

Alternatives to Blanket Guarantees for Containing a Systemic Crisis

Edward J. Kane, Boston College

Daniela Klingebiel, World Bank

Definition: A systemic crisis occurs when members of an important segment of a country's financial system are recognized to be economically insolvent at the same time and these institutions experience open depositor runs.

Three Phases of Crisis- Management Tax-Transfer Programs

1. Immediate Damage Containment
 2. Medium-Term Restructuring of Insolvent Banks
 3. Long Aftermath
- In each phase, heavy lobbying by politically influential sectors seeks to redistribute losses and risks away from the immediate victims of the crisis.

Our study has three goals:

1. To describe crisis-management options and how authorities deployed disaster-relief policy options in recent systemic crises in 12 countries.
2. To compare the effects of different disaster-relief programs on these countries' fiscal expenditures, macroeconomic disruption, and industry market structure.
3. To infer from this record what combinations of depositor-protection, bank-protection, borrower-protection and taxpayer-protection schemes are and are not economically efficient.

- Accountable and time-consistent crisis-containment policies are hard to devise amidst the turmoil and conflict a crisis generates.
- Infrequency of crises --and lack of planning and rehearsal for them-- shortens policymaking horizons and leads to copying uncritically policy responses recently employed elsewhere.
- What is being copied is a sequence of trial-and-error decisions after which policymakers deny or cover up their errors: systematically exaggerating the wisdom and success of their particular programs of loss and risk reallocation.

Problem of Time Inconsistency

Our analysis underscores how policy actions taken at the outset to contain a developing crisis-- particularly the issuance of extensive liquidity support and government guarantees-- absorb off-budget fiscal resources and tend to inappropriately constrain policy options for dealing with insolvent institutions in the later phases.

A banking crisis resembles a battlefield.

- Loss-generating banks wounded by open deposit runs resemble serious casualties.
- Supervisory personnel resemble emergency medical personnel (“paramedics”) required to administer first aid to wounded banks under continuing hostile fire.
- Containment strategy, like battlefield medicine, seeks to locate the wounded, alleviate their suffering, and temporarily stabilize their condition.
- The tools of a paramedic are kind words, painkillers, tourniquets, and bandages.
- Financial-sector restructuring resembles follow-up surgery that take place in a more sterile environment located some distance from the firing line.

Restructuring entails careful diagnosis and a prioritized queuing for conclusive treatment.

- Restructurers use sophisticated methods to estimate asset values and seek lasting methods for restoring salvageable institutions' profitability and reputation. Their task is to identify, clean up, and consolidate the portfolios of insolvent banks and to see that the capital positions of the reconstituted firms is adequately patched up by financial surgery.
- How much good supervisory surgeons can accomplish depends very much on how well the battlefield medics have done their jobs.

Containment treatments consist of standstill requirements, loans, credit lines, and guarantees.

1. Standstills put the claims of various private parties on hold for a specified period of time.
2. Other treatments create immediate or deferred government obligations.
3. The credibility of these obligations depends on the government's ability to service them.
4. A government's fiscal capacity depends in turn on officials' ability to scale back other planned expenditures and to collect new taxes.

