

Policy Responses to Systemic Financial Crises and Lessons

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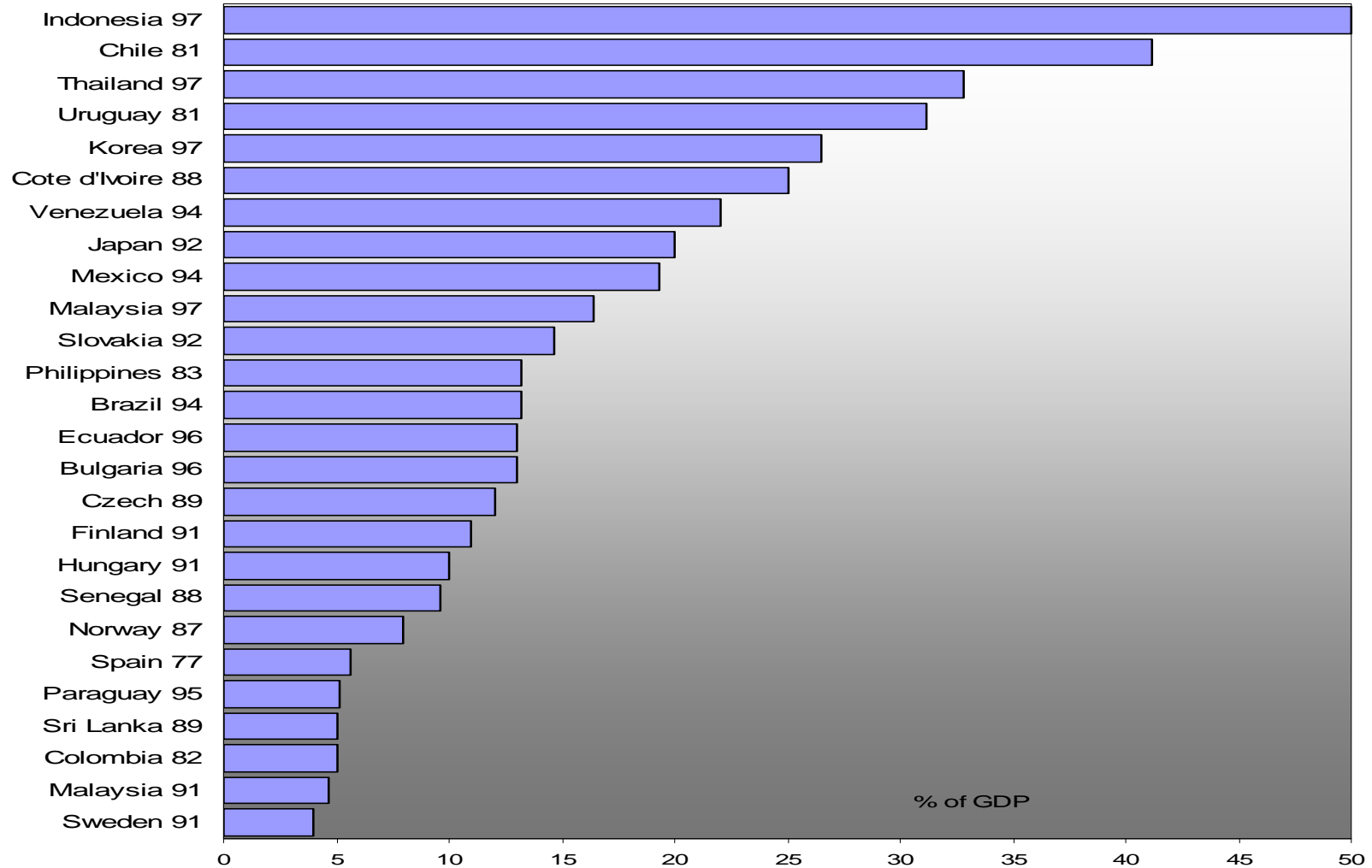
Crises Vary in Type

