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Rescue Strategy without moral hazard – an attempt to provide a master plan for avoiding banking crises

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Rescue Strategy without moral hazard –

an attempt to provide a master plan for avoiding banking crises*

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Objective

The financial crisis caught unaware all those involved - from the central banks, the regulatory authorities to the financial industry itself. Although the collapse of the banking system, with the exception of Iceland, could be prevented, the measures taken (at the time) are now generally considered to be unsuitable for preventing and resolving future crises. The main objection concerns the enormous incentives for malpractice (moral hazard), frequently associated with state-financed rescue measures and the lack of procedures to handle failing financial institutions with systemic relevance.

Against the background of the last two and a half years, the following analysis will develop a concept for crisis prevention and intervention, outlining a reaction strategy for dealing with crises at both the micro and macro level that is consistent, effective and embedded in an institutional/constitutional framing ("Ordnungspolitik").

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In this context, the term “consistent” is intended to imply that measures adopted in the short term (crisis intervention policies) and those implemented on a long-term basis (crisis prevention policies) will complement rather than contradict one another. The institutional framing is to make sure that the policy neither generates the wrong incentives nor distorts competition to any large degree.

The proposals made here are based as far as possible on instruments and institutions that already exist. The creation of new instruments and institutions is kept to a minimum. Numerous other concepts are currently being discussed that allow for a completely fresh start and envisage the extensive structural reorganization of financial institutions. The suggestions put forward by Paul Volcker and the US Senate are examples of this type of approach. These concepts can only be briefly touched upon here since they still require intensive scholarly appraisal.

First, the paper provides a brief overview of the taxonomy of the proposed concept (I: Concept outline). In the following section, the four fundamental elements of the proposal are discussed (II: Elaboration). This section comprises the main focus of the analysis. The paper concludes by identifying some further implementation and reform issues (III: Implementation issues). These issues require more in depth analysis; possibly during the scheduled talks.

The deliberations in all sections are in essence restricted to credit institutions (banks) and their market. The remaining segments of the capital market, which also played a decisive role in the emergence and development of the financial crisis, are not dealt with here – including, in particular, monetary policy, asset securitization, the existence of derivative markets outside the stock exchange (OTC trading) for CDS and CDO, counterparty risk and the failings of (private) rating agencies. The emergence of “shadow banks“ is also not discussed nor is the remuneration of dealers or managers of financial institutions. Furthermore, a discussion of questions relating to the “democratization” of access to capital markets, which includes aspects such as investor protection and deposit insurance as well as the transparency and controlling of credit ratings, is excluded. The same also holds for problems related to corporate governance, fair value accounting and the procyclicality of equity capital requirements. They need to be dealt with separately.

I. Concept outline

One of the most common insights gained in the course of this crisis has been that systematic risks in the highly interlinked, derivative-laden modern financial system represent a very real threat. This suggests that a balanced set of instruments must be at hand with which banks may not only be rescued but also wound up in an orderly fashion. The danger of systemic market instability and worldwide contagion must be faced, without at the same time creating negative incentives “ex ante” via the preemptive effects of regulatory procedures.

Making a distinction between acute and preventive rescue measures (crisis intervention and crisis prevention) is crucial. Furthermore, a distinction must be made between the problems of an individual bank and those of the financial system as a whole. The four cases that arise from making this distinction are presented in diagram 1. They form the basis for the discussion in section II.

Overview 1: Matrix of crisis type vs. choice of strategy

Crisis type/ strategy	Crisis prevention	Crisis intervention
Single bank (idiosyncratic)	① Equity/Basel II (+ESF)	② bank hospital (+creditor liability
Several banks (systemic)	③ Risk map, Systemic Risk Charge (+ESRB)	④ bank hospital (+CoCo)

Key: ESF = deposit guarantee funds, CoCo = contingent convertible bonds, ESRB = European Systemic Risk Board

II. Elaboration

We briefly present the four action alternatives depicted in diagram 1.

