ST-NUS BUSINESS SCHOOL SERIES ON THE FINANCIAL CRISIS

Making sure the right banks are helped

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THERE is a long and growing list of financial institutions that have failed across the world recently: Northern Rock, Bear Stearns, Washington Mutual, Kaupthing, IndyMac, Hypo Real Estate Holding, Bradford and Bingley, and many others.

A bank is said to fail when it is unable to service its obligations. But failure does not necessarily mean that the bank is insolvent.

We need to understand the difference between a solvent and an insolvent bank. Insolvent banks are those that have made bad investments and, as a result, are unable to generate high enough returns to pay off their liabilities. Solvent banks are fundamentally sound. But they too can fail if too many of their depositors decide to withdraw their deposits simultaneously. Since fire sales are inefficient, banks might be unable to fully realize the value of their good investments to satisfy their depositors, and thus fail because of temporary liquidity problems. Such banks are solvent yet illiquid.

As lender of last resort, central banks can prevent the failure of solvent banks. They can provide liquidity to such institutions. The insolvent banks can then pay off the central bank in the future when the returns on their healthy assets are realised. In the absence of central bank intervention, the assets would have been sold off at fire-sale prices. Thus central banks can improve the efficiency of the banking system by providing emergency funding to solvent institutions.

However, there is a catch here: In practice, policymakers can find it hard to distinguish between solvent and insolvent banks. Central banks should ideally bail out only solvent institutions. But owing to imperfect information, they could bail out insolvent institutions as well.

Deposit insurance and central bank bailouts of solvent but illiquid banks are essential policy tools. But the authorities, especially in the US and Europe, need to also identify and deal with the roots of the problem – toxic assets on bank balance sheets and inadequately capitalised banks, among other things – before the financial crisis further undermines the real economy.

Did the United States government really know for sure that Freddie Mac, Fannie Mae and AIG were solvent and merely illiquid – and thus ought to be rescued? While Lehman Brothers and Washington Mutual were insolvent – and thus candidates for bankruptcy – the US government’s decision to rescue them, and the collapse of AIG, are respectively?

In a competitive banking system, such asymmetry of information can affect the risk-taking behaviour of banks. If they knew they might be bailed out even if they were insolvent, banks would make risky investments. They might end up holding sub-prime assets, and hence become vulnerable to shocks.

Central bank bailouts can be efficient if the banks are not insolvent but are temporarily illiquid; but they can be inefficient if the banks are insolvent. If banks are insolvent, it is difficult to estimate their failure costs accurately.

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Deposit insurance might take less care of his car compared to someone without such insurance. Analogously, banks whose deposits are insured might be tempted to hold risky assets.

Nevertheless, by giving depositors the peace of mind that their money is safe, deposit insurance can discourage panic runs. In recent weeks, many governments have raised deposit insurance coverage. The US government increased deposit insurance coverage from US$100,000 to US$250,000. The British increased retail deposit protection from £35,000 ($49,500) to £50,000, Australia, Hong Kong and, most recently, Singapore have decided to fully insure all deposits.

There can be circumstances when deposit insurance can be inadequate. Even with insurance, a bank fails, depositors may still be tempted to withdraw their cash for peace of mind. For instance, when the British bank Northern Rock collapsed last year, it took months for depositors to be paid off.

People have bank accounts to get ready access to liquidity. Even in the absence of bureaucrat stalls, depositors may still be tempted to withdraw their cash for peace of mind. For instance, depositors withdrew their money from Iceland as soon as they heard the bank was in trouble, despite deposit insurance.

Deposit insurance does provide relief. But it can also build up problems for the future. For instance, following the failure of Washington Mutual, the regulators of the US Federal Deposit Insurance Corporation (FDIC) were so depleted that it could not afford another failure. On June 30 this year, Washington Mutual had US$140 billion in insured deposits, about three times the size of the deposit insurance fund. Fortunately for FDIC, JP Morgan Chase agreed to acquire the banking operations of Washington Mutual. Critics say that the FDIC raised the deposit insurance coverage subsequently to avoid another failure.

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