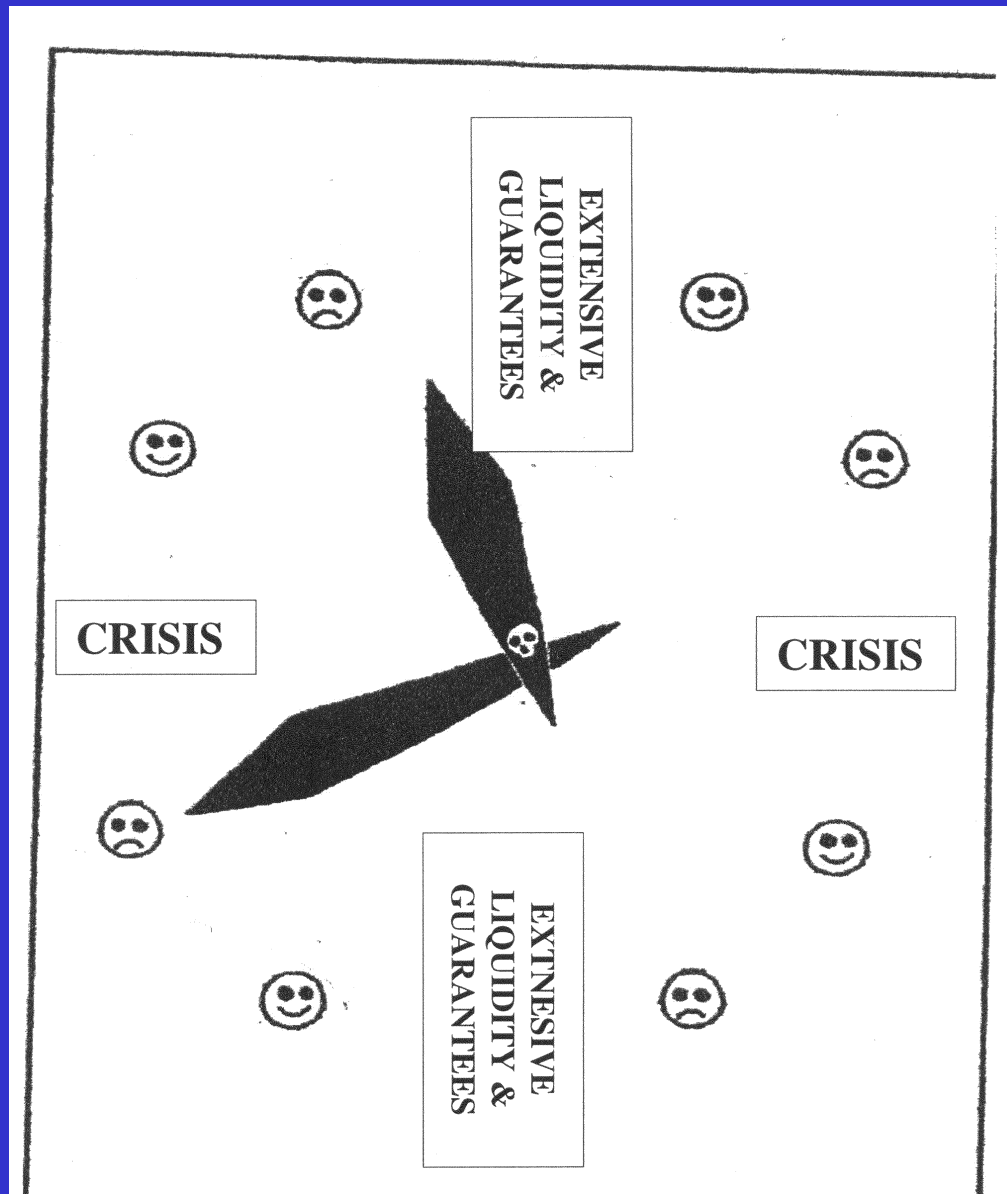
SUBSIDIES

- To the extent that government loans, guarantees, and credit lines are written at a below-market interest rate, the government is implicitly transferring free equity capital to the recipient.
- Similarly, unless the government requires banks to fully compensate it for the costs of supporting the credit enhancement, free equity capital is also transferred from taxpayers to recipient banks.

Issuing blanket guarantees distorts the government's intertemporal budget restraint by deferring all triage activity to the restructuring phase.

- By issuing blanket guarantees, a government hopes to avoid designating the liabilities of even the most severely wounded institutions as unworthy of government support.
- Whatever political and administrative benefits blanket guarantees may generate, keeping moribund institutions on life support is a costly strategy over the crisis as a whole.
- Governments that try to contain a spreading financial crisis by guaranteeing the liabilities of hopelessly insolvent banks paint themselves into a corner. Because such guarantees cede control over future restructuring costs in part to the machinations of the country's weakest institutions, the loss tends to increase the longer the guarantees are kept in place.

- Once credible blanket guarantees are issued, the government faces three new challenges: to control the amount of new debt that wounded institutions load onto the balance sheet of the government, to control how prudently guaranteed institutions invest the funds they receive, and to cut back or eliminate the guarantees once the restructuring process goes forward.
- Because banks whose credit is fully guaranteed can issue the functional equivalent of new government debt as long as they remain open, managers of insolvent banks are tempted to abuse their access to government assistance by taking on inordinately high-risk projects.
- Although abusive “gambles for resurrection” reduce the nation’s capital stock, they make sense to owners and managers of insolvent banks.



