

The Need for an Emergency Bank Debt Insurance Mechanism

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This article proposes the creation of an Emergency Bank Debt Insurance Mechanism (EBDIM) as an alternative to the massive lending of last resort (LLR) operations undertaken by central banks since the start of the subprime crisis. Both arrangements share the rationale of providing banks with sufficient liquidity in case of crises, such as the current one, where widespread fear of counterparty risk impairs the normal functioning of money markets and, more generally, the markets where banks obtain short and medium term financing for their operations. They also share some drawbacks such as the temporary removal of market discipline, the socialization of the losses due to private risk-taking decisions, and the potential creation of moral hazard. It is argued, however, that an EBDIM can be superior to LLR in a number of important dimensions: it is more effective in re-establishing the operation of money markets and the confidence in the banking system, less distorting to core central bank activities, more transparent about its potential costs to taxpayers, less subject to problems of coordination or conflict of interest between the involved government agencies, and clearer about the allocation of its costs in cross-border transactions.

Background

The so-called subprime crisis that started in the Summer of 2007 has created an unprecedented situation in global money markets: never before has an episode affected the liquidity of wholesale money markets (and their closer substitutes) to such a geographically broad and quantitatively significant extent. Essentially, all market means for the short- and medium-term financing of banks (from traditional interbank deposits to the most ingenious forms of securitization) exhibit large spreads and shrunk volumes of transactions.¹

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¹ Readers interested in a detailed account of the facts and an early assessment of the long-term policy lessons from the current crisis should refer to *CEPR Policy Insight No. 18*, 'Lessons from the 2007 Financial Crisis,' by Willem H. Buiter, December 2007.

Central banks have orchestrated massive LLR operations in an attempt to help many banks to sort out their liquidity problems. Newer forms of LLR schemes (such as the Fed's Term Auction Facility) have been introduced and kept in place for several months now, but money markets do not seem to be returning to normality. Meanwhile, many bank and non-bank investors around the globe (including sovereign funds from emerging and commodity-rich economies and hedge funds) are believed to be holding on to their excess liquidity, maintaining it in the form of cash, treasuries, and other assets with low counterparty risk (such as gold and other precious metals). The diagnosis is not that there is a global net shortage of liquidity, but rather that the markets for short term capital are failing to transfer funds from agents with financial capabilities to agents with financial needs.

...an Emergency Bank Debt Insurance Mechanism (EBDIM) can be superior to the massive lending of last resort (LLR) operations

Very much in parallel to what happens in a text-book self-fulfilling bank run, investors with both short and long-term financial capabilities seem no longer willing to invest in short term bank liabilities. For the institutions that adopted a business model based on a continuous or recurrent resort to short-term borrowing, the current situation may be fatal. The banks that kept their risky assets on balance sheet face a dilemma between having to pay high spreads on new borrowing and, otherwise, having to sell assets at fire-sale prices (or in declining real state markets), to incur penalties for the breaking of prior lending commitments, or to deny credit to some of their locked-in customers. For the banks using an originate-to-distribute strategy involving highly-levered conduits, the situation is similar. Many of them either kept the equity tranches or provided implicit or explicit refinancing guarantees to their vehicles, which in the current situation is bringing back

to the banks' balance sheets the credit risk that had been supposedly transferred. All in all, the current situation in refinancing markets poses serious threats to banks' ability to generate positive profits and remain well-capitalized without resorting to (typically very costly) outside equity injections.

Economics of the situation

The microeconomics of the current situation in money markets responds to the combined logic of various well-known theories of adverse selection, bank panics, and credit cycles developed by economists over the last thirty years. The unique feature of the current crisis is the mixing of the three.

It all started with a significant shock (the change in the cyclical position of the US housing market) and its impact on the oversized US subprime mortgage market. Globalization explains the propagation of the losses throughout the world financial system. Securitization excesses, with a combination of high leverage, large reliance on short term borrowings, large complexity, little transparency, and an inadequate assessment of systemic risks, converted the global shock into a collection of asymmetric, potentially fatal, but hardly observable, shocks to the financial health of systematically important financial institutions.

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The fear of some not-yet-identified institution being the next to go under, made investors skeptical about the creditworthiness of any institution, specially those with a greater willingness to borrow in money markets (a typical 'lemons problem'). Money markets collapsed.

Given the huge money-market refinancing needs implied by the prevailing model of banking, a situation similar to a bank panic of the old days emerged. The possibility that many solvent, yet illiquid banks may not be able to access sufficient refinancing capacity may turn banks' initial liquidity problems into solvency problems, confirming or even aggravating investors' skepticism towards bank liabilities.

Weak bank balance sheets may lead to an overall restriction in bank credit supply, forcing some bank-dependent households and non-financial firms to cut their spending and investment plans above and beyond what would occur in the absence of these effects.