Not All are (or become) Systemic

	Type of crisis		
		Single institution	Multiple institutions
Contagion	No contagion	Small – medium bank (Barings, BCCI)	Sectoral banks (US S&L Crisis)
	Potential for widespread contagion	Isolated failure (Continental Illinois)	System failure (Nordic countries, East Asia, Turkey, Argentina-Uruguay)



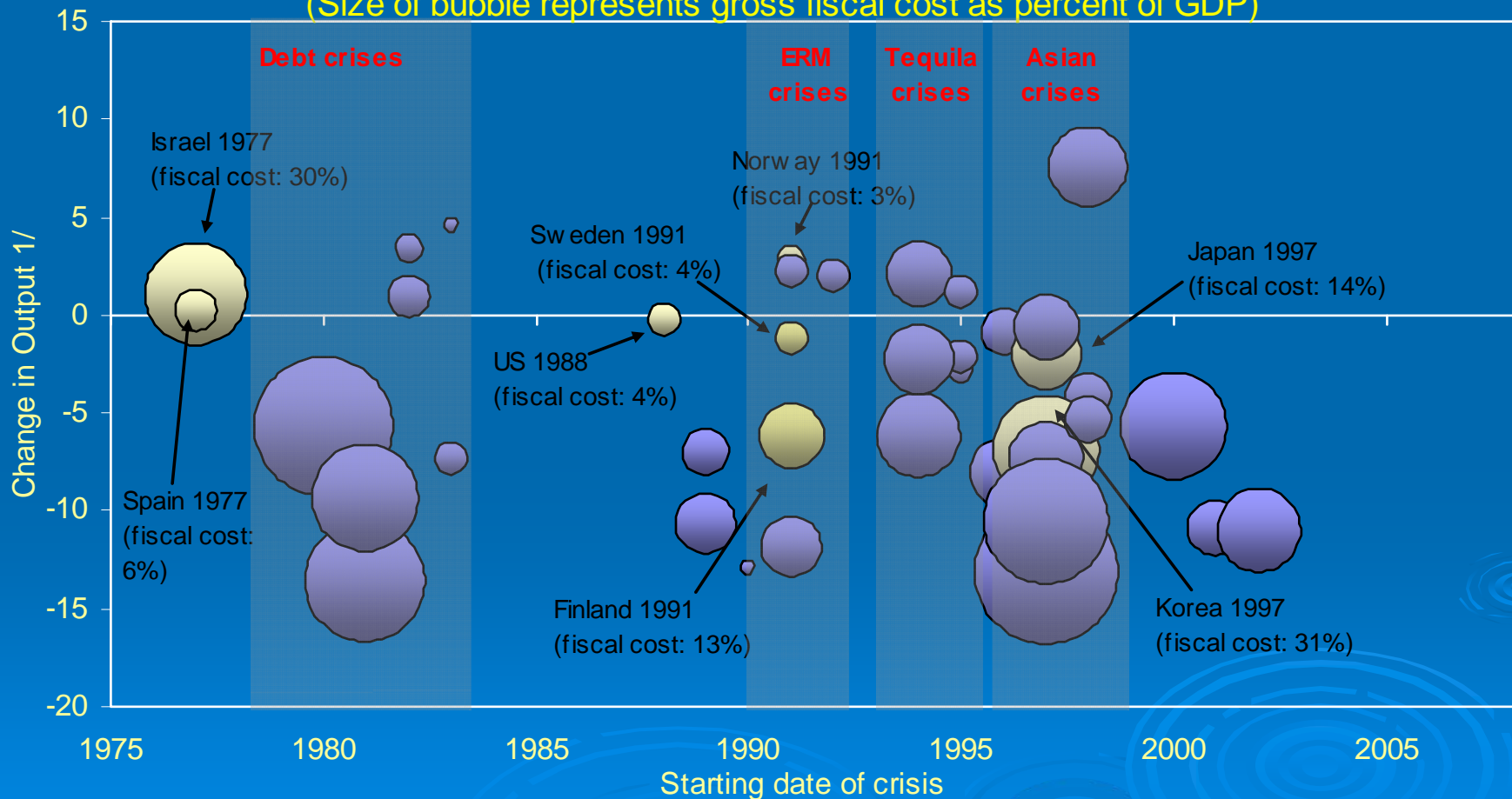
Fiscal Costs of Crises can be Large



Also: Crises Come in Costly Waves

Cost of Banking Crises in Advanced and EM Countries


(Size of bubble represents gross fiscal cost as percent of GDP)



