Crisis Management

- **Phase 1 - Containing the Crisis**
- Phase 2 - Bank Restructuring
- Phase 3 – Management of Impaired Assets

4. Phase 1: Containing the Crisis

- **Policy priority**: To stabilize the situation and restore public confidence

- Accommodate bank liquidity needs
  - Emergency liquidity assistance
  - Excess liquidity must be sterilized

- Identify and address the causes of the crisis

4. Phase 1 – Containing the Crisis

- **Measures**:
  - Protect depositors (possibly with a blanket guarantee)
  - Establish credible macroeconomic policies
  - Take measures to stop capital outflows
  - Close clearly unviable institutions
  - Announce a medium-term restructuring program
  - Be transparent in policies to regain confidence
  - If all this fails: resort to administrative measures as a *very last resort*

4. "Standard Model" of Crisis Management

- Phase 1 - Containing the Crisis
- **Phase 2 - Bank Restructuring**
- Phase 3 – Management of Impaired Assets

4. Phase 2 - Bank Restructuring

- **Policy priority: Restore viability and efficiency of the sector at minimum fiscal costs**

- Institutional and legal arrangements
  - Laws and institutions that facilitate bank intervention
  - Laws regulating asset valuation and transfer
  - Accounting and auditing rules

4. Phase 2 - Bank Restructuring

- Diagnosis of banks
  - Uniform criteria
  - Focus on medium term viability (ability to generate profits)
  - Role of special audits

4. Phase 2 - Bank Restructuring

Bank Resolution:

Viable, undercapitalized banks:

1. present time-bound restructuring plans, private recapitalization
2. Be subject to intensive reporting and monitoring

Insolvent, unviable banks:

1. Should be intervened and resolved as soon as possible
2. Should be passed to agency responsible for resolution
3. Deposits should be transferred to sound banks

4. Phase 2 - Bank Restructuring

- Use of public funds for recapitalization:
  1. May be justified under special circumstances
  1. Could be designed to encourage private sector contributions

4. “Standard Model” of Crisis Management

- Phase 1 - Containing the Crisis
- Phase 2 - Bank Restructuring
- **Phase 3 – Management of Impaired Assets**

4. Phase 3 – Management of Impaired Assets

Policy priority: Resolution of Nonperforming Loans

- Institutional framework for dealing with impaired assets
  - centralized versus decentralized
  - narrow mandate of broad mandate
  - speed versus value

4. Phase 3 - Management of Impaired Assets

		Institutional Arrangement	
		Decentralized	Centralized
MANDATE	NARROW	Private AMCs Private resolution trusts	Rapid resolution vehicles (US RTC, Thai FRA)
	BROAD	Bank workout units Private resolution trusts	Broad mandate CAMCs (Danaharta, KAMCO, Securum)

4. Phase 3 – Management of Impaired Assets

- Linkages to corporate restructuring
  - Importance neglected
  - Two sides of the same coin
  - Highly complex operation
  - In parallel as much as possible

4. Post-crisis Management

- Exit from blanket guarantee, or
- Exit from administrative measures
- Exit from government ownership
- Continue corporate restructuring to avoid “second-wave crisis”

5. Complicating Factors for Standard Model

- Debt Sustainability and Bank Resolution
- Dollarization
- Safety Net/Depositor Protection
- Issue of Political Support

5. a. Debt Sustainability and Bank Resolution

Debt sustainability issues may constrain restructuring options.

- High debt levels and high resolution costs can force policy tradeoffs
  - Less depositor protection
  - Less capacity to restructure banks
  - Shift of burden sharing from government to shareholders and creditors
  - Lower post crisis financial intermediation
- The policy challenge is identifying measures to improve debt sustainability while reducing resolution costs to a minimum.

5.a. Debt Sustainability and Bank Resolution

Debt sustainability depends on inflation, growth and the budget deficit:

Change in *d* = (primary deficit/GDP) – (seigniorage/GDP) + *d* (real interest rate – growth rate)

- Debt declines with high growth, low inflation, and low deficits
- Debt increases with large deficits and high real interest rates

5. b. Dollarization

Dollarization-use of another country's currency–poses special problems

1. Makes it difficult to stop disintermediation once runs occur
2. Makes it difficult to recognize the size of the problem
3. Imposes severe constraints on the availability of policy tools

5.b. Dollarization

1. **Traditional tools are limited or must be ruled out:**
   - There is no unlimited lender of last resort in foreign currency
   - A blanket guarantee may not be credible

2. **Administrative limits may be needed:**
   - Securitization of deposits
   - Extension of deposit maturities
   - Other restrictions on deposit withdrawals

5.b. Dollarization

1. **The framework for crisis prevention and management needs to be adapted :**

   - Added safeguards in terms of bank liquidity, soundness
   - Higher levels of international reserves
   - Continual monitoring of macro and micro conditions
   - Emphasis on prevention actions

5. c. Safety Net/Depositor Protection

- A blanket guarantee can stabilize depositor expectations
- But if a large portion of the system is insolvent:
    - bank resolution costs rise, and
    - public debt dynamics may become unsustainable.

5.c. Safety Net/Depositor Protection

- What options?
  - Depositor confidence is essential in managing systemic crises
  - Ensure bank restructuring combines with sustainable fiscal policies
  - Ensure only eligible depositors are protected (excluding shareholders, offshore deposits)
  - Remove insolvent banks before introduction of a protection program

5.c. Issue of Political Support

Political support is needed:

- To break vested interests
- To bear the fiscal burden
- To shepherd the restructuring program through the legislative process
- To maintain confidence
- To keep the process transparent
- To ensure close international coordination and communication

Issue of Political Support

- Preventive measures
  - (an adequate legal framework that mitigates the areas of disagreement and
  - Agreement in advance on how burden sharing.

- Public "disclosure" of a comprehensive reform program.
- Move as fast as you can
- Immediate and very visible successes
- A realistic assessment about what is possible

6. Conclusions and Lessons

- Supportive legal and institutional framework should be in place before crisis hits
- Make sure official safety nets are well designed (LOLR, Deposit Insurance, Blanket Guarantee)
- Aim for quick resolution, when momentum is there
- Transparency in government actions is essential
- Pay attention to corporate restructuring
- Last but not least: Need for political leadership and coordination

6. Conclusions and Lessons

A Word of Caution

No "right" model of crisis management

This presentation has sought to identify principles, not steps.