



Crisis Management Framework: Whose Responsibility is Financial Stability?

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Outline



- Financial crises come and go
- Financial Stability: A Strategic Priority
- Financial Safety Net: More Clarity
- Contingency Planning and Crisis Management
- Sierra Leone banking sector – selected indicators
- Financial Stability of Sierra Leone: The Way Forward
- Elements of a good contingency planning
- Financial stability as a shared responsibility



Crisis has always been there, and...



- But, the character, magnitude, and cost was not always the same.
- Common and New Causes of Global Financial Crisis (*Claessens and Kodres, 2014*).
- Common causes:
 - ◆ **Credit boom** associated with deterioration in lending standards;
 - ◆ Rapid **asset price appreciation** (mainly housing) accelerated credit extension;
 - ◆ Creation of **new products** (Collateralized Debt Obligations) associated with risks not fully comprehended or appreciated;
 - ◆ **Sluggish regulation and supervision** vis-à-vis new developments;



Crisis recur...?



- There will be always New Causes, **as seen in 2008** crisis :
 - ◆ Widespread and sharp rise of **households' leverage** and subsequent defaults on (housing) loans;
 - ◆ The increased leverage manifested **across a wide range of agents** – financial institutions, households – and markets.
Illiquid collateral → limited system's ability to absorb even small shocks → which led to a rapid decline in collateral values = shaking the confidence;
 - ◆ Increased **complexity and opacity of the securitized** products made difficult to know their true value and risks associated, which led to quick insolvency;
 - ◆ **International financial integration** had increased dramatically over the decade before the crisis;



Financial Stability: A Strategic Priority



- Promotion of financial stability is becoming a **strategic objective** for many central banks, especially after the global financial crisis.
- Maintaining financial stability and a sound market-based banking sector requires progressive **convergence** and **harmonisation** of **micro** and **macroprudential regulations and policies**.
- Let's be clear here: it is obvious that first and foremost, financial institutions' owners and executives bear **primary responsibility** for sound and prudent operations and management.
- But, failures do occur and countries have to establish **financial safety nets (FSN)** to provide a financial stability buffer when management fails and as a result a financial institution must be closed.



Financial Safety Net: More Clarity



- Key lesson from the crisis of 2008: a **financial safety net is itself insufficient to deal with a systemic crisis**, whether the crisis is due to the distress of a single systemic bank or system-wide distress caused by external factors.
- Components of a **Well Designed Safety Net** revisited:
 - prudential regulation and supervision,
 - deposit insurance,
 - lender of last resort, and
 - insolvency resolution.



Prudential Regulation and Supervision



- A crucial **defense against the abuse of the safety net** .
- Global Regulatory Reform (mainly Basel III regulations):
 - ♦ Quality and quantity of **capital**, capital conservation buffer introduced;
 - ♦ **Risk coverage expanded** (in the trading book and related to counterparties);
 - ♦ **Global liquidity framework** introduced;
 - ♦ Most importantly, the **systemic risks** has been recognized , including its two dimensions: procyclicality and interconnectedness;
 - ♦ Progress in measuring **systematicity** of G-SIFI's and D-SIFI's;
 - ♦ Work in progress related to oversight/regulation of **shadow banking** system;
 - ♦ Ongoing dilemmas and debates (impact of **regulation on growth**, relative vs. absolute **metric** for measuring SIFIs, monetary policy vs. financial stability – where to place the **mandate** for Financial Stability, implementation **schedule for Basel III**, consolidation, large exposures, CAMELS vs. **Risk Based Supervision**, etc.);
- **More regulation** sometimes reflects **ineffective supervision** of existing regulation!?
- Why there are so few words about bank **licensing** so far?



Good Supervision: Learning to Say 'No'



- **Good supervision** (IMF SPN 10/08) is:
 - ◆ Intrusive
 - ◆ Skeptical but proactive
 - ◆ Comprehensive
 - ◆ Adaptive
 - ◆ Conclusive
- **The ability to act:**
 - ◆ Legal authority
 - ◆ Adequate resources
 - ◆ Clear strategy
 - ◆ Robust internal organization
 - ◆ Effective working relationships with other agencies
- **The will to act:**
 - ◆ A clear and unambiguous mandate
 - ◆ Operational independence
 - ◆ Accountability
 - ◆ Skilled staff
 - ◆ A healthy relationship with industry
 - ◆ An effective partnership with boards



Deposit Insurance – Key benchmarks



- The 18 Core Principles for Effective Deposit Insurance Systems (Basel Committee and IADI) set an important benchmark in establishing or reforming DIS and address a range of issues including:
 - deposit insurance coverage;
 - funding;
 - prompt reimbursement;
 - public awareness;
 - resolution of failed institutions; and
 - cooperation with other safety net participants including central banks and supervisors.



