

Global Financial Systems

Chapter 7

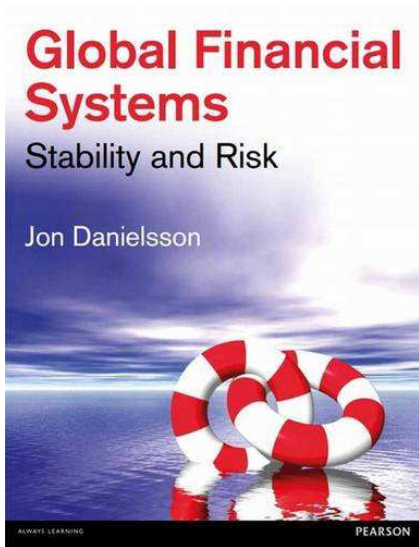
Banking Crises

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Book and slides



- The tables and graphs are the same as in the book
- See the book for references to original data sources
- Updated versions of the slides can be downloaded from the book web page www.globalfinancialsystems.org

Banking

Banks act as middlemen between lenders and borrowers. Why can't borrowers and lenders come together without them?

- Search costs
- Verification costs
- Monitoring costs
- Enforcement costs

Banking

- Pooling of assets provides *diversification benefits*
- Provide *liquidity*
- Engage in *maturity transformation*
- Banks are special as their liabilities are *money*

Fragility

- Bank *runs* if a sufficient number of depositors wish to withdraw at the same time
- *Fire sale externalities*, result in insolvency
- Failure of one bank may lead to runs on another bank if depositors perceive similarities between the two
- Alternatively contagion through *network effects*. One channel is *interbank lending* which is usually unsecured so a default by one bank may have an immediate effect on others

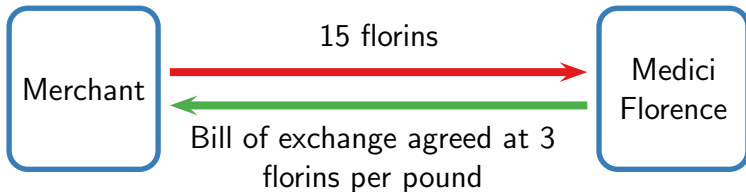
Early bank — Medici

1397–1494

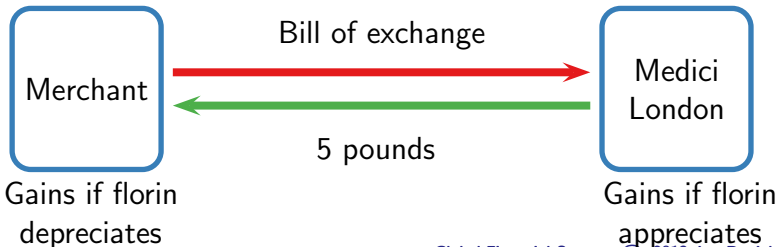
- Diversification
 - Held deposits, discounted commercial obligations (*bypassed usury laws*)
 - Foreign exchange trading (large number of currencies in circulation)
 - Lending to royalty and the Vatican
- One example of profitability: 32% per year 1397–1420

Bill of exchange transaction

Initial deal



3 months later



Amsterdamsche Wisselbank

1609–1795

- Problem: large number of foreign currencies, costly to convert into local money
- Merchants set up accounts denominated in a standardized currency
- Pioneered system of cheques and direct debits — *bank money* worth more than coinage
- But deposits almost same as money supply
- No credit expansion

Moral Hazard

Moral hazard

What happens when those taking risk do not have to face the full consequences of failure but get to enjoy all the benefits of success.

The consequence of moral hazard is that those fortunate enough to be in that situation are encouraged to take on more risk than they otherwise would do.

Do we care?

