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**International Financial Crisis:
Consequences Regarding Banking Regulation and Monetary Policy**

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During this lecture, I shall briefly and rather summarily analyze the causes of the crisis now affecting the international financial markets. Thereafter I will address the main question: what can be done to restore the banking system's capability to function again in a satisfactory manner, examining additionally suitable measures to avoid to the utmost extent the recurrence of such a disastrous financial crisis as happens now.

Causes of the Crisis

In my opinion, the financial crisis originates from a triple root: a policy of easy money kept going during far too long a period in the U.S. and in Europe, an international securitization of heterogeneous debts whose structuring was all too often almost incomprehensible, and finally a lax regulating attitude largely tolerated by supervisory authorities. From the autumn of 2001 until the autumn of 2005, the Federal Reserve System of the U.S. drastically enforced a low-interest policy. The short-term real interest rate was negative, averaging most often minus 1 per cent. After the FED, the European Central Bank (ECB) followed suit, although more moderately. In the period from 2003 until 2005, the short-term real interest rate within the Euro zone amounted to approximately 0 per cent. This excessive easy-money policy generally facilitated financing operations, followed by steadily rising prices of any type of assets during many years, from real-estate to stocks. At the same time, a precipitous rise could be noticed in the practice of bundling, securitizing and selling of all types of credit, ranging from mortgage credits to credit-card debts. Financial institutions got used to grant loans and credit without being able to sufficiently assess the debtor-related risks and the often dubious reliability of the "structured products"; people relied on the standardized quality label of rating agencies (senior, mezzanine, junior). What's more: quite a few big American and European banks did circumvent banking regulations by setting up special-purpose companies not contained in the balance sheet and funded by extremely short-term financing, a practice on the one hand not detected, but on the other hand evidently tolerated by the banking

supervisory authorities. Consequently, it is safe to say that in this respect the modern State failed to accomplish its duties.

Market Failure?

The worsening of the international crisis involving financial markets since September 2008 has provided an enormous boost to people who feel critical about the market-directed economy. Of course, that could be expected, as financial markets, according to general opinion, obviously failed to function correctly.

Economists speak of market failure whenever competition in a given market, due to cost depression, degenerates into a steadily increasing concentration and finally into a (natural) monopoly. A more serious form of market failure impairing financial markets consists in the breakdown of the payment and credit system due to a fast spreading lack of trust among depositors regarding the safety of their deposits. The classic bank crash is initiated by the run of panicking depositors to bank counters in order to withdraw their deposits wholly in cash. If a commercial bank, either on the strength of mere rumours or due to actual facts, is supposed to be close to bankruptcy, it will be unable to repay all deposits on its own because the same have meanwhile been converted into medium-term and long-term credits to companies and households which cannot simply be called in at a moment's notice. If the involved bank has to admit its insolvency, this will trigger a run on all other banks, which will have to shut down operations, although they might so far have restricted themselves to absolutely sterling banking transactions. Banking's financial markets may thus fail due to their clients' lack of trust and the fact that commercial banks cannot extricate themselves from their misfortune, but need instead the State's helping assistance, in particular that of the central bank of issue.

In actual fact, Germany narrowly escaped such a situation during October 2008. A general panic and consequently the breakdown of Germany's monetary system could only be avoided by the intervention of Germany's Federal Government on 5 October and the simultaneous vouchsafing that all personal (savings) deposits would be covered by a state guarantee. Similar governmental guarantees were granted in other countries, which in Ireland reached an especially large extent. It is noteworthy that Germany's Federal Finance Minister at that time felt like publicly ridiculing the Americans for their curious belief that, even in a market economy, the State should acquire a stake in private banks if so required by an emergency.

In the meantime, things changed drastically: the German government authorized not only a state participation of 25 per cent in a big private bank, but also an umbrella guarantee for banks amounting to 480 billion Euro, whereof 400 billion are earmarked to guarantee interbank credits and 80 billion Euro for governmental participating interests in financial institutions and for risky take-over acquisitions.

Guarantees for Individual Banks or for the Interbank Market?

However, the newly created institution called Sonderfonds Finanzmarktstabilisierung SoFFin (Special Fund for Stabilizing Financial Markets) managing and providing the umbrella rescue guarantees will only take action regarding any emergencies involving single banks. Aid will be granted upon request. Accordingly, a single bank may for example obtain governmental protection in the form of a guarantee covering its bond issues, but the entirety of the banking market cannot obtain a similar guarantee. Obviously, the basic problem of lacking trust in the market partners cannot be solved by such a system, focussed on individual cases. As revealed by the high spreads at the interbank market, the banks show very little trust or none at all in one another. An A bank is only willing to grant a loan to a B bank provided there is sufficient collateral security promising that the principal plus interest will actually be repaid. Now it is possible for the B Bank to provide the said security by making available a governmental guarantee. However, this presupposes that the B Bank approaches the SoFFin Special Fund with such a request, revealing thereby its fear to belong to a class distrusted by other banks. SoFFin immediately checks thoroughly such a request and grants - in case of a favourable outcome - a guarantee covering the bank's instrument of debt. So far, governmental guarantees for 6 bond issues totalling 133 billion Euro have been granted. The procedure is thus hardly made use of - which is not surprising since it is rather complicated, bureaucratic and in a certain sense also denouncing.

