Foreword

The 2010 Banking Law Symposium on Managing Systemic Risk

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The symposium covered a great deal of ground. Given the severity of the recent crisis and the need for a massive response, there will continue to be debate for some time. Many of the issues raised are fundamental and still controversial. One can divide the discussion into a number of broad topics. Some of them – such as the future of bank regulation – aim at limiting the occurrence of systemic crisis in the future as well as its consequences; others – for instance the explosion in the size of central bank balance sheets – are amongst the by-products of the handling of crisis, and may or may not have consequences that would need to be addressed later.

The macroeconomic aspects are the most visible and immediate sign of the global banking crisis, with the world having fallen into the deepest recession since the 1930s, and still struggling to recover. The long period of uninterrupted growth backed by the ‘great moderation’ came to an abrupt end in 2008. Massive Keynesian-type fiscal expansion was carried out in response pretty much everywhere, to avoid a recession that would lead to something even worse. In some places, such as the US, the stimulus was illuminated with high media visibility; in others, such as China, the stimulus was introduced relatively quietly. The public emphasis was on ‘shovel ready’ projects, rather than well-planned overall programmes. Whilst the stimuli were introduced pretty much by consensus at the time, now there is much less certainty as to what needs to be done – and indeed even whether those who pushed the stimulus were right to do so. Should the stimulus be reined in now, or would that jeopardize the still anaemic growth? Perhaps this is one of many areas where one size might not fit all, and policies that are appropriate in one place may not be appropriate universally.

While demand-enhancing stimulus was an initial response to the global crisis, as one goes forward and policymakers consider how to encourage sustainable medium-term growth, there is a particular focus on structural factors. Amongst these are some quite fundamental issues concerning
the optimal size of the banking sector. Those suggestions lead to widely diverging policy recommendations, for instance as regards increasing taxes on the banking sector. On the one side, there are concerns that if taxes are imposed this may reduce the sector’s willingness or ability to lend, and hence its potential to revive economic growth. In much of the world credit growth is weak, despite direct fiscal support into the banking sector, and further taxes on the banking sector might be considered likely to cripple it further, hence also jeopardizing economic growth. On the other side, however, are those who argue that the various ‘bail-out’ facilities, whether fiscal, monetary, or structural such as the provision of guarantees, are at present not fully financed by the banking sector. They represent a subsidy to the sector, which therefore is larger than would be optimal from a social cost–benefit point of view. If this subsidy were countered by taxes, it would at least partially address the negative externalities of systemic risk.

When considering the handling of the banking sector, it has been recognized that policymakers in the past have been defective in defining what precisely the banking sector is. Beyond the core issue of deposit taking there is a spectrum of financial activities and institutions (e.g. shadow banking systems; investment banks; insurance companies) that in many ways raise similar issues of safety and soundness, but that traditionally have been more or less excluded from the perimeter of prudential regulation. For instance, there was pervasive ‘shadow banking’ hiding the true leverage of banks; there were financial institutions such as AIG taking large amounts of credit risk from the banking sector via guarantees and contingent contracts so that its problems were considered systemic. And, if these institutions are so interconnected with the deposit-accepting banks that it is not possible to separate their handling from that of the banking sector, should one instead create narrow banks – or rigid firewalls within banks – so that what is within the narrow bank or the firewall cannot be contaminated by high risk-taking financial activities? But would narrow banking make the cost of credit too high? Would it lead to risk again moving beyond the regulatory perimeter, potentially resulting in further threats to financial stability?

As well as questions regarding the perimeter of the banking sector, there are issues concerning the optimal size of the banks. At the outset of the crisis, the authorities in several countries – in particular the US and the UK – pressed what appeared to be strong banks, such as Bank of America and Lloyds TSB, to take over weaker banks. This has been in other countries a fairly standard supervisory response to banking problems that are thought to be not systemic. In some cases the authorities offer protection to the ‘white knight’ bank, for instance limiting its liability in the event the loan book it is acquiring turns out to be worse than anticipated. In the
great recession of the global financial crisis, however, it quickly became apparent that the ‘white knight’ banks were themselves under water, if not originally then certainly very shortly afterwards. Bank of America acquired Wachovia with the support of the regulators, but soon required government infusions. In the UK, Lloyds TSB was encouraged by the regulators to take Halifax Bank of Scotland, but almost immediately thereafter was seen to be deeply distressed and still remains with substantial government equity.

