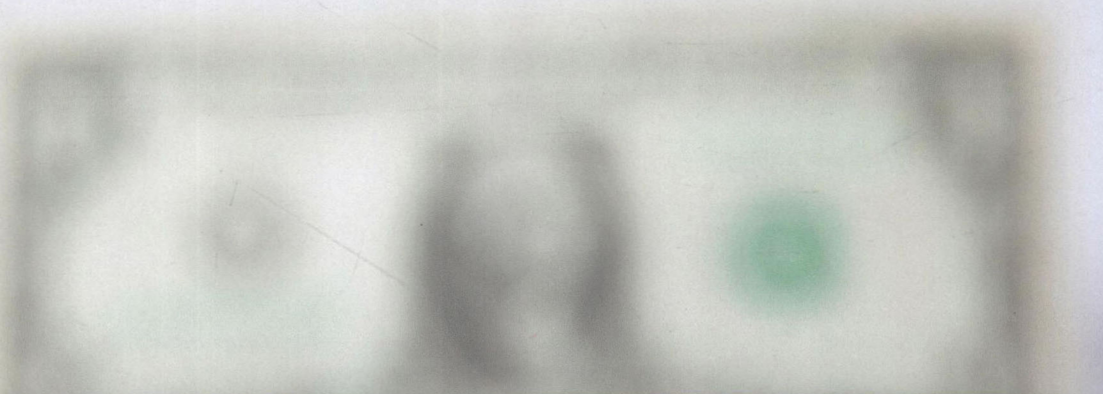
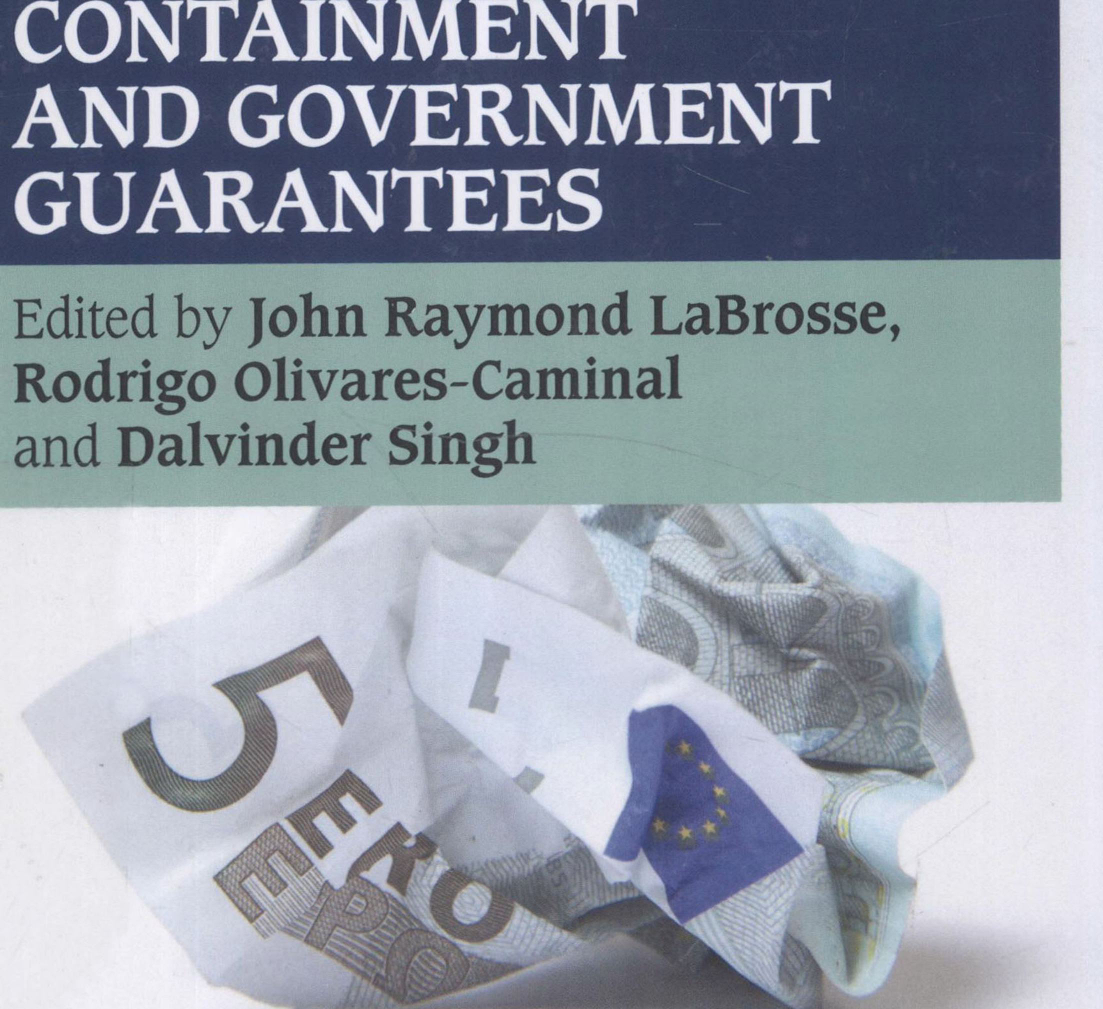