Deposit Insurance – Key Consideration



- **Credibility:** properly designed, well implemented and understood by the public.
- **Timing:** introduce it when the banking system is healthy.
- **Infrastructure** : with strong prudential regulation and supervision, sound accounting and disclosure regimes, and the enforcement of effective laws.
- **Premium:** flat versus differential rates.
- **Mandate:** ‘Pay-box’ versus ‘risk-minimizer’.
- **Membership:** compulsory versus voluntary; state-owned banks, branches of foreign owned banks.
- **Make clear:** DI protects usually small depositors in case of a bank failure, but it is not designed to protect banks from failing.
- DI can deal with limited number of simultaneous bank failures, but can not be expected to deal with a systemic banking crisis by itself.



Lender of Last Resort – Emergency Liquidity Assistance



- Lenders of last resort typically seek to lend only to:
 - (a) **solvent** banks, on
 - (b) good **collateral**, at
 - (c) a **penalty** rate relative to normal market rates, and
 - (d) is expected to be paid back in the **short-term**.
- These are rules of an **ex ante** ‘**Just Say No**’ policy and as such it is designed to discourage the abuse of the safety net (banks incentivized to operate prudently, political authorities to develop adequate crisis resolution tools).
- Unfortunately, many countries used lender-of-last-resort facility to implicitly **bail out** their insolvent institutions.
- LOLR requires **precise procedures and institutional arrangements** by authorities to assist solvent banks that are facing temporary liquidity shortages, originating from an individual or systemic event.



Lender of Last Resort – Emergency Liquidity Assistance



- LOLR is **not a way to capitalize banks**, to apply open bank assistance as part of the resolution process, or to bail-out banks in a systemic crisis.
- These kind of measures are beyond LOLR assistance.
- Specific challenges for LOLR/ELA:
 - **in semi-dollarized, and**
 - **fully-dollarized countries.**
- Possible solutions: **Bank Liquidity Fund** (government contribution, banks, private lines of credit, external credit from IFIs?).



Insolvency Resolution



- The G20 countries have been working hard in recent years to incorporate important **lessons from the global financial crisis**.
 - ◆ When the authorities intervened it was usually far **too late** – their banks were already at the point of failure.
 - ◆ There had been **no serious contingency planning** to deal with the failure of large, systemically important banks; and
 - ◆ As a result, there was no choice but to spend enormous amounts of money to **bail-out banks**.
- **The outcome of this work is the FSB’s “Key Attributes of Effective Resolution”.**



Insolvency Resolution: FSB's Key Attributes



The preamble ... the core of the standard

The objective of an effective resolution regime is to make **feasible the resolution** of financial institutions **without severe systemic** disruption and **without exposing taxpayers to loss**, while **protecting vital economic functions** through mechanisms which make it possible for shareholders and unsecured and uninsured creditors to absorb losses in a manner that respects the hierarchy of claims in liquidation.

Key Attributes of Effective Resolution Regimes for Financial Institutions (Oct 2011)



Key Attributes of Effective Resolution Regimes

1. Scope covering all systemic firms

Not just banks

2. Resolution authority

Need to be clear on who is responsible for resolution actions

3. Resolution powers

Including sale / transfer, separate assets, write-down / convert debt (“hail-in”)

4. Contractual clarity

Make sure that resolution isn’t complicated by early termination rights in contracts

5. Creditor safeguards

“No creditor worse off”, clear hierarchy, right to compensation and legal redress

