



BANK OF ENGLAND

Speech

Practical Issues in Preparing for Cross-Border Financial Crises

Speech given by

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PRACTICAL ISSUES IN PREPARING FOR CROSS-BORDER FINANCIAL CRISES

Introduction

My subject this evening is the challenge that globalisation poses for handling and resolving financial crises.

If that seems a typically gloomy subject for a meeting of central banks, regulators and finance ministries, I would like to start by emphasising two points. First, I do not believe that globalisation is a source of instability; indeed in financial as in other markets, the opening up of international competition has been a huge force for good; by spreading and diversifying risk, it has in many ways made financial markets more efficient and stable. However, the fact is that governments, regulators and central banks remain largely national and our machinery for cooperation has not kept pace with the internationalisation of markets.

Second, I have not chosen the subject because I believe a crisis is imminent. Indeed, in the UK and elsewhere economic and financial conditions currently are mostly benign and are forecast to remain so. Of course concerns about global imbalances and the search for yield in financial markets remain but our central projections like those of the IMF and most other international forecasters show the ‘Great Stability’ of the last 10 years continuing at least in the near term. But remote events do happen – and by their nature we cannot always see them coming. Researchers at the World Bank have recorded 13 borderline or full-blown financial crises since the late 1970s, involving at least one Financial Stability Forum (FSF) member country.¹ And there are well known incidents not on the list: including the 1987 crash, the less developed countries’ debt crisis and LTCM’s near collapse.

So we are fortunate in having a time of relative calm to work out together how we should react when a problem does arise. And we have in the FSF a body that was established “to co-ordinate the efforts of ... various bodies in order to promote international financial stability, improve the functioning of markets, and reduce systemic risk”². In its first 7 years, much of the FSF’s focus has been on the identification and assessment of risks in a rapidly changing financial system; it has

¹ Gerard Caprio and Daniela Klingebiel, 2003. “Episodes of Systemic and Borderline Financial Crises”, World Bank Research Dataset. <http://econ.worldbank.org>

² <http://www.fsforum.org/home/home.html>

played a valuable role in building a common understanding among authorities and among market participants of what the risks are and how they can be reduced. However, that level of progress has been less apparent on putting in place arrangements for handling and resolving cross-border crises.

During that period a number of countries, including the UK, have improved their processes for handling financial crises – including for crises sparked by business continuity events. And there have been a number of exercises and co-ordination initiatives in different regional groups (for example amongst the Nordic countries, Dutch and Belgian authorities, and more widely across the EU). But there has been less progress on the wider international front. Overall, I do not know anyone who believes that we have established either the common approach to crises or the practical machinery which would enable us to handle a complex cross-border failure with confidence.

I would like to make some suggestions tonight on how we might take matters forward.

When and how should the State intervene to prevent or manage a financial crisis?

Of course the underlying questions are very difficult even for one country. Financial markets are often volatile and they can only work well if investors and firms expect to live or die by their own decisions and do not come to rely on a safety net to mitigate their losses. To avoid that ‘moral hazard’, authorities have tended to be reluctant to spell out in what circumstances and what ways they would be willing to help support a market or a participant, beyond making clear that it would only be in exceptional circumstances and where it was essential in the wider systemic interest. But the difficulty in spelling out underlying reasons must not become an excuse for lack of analysis and preparation. In order to make cross-border crisis management work, we may have to consider sacrificing some mystery – even if only amongst ourselves – for greater effectiveness.

The most recent cases of official emergency liquidity support to UK banks occurred in the early 1990s, when the Bank lent to a few small banks in order to prevent wider loss of confidence in the banking system. The Memorandum of Understanding (MoU) between the Treasury, FSA and Bank which sets out our current roles in maintaining financial stability makes clear that decisions on support operations now rest with the Chancellor, acting in the light of advice from both the Bank and the FSA.

Following the early 1990s experiences, Eddie – now Lord George – discussed various options for intervention.³ He argued that, in deciding whether to provide support, the authorities should: explore every option for a commercial solution before committing public funds; structure any support such that losses would fall first to shareholders and any benefits fall first to the authorities; not, in normal circumstances, lend to a firm known at the time to be insolvent; and, look for a clear exit from provision of the lending.

These guidelines go more to the question ‘how’ rather than the question ‘when’ the authorities should intervene, and they were drawn up before the globalisation of banking and capital markets had got fully underway. So I do not put them forward as the complete answer; rather I think we should be discussing whether there are some common understandings which could inform and shape cross-border cooperation.

International complexity

Of course reaching a common view will be difficult. But it seems to me a necessary step towards meeting the challenges of handling financial instability in the new world of open international capital markets and giant complex financial institutions.

Many of the challenges have been discussed in the international community. In particular: the potential difficulty in amassing a complete picture of the health of firms and capital markets in crisis from different authorities; the potential complexity of large firm structures, where entities within a firm may be subject to different legal arrangements, preference rules and rules concerning ownership interests and creditor arrangements; and the possible technical difficulties in winding down an entity that is engaged in complex trading strategies. There are also of course issues around how liquidity and capital can be moved around a group: whether collateral, funding or capital can be moved quickly across borders to where it needs to be.

Further, some of the commonly preferred methods for resolving a financial crisis, before moving to winding down methods, may be less easy to deploy than they were even a few years ago. I think many of us would share Eddie George’s view that we should look first for a private sector solution before committing public money to a rescue operation. When LTCM got into serious difficulties in 1998, and there was a risk that its liquidation could further destabilise markets, the New York Federal Reserve was able to facilitate discussions that resulted in a cooperative market solution.

³ George, E (1994) “The pursuit of financial stability”, Bank of England Quarterly Bulletin, February.