Source: Laeven and Valencia (2008)

Note: 1/ Minimum real GDP growth during crisis (percent of GDP)

Origins of Systemic Crises

- Often triggered by “non-systemic” event, macroeconomic or microeconomic shocks
 - First emerges as a **liquidity problem**
 - But liquidity problems and deposit withdrawals are **symptoms of underlying problems**
 - Causes can be **microeconomic or macroeconomic**, or a combination of both
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Systemic Crisis Management

Phase 1 – Contain Crisis

Phase 2 – Restructure Banks

Phase 3 – Manage Impaired Assets

Phase 4 – Exit from Crisis Mode



Phase 1 – Contain Crisis

- Establish credible macroeconomic policies
- Provide needed liquidity
 - All countries have done this
 - Short maturity, collateral, penalty rates but be flexible
 - Open market operations successful for sterilizing
- Protect depositors
 - Most countries have done this
 - Blanket guarantees successful but may be costly
 - Depends on size of hole and restructuring alternatives
 - Cover all liabilities except subordinated debt & equity
- Announce medium-term restructuring program

Phase 2 – Restructure Banks

- Diagnosis, focus on medium-term viability
- Recognize losses upfront
- Preserve viable, undercapitalized banks
 - request time-bound recap/restructuring plans
 - close oversight and prompt corrective actions
- Resolve insolvent, unviable banks
 - not all institutions to be rescued
 - close/merge and liquidate assets

Use of Public Money for Recap

- Rationale: To encourage private sector contributions (investor of last resort)
- Principles and safeguards:
 - All losses recognized/absorbed by existing shareholders
 - Match private injections with government funds
 - Government shares with preferred status, Board representation
 - Require operational restructuring/asset workouts
 - Sweeteners (option to buy back government shares)
 - Allow convertibility of state contribution to Tier 2 capital into Tier 1 capital if CAR falls below given ratio

Phase 3 – Manage Impaired Assets

- Resolution of debt overhang needed to restart supply and demand of credit
- Corporate (or household) debt restructuring often neglected
- Issues in institutional framework
 - speed versus value
 - centralized versus decentralized
 - legal reforms (bankruptcy/foreclosure)
 - out-of-court debt restructuring (London approach)

