Stanley Fischer

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Financial Sector Crisis Management

Remarks by Stanley Fischer
First Deputy Managing Director
International Monetary Fund
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Introduction

What I want to do today is to identify some of the lessons we have learned from recent experience of financial crises-and we have certainly had plenty of crises and plenty of experience-that might help us mitigate the impact of possible future crises. But before doing that, let me first outline how a typical systemic banking crisis unfolds, and how policymakers typically respond.

The Anatomy of a Systemic Banking Crisis

In describing how the response to a systemic banking crisis evolves, let me break it down into three phases: first, measures to stop panic and stabilize the system; second, measures to restructure the financial system and resolve financial institutions, and; third, measures to normalize the system after the restructuring is complete.

The Stabilization Phase

To begin at the beginning of the crisis: When a systemic banking crisis gets underway, the banking system and the economy typically exhibit some common weaknesses:

- First, poor macroeconomic management;
- Second, poor banking practices and excessive risk taking, typically involving too much reliance on collateral, names and connections in lending decisions, including lending to cronies and for political purposes;
- Third, balance sheet problems, including inflated values for real assets, and excessive credit expansion of deteriorating quality, sometimes fed by large capital inflows;

- Fourth, weak regulation and supervision that has often been an important factor in allowing the crisis to develop and a lack of effective market discipline.

During the very early stages of a banking crisis, when the problems are developing, bankers and the government authorities are frequently in denial. To be confident that the authorities fully understand what is going on in the banking system-and are therefore in a position to take prompt action-strong, independent, and competent supervision is essential.

Then, typically, a specific event triggers the crisis and large creditors and depositors begin to withdraw funds, prompting widespread runs. This could be a variety of "events" such as an external shock, policy slippages, or political difficulties. At that stage, the central bank will be called upon to provide liquidity support to banks experiencing liquidity problems. The lender of last resort role of the central bank is a critical one to keep the payments system operating. At the same time, however, the central bank cannot provide liquidity indiscriminately.

Liquidity support may have to be accompanied by the announcement of a blanket government guarantee for depositors and creditors in order to stop a run on the banks. This is an important confidence-boosting measure and it needs to be implemented correctly to achieve the intended goal. Blanket guarantees buy the authorities time to develop a strategy for the orderly restructuring of insolvent banks. If banks are to be closed and any losses imposed on creditors and large depositors it has to be done before a guarantee is introduced.

The central bank may have to provide large amounts of liquidity during this phase of the crisis. It is important to sterilize this support so as not to lose control of monetary policy. This may require relatively high money market interest rates for a while. It may also be necessary to change the exchange rate regime, provided it had not already been changed at the outbreak of the crisis.

Blanket guarantees and liquidity support raise concerns about moral hazard. That is understandable, but the alternative-a further loss of confidence and a major loss of macroeconomic control-is much worse. Measures can be implemented to keep moral hazard manageable. Such measures could include caps on deposit rates, ensuring the owners share in the resolution costs, tightening of supervisory enforcement and restrictions on bank behavior.

The Restructuring Phase

Let me turn now to the second phase: restructuring the financial system and resolving financial institutions.

The authorities have to design a financial sector restructuring strategy. Typically, viable banks need to be recapitalized, unviable ones resolved, and bad assets dealt with. At this stage, bank and corporate debt restructuring should be closely coordinated, but often are not because of lack of capacity, data, and sheer complexity of the banks. The management of nonperforming loans is one of the most complex parts of financial restructuring. Troubled assets can either be handled by financial institutions themselves (if they have the capacity and capital to do so), by bank-specific or centralized asset management companies, or put through traditional liquidation processes. Policies for asset management must be carefully coordinated with the corporate restructuring strategy.

The authorities have to identify the tools for a comprehensive restructuring of the banking sector. This may mean changing the institutional and legal frameworks, for instance strengthening bank exit procedures, bankruptcy procedures, and the court system, and developing uniform criteria for distinguishing between viable and nonviable institutions.

Identifying losses in individual institutions allows the authorities to shift their focus from liquidity support to recapitalization. At this stage of the crisis, the valuation of bank assets becomes critical to determine which banks are viable and which are not. Loan classification and loss provisioning rules become crucial. It is important that the authorities make these decisions based on uniform and fully transparent criteria and it should be remembered that the quality of the data at this stage always carries a lot to be desired.

Bank restructuring cannot take place in isolation from corporate restructuring. Ideally, these two should proceed in parallel, with nonviable enterprises identified and reformed.

The Recovery Phase

Now let me turn to the recovery phase. After the major restructuring, measures can be taken to normalize the system. We have little experiences of the phase as a systemic crisis always seems to take much longer to resolve than anyone expects and would want.

Nationalized banks can now be reprivatized, corporate restructuring completed, and bad assets sold. Government ownership is inevitable in systemic crises as old owners lose their stakes and the government by necessity often becomes the owner and capital provider of last resort. The goal should be to reprivatize nationalized institutions as soon as possible to fit and proper new owners. But this may take time especially if the government wants to maximize the value of its share ownership.

Once the banking system has been restructured the blanket guarantee must be revoked. This should be a nonevent as long as the financial sector is back in good health. This means that the macroeconomy, bank governance, profitability and solvency should have returned to sustainable levels, and appropriate prudential standards, supervision, as well as enforcement should be in place.

A more limited safety net should then be put in place. The safety net should allow for orderly failures of individual banks in the future, it should ensure that appropriate arrangements are in place to meet bank liquidity needs, and provide unsophisticated small savers assurance as to the safety of their deposits.

