Managing Systemic Banking Crises

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Introduction

Systemic banking crises of unprecedented scale:

Argentina, East Asia, Ecuador, Mexico, Turkey and Venezuela

- These crises were due to a mixture of macroeconomic and microeconomic factors

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


BANCO DE LA REPUBLICA
ORIENTAL DEL URUGUAY
(FOTO AP)

AP

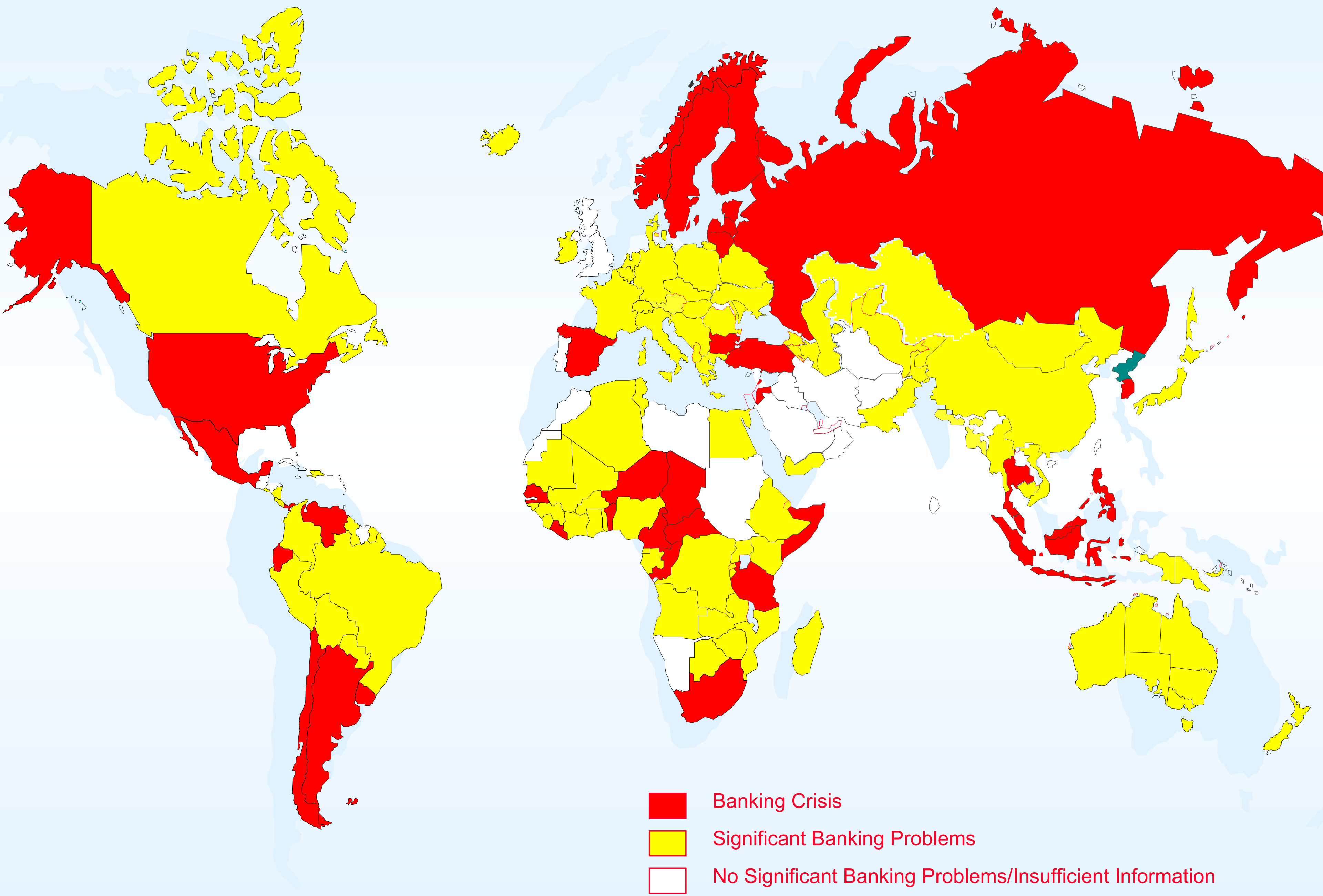
Outline of Lecture

- What are systemic banking crises?
- Origins of a crisis
- Costs of banking crises
- Standard model of crisis management
- Complicating factors for the standard model
- Conclusions and lessons

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

Banking Problems Worldwide 1980-2003



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

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

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

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)