① The single bank: crisis prevention

It can undoubtedly be said that the entire statutory system of banking supervision aimed at preventing a crisis within the financial system has not fulfilled its intended purpose. This is true with respect to both the actions and the organization of the supervisory institutions as well as the substantive legislation by the EU and its member states pursuant to the recommendations of the Basel Committee (Basel II) (in specific, sections 10-12a German Banking Act [Kreditwesengesetz - KWG]) and the subsequent administrative regulations (e.g. Solvability Regulation). The implications of systemic risks and the eventuality of contagion between banks have hitherto received little or no attention. This will be discussed in more depth in section ③.

If the existing regulations were to continue to operate unchanged, then crisis prevention would be limited to stipulating a minimum requirement for the equity capital of individual institutions, groups of institutions, financial holdings groups and financial conglomerates (sections 10–10c KWG) as well as specifications designed to guarantee the sufficient ability to pay (liquidity), section 11 KWG. The resulting limitation to the degree of indebtedness is also intended to limit the "appetite for risk" and thus the incentive to commit to risky investments. Necessary enhancements and reforms are discussed frequently by academics and committees of experts. They must be excluded here.

An important issue, which because of its significance for the stability of the system as a whole will be briefly considered here, is the protection of individual institutions against a run by depositors or other financial institutes. Since credible safeguarding against such a run also reduces the risk of contagion for other financial institutes, the protection of investments of each individual institution contributes to the stability of the system as a whole. In Germany, there exists in this context a considerable need for reform. For one thing, the safeguarding of claims against the banks is partitioned according to the "pillars" of the German banking system and these claims are thus walled off from one another. This possibly reduces the safeguard's efficiency. Furthermore, it is inconsistent with respect to the claims in question, since in some cases only deposits are protected and in others the institutions themselves are covered so that the bonds they issue are also protected. The protection schemes that voluntarily exceed the legally prescribed minimum insurance do not allow legal claims to be made against them, and their ability to pay is questionable for lack of sufficient reserves or legally binding reserve liability. Finally, the liquidity of the various institutions is also not covered by any form of government guarantee. The verbally proclaimed guarantee given by the German Government in fall 2008 is hardly likely to have constituted a legally enforceable claim.

The voluntary assurances given, that do not in essence constitute a legal obligation, are not sufficiently covered by a capital stock. The designated reserve liabilities are, at least in the case of the deposit guarantee funds of the Association of German Banks (Bundesverband deutscher Banken e. V.), too low. With respect to the mandatory protection scheme of security traders, they proved to be both legally and economically insufficient even before the onset of the financial crisis. All types of pay-as-you-go systems that only call upon the necessary means in the event of losses are likely to be inadequate in the face of an escalating crisis. Furthermore, reciprocal insurance can only work in the case of isolated banking problems.

For this reason, the German deposit insurance funds system cannot be viewed as efficient. In any event, an additional state deposit guarantee fund will be required, which, in order to ensure risk-appropriate premiums, will need to generate its own regulatory environment. It might be advisable to emulate the American Federal Deposit Insurance Corporation, that also acts as the regulator, and in the US is perceived to be one of the most efficient supervisory institutions.

② Single institutions and crisis intervention

Crisis prevention measures can only be successful when they are not counteracted by the expectations of market participants with respect to the actual behavior of the regulatory authorities and the central bank in the event of a crisis (crisis intervention). Thus, the expectations of banks and investors regarding the behavior of the state in the event of a crisis involving a single institution is of considerable importance and can be likened to the significance of *credible* monetary policy on the part of a central bank. By analogy, great importance is to be attached to credible commitments by the central bank, the regulator and the finance minister to a previously established crisis procedure.

The rescue measures over the course of the current crisis were aimed at a single institution only at the onset of the crisis but were quickly followed by the implementation of further general provisions and regulations. However, these regulations have had to be frequently revised and supplemented. Overall – as in other countries - the persistent expectation has in general emerged that in an emergency, banks, and indeed insurances as well, will be unconditionally supported using taxpayers' money. Thus, the expectation has been allowed to develop that in this way creditors will also be unconditionally safeguarded from any financial losses. These expectations must now be credibly countermanded. A legally binding mechanism must be introduced by which equity providers and creditors, to the extent that they are not safeguarded by a deposit guarantee fund, have to bear the burden of a banking collapse and not the taxpayer.