The rationale for pushing a takeover of a weaker bank by a stronger one is in principle clear: the performing assets and liabilities of the weaker bank remain within the banking sector, and will be managed by a stronger institution within the sector – this should limit the public costs compared to the takeover of the entire weaker bank by the public sector, even if the public sector has to financially help the acquiring bank, in one form or another, in order to persuade it to undertake the takeover. On the other hand, even in the best of conditions, mergers between – or takeovers of – financial institutions may not turn out well; when the merger or takeover is being undertaken at speed in conditions of turmoil, prospects of success are potentially going to be dim. There will be second-guessing of any takeover decision if it starts to go badly, and questioning of who knew what when and what did they do about it. Bank of America executives are being questioned closely by shareholders about the details of their takeover of Merrill Lynch. On the other side, if, notwithstanding these initial challenges, the takeover nevertheless works out well for the acquiring bank, this causes its own difficulties. A banking system that has gone through a process of strong banks taking over weak banks with official support will be a more concentrated system, with all the attendant issues: such a system may be subject to oligopolistic power, with resulting costs to the consumers; and if banks in such a system run into difficulties, there is greater likelihood that such banks would be ‘too-big-to-fail’. Even worse, particularly for a small country, if such a process has gone on far enough, individual institutions might become ‘too-big-to-save’, with potentially catastrophic implications for the country as a whole, and potentially for the global financial system. An alternative model, practised in Sweden and to some extent in Asia in the 1990s, involved the state taking over the weak institutions for a while, restructuring them under government auspices, generally through having such banks unload their bad assets into a dedicated asset-resolution agency, and ultimately selling the cleansed institution back to the private sector – in many cases much smaller than they were at the time that they went into crisis. There were few proponents of such an approach during the present crisis, perhaps because finance is now much more complicated, and it is not clear where governments might
find the substitute managements that could fully understand the business and turn it around, and because at this point there were too many institutions for the governments to swallow. Also, while the active breaking-up of large banks was discussed at the outset of the crisis from the financial stability perspective, this debate now seems, particularly in the European Union, to be in the hands of the competition authorities.

With the wide variety of orthodox and heterodox measures that have been employed, often in haste, to stimulate the economy and protect weak financial institutions, there is naturally a focus on countries’ fiscal position. In virtually all countries, there has been a major deterioration in the fiscal stance. In the European Union, for instance, only five of the 27 member countries are now not subject to the excessive deficit procedure: within the euro area, only Finland and Luxembourg are not in breach. Beyond the headline fiscal position, however, there is uncertainty as to what the fiscal position actually is. Guarantees, for instance, have been widely used in the crisis; the potential liability that arises is not included in headline fiscal measures. Also, institutions outside the central government have been brought in to help effect the stimulus – most particularly the central banks. Central bank balance sheets have expanded multiplicatively, and in some cases central banks have intervened directly to support institutions. Central banks have also compromised their earlier standards on the quality of the assets that they have assumed. In the event that those assets lose value or fail to perform, the central bank – or other agency – will itself make losses of a fiscal nature. Quasi-fiscal activities may be less immediately apparent on the fiscal balance sheets, but of themselves create contingent fiscal liabilities that may ultimately lead to pressures to recapitalize one or more troubled central banks at a time when governments are already under fiscal pressure. Early recognition of such liabilities is important for appropriate policy formulation. Late recognition may cause a loss of credibility in the government more generally, particularly if the overall economic and financial situation still remains fragile.

Moral hazard will be a pervasive and long lasting result of the measures introduced in the face of the global financial crisis. Banking sector activity is determined by the balance between risks and rewards. If risks are not fully assessed, activity may be reckless. If risks are essentially removed, absent anything else, reckless behaviour seems assured. The blanket guarantees on deposits, and the reductions on interest rates and provision of quantitative easing, together with forbearance and the provision of capital without the state taking full equity control, have served to reduce the role of risk in mitigating reckless behaviour. Moreover, even if some of these measures are quickly reversed – for instance, the blanket guarantee has a notional time limit or a quantitative limit, and some banks
have already paid, or are in the process of paying, back the direct public
capital infusions – it is not credible that for the foreseeable future ‘next
time’ governments and central banks will not provide the same protec-
tion. Traditionally moral hazard is addressed by distinguishing between
saving an institution and saving those responsible. The institution may at
least partially survive, but managers will quickly be replaced; sharehold-
ers and unsecured creditors will be wiped out, or at any rate have their
stakes substantially reduced; and any malfeasance will be investigated and
prosecuted; meanwhile, regulatory reform serves to avoid a recurrence
of such behaviour in the future. Views differ as to the extent to which
measures taken so far will serve to mitigate moral hazard, and indeed even
how serious the moral hazard problem is. Regulatory reform is coming,
although it is not clear at this stage how extensive it will be. In most
of the financial institutions requiring the largest infusions, sharehold-
ers – although not wiped out – have lost substantial amounts of equity
value; in many institutions management has been largely replaced, but
unsecured creditors have been bailed out for the most part. In the US and
elsewhere, banks had to undergo stress tests to establish whether they were
adequately capitalized; and where they were not would have had to take
action to replenish their capital. On the other hand, however, low inter-
rest rates and quantitative easing have enabled many of these institutions
rapidly to make a come-back, showing high profitability while the overall
economy stays weak; and key staff are again being paid large bonuses to
avert their departures. Oxford students are being enticed once again with
huge salary offers, implying that banks’ behaviour may not have changed
from before, or indeed may even be considered to have been validated.
Moral hazard undermines the core principles of the market economy;
addressing the present enhanced level of moral hazard is likely to be criti-
cal for the sustainability of the post-crisis economy. An exit strategy from
the moral hazard conjuncture should be a priority.