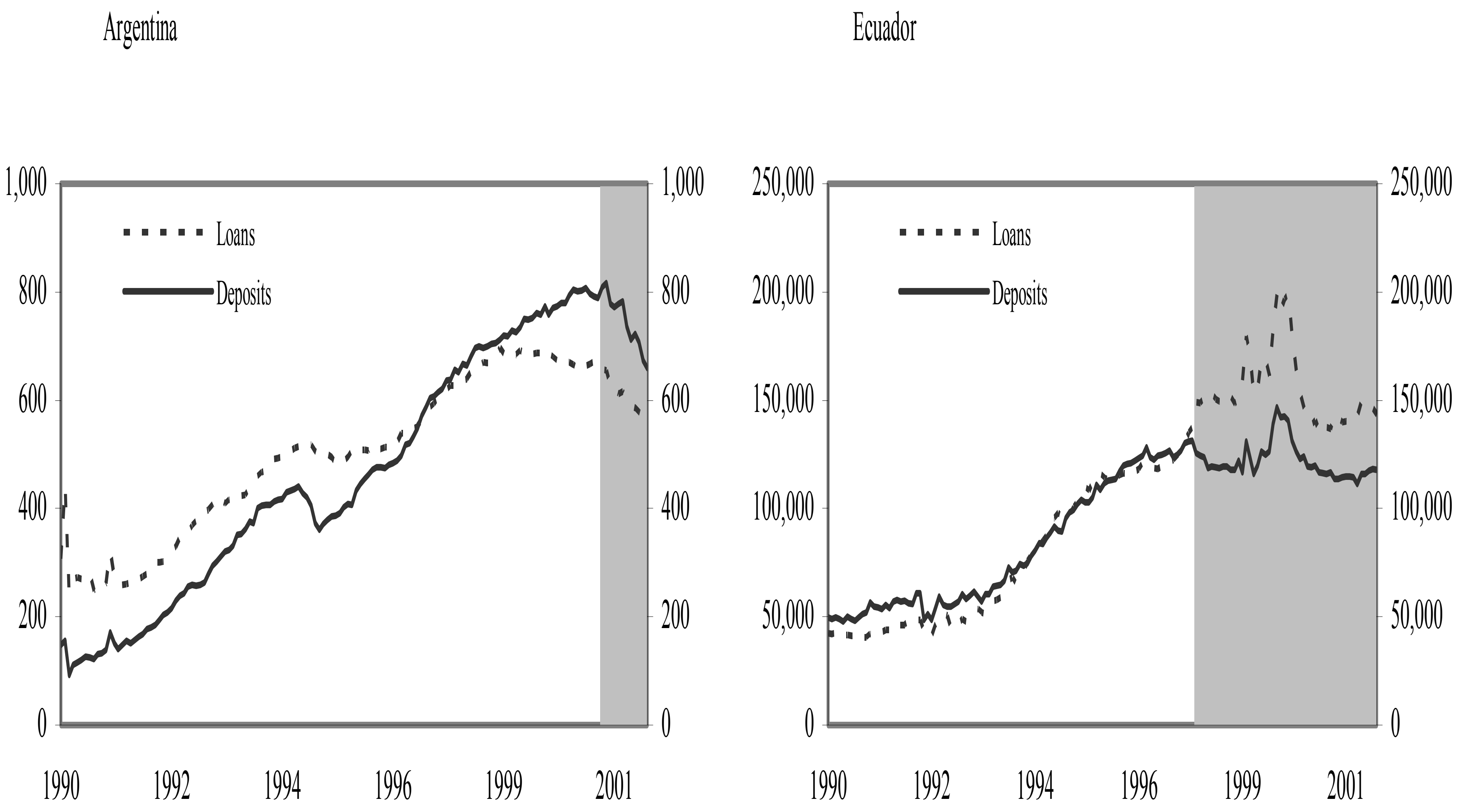
	Crisis Period	Gross Outlay	Recovery	Net Cost	Assets 1/
Chile	1981-83	52.7	19.2	33.5	47.0
Ecuador	1998-2001	21.7	0.0	21.7	41.3
Indonesia	1997-present	56.8	4.6	52.3	68.1
Korea	1997-2000	31.2	8.0	23.1	72.4
Malaysia	1997-2000	7.2	3.2	4.0	130.6
Sweden	1991-93	4.4	4.4	0.0	102.4
Thailand	1997-2000	43.8	9.0	34.8	117.1
Turkey	2000-present	29.7	1.3	30.5	71.0

Source: IMF.

Notes:

1/ Assets of deposit money banks in the eyar before the first crisis year.

Impact on Deposits and Loans
(In real terms and billions of local currency)