Lessons for Crisis Management

I remember asking colleagues at the beginning of the Asian crisis what general principles should be followed in dealing with banking crises.The answers were not entirely clear. We only had limited experiences at that time, primarily in industrialized countries. Fortunately or unfortunately, we now have more experience to draw on in answering that question. Let me try to draw out some of the important lessons we have learned. I will emphasis three points: first, the importance of political leadership; second, the need to move quickly with bank resolution, and; third, the need to have a framework for crisis management in place before it is needed.

Political Leadership

First, political leadership. Managing a financial crisis involves tackling a number of politically contentious and often technically complex issues. Burden sharing is one example. The owners of failed banks and the holders of subordinate debt should always lose out, but the authorities must decide how and to what extent to impose losses on creditors and depositors. The extent to which the government can assume losses will depend on its fiscal and debt servicing ability. These decisions often have to be made early on, with limited information.

Tackling these issues requires political leadership. Mustering political support for change can be difficult: in many countries, restructuring banks means breaking vested interests. Political skills are also needed to shepherd the restructuring program through the legislative process in the face of various groups trying to sabotage it.

Maintaining public confidence in the integrity of the process is critical to its success and to achieving the confidence of international financial markets. It is important to ensure that the process is conducted in a transparent and technically competent manner with accountability to the public and the markets. This will require close institutional coordination,

a highly qualified staff, and a good ability to communicate. There is a need to draw over foreign advisors, experienced in bank restructuring issues. These skills are very expensive, but not using them would be a far worse experience.

The Need for Speed

A second lesson is the need for speed. The best opportunity to make progress in bank resolution is early in the crisis when also most of the crucial decisions are made. This is when political interest will be at its greatest and it is the best time to manage vested interests. Swift action, clear messages and well-defined leadership also have a positive effect on public confidence.

As the financial sector and the macroeconomic situation stabilize, it becomes more difficult to maintain political support for difficult actions because complacency returns. Leaders and market participants begin to suspect that the need for reform was overstated and that now, with conditions improving, less needs to be done. Corporate debt restructuring is often found to be most nebulous to manage.

Having a Crisis Management Framework in Place

The third lesson is that it is important to have a framework for crisis management in place before you need to use it. This would have made it easier and faster to deal with the existing crisis-and it can help make any future crisis less painful. Having a framework in place requires the authorities to be aware of the complexity of the process, to have authority established to make decisions, and to delegate responsibility once the broad principles have been determined at the political level.

Banking systems need to be able to deal with credit problems. Provisioning for increased exposure must be a large part of the regulatory framework. Moreover, banks must be in a position to foreclose on collateral and enforce creditor contracts or losses will steadily increase. Regardless of the structure chosen, it is imperative to be able to accommodate corporate debt restructuring to minimize losses on business loans.

One of the most important things to have in place at all times is an effective foreclosure and insolvency process as well as a framework for debt restructuring. The legal and institutional framework should allow the authorities to quickly resolve a bank once it is deemed to be insolvent. As part of the resolution process, the government also needs to have the ability to take over assets from the insolvent institution. It is also important to ensure legal protection for supervisors, without which the restructuring process may be delayed considerably.

Finally, bringing domestic regulatory and supervisory standards closer to

internationally accepted practices is useful in guiding the restructuring and ensuring higher standards to mitigate future problems. At the same time, the authorities should strengthen prudential regulation and supervision, bank governance, and market discipline.

The Role of the IFIs

I have managed to talk about banking crises without mentioning the role of the Fund, and the Bank, and other agencies that helped respond to crises in Asia and elsewhere. These crises have been exceptionally difficult for countries to deal with, and we have had an important role to play in helping countries respond to them.

The Fund has a unique role to play as we see these problems occur throughout our membership. Financial crisis in individual countries happen perhaps once in a generation or two, but in the Fund we see several cases per year. We therefore have a role to play in internalizing these experiences and sharing them with our membership. We are right now in the process of preparing a policy paper on these issues and will share the outcome with banking supervisors and policy makers worldwide towards the middle of next year.

But an ounce of prevention is worth a pound of cure, and the Fund, the World Bank and other international institutions have an even more important role to play in helping countries strengthen their financial systems and crisis management frameworks. Our Financial Sector Assessment Program-which also draws on the expertise of national central banks and supervisory agencies-can help countries identify weaknesses and areas where strengthening technical assistance is needed including with the support of the private sector.

Concluding Comments

Let me conclude by returning briefly to the importance of leadership.

Effective leadership is the single most important factor in financial crisis management. Those charged with providing developing and executing a crisis management strategy must always act in an equitable and transparent manner. Effective leadership also means acting while the momentum is in your favor, in other words, the sooner the better. But perhaps most important is honesty in public pronouncements. One of the lessons we have learned is how fragile confidence can be. It is hard to build and can be easily destroyed.

Banking crisis and resolution is not a process that can be planned in great detail several months or years ahead. It should be understood that the number of factors maybe overlooked at the beginning of the process, such as legal details that will prove to be insurmountable constraints later on. Human resources simply may not be available to handle so

many processes and decision simultaneously. The broad policy framework and its sequencing must be in place, but it must be designed to deal with unexpected events-which always will happen. (This also means that the Fund in its program design can set the broad strategy but not over specify the process.)

It also means ensuring that you are in a position to deal with the unexpected-which always happens. Banking crises have been with us as long as banking systems. They can never be prevented entirely, and they can never be resolved painlessly. But we must all hope that the lessons we are learning as a result of recent crises will help make banking crises less frequent and less damaging the future.

Thank you.

IMF EXTERNAL RELATIONS DEPARTMENT
Public Affairs: 202-623-7300 - Fax: 202-623-6278
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