Policy responses: massive LLR operations

The previous diagnosis identifies several intertwined vicious circles that explain why negative shocks that appear relatively small on impact may end up propagated and amplified throughout the economy, giving rise

to a serious and persistent downturn. Standard counter-cyclical macroeconomic recipes call for reacting to the threat of a downturn by stimulating aggregate demand, that is, by giving a more expansionary bias to traditional monetary and fiscal policies. Movements in this direction have already been undertaken in the US and several other countries. These policies are in some cases combined with others, or specialized so as to break some of the vicious circles mentioned above. This is the case when, for instance, government spending is used to prevent households to default on their mortgages or their properties to be foreclosed.

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Coordinated LLR operations by major central banks since the start of the crisis are aimed at breaking the vicious circle whereby banks' liquidity and solvency problems reinforce each other. In principle, they fit well into the doctrine first established by Bagehot (1873) on why, when, and how central banks should act as lenders of last resort. However, the dimension of the current episode has pushed central banks to make LLR interventions much more systematic than ever before. In the last weeks, media around the world have echoed the increasing controversy surrounding these LLR interventions. Meanwhile, if one is to judge from the increasing pessimism among bankers and bank stock traders, it is not clear that LLR interventions have succeeded in keeping banks' marginal short-term refinancing cost at normal, non-crisis levels.

The discussion about the current LLR interventions goes from issues extensively treated in the literature on the pros and cons of the banks' safety net, such as moral hazard, to details of the implementation, such as the rigor or laxity of the criteria for inclusion in the list of assets that are acceptable as collateral. An important number of concerns refer to issues of institutional design, for instance: the lack of transparency about the costs of these interventions; their cross-border allocation; the ability of tax-payers to make central banks accountable for their use of public funds; the degree of coordination between bank supervisors and central banks; central banks' temptation to support large domestic institutions more than smaller or foreign ones; and the distortion to central banks' main role as controllers of inflation.

EBDIM as an alternative

The central point of this article is to advocate that the goals of systematic and prolonged LLR support during a crisis like the current one could be more effectively attained by an Emergency Bank Debt Insurance Mechanism (EBDIM). The design of such a mechanism would essentially rely on the lessons of over 70 years of experience with explicit retail deposit insurance systems (DIS) around the globe, and a clever adaptation of their

codes of good practice to a crisis situation in which the lack of confidence is widespread among wholesale short-term lenders rather than small depositors.² The logic of the proposal is essentially the same that led to the introduction of a federal deposit insurance scheme in the Banking Act of 1933. Interestingly, the US Fed intervened intensively as a lender of last resort during 1932 and 1933, but the wave of bank runs associated with the Great Depression only reached its end after deposit insurance was put in place on 1 January 1934.³

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The crisis situation makes the solution of banks' pressing refinancing problems a priority vis-à-vis market discipline – the desirability of allowing markets to charge larger spreads (or to deny credit) to the institutions that are perceived as riskier – and moral hazard – the extent to which public intervention confirms the expectations on the socialization of the losses that contributed to banks' excessive risk-taking in the first place. It is evident, however, that market discipline can only provide a cost-effective control on moral hazard in a sufficiently transparent non-panic situation where the higher spreads can be really applied to the fundamentally riskier borrowings. It does not work well in a panic situation where all institutions are assessed as very risky on the basis of collective self-fulfilling expectations. Short-circuiting the panic logic calls for the EBDIM to provide full coverage to any short-term lending explicitly supported by the insurer (although, as explained below, not all lending should be supported).

The EBDIM should be considered temporary in nature. In a systemic crisis, the EBDIM should allow money markets to remain functional (that is, serving their role of transferring short and medium term funds from agents with financial capacity to banks with financial needs). The idea is that banks would be able to meet their refinancing needs as in normal times, buying time for banking institutions and supervisors to clear up the mess, disclose the losses, and proceed with the recapitalization, intervention or closure of the capital-impaired banks. The EBDIM should last insofar as the risk of a severe confidence crisis persists, and leave way to market discipline as soon as it could be expected to operate effectively.

Under the EBDIM, market discipline would only be relevant insofar as banks wish to access uninsured sources of bank financing. The access to insured borrowing may crowd out most forms of uninsured financ-

ing, although banks may remain interested in issuing core equity and subordinated debt financing either to comply with capital regulation or to voluntarily enhance their solvency. With low market discipline, supervisory discipline becomes essential and, thus, the providers of EBDIM should act in close cooperation with (or act as) the banks' main supervisors. These supervisors should be especially active while EBDIM is in place, exerting their discipline through the usual means (capital regulation and prompt corrective action), as well as by establishing the extent of the support provided by the EBDIM. Specifically, the total borrowing under coverage (or the net additions to the balance of covered borrowing) might be made a function of a bank's book-value capital position, perhaps after some supervisory-defined adjustment for the risk of the bank's assets.

Making the total borrowing under coverage a function of some supervisory-adjusted measure of capital or good-quality assets should allow supervisors to exert discipline in a flexible manner. If properly tailored, in line with the spirit of Pillar 2 in Basel II, supervisors might use them to encourage banks to undertake controlled asset sales or fresh equity injections, or to move into a gradual use of uninsured borrowing once the current crisis gets resolved.