FINANCIAL CRISIS CONTAINMENT AND GOVERNMENT GUARANTEES

Edited by **John Raymond LaBrosse, Rodrigo Olivares-Caminal** and **Dalvinder Singh**



Financial Crisis Containment and Government Guarantees

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Foreword

Joseph J. Norton

Do we really need another volume on the current and ongoing global financial crisis (GFC)? As I sit in my home study facing a clutter of GFC-related books, reports, articles, conference materials, and enacted and proposed legislation and rules, my visceral reaction is 'enough is enough'. Yes, it is important to decipher the various 'causes', to sort through the sundry public and private failures, to learn appropriate lessons and to ponder new, appropriate laws, regulations, standards and practices; but, much of this has already been done over the past three years. As aptly pointed out by Professor Lastra, much of the GFC literature and actions are about fighting the last war.

On a personal level, I have developed a large lump of cynicism in my craw as I re-read *Reinhart and Rogoff* (2009) to understand more fully that the GFC, in many (but not all) ways, is really not that different in historical perspective from prior financial crises and that 'all the red lights were blinking in the run-up to the crisis'. Indeed, 'the real problem is that the global economy is badly overleveraged', and that we are probably in for a decade of 'painful deleveraging and slow growth'.

Also, when I reflect upon the value/non-value of my over three decades of comparative study of domestic, regional and international financial law and policy initiatives, I am left with a 'What's it all about, Alfie?' moment. Over the past several decades and on the domestic, regional and international levels, much thought, energy and international collaboration have been generated by well-meaning policy-makers, governmental and intergovernmental bodies, the legal and accounting professions and the Academy in terms of developing and fostering appropriate risk-based and law-based frameworks respecting putting in place and sustaining viable and stable financial sector infrastructures around the world. Yet, we still did not foresee the GFC – the 'Second Great Contraction'.

Further and presently, particularly with the current, polarized political environment in the US Congress and contracting federal budgetary constraints, I have come to harbour increasing doubts whether the 848-page Dodd-Frank Act (with the approximately 400 enacted or contemplated related regulations, 67 studies and 22 periodic reports) and the 298-page proposed 'Volcker Rule' will 'connect all the dots' in any meaningful, enforceable way, particularly as to (i) the resolution of the 'too-big-to-fail' (TBTF) dilemma (which supposedly, in the US, was set to rest in rigorous 1991 federal legislation, which legislation also had provided for a comprehensive 'prompt corrective action' framework) and, as to (ii) the establishment of an effective Financial Stability Oversight Council to oversee excessive macroeconomic risks to the US financial system (that is, a macro-prudential regulator, although its 1988 predecessor, the President's Working Group on Financial Markets, had proved itself wholly ineffective).