The general procedure provided for this, insolvency proceedings pursuant to the insolvency code, has proved to be unsuitable already with respect to medium-sized institutions[1].

This deficiency should be remedied by creating an institutionalized restructuring process for failing banks. A state-run institution will be required, endowed with the power to enforce the necessary procedures in a way that is compatible with the system, even in the face of opposition from creditors and the bank's previous owners. This task could either be assigned to the Federal Agency for Financial Market Stabilization (SoFFin - the "bank hospital"), which is a legal person since the Law on the

[1] It is true that the BaFin may already initiate insolvency proceedings following, section 46b para. 1 article 4 KWG. Proceedings can be initiated when insolvency only threatens to occur, section 46b para. 1 article 1 KWG. An institute may, in the event, also continue to operate, sections 217 ff. Insolvency Code. The danger of initiating a "domino" effect and thereby destabilizing the entire system is, however, too big. Section 104 para. 2, which was incorporated in the Insolvency Code as a result of lobbying by the credit services sector, exacerbates this situation. The amended crisis management system in sections 45–46a KWG allows neither a consistent restructuring nor an orderly wind-up without incurring negative effects for the whole system.

Further Development of Financial Stability took effect on 17 July 2009, or to the Federal Financial Supervisory Authority (BaFin).

In the event of a sudden crisis, either the entire failing financial institution or only its systemically relevant financial dealings could credibly and comprehensively be insured through this state-run institution. Safeguarded in this way from insolvency, the institute concerned could then, in a next step, be restructured without haste. Parts of the business could be sold off or liquidated. Finally, the accounts could be settled and the remaining losses charged to the equity holders and should this not be sufficient to the non-systemic creditors, that is, the bondholders and finally the depositors. They would have to carry out the necessary write-offs. In the end, all those involved would fare in the same way as they would in insolvency proceedings, but there would be no negative external effects for the system as a whole. From the point of view of the institutional framework ("Ordnungspolitik"), the significant principle of privatizing profits *and* losses could be enforced. This could effectively curtail the incentives for economically unsound risk assumption.

In order to achieve these objectives, it would be appropriate to identify systemic importance not on the level of entire institutions but rather in parts of the business or better still on the level of individual contracts that a bank has entered. Bonds may also fall into this category. It is thereby assumed that a financial institution's commitments can be classified as being either systemically relevant or systemically non-relevant. The same holds for the systemically relevant parts of a company. It is only necessary to guarantee those debts or parts of the company that are systemically relevant. With respect to those debts or parts of the company that do not need to be guaranteed, creditors according to their order of precedence will continue to be liable. Systemically relevant debts are those that crucially must be met in the interests of the stability of the financial system as a whole. This evaluation of debt is the task of the state that underwrites the guarantees. In this way the systemically relevant debts or parts of the company can be safeguarded without eliminating the insolvency risk for the remainder. Provisions must be made for the case that creditors anticipate these guarantees and refrain from taking the appropriate measures for securing their receivables.

The risk of default on non-systemic debt must rest solely with the creditors. Through appropriate legislation and its enforcement by competent authorities and by the actions of the (possibly state-backed) deposit guarantee system with a supervisory function it must be ensured that all institutions, at all times, have sufficient non-systemic outstanding liabilities at their disposal. In this way, an institution is to be prevented from evading its immediate responsibilities by claiming that all its debt is "systemic".

③ The banking system: crisis prevention

It is not always easy to differentiate between the crisis of a single institution and that of several institutions, or indeed of the system as a whole. This is one of the lessons to be learnt from the present crisis. The Lehmann bankruptcy showed that the linkage between financial institutions and their common dependency on the market evaluation of individual assets can, in the presence of largely similar portfolio structures, have fatal results for other institutions. For this reason, the state guarantee with respect to systemically relevant financial relationships, as explained in ②**,** is very important when it comes to being able to isolate a failing institution from within the tightly knit financial system and to "surgically" treat it. If, however, a systemic crisis threatens with the potential simultaneous collapse of several, or of all, important institutions, then there is no alternative to coordinated state intervention. In this case it makes no difference whether the cause is a run on the banks by depositors or the mutual loss of confidence between the banks themselves.