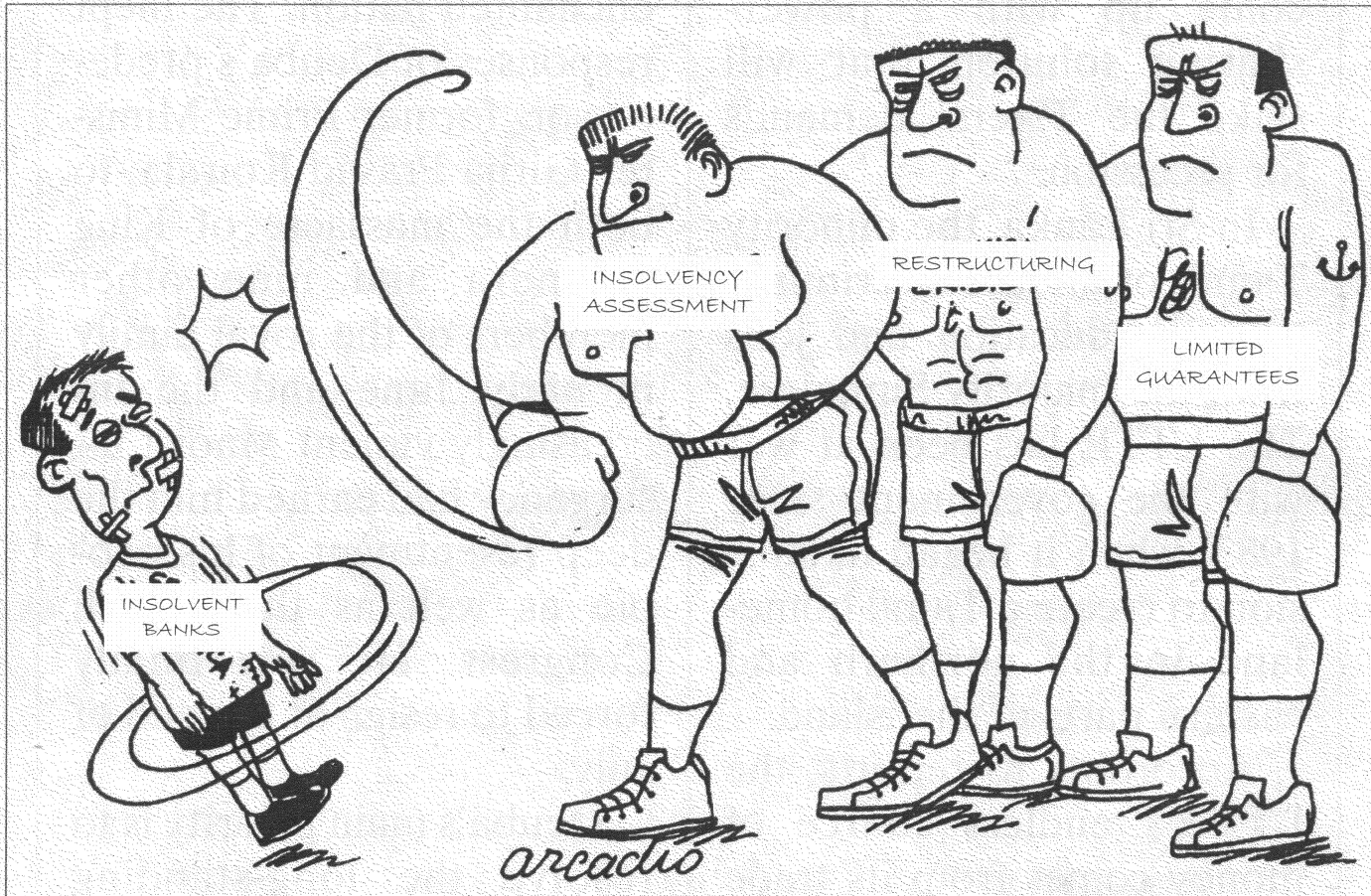
Blanket-Guarantee Crisis-Management Clock

Time-Honored Form of Standstill: A brief timeout taken to allow government forensic analysts and private auditors to assess the depth and character of troubled banks' wounds is called a "banking holiday."

- It allows supervisory medics time to diagnose individual-bank insolvencies and to recommend and impose preliminary "haircuts" on formally uninsured depositors and nondeposit creditors before these parties can liquidate or collateralize their exposure in the bank.
- Each haircut reduces the depth of a bank's insolvency by cutting back the size of its debts. This protects taxpayers by lessening the extent to which restructuring has to use taxpayer-financed loans, credit lines, and guarantees.

Using the holiday to prepare a program of limited guarantees and to write down insolvent banks' uninsured deposits to values that their earning assets can genuinely service promises to simultaneously restore public confidence both in the government and in the banking system.

- Examining the aftermaths of pre-1992 systemic crises in which governments assigned losses to depositors of insolvent banks, Baer and Klingebiel (1995) find that the positive benefits of the reducing depositor uncertainty relatively quickly overcame the negative effects that surviving banks experience from the deposit writedown.



Adapted from a cartoon drawn by Arcadio/*La Nación*/San José, Costa Rica
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