In my opinion, it would have been more purposeful to grant over-all aid to the whole *market* of interbank credits instead of dealing with peculiarities of individual institutions (such a regional banks, i.e. Landesbanken, Commerzbank, Hypo Real Estate). Why was it not possible for the Federal Government of Germany to simply declare that it would guarantee - for a restricted time - all interbank liabilities of German banks? In that case no German bank would have had to worry that a credit granted to another German bank might perhaps not be repaid. Would such a procedure have been tantamount to an untenable guarantee, thus

creating no trust? One may judge the volume of the domestic German interbank commerce as being too big. It totals a hefty 3.3 trillion Euro; which corresponds to more than 140 per cent of the German gross domestic product (GDP). Out of this total, a share of 1.4 trillion represents liabilities vis-à-vis foreign banks. Admittedly, these are huge sums. Should we assume that almost all banks will fail, the German taxpayer would indeed be confronted with a monstrous problem. But that is really an unlikely scenario. A crash of all banks is indeed unlikely, but rather the insolvency of individual banks, which will still cause problems. Moreover, the guarantee is not intended to keep every bank afloat, but is aimed instead at securing the due performance of assumed interbank liabilities. Besides, it is evident that every German bank fearing to get insolvent over the short term would have already applied, under present conditions, to SoFFim for a governmental guarantee or even for a direct state participation. Up to now, however, there is evidence that barely a few banks are involved in such instances.

The risk incurred by the German Federal Government by providing an over-all guarantee of interbank liabilities would not have been bigger than the total risk now assumed by granting separate guarantees for the debts of individual banks. But the advantage of a market-wide solution, specifically consisting in abolishing instantly the widespread diffidence of banks against reciprocal granting of credit, would have been significant. Of course, in such an event it would have been obvious to go one step further and to offer this facility not only to domestic banks, but to take the initiative to include also other European banks by means of a comprehensive solution applied to the whole Euro region.

How to Dispose of Toxic Vehicles?

A further very grave problem consists in the „toxic“ securities included in the balance sheets of banks and partly also of life insurance companies. The fanciful term of toxic vehicles initially only concerned securitizations of second- and third-grade U.S. mortgage debentures, especially the rotten "subprime" credits, now comprising however all types of debentures involving default risks exceeding 50 per cent and more. The existence of such default risks means that high losses might possibly - but not necessarily - occur. The basic problem inherent in possession of the toxic vehicles is of a fundamental nature. In case of default the equity capital will be lost. Due to the regulations regarding the equity capital to be held, a bank might subsequently be compelled by circumstances to downsize its capital drastically.

Banks holding large portfolios of toxic vehicles may prefer rather refrain from granting new credits. In a microeconomic context such a prudence is certainly justified, although in a macroeconomic perspective it might be undesirable, as such a behaviour could entail a credit crunch affecting the entire economy. Such an event could in its turn jeopardize the braking of the presently drastic economic downturn as well as hamper the financing of a new upswing.

That's why shifting the toxic securities to one or more „bad banks“ is now being considered. The standard trick of every special solution of this type consists in making the taxpayer participate in credit defaults by burdening him to the utmost with the risks involved. Here, one may ask the key question why the taxpayer should at all participate in this respect. As the banks have been engaged in a faulty and often careless investment policy, the principle of liability would really compel the responsible managers and subsequently the shareholders to answer for the damages caused by their fault. This is a valid principle based on market-economy considerations, which should not be forgotten. By contrast, there is another consideration: Should the State refuse its aid, it is quite possible that the finance system as well as the entire economy will be subject to a crisis protracted during many years. In this respect, the responsible politicians must ponder rationally the eventuality of incurring such a risk, and further whether they will thereafter be able to endure all the same in a political context. The conclusion arrived at by the political elites of most countries consists obviously in trying to keep risks at the lowest possible level. Rather reluctantly, the decision-makers now are approaching the problem as to whether there might be a justifiable solution of the bad-bank quandary.