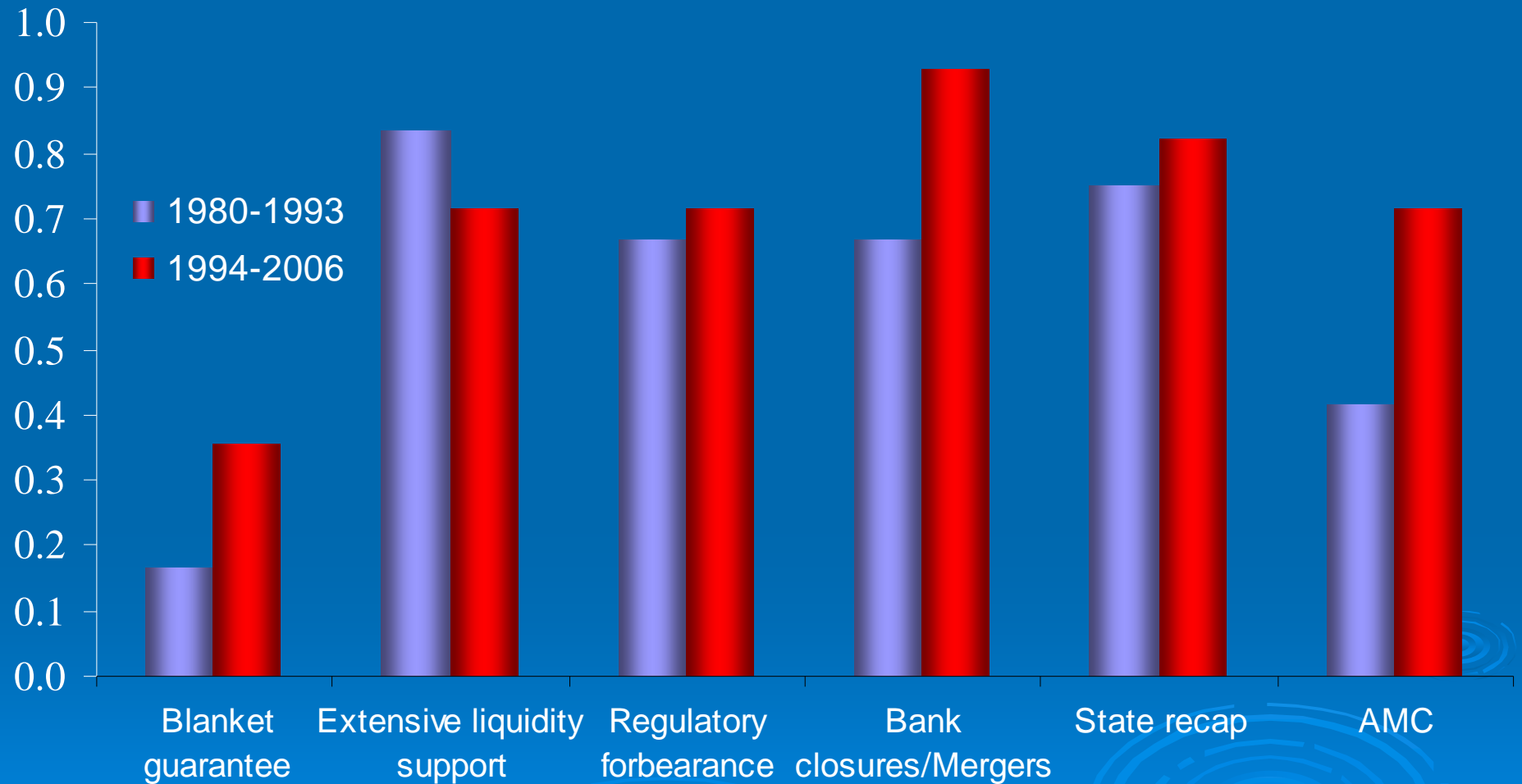
Centralized: State-Funded AMCs

- **Mandate:** narrow (min taxpayer losses), as supposed to broad (min fire sale effects), facilitates success;
- **Pricing:** current market value, but higher prices OK if loss sharing agreement (with cap)
- **Legal backing:** strong legal basis needed for transfers of titles; adequate powers to maximize recoveries
- **Funding:** adequate capitalization by treasury; consider joint ventures with private investors
- **Governance:** independent board/private sector participation; disclosure; auditing; reports to parliament

Phase 4 – Exit from Crisis Mode

- Exit from blanket guarantee if applied
- Exit from government ownership of banks
- Sale of assets taken over
- Overhaul of regulations to not repeat mistakes
- Continue corporate restructuring to avoid “second-wave crisis”

Resolution Instruments in Past Crisis Episodes (Proportion used per systemic banking crisis)



Source: 40 past systemic banking crises reported by Laeven and Valencia

Lessons—Crisis *Response*

- A. Adopt comprehensive response
 - B. Secure confidence of creditors/depositors
 - C. Ensure upfront loss recognition
 - D. Facilitate recapitalization
 - E. Remove nonviable institutions
 - F. Do not ignore debt restructuring
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Lessons—Crisis *Management*

- A. Confront key questions early on
 - B. Ensure adequate communication policy
 - C. Garner political support
 - D. Plan for uncertainty
 - E. Plan for failure
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