Moreover, as I read in the press today (30 May 2012) more about Mr Dimon (supposedly 'the best US banker', a trusted adviser to and Board member of the New York Fed, and the Chairman and CEO of the 'best managed' and recently 'stress-tested' major US bank, JPMorgan Chase (effectively a 'systemically important financial institution' (SIFI), with over 400 bank supervisors embedded throughout this bank on a regular basis) and the unspotted USD2–4 billion loss on derivatives activities out of Chase's Chief Investment Office in London; as I muse again over the incredibly cavalier and uninformed 2010 testimony of former US Treasury Secretary Robert Rubin (whom President Clinton estimated to be the best Treasury Secretary since Alexander Hamilton), former Chairman of Goldman Sachs, and (at 2009), a senior-counsellor to and Board member of Citigroup; and, as I flip through Jon Corzine's (former Chairman of Goldman Sachs, US Senator and New Jersey Governor) clueless 2011 Congressional testimony concerning the financial collapse and bankruptcy of MF Capital, a major global financial derivatives broker he founded and managed and a primary dealer of US Treasuries, my confidence level bottoms-out as to senior financial institutions executives' and to the financial institution regulators' ability to manage risks and otherwise to instil and to maintain prudent governance within complex financial institutions (SIFIs) bottoms-out.

Add to this the high-risk tentacles being generated internally and externally by the current Eurozone crisis (including even possible impact on the November 2012 US presidential elections), and one could easily foresee a bleak global landscape over the next decade (we are already 3–4 years into the GFC). This landscape most probably will portray future domestic, regional and global financial stress and crises, and an absence of the required individual and collective country political-will to redress the fundamental economic disequilibria built up since the 1970s and underpinning our current domestic, regional and global financial systems and economies.

Yet, when I step back and take a deep breath, I see that John Raymond LaBrosse, Rodrigo Olivares-Caminal and Dalvinder Singh, in fact, have assembled another special collection of fresh and thought-provoking insights by leading governmental, intergovernmental, practising and academic experts. This 2013 volume (*Financial Crisis Containment and Government Guarantees*), emanating from a special fall 2011 symposium at the OECD celebrating its 50th anniversary, is most impressive in itself; but, it is even more so when considered in light of their 2009 volume on *Financial Crisis Management and Bank Resolution* and 2011 volume (nearly 30 excellent chapters) on *Managing Risk in the Financial System*.

These three co-editors/contributors represent the very best of the current trend toward considering financial sector reform and crises in a forward-looking context and on an interdisciplinary basis and involving the very best academic, governmental, intergovernmental, financial industry and practitioner minds in the ongoing discussion and debate of the basic and ever-moving question, 'Quo vadis?', as to efforts to assure global financial system stability. These editors and the other stellar contributors are helping to set the policy stage for this coming decade by raising the right questions and by putting forward a provocative range of possible solutions/policy approaches/challenges. I am so impressed with the editors'/contributors' ability to bring together under one roof for an open and candid discussion the following experts: Lee Buchheit (Cleary Gottlieb); Christine Cumming (First Vice President, Federal Reserve Bank of New York); Charles Enoch (International Monetary Fund); Gillian Garcia (Gillian G.H. Garcia Associates); Charles A.E. Goodhart (Financial Market Group, London School of Economics); Már Guðmundsson (Governor, Central Bank of Iceland); Mitu Gulati (Duke University); Eva Hüpkes (Financial Stability Board); Rosa M. Lastra (Queen Mary, University of London); David G. Mayes (University of Auckland), Maria Nieto (Bank of Spain); Fabio Panetta (Banca d'Italia); and Christopher Pleister (German Federal Agency for Financial Market Stability), among others!

Indeed, the GFC has spun-off a high level of pessimism as 'to getting things right this time around'. Real degrees of culpability can be attributed to an incredible array of banking and non-bank financial institutions (and their management), of financial sector regulators/supervisors, and of economic policy-makers (at the domestic, regional and international levels). However, the driving and shifting goal of pursuing global financial stability encompassing 'safe and sound' financial institutions and (at the same time) robust and innovative financial markets is too important a *public good* to give up on.