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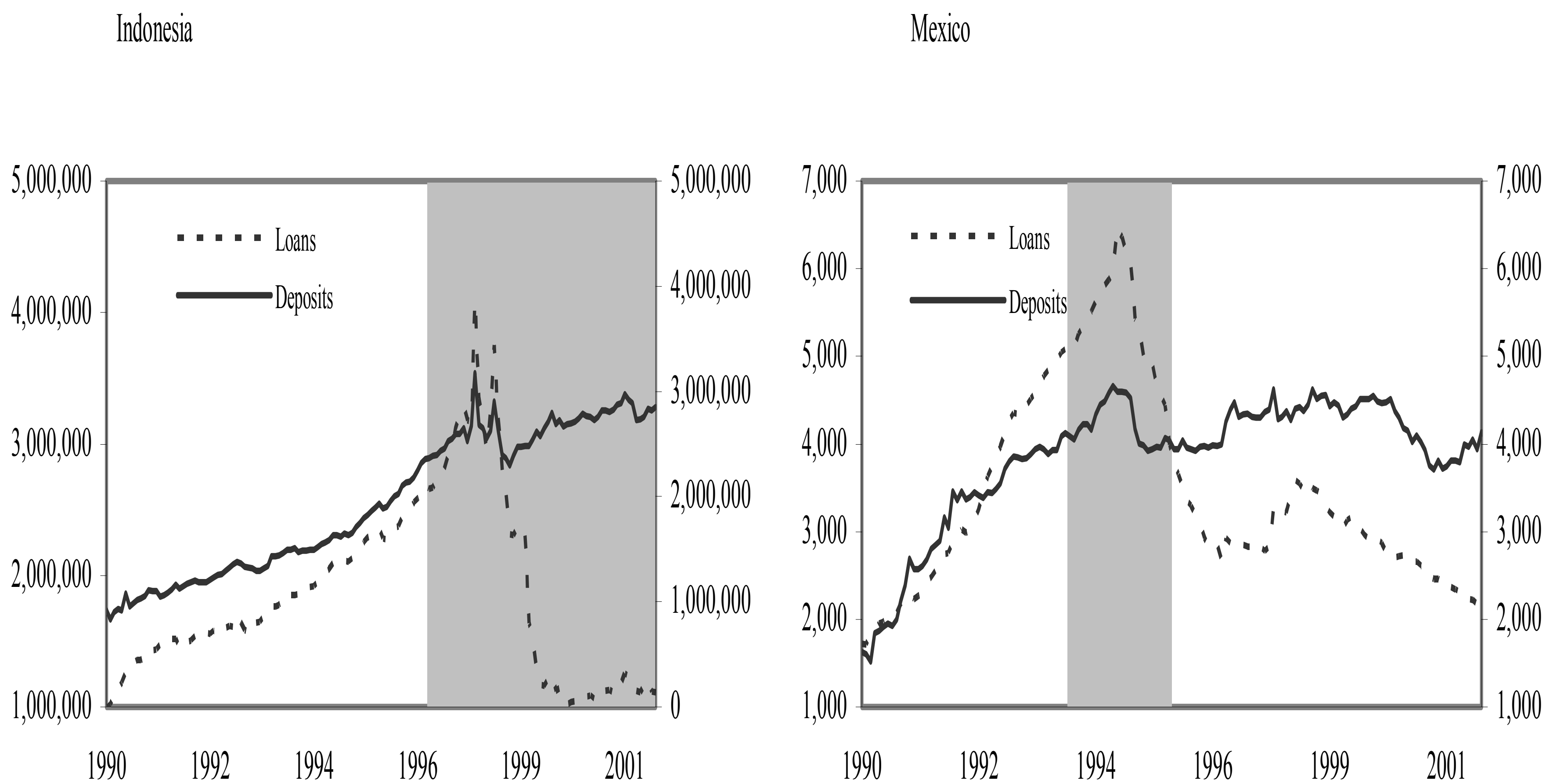

