

*Comment on*  
*Resolving Systemic Crises:  
Policies & Institutions*  
by  
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and Luc Laeven**

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**World Bank**

**Washington, D.C.**

# Definition & scope

- ✓ Large scale banking & corporate distress within a short period
  - Defaults
  - Rising NPLs decapitalize banking system
  - Collapse of asset prices
  - Capital outflows
- ✓ Policy phases
  1. Containment
  2. Financial and operational restructuring
  3. Structural reform

# Weak institutions

- ✓ Poorly defined creditor & shareholder rights
- ✓ Deficient bankruptcy laws and procedures
- ✓ Inefficient judiciary system
- ✓ Weak disclosure and accounting rules
- ✓ Massive conflicts of interest
- ✓ Poorly trained and badly compensated regulators
- ✓ Corruption

# Policy Objectives Once Crisis Has Begun

1. Restore confidence in the financial system
2. Minimize loss of output
3. Hasten economic recovery
4. Limit fiscal costs
5. Strengthen system to reduce likelihood of a recurrence

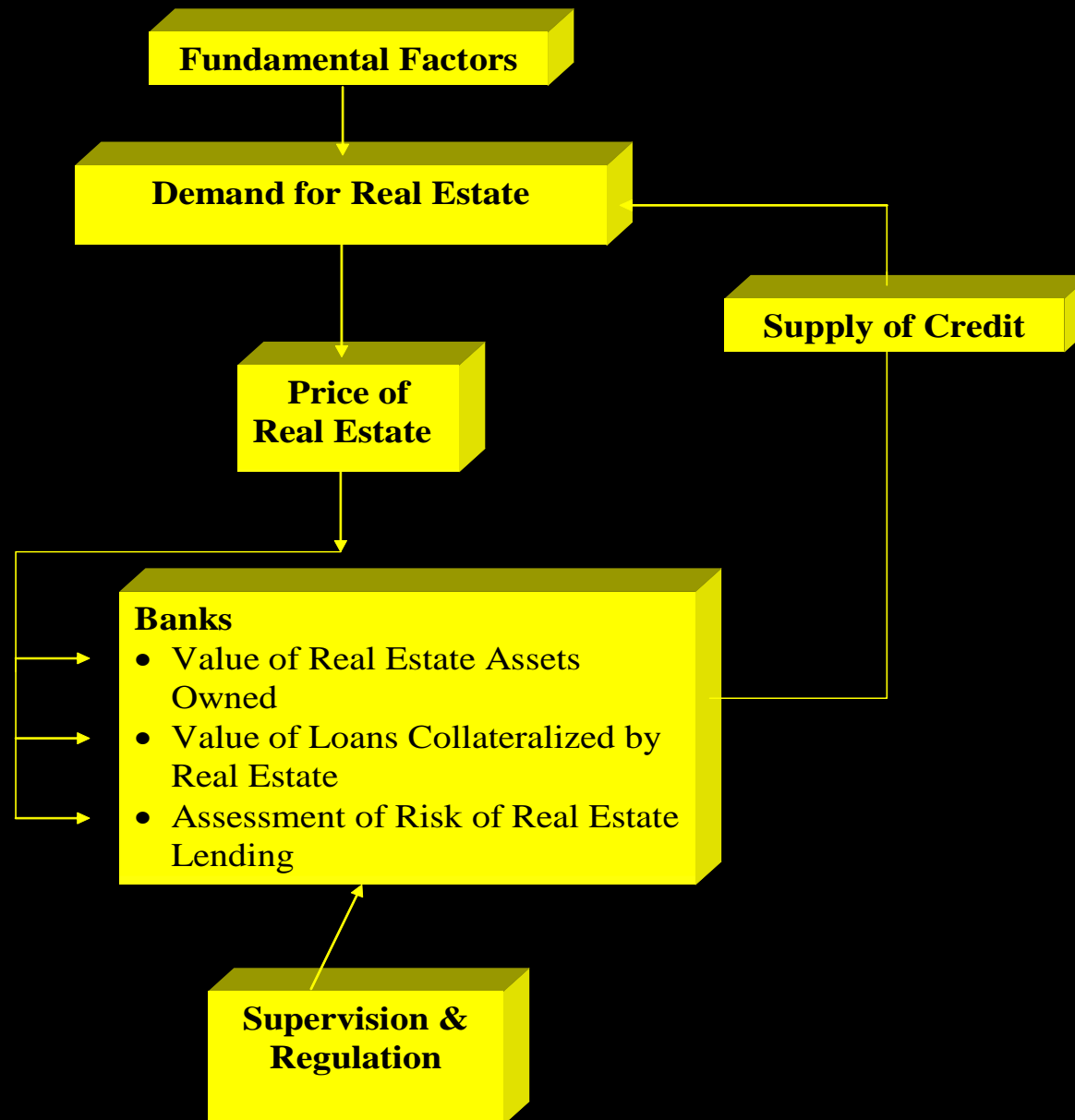
# *Perceived Trade-Offs*

- ✓ **Minimizing fiscal costs vs.**
  - Restoring confidence
  - Reducing loss of output
  - Hastening economic recovery
- ✓ **Claessens, Klingebiel & Laeven present persuasive evidence that perception is false**
- ✓ **Output loss is less & recovery more rapid if**
  - Avoid accommodative policies which do increase fiscal costs

# Nonetheless perception informs policy choices

- ✓ Generally restoration of confidence, minimization of loss of output and acceleration of recovery take priority over minimization of fiscal costs
  - Liquidity assistance
  - Government guarantees
  - Forbearance

# Bank Lending Contributes to a Real Estate Bubble



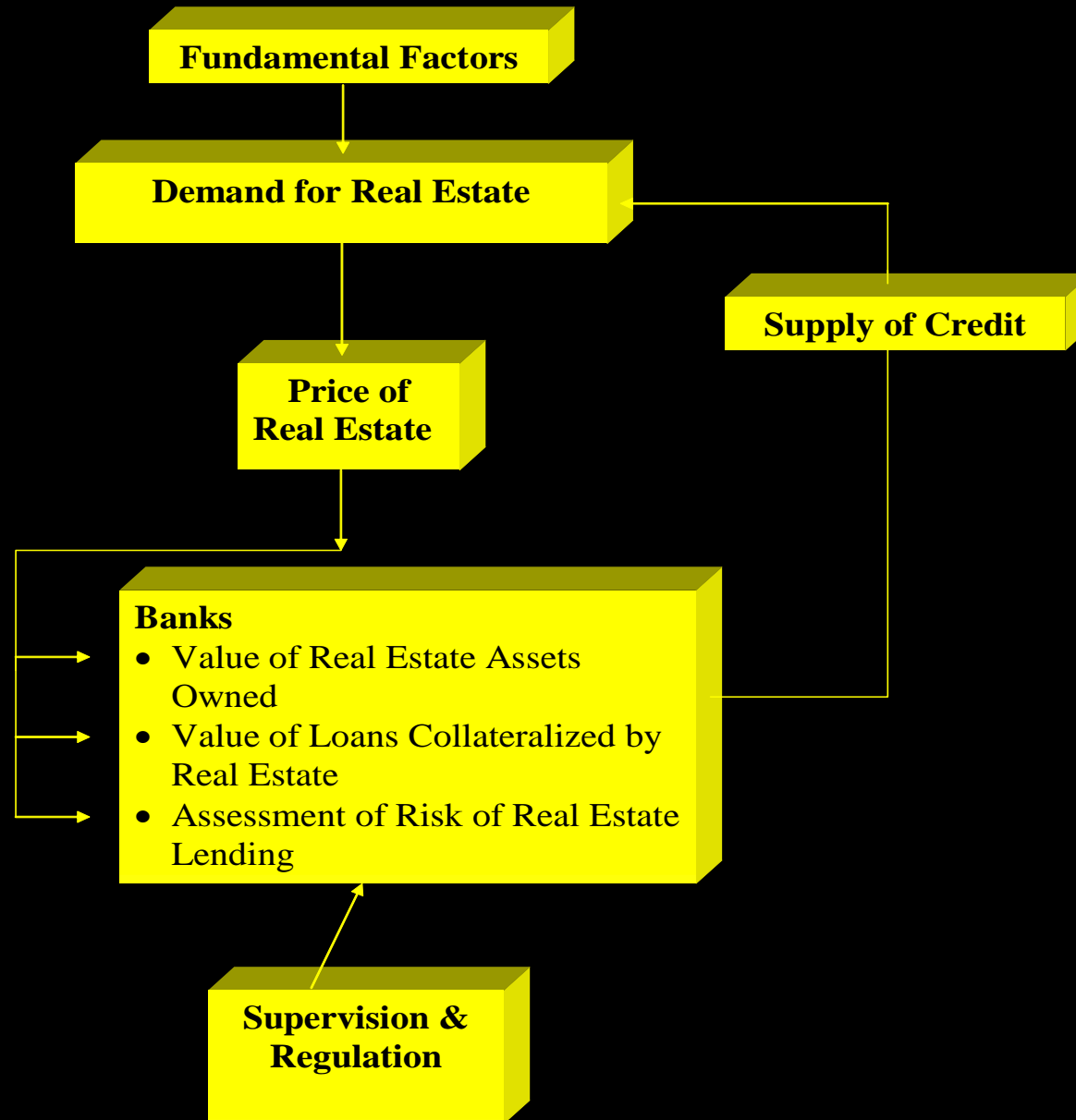
# Commercial real estate markets are vulnerable to waves of optimism