Financial system stability as a *public good* – in fact, as a *global public good* – has been bandied about in governmental/intergovernmental and academic circles for some time – well before the unfolding of the GFC in 2007–8. In fact, one could well-argue that bank regulators and central banks, while historically placing their primary focus on institutional 'safety and soundness' have long been concerned with systemic stability. For example, the development of the G10, the Basel Committee, IOSCO, IAIS, the Joint Forum, the CPSS, the CGFS, IADI, IASB, the numerous EU/EC financial 'legislation', the Eurozone, IMF enhanced surveillance and efforts to devise Early Warning Systems, the IMF Article IV consultations and ROSC programme, and the IMF-WB FSAP initiative can be seen as being a part of this policy concern. The formation of the Financial Stability Forum in 1999 (now since the GFC, renamed and revamped as the Financial Stability Board) and the G7/8 Finance Ministers since 1994 and also the G20 Finance Ministers since 1999 have focused on directing and coordinating financial stability efforts, albeit (pre-GFC) primarily with emerging and transitioning economies in mind. Yet, all these efforts to create a 'New International Financial Architecture' really did not appreciate the full complexities of, the full set of risks inherent in, and the market interconnections within the so-called global financial system.

Since its creation in the fall of 2008, the G20 (Leaders) has taken upon itself the primary direction of global governmental/intergovernmental strategy on determining, revising, and overseeing the implementation of a comprehensive global 'Work Plan' related to global financial stability. Pursuant to this Plan, the recent work of the FSB and its member institutions (including the OECD, IMF, World Bank, and major domestic bank regulators, finance ministries and central banks) indeed has been most constructive and impressive.

In addition, a key long-term task of the G20 (Leaders) is the establishment over time of a global 'Framework for Strong, Sustainable and Balanced Growth': this Framework is intended to begin to address the fundamental global macroeconomic disequilibria plaguing the global economy since the 1970s. Most recently, as to the US, President Obama has signed an Executive Order directing the relevant bodies with the Executive Branch vigorously to pursue international collaborative efforts respecting implementation of this Framework.

I will be keeping this third volume by the 'dynamic trio' of LaBrosse, Olivares-Caminal and Singh, along with their first two volumes, in the centre of my worktable as I continue to struggle to give a coherent context to the GFC vis-à-vis the US financial system and the related maze of new US laws, regulations and practices. Ray, Rodrigo, and Dal, thank you so very much for 'keeping the faith' and for all you are doing; and, I very much look forward, in due time, to your fourth volume concerning further issues relating to global financial stability.

Foreword

Arthur E. Wilmarth, Jr.

In September 2010, US Federal Reserve Board Chairman Ben Bernanke declared that '[i]f the [financial] crisis has a single lesson, it is that the 'too-big-to-fail' (TBTF) problem must be solved'.[1] Notwithstanding the enactment of reform legislation on both sides of the Atlantic during the past two years, many policy-makers and analysts believe that TBTF banks still pose a major threat to financial stability and fiscal policy. On 9 May 2012, former US Federal Reserve Board Chairman Paul Volcker affirmed that '[t]he greatest structural challenge facing the financial system is how to deal with the wide-spread impression – many would say conviction – that important institutions are deemed "too large or too interconnected" to fail'.[2] The very next day, JPMorgan Chase disclosed a multibillion US dollar loss from a massive 'hedging' strategy that badly misfired. In response to that disclosure, journalist Gillian Tett warned that 'the swelling size of [banking] groups such as JPMorgan is making the [financial] system ever more concentrated, in a dangerous way'.[3]

At the same time, the spreading sovereign debt crisis in Europe revealed the close linkages between government bailouts of banks and fiscal insol-

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[1] B.S. Bernanke, 'Causes of the Recent Financial and Economic Crisis: Statement before the Financial Crisis Inquiry Commission' (2 September 2010), available at http://www.federalreserve.gov/newsevents/testimony/bernanke20100902a.htm (last accessed 1 October 2012).