Nonetheless, provisions can and must be made beforehand, not only in order to allow the build-up of systemic risk to be recognized early on, but also and above all to make felt to the perpetrators the potential costs. In fact, the accumulation of systemic risk is generally not directly perceived by the individual financial institution in its role as perpetrator, nor is it apparent in the balance sheet of that institution. However, even when the accumulation of systemic risk is recognized as such, it may still appear very attractive at the microeconomic level, owing to the frequently associated higher return.

The incurrence of systemic risk is in economic terms an *externality*. It needs to be internalized in order for it to appear in the microeconomic return calculation. Basically, every measure that increases the operational costs for assuming risks is suitable for effecting the necessary internalization. In the first place a levy may be envisaged. The selective burden of a tax is hardly likely to comply with constitutional requirements. The imposition of a (user) fee or a contribution ("Vorzugslast") lacks the required quid pro quo. Closer consideration can be given to an extra duty ("Sonderabgabe") in the form of an administrative compensatory levy or equalization charge. This type of charge is quite common in environmental policy aimed at minimizing negative (polluting) behavior or at offsetting specific advantages or disadvantages. It has to be carefully designed, however, to fulfill the close and stringent prerequisites set up by the federal constitutional court over the years. The level of such a charge should be set according to the degree by which the asset in question contributes to the overall systemic risk. This type of charge can be used to ensure that systemic risks are made sufficiently "expensive" for individual institutions so that the accumulation of excessive systemic risks, if not completely suppressed, at least becomes much more difficult. The internalization of external effects can, however, also be achieved by requiring equity reserves of the same volume. They would also result in the containment of risks.

Nevertheless, it cannot be denied that determining the systemic risks of individual banks or debts can give rise to considerable practical problems. This is already the case as regards their identification. Almost no one recognized the top rated securities held by some banks as the trigger for a global crisis. The entire highly complex network of regulations relating to stockholders' equity was not sufficient to reveal the risks that emerged. Moreover, there will be no lack of efforts made to avoid these charges. In this context, however, it should be remembered that the notion proposed by the German government at the G20 meetings contains the creation of a risk map. This proposal is currently receiving renewed attention in the context of the proposed National Institute of Finance suggested by Harry Markowitz together with several other Nobel prizewinners. Knowledge of the bilateral financial relationships between big, internationally active financial institutions, captured on the risk map, is a prerequisite for even being able to calculate the charges outlined above. The drawing up of a risk map is, therefore, still part of the measures being proposed here.

Assuming that it is indeed possible to levy such a charge, the question remains what should then happen with the proceeds. There are several arguments in support of the suggestion, currently also the subject of intense debate in the US, that the money should be reinvested in the encumbered institutions in the form of contingent convertible bonds (CoCo). These bonds can, upon demand, be converted into insured equity. The conversion takes place when the financial institution is deemed to be solvent but illiquid due to market conditions. Via the conversion the institution gains direct access to fresh capital resources and, at the same time, is able to reduce its interest payments, thus increasing its operating income and improving its liquidity situation. When there is no crisis, such bond holdings should bear risk adequate interest at the going market rate. The right to convert should lie with the state supervisory authorities and be exercised possibly in agreement with the Bundesbank or the new European Systemic Risk Board (ESRB). Further details must still be developed.

④ The banking system: crisis intervention and the role of the regulator

Combating a crisis of the entire banking system will again fall to the state restructuring institution (the Federal Agency for Financial Market Stabilization, the "bank hospital"). The measures adopted will differ, however, since the CoCo stock accumulated in times of no crisis can, at the instigation of the authority in charge, be completely or partially converted into equity capital. Following the conversion to equity capital, the obligation to repay interest is immediately dropped (liquidity effect) and an increase in liable equity capital results without having to resort to the capital market (solvency effect).

Although the tasks of the banking regulator in their entirety not only serve to intervene in a crisis but have also been increasingly designed to function in a preventive capacity, they will be analyzed in this section. An appropriately organized supervisory authority, suited to the job at hand, is imperative. However, the division of the regulatory tasks between the Deutsche Bundesbank and the BaFin is hardly likely to have played a significant role in causing or influencing the course of the crisis. Whether placing the responsibility for supervision solely under the auspices of the Bundesbank might have prevented the crisis, is also not certain. The variety of supervision models in the countries that have been worst affected by the crisis suggests not.