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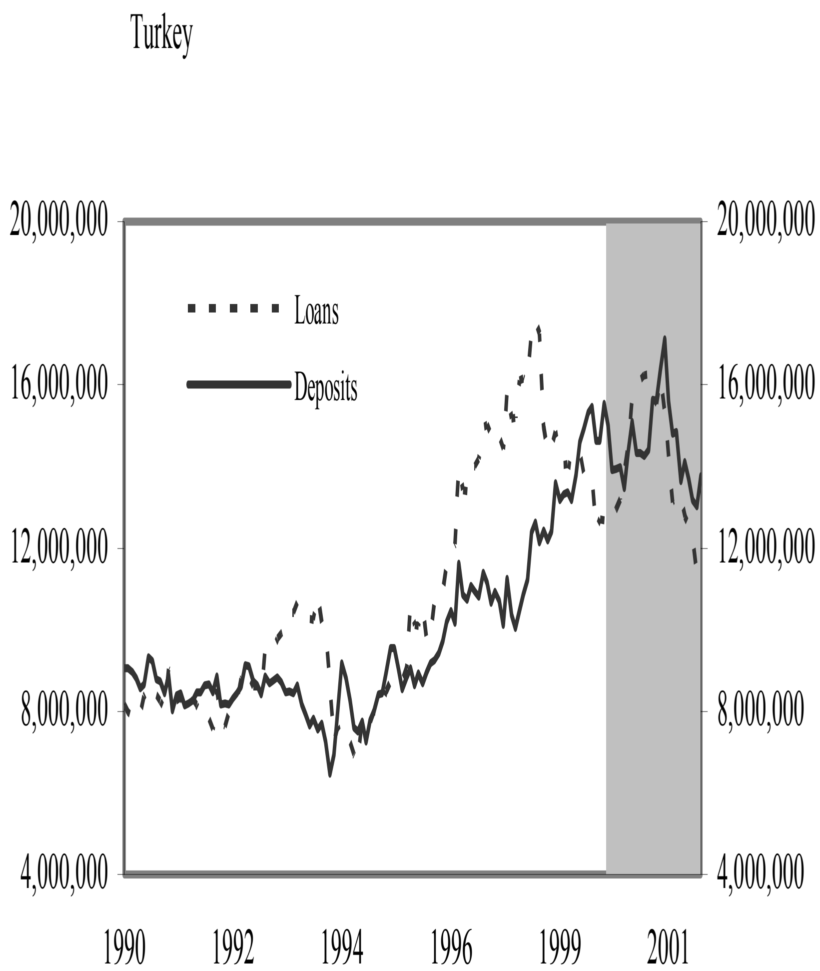