Much has been made, in this symposium and more widely, of the role
of institutions. Much has been made of the contrast between Canada
and other industrial countries. Canada has one institution per function:
a central bank; a banking supervisor; a financial consumer protection
agency; and a deposit insurer. It also has separate provincial securities
supervisors. Other countries have functions combined within institutions,
hence arguably causing confusion about objectives and reducing the overall
quality of decision-making and economic and financial management. On
the other hand, separation of institutions by function does not necessarily
mean that the resultant structure will be successful. The Bank of England,
for example, progressively lost its various functions and objectives over
the past 15 years, so that it finally focused solely on operating monetary
policy, while prudential regulation and supervision as well as debt management were taken away. Overall, it is not clear that the Financial Services Authority (FSA) managed oversight of the banking sector better than an unreformed Bank of England might have done. In short, the quality of institutions clearly matters, but it is not obvious that one system of institutions is necessarily better than another: any particular one might work well, but any might mess up. Moreover, the process of changing a country’s system of institutions is itself disruptive and may cause additional problems, particularly during the transition. In any case, even if there is one institution per function, if they coordinate properly, as soon as they take into account the perspectives of their partner institutions in such coordination, they will themselves be facing more than one objective.

Amongst the various institutions there is at present a close focus on the role of the regulators. There are serious concerns that the crisis was caused in part by industry capture – for example, that the regulators fell too far under the spell of the institutions that they were meant to regulate. Such behaviour could be ascribed to the pervasive culture that the most successful bankers were ‘masters of the universe’, responsible for economic growth and innovation in a rapidly-changing economy, and not to be easily challenged by ponderous bureaucrats. Neither at the most senior level amongst the regulators nor amongst the common foot soldiers would there be much incentive to try to pull away the punch bowl as the party gets into full swing, and although there were a number of whistle blowers they could not make themselves heard. No doubt to some extent the aura of bankers’ invincibility is gone, and regulators will be more confident in standing in the way of a banker’s deviant behaviour. On the other hand, with economies very fragile and strong official pressure on banks to lend more on the back of official guarantees, regulators may be conflicted in taking strong positions against the banks. In order to encourage them, there are some ideas on how to stimulate increased accountability amongst the regulators, for instance public disclosure in close to real time on their interactions with the banks. Beyond this, there is recognition that there might be an underlying flaw in having regulators focus solely on risks in individual banks. As the recent crisis has shown, risks may rather be systemic and result from contagion across interconnected institutions. Prudential supervision of individual institutions is being complemented by systemic or macro-prudential supervision, which might not be hosted by the same set of regulators or indeed even the same regulatory institutions.

There was little agreement at the symposium on the relative merits of determinism or flexibility in addressing the crisis. Prompt corrective action was intended to be the deterministic policy response to the handling of the US savings and loans collapse in the 1980s, when it was perceived that the
ultimate costs of the collapse were much higher than if the regulators had intervened more quickly. In the present crisis, however, in spite of the large social cost, supervisors, particularly in Europe, still resist the adoption of prompt corrective action and early intervention. Moreover, the high integration of financial markets demands early recognition of financial problems and increasing coordination to avoid contagion, both in normal times and in crisis situations. Thus even more than in earlier crises, the pre-setting of deterministic rules could be argued to be critical to reduce overall costs. On the other hand, the present crisis is different from all those before, so rules based on ‘fighting the last war’ may not be helpful.