But would this kind of approach still be possible today? Certainly private sector solutions looked easier when lending was the predominant source of funds, banking systems were arranged predominantly along national lines, and it was possible to get the key counterparties round a single table. Will firms that have actively engaged in methods to lay off risk when a problem occurs – through, for example, credit derivatives and collateralisation – be as ready to contribute to solutions predicated on the give and take of long-term relationships? And will the increasing complexity and size of large complex financial institutions deter previously willing possible participants?

Since the FSF's creation, there has been further consolidation of international banking groups and globalisation of markets. Our vulnerabilities are more concentrated: although the firms and capital markets in which they are concentrated are probably more resilient, we have bigger and potentially more complex points of failure. This concentration has brought efficiencies, and has been supported by enhanced oversight of global firms and the capital markets they operate in. But the price we pay is more complicated (and therefore potentially more costly) crisis resolution.

A practical way forward

So how can we make more progress? I have spoken about drawing up a shared framework or set of principles but I am only too aware how easily that could become a drafting exercise in which difficult issues are evaded rather than dealt with.

Clearly initiatives such as this workshop are a useful way to bring relevant policymakers together – and I am encouraged by the shared commitment to make progress that you have shown by being here today.

My suggestion is that probably the best way of making further progress on a genuine and useful common approach is to work together on practical examples; to consider some of the operational problems that we would face if particular sorts of crises arose. And thus establish a shared fact base and understanding of what we might expect from each other in a crisis, and how we should go about handling it.

This idea of informal groups of relevant authorities is not new. In a sense, it is borrowed from the supervisory world, where colleges of regulators have existed for some time, with the aim of devising ways of pooling knowledge and developing common approaches – to supervise firms efficiently and to reduce the supervisory burden for them.

The groups to discuss crisis management issues would need to bring together supervisors and central banks. Both are likely to have day to day information which is relevant in a crisis, and both will also have control of tools which can be used to handle the problem. At the same time, the number of participants would probably need to be smaller than in a regulatory college if these groups are to be effective. To remain focused, the core group might perhaps need to be limited to authorities from two or three countries each, rather than wider groups.

And selectivity, flexibility and pragmatism would be absolutely key. I am not advocating, for example, that we form a group for every firm that includes all authorities in every jurisdiction where that firm has a presence. Instead, that we use a risk-based approach to concentrate on those authorities with a mutual interest, identify the specific firms and capital markets that that mutual interest might cover, and bring together those relevant authorities to discuss those firms and the capital markets they interact in. Indeed, some countries' authorities have already met bilaterally or in small groups to discuss crisis management topics of particular mutual interest.

There are a number of practical aspects of crisis management that these interest groups could enhance. First, co-ordination in a crisis. This, alongside information-sharing, is the area that has received most generic attention at the cross-border level. Our challenge is to embed processes that will be relevant for crises into our everyday interactions: co-ordination is likely to be much easier amongst colleagues who are already familiar with each other and with each other's views and approach, than with someone who is simply a name on a contact list. This is one positive feature of discussing these issues, just as some of the value of MoUs lies in the process of negotiation and the relationships that fosters.

Second: information-sharing in a crisis. Interest groups would be a good forum to discuss in advance what information it might be appropriate to share on specific firms, and to ensure that it would in practice be readily available. And in doing so, we will better understand the information and therefore be able to assess it more quickly and more confidently in-crisis.

Third: in-crisis systemic impact assessment. A key first step in deciding how to handle a crisis is in understanding the likely cost of not intervening in it – the likely systemic impact of it. The impact of a particular problem or failure of a particular firm will of course depend on the characteristics of that specific problem – and importantly on the resilience of the financial system, and the interlinkages amongst different elements of it at the time. However, there are common channels through which shocks propagate. And some of those channels will be more relevant for particular firms than others. The important aspect of developing this work is in providing a common

vocabulary in which policymakers can discuss the possible impact of a problem. This may also help to provide a framework for deciding whether to intervene in a crisis, as well as helping to understand who may be interested in intervening.

And fourth: the types of measures we have available in a crisis. I outlined earlier a number of challenges in resolving a crisis involving a large complex financial institution, and the obstacles we may face in addressing them. The Contact Group 2002 report on legal underpinnings⁴ provided more detail on the extent to which different legal regimes created vulnerabilities in managing crises. Through discussion of hypothetical problems for real firms we may get closer to understanding more concretely what these obstacles will look like in practice and therefore what we might want to put in place to mitigate them. Put another way, it is potentially a way to develop practical solutions, or at least a practical understanding of the specific issues we might face, within the parameters of our current legal and fiscal set up.

What we learn from firm-focussed interest groups should also put us in a better position to tackle some of the thorny issues we face. One which particularly exercises me is ensuring that we should always have the option of closing down a large firm in an orderly way, even if we need to use emergency liquidity assistance as a bridging loan to do so (rather than as a step towards keeping the firm open).

Looking further ahead, it is clear that these interest groups should not remain inward-looking. In order for any preparations for crisis to be relevant, authorities will need to ensure that they are informed by firms' plans and views – for example on their likely own actions in crisis, where they see their vulnerabilities in managing a problem, what they expect the authorities to do, and where arrangements could be improved. So the ongoing dialogue that the relevant authorities have with firms may well inform, and be informed by, the work of interest groups.

What role could the FSF play in promoting these kinds of bilateral or small multilateral discussions and exercises on practical topics regarding specific firms and markets? As we all know, it is not the role of the FSF to manage cross-border crises. But my view is that the FSF does have a role in this area. To me it seems the ideal group to draw out the common messages and lessons that may emerge from these interest group discussions, and to establish a common framework for handling crises which will be of use both to its members and more widely.

⁴ <http://www.bis.org/press/p021210.htm>