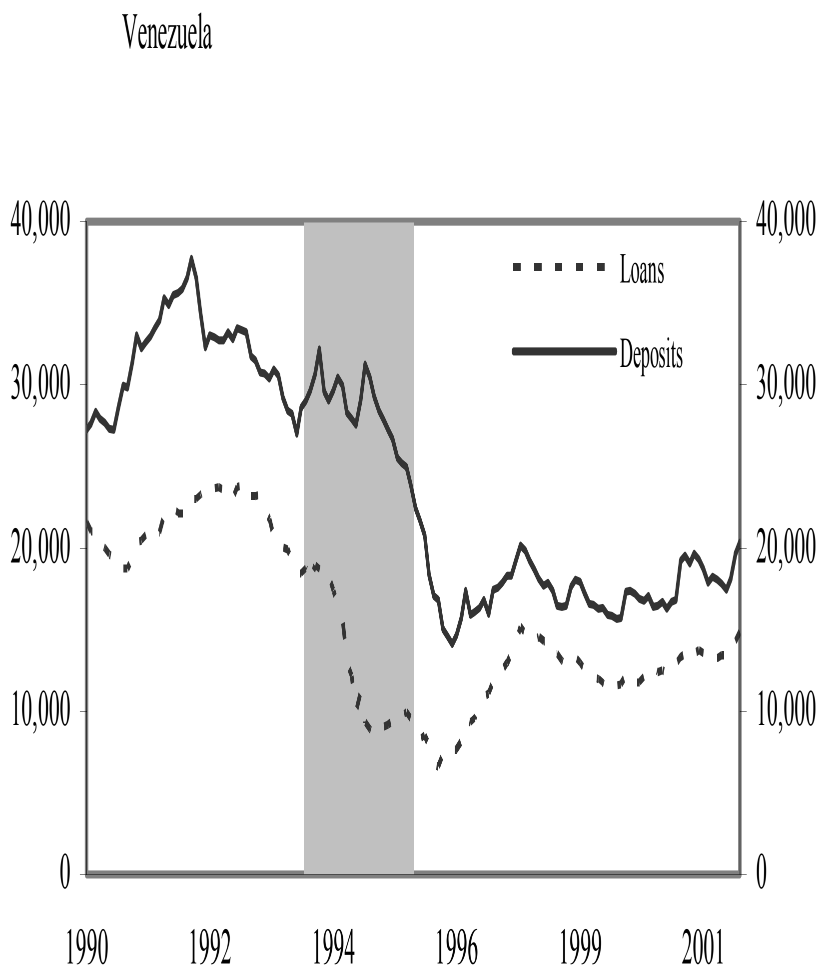
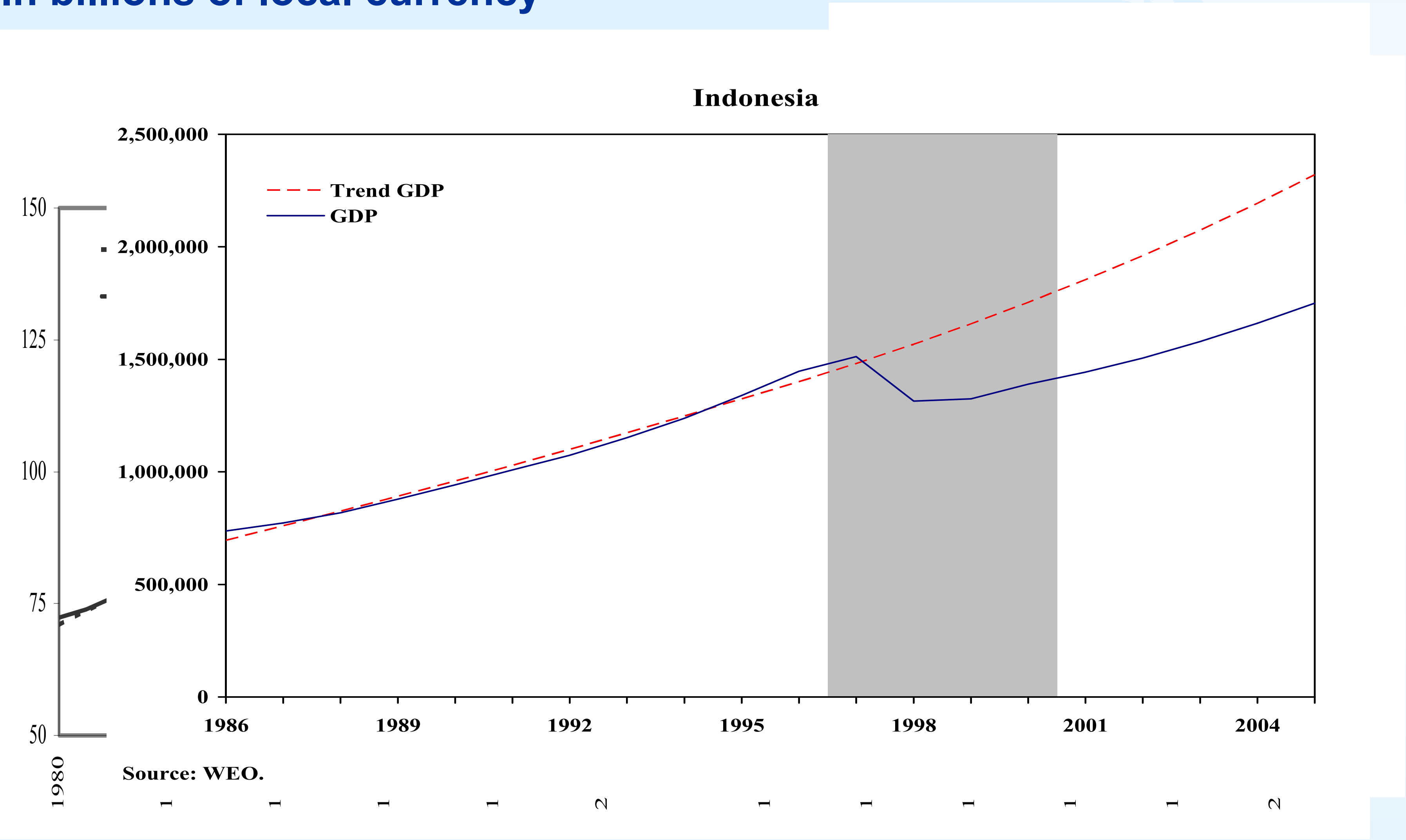