In contrast, there are clear indications that the trend towards „self regulation" in the credit services sector, in lieu of a neutral supervisory authority that pursues the objective of hazard prevention, contributed significantly towards causing the crisis. Such elements also exist in the institutional organization of the BaFin:

– BaFin is financed exclusively on the basis of fee-style payments and a financial contribution by those subject to supervision, section 16 para. 1 Law on Financial Services Supervision (FinDAG);
– Co-decision rights with respect to the authority's operations are granted to supervisees through their representatives in the administrative board of the BaFin , section 7 Abs. 1 and 3 Fin DAG; the administrative board also takes decisions about the resources awarded to the supervisory authority, section 12 para. 2 clause 1 FinDAG;
– An advisory body, formed in accordance with section 8 FinDAG, is, however, largely controlled by representatives with vested interests.

Measures and institutions aimed at securing financial market stability and values held in trust serve society as a whole and should therefore be largely financed by the federal budget. The decision taken in parliament about how to finance the supervisory authorities reveals, moreover, the extent to which the politicians really value a functioning regulator. The institution is not a self-governing body and with a view to its task of hazard prevention, it must not be allowed to become so. This is above all true with a view to its already existing obligation to deal with issues that infringe upon the proper conduct of banking business and financial services or that might lead to considerable disadvantages for the economy as a whole. An administrative board is therefore inappropriate and should be abolished. An advisory body might be appropriate but from the point of view of public welfare only in order to be able to make use of neutral (academic) expertise or to act in the interests of the clients of financial institutions.

The substantive regulatory law set out in the Banking Act and the implementation regulations issued in connection require a thorough revision. Due to numerous special provisions and exceptions the law's basic purpose is now hardly recognizable. Indeed, owing to its complexity it barely complies with the constitutional requirements of clarity and comprehensibility.

III. Implementation issues

1. Deposit guarantee funds: the reorganization of the entire deposit guarantee systems and the associated supervisory functions is complex, especially given the pillar structure of the German banking system. A neutral analysis of the issues involved is thus advisable. The role of the state must also be clarified. A deposit guarantee scheme is unlikely to do completely without (explicit) state guarantees in the future. Thus the question of risk- adjusted compensation in return for state protection arises.

2. The bank hospital or reorganization procedure: with respect to the individual design of the concept presented above for insuring and reorganizing institutions in difficulty, various questions still have to be answered. These include the question of "hospitalization", the question of selective guarantees for systemically significant obligations (following the example of special assets within the framework of the German Covered Bond Act [Pfandbriefgesetz]) and the question of precedence regulation for derivative positions (in keeping with IOSCO standards). The drafts put forward by the Federal Ministry for Economics and Technology as well as the Department of Justice together with the Ministry of Finance may provide important references, but they also contain numerous points that require discussion. The outsourcing of systemically relevant parts of a company into a new institute (the "bridge bank"-model) is one such possibility. However, the notion that an institute that has encountered difficulties or its owners might (actively) take part in this new enterprise is not very persuasive. Furthermore, it must also be verified whether amend-

ments to the German Banking Act [KWG] or the Insolvency Code are sufficient or whether a special statute is required.

3. Regulatory law: as mentioned above, a reform of the governance structure (administration and controlling) of the supervisory body and a strengthening of its independence are needed. In addition, comprehensive revision is required for substantive new regulatory law. Its complexity must be considerably reduced. Regulations pertaining to special interests must, as far as possible, be eliminated and the measures necessary for maintaining the stability of the system must, in the interest of the common good, be considerably extended.

4. Risk map/Systemic Risk Charge: the legal and operational prerequisites for compiling a risk map (already the subject of discussion at the G20 meetings in London and Philadelphia) are necessary for being able to internalize the externalities of systemic bank risks. All activities in this context must be coordinated with the ESRB (European Systemic Risk Board) and the proposed National Institute of Finance in the US.