- Pervasive — insurance contracts
- Not to be eliminated
 - limited liability corporations
- Not a problem when compensated
- However, it is not always compensated

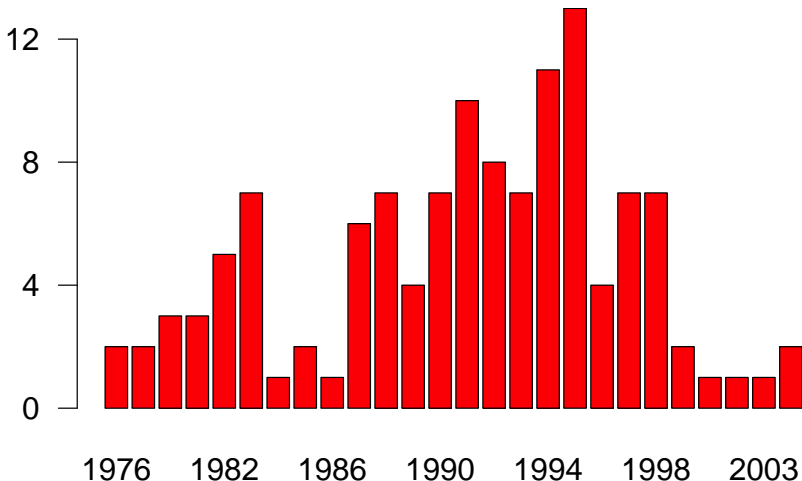
Government guarantees

- Government guarantees not priced
 - Motivation for financial regulations
 - Externalities from the failure can outweigh moral hazard
 - Risk return trade-off
 - Financial institutions know and exploit this
 - *The bigger, the more dangerous, the worse run and more interconnected a financial institution is, the more likely it is to be bailed out*
- The moral hazard problem in the financial industry is hard
- The powerful tools are very blunt
- Surgical tools may not be effective

Costs of Banking Crises

Frequency of banking crises

IMF&WB. Excluding the crises from 2007



What is the cost?

1. *Direct cost*: the fiscal cost associated with resolution of bank crises or the bail out costs. Can be relatively accurately measured
2. *Indirect cost* on the economy takes many forms, such as contracting government revenues and expanding fiscal expenditures
 - *Hard to measure and subjective*
 - Laeven and Valencia (2008) estimate output losses by extrapolating from the trend of real GDP until the year before the crisis, and calculating the aggregate difference between the trend prediction and actual outcomes. There are many other ways of doing this

Country systemic banking crisis

Fiscal Cost (gross, as % of GDP). Output loss as % of GDP

		Fiscal cost	Output loss
Argentina	1980	55.1	10.8
Finland	1991	12.8	59.1
Indonesia	1997	56.8	67.9
Korea	1997	31.2	50.1
Mexico	1994	19.3	4.2
Sweden	1991	3.6	30.6
Turkey	2000	32.0	5.4
United States	1988	3.7	4.1
Venezuela	1994	15.0	9.6

Cost of resolution

Honohan and Klingebiel (2003)

- If countries had not extended *some* of *unlimited deposit guarantees, open-ended liquidity support, repeated recapitalizations, debtor bailouts and regulatory forbearance*
 - The fiscal costs of resolution would be around 1% of GDP on average, 1/10 of the actual costs
- If, however, governments employed *all* of the approaches above, the fiscal costs would be *six times larger* than they are
- Main damage to the economy is not caused by the actual event but rather *inappropriate government responses*

Causes of Banking Crises

Banking crises in G10

	Real economy	Asset prices	Financial liberalization	Poor regulation	Bank specific
Switzerland (91–96)	✓	✓	✓	×	×
Spain (78–83)	✓	✓	✓	✓	×
UK (91)	✓	×	✓	×	✓
Norway (88-93)	✓	✓	✓	✓	×
Sweden (91-94)	✓	✓	✓	✓	×
Japan (94–02)	✓	✓	✓	✓	×
US(82–95)	✓	✓	✓	✓	✓

Financial liberalization

- Over-regulated financial sectors can often hold back economic growth, suggesting that financial liberalization is a good policy
- *Execution has to be right*
- A *common mistake* made by governments is to *reduce* oversight and activity restrictions but *maintain* implicit or explicit government guarantees such as deposit insurance
- This creates a *nasty moral hazard problem* because it can enable financial institutions to borrow cheaply and use the money for high-risk activities
- This was at the core of many banking crises, such as the Savings and Loans crisis in the *US* in the 1980s, the *Scandinavian* crisis in the late 1980s and early 1990s and Asian crisis