6. Resolution funding

Temporary public or private sources of funds in resolution

7. Cross-border legal framework

Domestic law should recognise foreign authorities’ resolution action

8. Crisis Management Groups (CMGs)

Home and key host authorities of all G-SIFIs to form CMGs

9. Firm-specific cooperation agreements

CMG to set out how authorities will cooperate, including during crisis

10. Resolvability assessments

Assess RRP feasibility, if necessary require business model & structural changes

11. Recovery & resolution plans (RRPs)

RRPs to be prepared by all systemically important firms

12. Information sharing

Eliminate barriers to sharing information for purposes of resolution



Key Attributes: Relevance



- The Key Attributes are designed for **GSIFIs**, but FSB is keen extending them to **Domestic Systemically Important Financial Institutions (DSIFI)** too;
- In the G20 countries a great deal of effort is now going into operationalizing the “Key Attributes”, in particular to **minimise the call on the Government** in a crisis.
- All this is **relevant** in order to:
 - ◆ Avoid perceptions that public support can be relied upon, or will be forthcoming, in times of crisis;
 - ◆ Ensure that any losses are ultimately borne by a bank’s shareholders and creditors consistent with the legal obligations they entered into;
 - ◆ Ensure that a bank’s customers (individuals and businesses) will continue to have access to deposits and to other transaction capabilities during the resolution process;
 - ◆ Keep the core functionality of a bank uninterrupted in order to minimise disruption to the payments system;
- Thus, an **ex-ante plan** is a **MUST**.



Contingency Planning and Crisis Management



- *'If you fail to plan, you are planning to fail'* (Benjamin Franklin)

- Contingency planning is not just about **resolution**.

It needs to incorporate three key elements:

- **Crisis detection** – the course of action for responding to warning signs detected from market operations, the payments system or from supervisory activities;
- **Crisis management** – exactly how do you handle a financial crisis once detected and what information do you need to facilitate sound decision-making;
- **Crisis resolution** – the full range of options for resolving a crisis, from orderly winding-up to maintaining the bank as a going-concern



Contingency Planning and Crisis Management



Each central bank needs a **crisis management plan** that:

- Makes it clear who is responsible for what actions, including:
 - ◆ A **diagnosis** of the exact nature of the crisis
 - ◆ The **liquidity and solvency** position of any distressed bank
 - ◆ The **systemic implications** of the crisis
- Will provide clear directions for responding to a range of scenarios:
 - ◆ Is it a **liquidity** issue that the central bank can handle; or
 - ◆ Are there **solvency** issues that will involve other agencies, including Government?



Contingency Planning and Crisis Managen



A plan without the existence of **'powers'** has little value:

- Within the **central bank** need to be clear when and how emergency liquidity assistance will be made available – what collateral will you accept;
- If there is a **solvency issue** – what exactly are you going to do? Are there adequate resolution powers – to transfer assets and liabilities establish a bridge bank etc.
- What is the **role of the deposit insurance fund** – is it just a “pay-box” or does it have an important role in resolution?



Crisis Management: Dealing with Systemically Important Bank



- When dealing with a Systemically Important Bank that needs to be kept ‘alive’ **where will the money come from?**
- G20 countries working on a “bail-in” approach in which non-deposit liabilities will be used to help recapitalize a systemic bank.
- Europe is to establish a **special resolution fund** to draw on – but will take 10 years?
- But **Government will still need to be involved**. In a crisis can’t wait for an appropriation of funds, need a far more rapid response.
- So working with the **Ministry of Finance is critical** – not just in a crisis but routinely



Crisis Management: Comprehensive Playb



- ✓ Detailed framework or **plan** for handling a potential crisis
- ✓ Assigned **team** within the central bank responsible for preparing for and managing a crisis
- ✓ Making sure that other financial regulators, including the MOF they too **understand their role and responsibilities**
- ✓ Once you have a plan in place, you need to **TEST** it.



Crisis Management: National Plan



- National authorities need a plan for responding rapidly and effectively to a financial crisis involving both small and large financial institutions.
- Crisis preparedness policies should be embedded in the areas of regulation, supervision, and financial stability monitoring, while the country's authorities as a whole must plan and prepare in advance to mitigate potential and actual systemic crises.
- Contingency planning: the efforts to preserve financial stability vs. inevitable risk of moral hazard.
- From the start, national crisis management plans must have a regional cross-border dimension where proposed actions to be taken by one country will not come at the expense of another country.