[2] Statement of P.A. Volcker before the Subcommittee on Financial Institutions and Consumer Protection of the Committee on Banking, Housing, and Urban Affairs, United States Senate (9 May 2012), available at http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=082d377a-5fd9-4e98-892b-26d80120d684&Witness_ID=f4bb09ce-b788-4746-9506-d030eadc62b8 (last accessed 1 October 2012).

[3] G. Tett, 'Size can be deadly in a low-rate world', *FT.com*, 17 May 2012; see also C. Hopkins and C. Sala Gage, 'JPMorgan So-Called Hedge Is Awkward for Fed Knowing Its Meaning', *Bloomberg.com*, 3 June 2012 (questioning whether JPMorgan's strategy, which the bank described as 'portfolio hedging', actually amounted to 'proprietary trading' that Congress intended to prohibit under the Volcker Rule).

vency. On 11 June 2012, EU governments announced that they would lend up to USD125 billion to enable Spain to support its deeply troubled banks.[4] The EU's rescue package for Spain followed similar bailouts totalling more than USD500 billion for Greece, Ireland and Portugal, which the EU and the International Monetary Fund organized after all three nations were overwhelmed by the costs of shoring up their banking systems. At the end of 2011, sovereign debt in the 17 euro-area nations exceeded 87 per cent of gross domestic product, the highest level recorded since the euro was introduced in 1999.[5] The Eurozone's sovereign debt situation has steadily deteriorated since 2008, because most euro-area governments have assumed heavy debt burdens in order to prop up TBTF banks, stabilize their financial systems and cushion the impact of severe economic recessions.[6] As I write this Foreword, the euro's survival is in grave doubt.[7]

This volume includes papers presented at the Banking Law Symposium organized by John Raymond LaBrosse, Rodrigo Olivares-Caminal and Dalvinder Singh and hosted by the Organization for Economic Cooperation and Development (OECD) in October 2011. The organizers of the conference (who also edited this volume) deserve high praise for their prescience in focusing on the issues of (a) containing systemic financial crises, (b) limiting moral hazard and other economic distortions created by government support for financial institutions, and (c) resolving Europe's sovereign debt problems. All three issues dominate today's headlines and preoccupy policy-makers, industry officials and scholars. The conference organizers and editors should also be congratulated for assembling a distinguished group of experts from government, industry and the academy to address these issues. I hope this book will attract a wide readership, because its important research findings and sound policy advice could help us to avoid a recurrence of the global crisis we currently struggle to escape.

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4 C. Penty, 'Spain's Bailout Gives Rajoy His Best Chance to Fix Banks', *Bloomberg.com*, 12 June 2012; see also C. Penty, 'Goirigolzarri's Aid Demand Helped Push Spain to Bailout', *Bloomberg.com*, 12 June 2012 (reporting that the EU's support programme was triggered by Spain's admission that it would need USD24 billion to recapitalize Bankia, the nation's third-largest lender).

5 A. Davis, 'Euro-Region Debt Rises to Highest in Currency's History', *Bloomberg.com*, 23 April 2012.

6 A. Mody and D. Sandri, 'The Eurozone Crisis; How Banks and Sovereigns Came to be Joined at the Hip', *Economic Policy*, April 2012, at 201–30.

7 See, for example, P. Boone and S. Johnson, 'The End of the Euro: A Survivor's Guide', *The Baseline Scenario* (blog), 28 May 2012.

Preface

John Raymond LaBrosse, James F. McCollum, Rodrigo Olivares-Caminal and Dalvinder Singh

'Collaboration between financial authorities has never been so testing and yet never has collaboration been so important. We face key coordination challenges in the area of financial regulation, particularly with respect to the consistency of the calculations of risk-weighted assets, the treatment of sovereign exposures, and liquidity standards. Yet, the institutional settings for collaboration are actually improving. Given sufficient commitment from the authorities, these new settings and processes will pave the way for enhanced cooperation'.[1]

I. THE GRAND SLUMP AND SETTING THE SCENE FOR RESTORING PUBLIC CONFIDENCE

At the time that the 2011 Banking Law Symposium[2] took place over 20 books and numerous professional journal articles had been written on the Global Financial Crisis (GFC). Interest in the crisis and its aftermath, including policy responses and corrective measures, continues unabated and the Symposium was one reflection of this. So too is this book and we are pleased to include several of the Symposium's papers in it. The principal objective of this book is to examine the response to the crisis, with particular reference to the extensive use that has been made of government guarantees in private financial markets and the impact that those guarantees have had on sovereign debt.