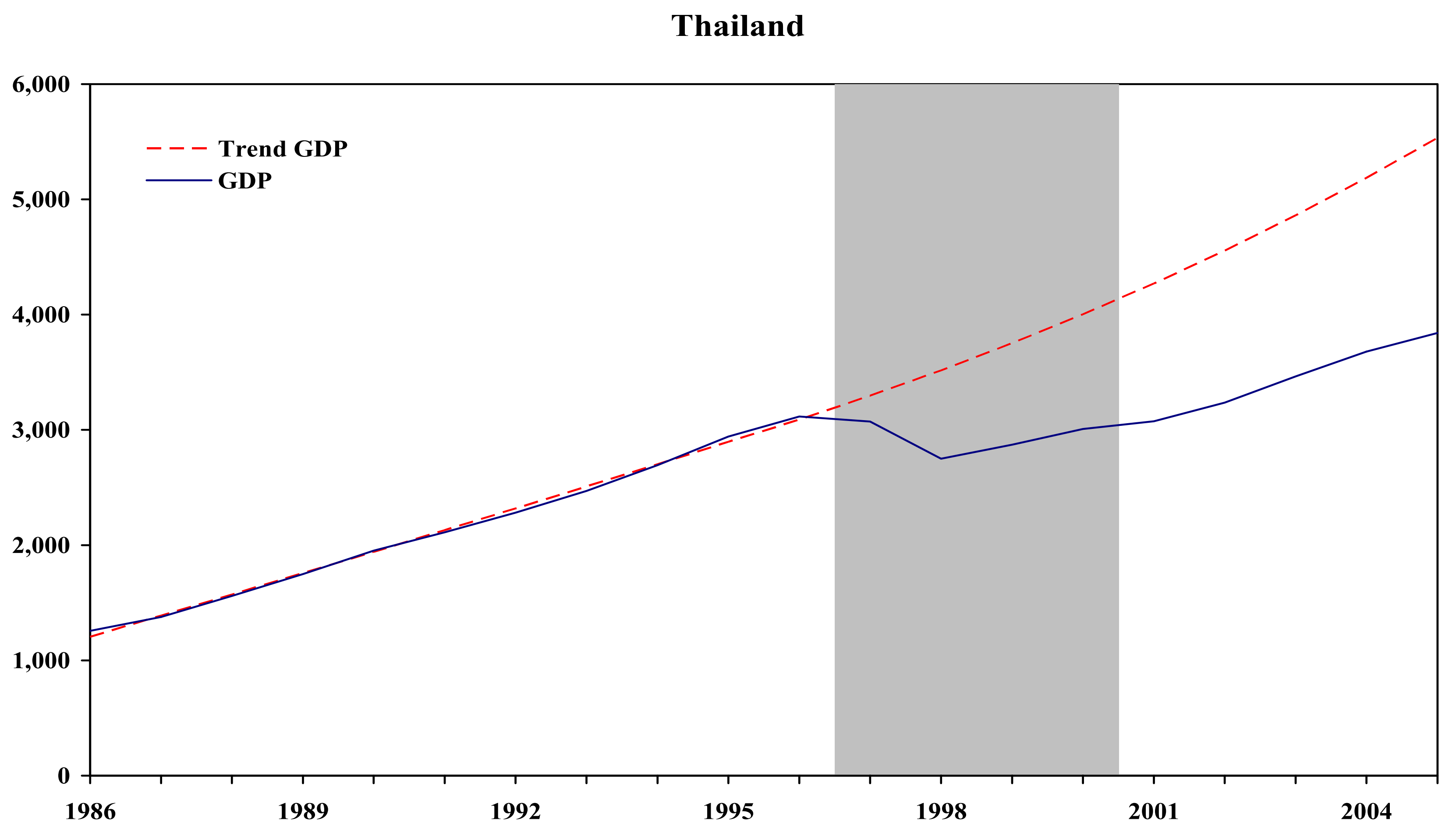


Impact on Real Growth

In billions of local currency

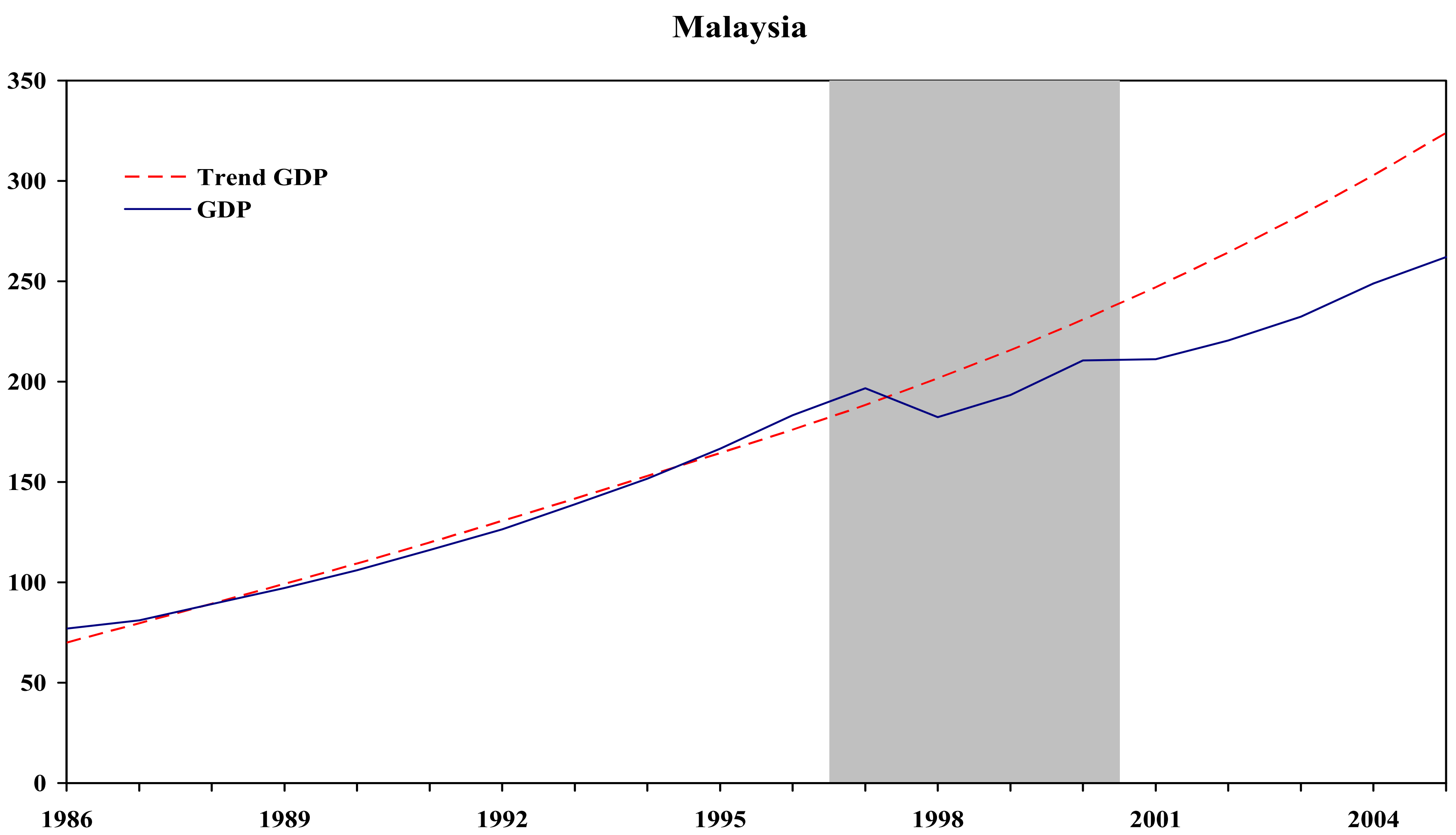


Impact on Real Growth



Source: WEO.

