

Deposit Insurance and Bank Resolution: Reforms Adopted in Response to the Crisis

Introductory Remarks by the Chairman of the Roundtable

W R White

Welcome to this round table discussion. Before introducing the members of the panel, let me make a few introductory comments.

My first point is that we have had historically, and likely always will have, repeated and severe financial and economic crises. In their recent book, Reinhart and Rogoff (2009) document eight hundred years of such crises, and their work is supported by other recent historical studies carried out by the IMF (2009), Schularich and Taylor (2009) and many others. It is certainly a pity that the warnings inherent in these works were presented only after the current crisis had begun. Since these problems emerged subject to a wide variety of monetary and regulatory regimes, I conclude that they are endemic to complex market based economies. In effect, because economies are complex adaptive organisms, they are subject to sudden and sometimes fatal breakdowns like all other such systems. There is a growing literature on “complexity economics”¹ and I strongly urge you to become acquainted with it.

My second point is obvious. If we will always have crises to deal with, we should be prepared for them. Unfortunately, history also teaches us that we never have been adequately prepared. In an article written over fifteen years ago, Caprio and Klingebiel (1996) looked at eighty six separate banking crises and concluded

¹ For an excellent introduction see Beinhocker (2007)

“few governments have responded well to such episodes” . In particular, governments consistently failed to take measures to make future crises both less likely and more manageable. And twelve years later, when the current crisis hit, the situation was no better. Think of the United Kingdom, ostensibly home to both a highly sophisticated financial system and a world class system of regulatory oversight. In practice, the Northern Rock affair revealed that: deposit insurance arrangements were wholly inadequate; bank insolvency arrangements were wholly inadequate; Memoranda of Understanding between relevant agencies were seriously deficient; and so on. And not only were there similar inadequacies in many other countries, but the international arrangements for dealing with cross border crises were even worse.

We are now midway through 2011 and at least three years into the crisis. Have the “Reforms Adopted in Response to the Crisis” made things better or worse? In answering this question, it is important to distinguish between policies introduced (ex post) to help manage this crisis, and policies proposed (ex ante) to help us manage future crises better. To the extent the former set of policies have been unhelpful, the challenges posed for the second set of reforms have been substantially increased.

Concerning ex post crisis management, I believe that virtually all the policies followed – while likely the only alternative at the time – have made future economic and financial crises both more likely and more dangerous. To be more specific, the massive easing of global monetary policy has encouraged more “bubble” like behavior , especially in the Emerging Market Economies. Moreover, global inflationary pressures are also on the rise. In addition, the massive easing of fiscal policy has also led to a dangerous buildup of sovereign debt in many countries. This raises the issue of what happens when a bankrupt banking system can no longer can fall back on the support of the government.

Within the financial system, some combination of forbearance, bank bailouts and a massive extension of deposit insurance coverage seems sure to reduce financial market discipline and to increase moral hazard going forward. Moreover, it must also be noted that government sponsored mergers and takeovers have left many

financial institutions (the so called SIFI's) bigger, more complex and more interdependent than ever before. And something similar could be said about many important markets, which are now more concentrated than before. In sum, systemic risks in the financial sector have grown significantly as a result of past policies. As a result, the need for effective ex ante reforms is now greater than ever before.

Fortunately, when it comes to ex ante reforms to facilitate crisis management in the future, there are at least two grounds for optimism. First, on reading the papers prepared for this conference, it appears that it is now generally recognized that instruments such as deposit insurance and bank resolution regimes cannot be treated in isolation. Each must be seen as part of a safety net "package", put together in such a way that today's problems are not made better only at the expense of making tomorrow's problems worse. More specifically, if deposit insurance schemes have to be more comprehensive, in a world made more "flighty" by electronic banking and other developments, it now seems accepted that supplementary measures to constrain risky behavior must also be enhanced as a counterweight. A second ground for optimism arises from reading the paper from the Basel Supervisors on cross border resolution² and the FSB paper on reducing the moral hazard posed by SIFI's³. These papers, having been endorsed by the G20 and containing specific timelines, make it clear that significant progress is already being made and that more can be expected.

Having given some grounds for optimism, let me finish with a last and less optimistic remark. Dealing with the SIFI problem is central to reducing systemic risk in the financial system. In this regard, I believe that the fundamental impediment to an effective resolution of SIFI's is the complexity of their legal and business structure. If the official community is not prepared to roll this back- even in the face of massive lobbying by firms who see their rents threatened- then our reform

² See Basel Committee on Banking Supervision (2010)

³ See Financial Stability Board (2010)

efforts will be effectively finished. As Shakespeare might well have put it “Much Ado About Nothing”.

We have a fine panel this morning. Let me introduce them in the order that they will speak.

First, Francesca Campolongo, Head of the Financial Crisis Task Force at the Joint Research Centre of the European Commission

Second, Andrew Campbell, Director of the Centre for Business Law and Practice at the University of Leeds

Third, Arthur Murton, Director of Insurance and Research at the FDIC

And finally, Jerzy Pruski, President of the Bank Guarantee Fund of Poland

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