While managing the crisis in a single country would be complicated enough, the situation becomes even more difficult given the international character of large cross-border banks and the many sovereign interactions. Many of the main institutions involved are active in many countries; indeed, some institutions no longer have a clear national parentage. There are important asymmetries in the importance of some of these institutions across the countries in which they operate. While an institution may be barely systemic in its home country, it may have a dominant presence in countries where it operates. In a crisis situation the institution may show home country preference, withdrawing disproportionately from the ‘peripheral’ countries of its activities. At the outset, there were no clear rules as to how such situations should be resolved, although considerable work has been undertaken, both at the Bank for International Settlements and in the European institutions, to have a framework under which countries can cooperate. Nevertheless, there remains severe discomfort. The UK and the Netherlands used an array of weapons to seek that their nationals were compensated for the collapse of an Icelandic bank in which they had deposits. Going forward, nobody is suggesting that citizens should not be permitted to deposit in an overseas bank; but there is plenty of ongoing work to ensure that in future it will be clear what are the respective responsibilities if another international bank failure causes problems in countries outside its home base. The complexity of the large cross-border banks makes their reorganization and winding-up so complex that it is an invitation for governments to rescue banks. In the absence of an international bank resolution authority and international harmonization of bank reorganization and winding-up procedures, ‘living wills’ are contingency plans under which banks specify in advance how they are to be treated if they approach failure – hence seeking advance preparation for resolution even before the background to the resolution is known. Having such a framework in place in advance may well be a useful protection against confusion and knee-jerk reactions in the event of a crisis. But one cannot foresee all states of the world, and however precisely
a ‘living will’ may have set out a course to be followed, there presumably still needs to be some flexibility in how it will be applied in reality – and its success in terms of limiting the cost of resolving failed banks is very much dependent on the national institutional frameworks for supervision and the resolution of failed banks.

In this environment international coordination and the role of international institutions comes to the fore. Hong Kong, Malaysia and Singapore are reportedly coordinating over their plans to exit from their crisis measures. This no doubt is helpful. But an interesting question then arises as to where are the limits of coordination. For instance, could the rest of ASEAN be included in this coordination framework? Probably every country wants to be the last member into a coordination club – happy to get the benefits from association with a ‘stronger’ country, but they may be reluctant to share with one that is perceived to be ‘weaker’. Beyond these informal groupings there are the established international financial institutions such as the International Monetary Fund (IMF) and the collectives of subsets of the Fund’s membership. The present crisis has led to some creativity as regards these. The former Financial Stability Forum, established after an earlier crisis, has morphed into the Financial Stability Board, with an enhanced mandate, while the G-20 seems to have become a key strategy-defining body. Meanwhile, the IMF focuses also on its own internal governance in order to address issues of legitimacy as it comes to the centre in handling the present crisis.

So, is the global financial crisis over? Views differ, and the issue can only be resolved ex post. Certainly the momentum for significant reform seems to have diminished, at least for the moment, perhaps because the focus shifts towards the need for fiscal retrenchment. Most likely the answer depends on the answers to the questions being addressed earlier, in particular that of macroeconomic prospects. If growth does not falter, the worst may well be behind us, and the momentum for serious reform may flag, although the possible emergence of new sovereign problems suggests caution as regards any early declaration of victory.

The symposium looked also briefly at possible overarching solutions to problems of over-indebtedness and macroeconomic imbalances. Clearly the IMF has a revived role, but there was also interest in private solutions that have been put forward, such as bond contracts. More fundamental would be asset sales. When lending to the UK in 1976, the IMF required that the UK begin to sell off then-state owned British Petroleum (BP). Much earlier, Charles II had progressively sold off the territories he had acquired as a dowry when he married Catherine of Braganza: so England lost Tangier and Dunkirk. In the Latin American banking crisis of the 1980s, the wags said that Brazil should ‘sell off the Matto Grosso’ to pay
its debts; similar types in Germany are saying that Greece should sell some of its islands. This of course will not happen – but it indicates the desperation of creditors in dealing with a country that might be close to insolvency.

Next time there is a global financial crisis, its handling will have to be different. Unless the authorities show particular imagination, or demonstrate greater up-front accountability, there are likely to be fewer instruments available. The public will be less trusting of a US Treasury Secretary announcing that he needs USD700 billion or else the economy will collapse. And, in the next few years at least, there will be far less fiscal space available for governments to try to spend their way out of trouble.

Finally, what is the conclusion? Overall, one can be cautiously optimistic. Countries are likely to be able to muddle through, or to be able to receive help if they cannot. Some things were learned from the last crisis which prevented this crisis becoming even more serious; more will be learned this time. Recovery and resolution funds, greater powers for regulators, heightened transparency and accountability, and much better coordination are all ideas that are being further developed, and all are likely to have a role to play in safeguarding the exit from the present crisis and reducing the risk of a crisis in the future.

NOTE

1. The views expressed are those of the author and should not be attributed to the International Monetary Fund, its Executive Board, or its Management. I am grateful for comments from Gillian Garcia and María Nieto.