Political economy arguments for bubbles

- Prince: *“As long as the music is playing, you’ve got to get up and dance”*
- Public sees the benefits brought by a bubble. Politicians follow
- Bankers also, even if they should know better
- The *technocrats* should be in know, and if they warn, risk being *denounced, losing income or being prosecuted*
- Ultimately this means that it is very difficult to follow William McChesney Martin Jr., former head of the US Fed, who said that the Fed’s most important job is *“to take away the punch bowl just as the party gets going”*

Corruption

examples: Venezuela in 1994 and the Dominican Republic in 2003

- The banks did not seem to record deposits as liabilities
- Enabling the insiders to *loot the banks' assets from inside*
- The central bank of each country felt it necessary to make depositors whole, destabilizing the macroeconomy.
- Furthermore, the rogue bank in Venezuela payed high deposit rates, forcing other competing banks to do the same
- In turn that increased overall risk-taking because of risk-shifting

Zombie banks

- Insolvent but operating because of government policies
- Japanese banking sector
- *Evergreening*
- Better to quickly resolve, restructure or shut down failed banks
 - Scandinavian crisis in the 1990s
 - US and UK now
- Not in Europe now — zombies are coming
- ECB sole liquidity provider to banks and banking systems
- Insufficient recognition of losses

Some Individual Bank Failures

Why these examples

- There is a large number of cases to choose from
- But these have had a particularly strong impact on future policy
- Some others worth mentioning include Continental Illinois
 - Which had a major impact in revamping US financial regulations
 - Perhaps making them the best in the world right now
- Failures often cause changes in policy

Herstatt 1974

- Used to be a large German bank
- Forced it into liquidation, same day banks paid DEM to Herstatt in Germany, expecting USD in New York
- Because of time–zone differences, Herstatt ceased operations between the times of the respective payments
- This is an example of *settlement risk*
- The failure of Bank Herstatt was one factor that led to the creation of the *continuous linked settlement platform*, which launched almost 30 years later in 2002

Banco Ambrosiano 1982

- The largest private banking group in Italy
- The Chairman, Roberto Calvi, was a member of the illegal masonic lodge Prograganda Due (P2), called “God’s Banker”, due to his close association with the Holy See
- Formed a Luxembourg holding company not subject to Italy’s banking regulations

- Bank of Italy noted it buying Ambrosiano stock with borrowed foreign funds, then the lira fell
 - Currency mismatch problem
- Calvi was sentenced to jail, fled
- Found hanging under the Blackfriars bridge in London
- Threatened the stability of the entire international banking system
- Brought on changes in the way the world's major banks do business and *new regulations*

BCCI 1991

- Registered in Luxembourg with head offices in Karachi and *London*
- Failed because of widespread fraud, its financial statements had been falsified from its establishment in 1972
- Failed to record deposit liabilities and created *fictitious* loans that generated *substantial but fictitious profits*
- Used depositors' money to fund trading losses
- BCCI was sometimes mentioned in the press "chiefly for the mystery that surrounded it", financial market participants generally saw BCCI as a bank that had made losses through incompetence rather than fraud

- In 1991, Price Waterhouse became increasingly convinced that the fraud within BCCI was endemic and that published financial statements were grossly inaccurate, informing the BoE of their findings
- The liquidators, Deloitte & Touche, filed a lawsuit against the bank's auditors, Price Waterhouse and Ernst & Young. This was settled for \$175 million in 1998
- BCCI creditors also attempted to sue the Bank of England as BCCI's regulators
- This case demonstrated the *reputation risk for central banks* who also in charge of banking supervision
- One reason for the separation of banking supervision from the BoE in 1997

Some System–Wide Failures

Why these failures?