In case of default, the guaranteed borrowings should be repaid immediately by the EBDIM, which should then enjoy expeditious access to central bank liquidity

Because the EBDIM has the potential to create large implicit liabilities for the insurer, it would be necessary to back it with government support, in case of need. To facilitate the removal of the EBDIM after the crisis and prevent interference with the regular DIS, the EBDIM might be considered an institution separate from and junior to the DIS fund.

In case of default, the guaranteed borrowings should be repaid immediately by the EBDIM, which should then enjoy expeditious access to central bank liquidity – LLR by central banks would then return to play a genuine last-resort lending function, either for the EBDIM or, as usual, for isolated institutions with specific troubles. In countries where the central bank already plays a supervisory function, it might be reasonable to leave the EBDIM under the management of the central bank.

In order to facilitate the management of the mechanism, the EBDIM could limit its coverage to a small number of standardized instruments for short and medium term borrowing. Building on the experience from years of oversight of electronic interbank markets, the EBDIM could start with the insurance of interbank deposits, as well as other wholesale deposits from non-bank institutions such as sovereign funds and hedge funds that might have (or be given) access to the corresponding electronic trading platform. Of course, extending insurance to a limited number of the money market instruments is most likely to produce a crowding-out effect on the uninsured instruments, leading to

² See the International Monetary Fund Working Paper No. 99/54, 'Deposit Insurance: A Survey of Actual and Best Practices,' by Gillian G. Garcia, April 1999.

³ See *A Brief History of Deposit Insurance in the US*, ch. 3, document prepared by the Federal Deposit Insurance Corporation, September 1998.

the temporary extinction of trading in some segments of the market. This is not necessarily bad, especially in a transitory phase in which it would be most valuable for supervisors and the managers of the EBDIM to have real-time information on banks' cross exposures.

The EBDIM should build on existing DIS practices for the allocation of responsibilities for cross-border transactions. The 'home country principle' that applies to cross-border deposits within the EU is the obvious reference.⁴ According to this principle, the EBDIM could be decentralized at country level; the various national EBDIMs would guarantee, subject to the conditions set by the national supervisors, the money-market borrowings of the banks under their jurisdiction. Making supervisory responsibility coincide with liability for the potential losses should minimize concerns over the inadequate resolution of conflicts of interest regarding the degree of support and supervisory discipline applied to each bank.

The home country principle is also compatible with the adoption of the EBDIM on a country-by-country basis, although a coordinated introduction of the mechanism by a number of important countries would definitely help in restoring the normal functioning of money markets. Moreover, the harmonization of its key features would minimize criticism of its potential for 'unleveling the playing field' in international banking.

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Small countries with oversized banking sectors might have to reach agreements with other countries in order to achieve international support for their EBDIMs, and prevent undesired increases in country risk and their reflection in the spreads of the financing obtained by the banks under their jurisdiction.

Given their emergency nature, the EBDIMs should not be expected to build up funds with which to cover their potential losses. However, if needed, the EBDIMs could compensate their costs by charging periodic fees (perhaps following the models used for the pricing of credit default swaps). Even if these fees resulted in charges equivalent to a spread of 20-30 basis points, insured borrowing would still be much cheaper than uninsured borrowing under the spreads observed during the current crisis.

Conclusion

The rationale for an Emergency Bank Debt Insurance Mechanism is not very different from the rationale

behind the LLR operations massively undertaken by major central banks since the start of the current crisis. However, an EBDIM might improve on current LLR operations in a number of dimensions.

1. An EBDIM is more flexible and informative, since it restores the daily functioning of money markets, which under this scheme should work very similarly to 'normal' times, in terms of both spreads and quantities. In particular, liquidity surpluses would continue to be directly transferred from their holders to the banks with liquidity needs, and supervisors would have daily access to the information revealed by these transactions.
2. An EBDIM produces smaller interference with monetary policy implementation than LLR operations, since it eliminates the need to sterilize the liquidity injections due to LLR (open market operations should remain 'business as usual').
3. An EBDIM is more explicit than LLR about the potential costs of the bank safety net to taxpayers, and allows for a clearer allocation of these costs in cross-border transactions, as well as for the funding of its operating expenses with explicit assessments on the insured borrowing.
4. An EBDIM reduces the conflicts of interest in the running of banks' safety net since it explicitly assigns its potential losses to the authorities in charge of imposing supervisory discipline on the benefited banks.
5. Under the 'home country principle,' EBDIMs can be introduced on a country-by-country basis, although some degree of coordination (and harmonization) would definitely facilitate their success in restoring the normal functioning of international money markets and minimize criticism on its potential for 'unleveling the playing field' in international banking.

Afterword

This proposal is not intended to prevent future global financial crises but to resolve some of the liquidity problems present in the current one, and, perhaps, in other crises to come. As explained above, the subprime crisis involves several intertwined vicious circles. Lack of liquidity in money markets plays a key role in one of them. Deeper reflections on the current crisis will lead market participants and authorities to adopt additional precautions over the next few years. Standards of practice for securitization, rating and valuation of complex securities, transparency, liquidity management, and capital management are likely to experience major changes. Debating these changes will be important... but that is a different, somewhat less pressing issue.

⁴ See Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes.

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