During the editing process for the book we took the opportunity to look back at what analysts had to say about 2011 before the year began and the policies they felt were needed to restore confidence in governments,

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1 Speech by J. Caruana, General Manager, Bank for International Settlements, at the seminar on 'Long-term growth: organizing the stability and attractiveness of European financial markets', Berlin, 20 January 2012, available at http://www.bis.org/speeches/sp120124.htm (last accessed 1 October 2012).

2 For a summary of the proceedings please see J.F. McCollum, *Financial Regulation International*, Issue 14.8, pp. 4–7, October 2011.

banking systems and, of course, policy-makers and their advisors. At the end of 2010, publications such as *The Economist* were predicting 2011 to be 'a tale of two economies: a rich world struggling with a weak and jobless recovery, and an emerging world growing four times as fast'.[3] One year later, in its outlook for 2012, *The Economist* suggested that national leaders would be pre-occupied with domestic issues and that we should not expect very much out of global gatherings.[4] Leaders will clearly need a new mantra for prospective global gatherings, as there appears to be diminishing interest in committing to necessary initiatives in a co-ordinated way.

It can be suggested that finance 'will be more stable and thus more boring'. In the early days of 2012 and with a focus on the UK, the *Financial Times* released a survey of 83 economists that suggested that '[t]he coming year will rival 2009 for economic weakness as output is hit by the continuing debt crisis in the euro-zone . . .'.[5] It is noteworthy that the survey included '11 former members of the Bank of England's Monetary Policy Committee' and that 'three times more respondents thought the economic outlook would deteriorate rather than would improve in 2012'.[6]

While it is the mission of news organisations to sell their publications, they have no obligation to report on why things did not turn out the way they initially thought; the after-the-fact analysis task is often left to the academy. Accordingly, it is customary for books of this kind to analyse financial issues *ex post* and dissect decisions that were taken by policy-makers. This is a major challenge because so many uncontrollable factors can come into play and materially affect outcomes. Policy-makers concerned with the financial sector often focus on whether there was enough regulation or whether the regulation was of the right kind. In examining a financial crisis questions could be: have laws been adequately designed to smooth the exit of failing banks or to account for situations where sovereigns may not be able to repay bondholders and/or make good on programme entitlements. Answers can be inconsistent, confusing or even biased, as they may reflect less of reality and more of the views of the respondent.

Was the GFC and subsequent recession a result of too much regulation of financial institutions and markets, or not enough? It is still too early to know, but one area that is often overlooked is the impact of demographics on governments and financial markets. While this book focuses on

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[3] Franklin, D, (ed.), *The Economist*, 'The World in 2011', p. 13.
[4] Franklin, D, (ed.), *The Economist*, 'The World in 2012', p. 15.
[5] C. Giles and S. O'Connor, 'Economists See Bleak Year Ahead', *Financial Times*, (2 January 2012).
[6] *Financial Times*, 3 January 2012.

banking-law type issues, perhaps if we understood more about the impact that demographics can have on financial markets and institutions, we might better understand how to cope with or preferably avoid crises that seem to be recurring all too regularly.[7]

The sub-prime mortgage debacle that emerged in the US is often pointed to as the genesis of the GFC. Why were the accumulating risks to the financial system not recognised and preventive actions not taken? American families were (and still are) encouraged to borrow through tax-deductible mortgage interest. Bets on housing market price appreciation, due partly to demographics, for many years had turned out to be a sure thing. Many Americans acquired more properties than they needed, with a view to flipping houses for a profit. This all worked well until the proverbial music stopped and the chairs were taken away.[8] The glut of houses caused severe price declines and, as underwriting standards had been diluted (or even ignored), builders, homeowners and investors were stuck with huge inventories.