- There are many choices, but these are either particularly illustrative
 - The S&L nicely isolates the main problem from other factors
- Or demonstrate successful resolution
 - Sweden may have done the best job
- Or are recent and relate to this crisis
- A common thread is a relatively straightforward story

Savings and loans (S&L) in US

sleepy industry — in many countries called savings banks or similar

- Suffered from high interest rates and inflation at the end of the 1970s
- As a consequence the authorities at the time deregulated the industry with the view that the S&Ls could grow their way out of trouble
 - there were widespread deregulations in the US at the time
- Including allowing new activities and lenient accounting rules

- Such policies, combined with an overall decline in regulatory oversight (known as *forbearance*) contributed to the risk-taking in the sector
- The government continued providing deposit insurance, but did not increase oversight of the industry
- This is a classical problem in deregulation
- The final cost of resolving failed S&Ls is estimated at just over \$160 billion, including \$132 billion from federal taxpayers

Lessons from the S&L disaster

1. Strong and effective supervision needed
2. Industry should not be allowed to have influence over the supervisor who should remain politically independent — *no regulatory capture*
3. Supervisors need adequate financial resources
4. Failed institutions need to be closed down promptly
5. Deposit insurance funds should be strongly capitalized with real reserves, not just government guarantees

Scandinavian crisis in the 1990s

Sweden Norway and Finland

- Caused by a huge lending boom in the late 1980s
- Followed by severe *deleveraging* in the 1990s
- Finland had the extra factor of the collapse of the Soviet Union

- The governments liberalized the financial markets and implemented procyclical macroeconomic policies
- Neither banks nor regulators were used to operating in such an environment
- The banks did not develop the necessary risk management systems, so at the time when risk-taking was on the increase by inexperienced banks, government oversight was decreasing
- Having the government as provider of deposit insurance, creates moral hazard
- Dramatic increase in bank assets and asset prices, fueled by leverage

Resolution

- In order to resolve the crisis, the government employed both monetary and fiscal easing as well as abandoning currency pegs
- Furthermore, the government injected significant amounts of public funds into the banking system, recapitalizing failed banks, splitting them into *good banks and bad banks* (next slide)
- One study: fiscal cost of the banking recapitalization was 8.9% of GDP in Finland, 3.9% in Sweden, and 2% in Norway

Good bank — bad bank

- Government splits up a failing bank
 - dodgy assets into one institution
 - bank's operations and solid assets in other
- Eventually sells the good bank
- Holds onto the bad assets, like corporate loans
- If the assets are valued at fire sale prices, government may profit — an argument often used to justify this
- If the original bank was insolvent and the good bank is solvent then the bad bank must by definition have a negative value, so a profit for the government is not the expected outcome
- Taxpayers should expect to lose money — hopefully efficiency gains outweigh the expected loss.

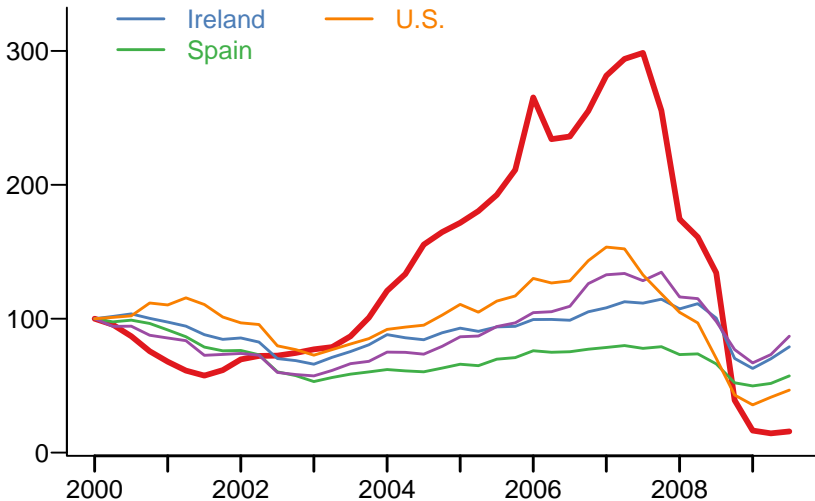
Iceland 2008

- Banks were in government hands or highly regulated
- Sold to politically connected parties for artificially low prices
- Eventually the entire banking system collapsed
- Regulatory failures and macroeconomic mismanagement

Annual asset growth in Euros 2004–2008 of the 3 largest banks

Glitnir	50%
Kaupthing	61%
Landsbanki	51%

Stock market prices, 2000=100



Kaupthing credit ratings and CDS spreads