A well designed safety net



- Clarity about power, duties and responsibilities
- Workable coordination
- Transparency
- Accountability





Sierra Leone Banking Sector - selected indicators



Indicators	2011	2012	2013	2014	2015	2016
GDP growth	6.3	15.2	20.7	4.5	-20.6	6.1
Inflation (end of year)	6.6	6.2	5.4	4.6	8.4	17.5
CAR:						
Regulatory capital/RWA	26.97	27.98	30.12	30.21	33.98	30.73
Regulatory tier1 capital/RWA	20.18	24.05	26.33	25.87	29.02	25.89
Capital (net worth)/assets	14.77	14.93	13.55	12.01	12.32	11.60
NPL	15.08	14.74	22.42	33.44	31.73	22.65
Reserve requirement (in SLL)	12.0	12.0	12.0	12.0	12.0	12.0
Reserve requirement (in FX)	-	-	-	-	-	-
Weighted av. interest rate on loans, SLL	27.92	28.55	21.68	21.13	19.63	18.52
Weighted av. interest rate on deposits, SLL	10.51	7.04	4.73	4.08	2.44	2.21

Source: BSL
All ratios expressed in %



Buffers?



Reserve Requirements

	2011	2012	2013	2014	2015	2016
SLL	12%	12%	12%	12%	12%	12%
FX	-	-	-	-	-	-

Loan to Deposit Ratio, excluding investment in T-bills

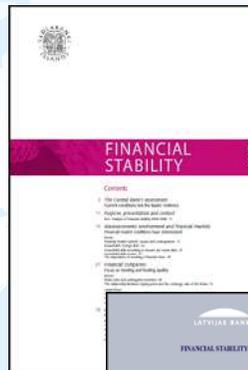
2011	2012	2013	2014	2015	2016
46.56	40.67	37.21	34.14	31.30	29.60



But...



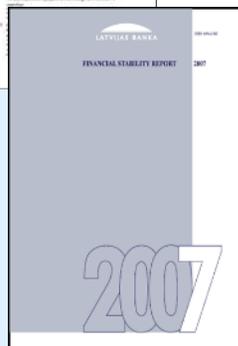
- Think about **financial stability paradox**: a system is most vulnerable when it looks most robust.



"Banks are well prepared to withstand increased delinquency and loan losses, which have been extremely low to date..."

"Nowhere has it been suggested that the banking systems of individual countries should be subjected to size limitations..."

Iceland's Financial Stability Report (2008)



"Low probability that in 2008 existing risks might materialize to the extent that it will have an impact on bank performance..."

Latvia's Financial Stability Report (2007)

- Hence, proactive approach and action on Strategic Priorities for Financial Stability are required by all relevant stakeholders.



Financial Stability of Sierra Leone: The Way Forward



- Further enhancement of prudential regulations.
- Further strengthening of financial supervision - introduction of **risk based supervision**.
- Strengthening **Financial Stability Analysis Section** with the focus on stress testing, financial stability reporting, and macroprudential policies.
- FSR, Quarterly Financial Sector Outlook, Research on FS.
- At the level of BSL: Establishment of **Macroprudential Committee**.
- **Deposit Insurance Fund**.
- At the national level: **Financial Stability Council (FSC)**: BSL, MoFED, SLICOM, and other relevant authorities specific to the country)



Elements of a good contingency planning



- Understanding your financial system, particularly its systemically important parts
- Understanding the external and internal risks to your financial system
- Identifying the parties with whom you would have to work in a financial crisis
- Reviewing your legal powers and resources for managing a crisis, particularly related to resolution power and resolution tools
- Preparing a crisis plan to guide supervisors and others in managing a crisis
- Summarizing the crisis plan in easy-to-use handbook
- Simulating crises at regular intervals to test readiness
- Updating/strengthening legal powers, resources and crisis planning in response to lessons from simulations



Financial stability is a shared responsibility



- Yet, somebody has to play **center!**





Thank you



Contingency planning aims to help the authorities respond well to events within their mandate. This requires tools to monitor pertinent developments, awareness of policy and operational options, advance decisions on the use of the authorities' powers, procedures to coordinate with other—domestic and foreign—agencies, and simulations to exercise implementing contingency plans.

Crisis management requires tools and procedures that allow authorities to respond promptly, decisively, and effectively when a crisis materializes. This builds on advance preparation ('crisis preparedness') and requires comprehensive tools and powers, sufficient funds, and efficient procedures for both domestic and foreign agencies.