Impact on Real Growth



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Impact on Real Growth

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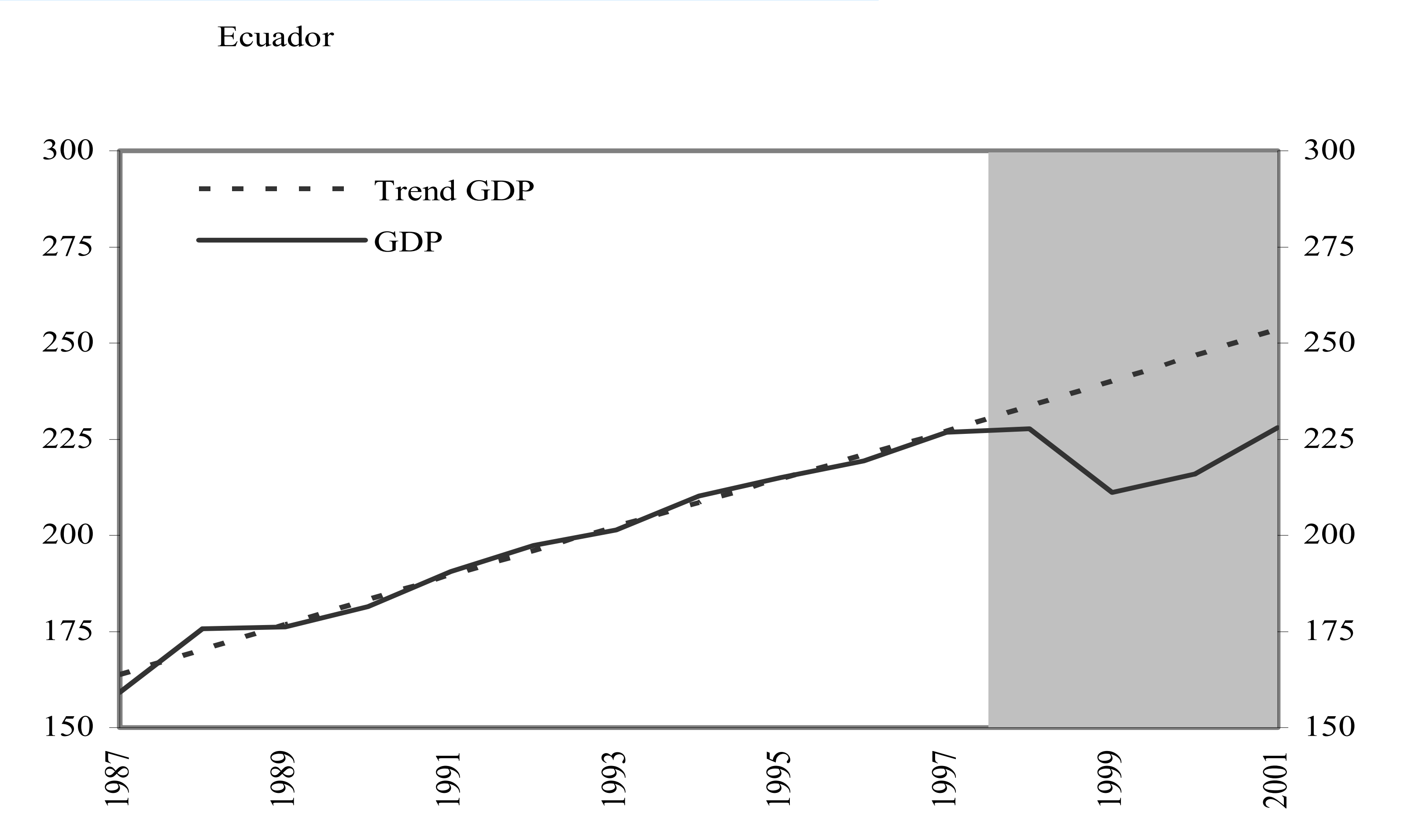


“Standard Model” of Crisis Management

Phase 1 - Containing the Crisis

Phase 2 - Bank Restructuring

Phase 3 – Management of Impaired Assets

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

Phase 1 – Containing the Crisis

Measures:

- Protect depositors (possibly with a blanket guarante
- 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*

