GOVERNMENT GUARANTEES AND CONTINGENT CAPITAL: CHOOSING GOOD SHOCK ABSORBERS

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MOTIVATION

- **Before the GFC temporary government guarantees had a good reputation in reducing the impact of crises and restoring confidence**
  - **Rapid, low up front fiscal cost, low long-term cost**
- **Experience in the GFC showed many disadvantages**
  - **High short and long-term fiscal costs**
  - **Poor substitute for good resolution regime**
  - **Perverse incentives**

OUTLINE OF PAPER

- **Assessment of experience from Nordic crises**
  - **Not as positive as sometimes thought**
- **Lessons from New Zealand (Australia) in GFC**
  - **Several mistakes, unnecessary cost for taxpayer**
- **Iceland**
  - **Good resolution of horrific problem**
- **Ireland**
  - **What not to do**
- **A better way forward**
  - **Limited role not substitute for good resolution tools**

NORDIC CRISES

- **Sweden and Finland lucky that problem did not get out of hand – drastic fiscal measures and depreciation generated rapid recovery in Finland from shock worse than 1929**
- **Norway had similar result as Sweden without blanket guarantee**
- **Unfortunate encouragement for those who followed**

NEW ZEALAND

- Unprepared
  - No deposit insurance; Australian-owned banks
  - Followed Australia in introducing voluntary wholesale borrowing and deposit guarantees (October 2008) - detail differed especially pricing
  - No supervision of non-bank deposit takers
    - Most failed but mainly not due to GFC
- Problems in implementation
  - Several rapid changes in design
  - Took months to decide on eligibility so no assurance for depositors in weak institutions – *i.e. no real fear of a run*

OPAQUE ELEGIBILITY CRITERIA

- size of the entity and the number of depositors;
- creditworthiness;
- related party exposure;
- quality of the information provided by the entity and whether its financial statements are audited;
- character, business experience, and acumen of controlling individuals;
- business practices and track record of the entity (that is, meets reasonable standards, bank-like in nature, length of time in business, meeting payments, and maintaining solvency);
- importance to the financial system; and
- any other factors relevant to the maintenance of public and depositor confidence.

NEW ZEALAND

- Guarantee led to increase in deposits and further risky lending
- Interest payable after failure but no procedures for swift pay out
- South Canterbury Finance ($1.6bn failure)
  – Had to pay out all creditors to take over and control insolvency
  – Likely cost $1.2bn > than total liabilities on introduction of guarantee
- Guarantee ended for all but 6 companies
  – Lasts till end 2011. *No deposit insurance*

ICELAND

- Guarantees impossible because of size of impending losses
- Instituted depositor preference
- Needed emergency resolution arrangements
- Split into domestic recapitalised banks and foreign insolvency
- Although major taxpayer costs, shareholders lose everything and junior creditors and bond holders bear most of rest of cost

IRELAND

- Blanket guarantee for creditors
- Major underestimate of losses
- Taxpayer bearing unnecessarily large share of losses

A BETTER WAY FORWARD

- Good resolution arrangements especially for large banks, with contingent capital, living wills/funeral plans will avoid need for many risky guarantees
- Difficult without deposit insurance – will Bank Creditor Recapitalisation work?
- Need fully thought out scheme in drawer for a crisis
- Guarantees without prior supervision highly risky
- Australia now extensive deposit insurance and depositor preference

A BETTER WAY FORWARD

- International spillover effects neglected
  - Would have been no taxpayer losses in NZ without Australian guarantee. (Ireland)
- Important to distinguish between guarantees against losses from new vs existing business
- Guarantees for new wholesale funding at plausible price clearly a good idea when markets become disfunctional
- Position needs to be clear to avoid future moral hazard