In looking back we could ask: Where were the regulators? Clearly there were some regulatory failures. Another question that could be asked is: Where were the boards of directors since they are 'ultimately responsible for the oversight of management and overall risk governance of financial institutions'?[9] In response we could say that actions or inactions of boards have raised some important governance issues. Clearly, those two critical questions have not been fully addressed and this may explain part of the reason why *Time* magazine determined that the Person of the Year for 2011 was 'The Protestor'. This book does not focus on the Occupy Wall Street Movement and other scenes of protests surrounding the avarice and short-sightedness of certain financial market participants. We do, however, consider several issues surrounding the global financial crisis and many worthwhile suggestions are put forward.

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[7] For a comprehensive look at the history of financial crises, please see C.M. Reinhart and K.S. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (Princeton University Press, Princeton, NJ 2009).

[8] In an interview with the *Financial Times* one month before the crisis began C. Prince, then Chief Executive Officer of Citigroup, was quoted as saying: 'So long as the music is playing, you've got to get up and dance. We're still dancing'. See *Financial Times* (10 July 2007).

[9] Speech by J. Dickson, Superintendent of Financial Institutions (Canada) to the Toronto Board of Trade (4 April 2012).

II. WHAT'S IN THIS BOOK

The book is divided into four parts. We begin with a focus on ways to contain a financial crisis drawing on some lessons learned. Attention then turns to the special problems facing Europe and measures that are being devised and continuously revised to convince financial markets that a corner has been turned. Several scholars consider the role of government guarantees in Part III and in the final section we turn to the sovereign debt problem.

Part I: Containing a Financial Crisis

The primary objectives in containing a financial crisis are first, simply to stop it, and second, to minimize adverse impacts on the real economy.[10] However, pulling out all the stops to contain a crisis can have serious long-term consequences for the ability of a central government to raise finance in the future at rates and levels approaching those prior to the crisis.[11] The GFC has led to considerable costs, which are well documented.[12] Panetta et al. note that:

> The overall amount of resources committed to the various packages by the 11 countries examined totalled around EUR5 trillion or 18.8 per cent of GDP; the outlays have been EUR2 trillion or 7.6 per cent of GDP. The size of the interventions varies greatly across countries: it is higher in countries such as the UK and the Netherlands (where outlays have reached 44.1 per cent and 16.6 per cent of GDP, respectively) where the banking system is large relative to the real economy and is dominated by large institutions that have been severely hit by the crisis.[13]

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[10] Please see A. Gelpern 'Financial Crisis Containment', (2009) 41 Connecticut Law Review; D.G. Mayes 'Did Recent Experience of a Financial Crisis Help in Coping with the Current Financial Turmoil? The Case of the Nordic Countries', (2009) 47 Journal of Common Market Studies; D.G. Mayes, (2009) 'Resolution Methods For Cross-Border Banks in the Present Crisis' in J.R. LaBrosse, R. Olivares-Caminal and D. Singh (eds) *Financial Crisis Management and Bank Resolution* (Informa, London 2009).

[11] A. Sighvatsson and G. Gunnarsson, 'Iceland's Financial Disaster and its Fiscal Impact', in J.R. LaBrosse, R. Olivares-Caminal and D. Singh, *Managing Risk in the Financial System* (Edward Elgar, Cheltenham, UK and Northampton, MA, USA 2011).

[12] To illustrate, from 2007 to 2011, 430 FDIC-member (insured) institutions failed or received some form of assistance. The FDIC took a number of actions to deal with the losses and stabilize the Deposit Insurance Fund; the measures included increasing assessment rates, imposing a special assessment on member-banks and offering a facility for banks to prepay assessments. For more details on the measures please see www.fdic.gov.

[13] F.T. Panetta, G. Grande, C. Ho, M. King, A. Levy, F.M. Signoretti,