“Standard Model” of Crisis Management

Phase 1 - Containing the Crisis

Phase 2 - Bank Restructuring

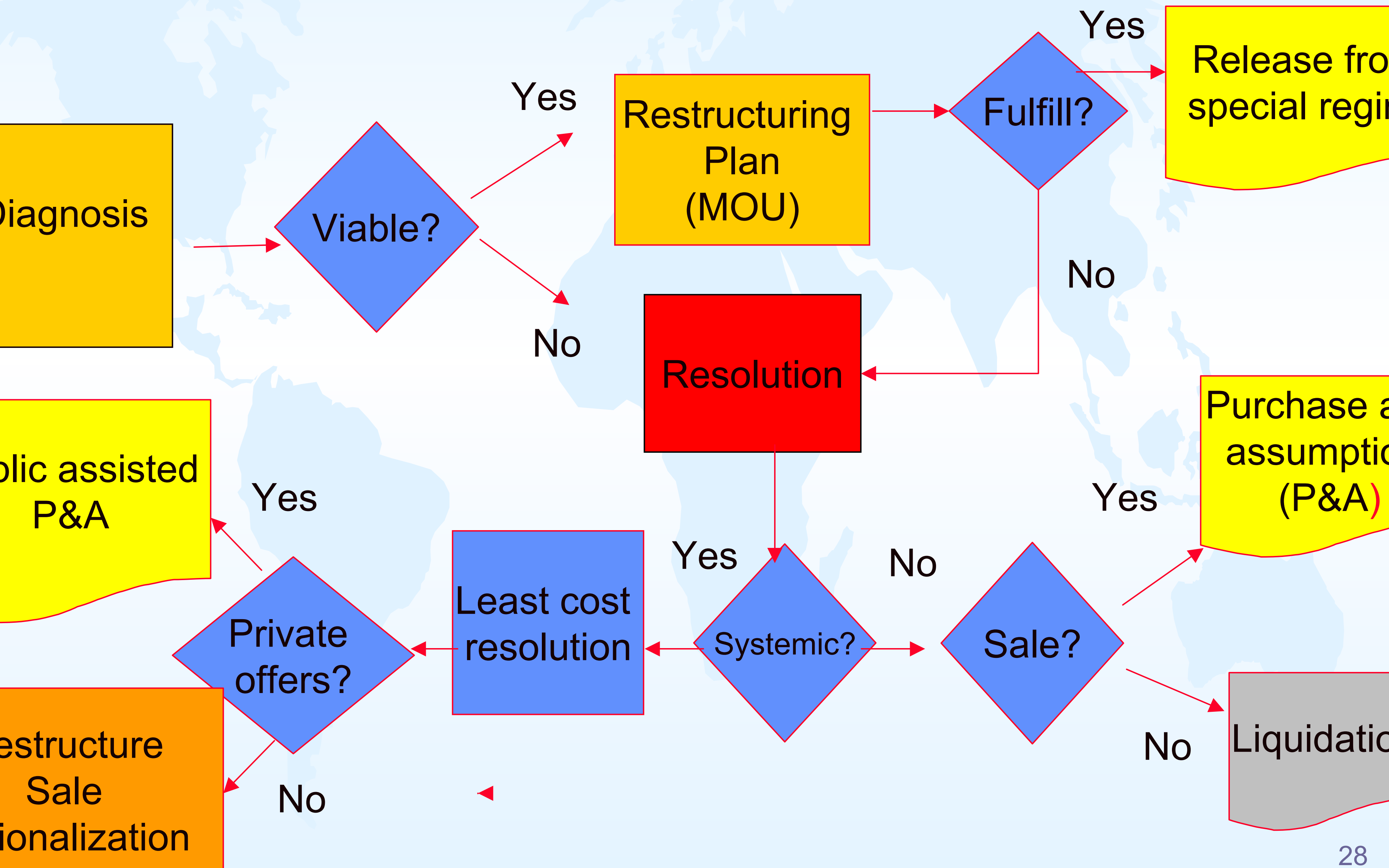
Phase 3 – Management of Impaired Assets

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 interventio
  - Laws regulating asset valuation and transfer
  - Accounting and auditing rules

Bank Resolution



Phase 2 - Bank Restructuring

Diagnosis of banks

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

Phase 2 - Bank Restructuring

Bank Resolution:

Viable, undercapitalized banks:

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

Insolvent, unviable banks:

- Should be intervened and resolved as soon as possible
- Should be passed to agency responsible for resolution
- Deposits should be transferred to sound banks

Phase 2 - Bank Restructuring

Use of public funds for recapitalization:

- May be justified under special circumstances
- Could be designed to encourage private sector contributions

“Standard Model” of Crisis Management

Phase 1 - Containing the Crisis

Phase 2 - Bank Restructuring

Phase 3 – Management of Impaired Assets

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

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)

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

Phase 3 – Management of Impaired Assets

NPLs in Asia, End –2001
In billions of USD

Country	USD Billion	% of Total Net Loans
China	345	25
Japan	346	9
S. Korea	8	4
Indonesia	4	12
Malaysia	14	11
Philippines	6	17
Thailand	9	11

Source: McKinsey & Company's Asia Financial Institutions and Corporate Finance & Strategy practices (2003), Banking in Asia Acquiring a Profit Mindset (2nd Edition).

Post-Crisis Management

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

Complicating Factors for Standard Model

Debt Sustainability and Bank Resolution

Dollarization

Safety Net/Depositor Protection

Issue of Political Support

Debt Sustainability and Bank Resolution

Debt sustainability may limit 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

Debt Sustainability and Bank Resolution

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

$$\text{Change in } d = (\text{primary deficit/GDP}) - (\text{seigniorage/GDP}) + d\,(\text{real interest rate} - \text{growth rate})$$

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

Dollarization

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

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

Dollarization

- **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

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

Dollarization

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

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.

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

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

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

Conclusions and Lessons

A Word of Caution

No “right” model of crisis management

Principles, not steps.