The simplest and also safest way would consist in the State's buying the toxic vehicles from banks, disposing of the same in a central fund. This would be tantamount to entirely relieve the banks from the risks incurred and would most probably tend toward excessively high valuation ratios. But even if the difficult valuation problems could be satisfactorily solved, such a procedure would cost the taxpayer a lot in view of the fact that for the sole German banking system one assumes a volume of "problematic instruments" (toxic vehicles and assets without a current market price) at present totalling 816 billion Euro, whereof the toxic vehicles amount to just about 400 billion Euro. However, the envisaged losses should be substantially lower. Round about 200 billion Euro is an acceptable forecast, but this is still a huge amount. An unconditional purchase of problematic assets by the State is out of the

question, not least because this should by no means serve as an incentive or an example to be copied.

The American „Summers-Geithner“ plan of a public-private partnership is based on the intention to make available fresh private capital, thereby taking over the toxic vehicles at extremely favourable subsidized conditions. But in my opinion the model computations of many U.S. economists evidence convincingly that this plan would enable banks to burden the U.S. Government with fictitious values further increasing the public debt.

The German plan actually envisaged aims at the solution that private banks may shift their toxic vehicles at book values to special-purpose companies to be administered by a governmental "mobilization fund". As a quid pro quo the banks will receive bonds guaranteed by the German Government. This public debt shall be redeemed by using the proceeds resulting from the realization of the toxic vehicles at a later date. Any remaining losses shall be burdened on the specific bank involved, but the manner whereby this should be achieved is still to be decided. Most probably, the banks have to set up contingency reserves, which could be resorted to after dissolving the special-purpose companies. For the regional banks a similar instrument (called Aida, short for "Anstalt in der Anstalt") will be chosen subject to the proviso that, first of all, any losses have to be borne by the regional "Land", to which the involved "Landesbank" belongs, with participation of the Federal German Government only after a certain ceiling has been attained.

However, it is possible to envisage even a solution of the "bad bank" problems without participation of the State. Every problem bank would be subdivided into a "good" bank and a "bad" bank. The unproblematic, i.e. risk-wise safe assets would be transferred to a good bank to be set up as a new institution, along with bank deposits. Moreover, the good bank would be financed by stock to be issued, held exclusively by the bad bank as assets, beside the toxic securities and credits. The bad (parent) bank would continue without change to be funded by the original share capital and by the existing long-term liabilities. Should subsequently bigger-than-expected credit defaults and exchange-rate losses occur, the bad bank will have to be closed. The bad bank's shareholders and bond creditors would then lose their capital, but - and that's the main point - the newly created good bank would be a good asset, readily saleable. Unimpeded, the good bank could pursue its normal deposit and credit business. Such a solution would exempt the taxpayer from a direct participation in the bank's losses. But it is

quite possible that depositors would feel worried when their deposits are suddenly transferred to a new bank.

Reforming Basel II and Supervision of Banks

A medium-term problem consists in the Basel II Regulation, which has just been introduced. The present big crisis did glaringly evidence the fact that risk-oriented equity-capital regulation in a pro-cyclical manner poses very difficult problems, since a decreasing value of assets ties down more equity capital and thus triggers perforce counterproductive reactions. In this respect, it will be necessary to find a solution adjusting the level of the mandatory equity capital less to the situation prevailing at the time involved, but more to the general trend not subject to swings in the economic cycle. So much for the basic principle, but how such regulations would actually look like is so far an entirely open question.

In view of the obvious fact that the international financial crisis did reveal the inability of the authorities supervising banks in many countries to detect the emergence of the systemic crisis early enough, it is evident that now every possible type of measures aiming at an increased transparency should be pondered in an internationally coordinated manner. This should help to avoid arbitrary regulation and above all sharpen the capability for early detecting of systemic errors. To cite an example: the macro stress tests used up to now did obviously fail. It is certainly advisable to cooperate more closely with the national supervisory boards. In the meantime, the EU Commission has received a pertinent analysis of the group of experts headed by Jacques de Larosière. Basically, it will be necessary to decide whether or not one would like to engage in a development aiming at a centralized European supervisory authority, or if one prefers to improve cooperation between the various supervisory boards, deeming such a solution to be sufficient.

More Responsibility Required for Monetary Policy

As outlined by me at the beginning, central banks in the U.S. and in Europe observed a policy of easy money even bordering on outright foolhardiness, thereby providing financial markets with an overdose of liquidity during many years. The result was a financial climate strongly favouring the faulty developments affecting financial markets. This is a lesson not to be forgotten. The sole rate of escalation of consumer prices is not a sufficiently reliable yardstick

in order to decide whether or not the monetary policy is to be conducted in an expansive manner. After an intermediary period of higher interest rates, the monetary policy is steering again a very expansive course. For the time being, such a course appears to be quite advisable and not at all perilous in view of the seriousness of the worldwide recession. However, central banks must be watchful. That's because after a steep decline, we could witness in the coming year a steep economic upswing - even though few people would believe this now. But should this happen, it will be necessary to react very early in a decisive manner in order to absorb again the excessive liquidity as well as to prevent a renewed overheating of financial markets.