- ✓ Short sales are extremely difficult
- ✓ Supply increases only after a very long lag
- ✓ Banks fuel by increasing concentration of real estate lending
  - Disaster myopia
  - Weak information & faulty analysis
  - Perverse incentives

# Perverse Incentives

- ✓ High leverage and risk shifting
- ✓ Explicit deposit insurance & implicit guarantees
  - State-owned banks
  - Lender of last resort operations
  - Purchase and assumption transactions
  - Herding
- ✓ Conflicts of interest and cronyism
- ✓ Herding and forbearance
- ✓ Principal/Agent conflicts between supervisors and taxpayers

# Collapse of Bubble Causes Banking Crisis



# Authorities Attempt to Contain Crisis

## ✓ At first

- Exercise forbearance
- Provide liquidity assistance
- Strengthen guarantees

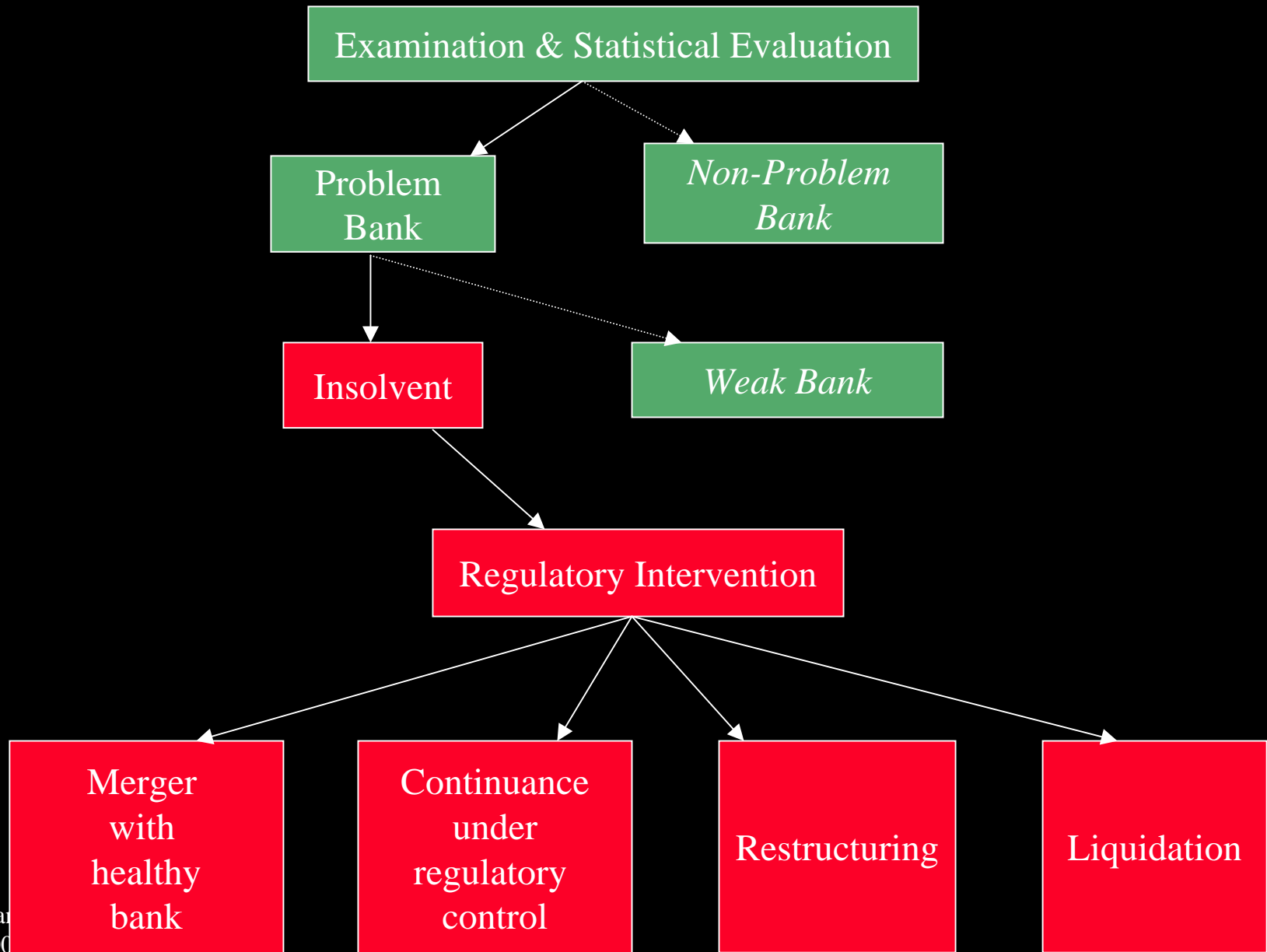
## ✓ As NPLs rise relative to tax capacity of government, lose credibility and control

- Call in the IMF and World Bank

# What should they do?

- ✓ A clear answer *before* the crisis begins
  - Strengthen institutions
    - Strengthen bankruptcy laws and procedures
    - Improve efficiency of judicial system
    - Enhance accounting and disclosure practices
    - Reduce corruption and improve corporate governance and supervision
  - Implement prompt corrective to forestall
    - Forbearance
    - Excessive liquidity support
    - Unlimited guarantees

# Schematic Overview of Regulatory Assessment & Disposition



# But after the crisis has begun..

- ✓ Liquidity has been provided
- ✓ Forbearance has been granted
- ✓ Guarantees have been offered
- ✓ And the system is largely insolvent
- ✓ What is optimal resolution policy under these conditions?
  - Prompt allocation of losses
  - Rapid & full recapitalization

# Another set of trade-offs demands attention

- ✓ **Strengthening system in long run vs.**
  - Restoring confidence
  - Minimizing loss of output
  - Hastening economic recovery
- ✓ **Financial Sector Assessment Program and Core Principles useful**
  - Should preconditions be set for crisis assistance?
- ✓ **How can the crisis be used to advance institutional reforms?**