Comments
on
Challenges Associated with the Expansion of Deposit Insurance during Fall 2008
By
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This paper describes several measures, such as extending existing deposit insurance and introducing new ones, implemented by several governments facing financial crisis starting in the fall of 2008. The paper then goes on to discuss the challenges posed by these measures. Among them are: (1) moral hazard associated with deposit insurance; (2) potential cross countries competition among banks due to differences in deposit insurance; (3) the credibility of the governments' commitment to funding of the deposit insurance; (4) appropriate "exit strategies"; and (5) the extent government deposit guarantee can be fully withdrawn under all circumstances. All these are effectively summarized in the concluding section.

I comment Sebastian for this well-written paper. However, Sebastian offers no assessment of how successful these measures have been so far, and takes no position on whether or not these are appropriate measures. In my comments, I will address some general issues concerning government handling of financial crisis in general, and offer some thoughts for the future. Thus, my comments are not explicitly addressing Sebastian's paper.

Banking crisis, unfortunately, happens more frequently than we would like. Limited deposit insurance has always been thought of as a compromise between the need for a safety net and the risk of moral hazard. During the latest crisis which began in the fall of 2008, instead of closing insolvent banks and paying off insured depositors as is the intention of limited deposit insurance, the immediate course of action by many governments is to offer blanket guarantees to insured and uninsured depositors, generally by providing unlimited liquidity to financial institutions. Under this course of action, the challenges discussed by Sebastian become very real. Much of the justification for adopting this course of action is based on the need to quickly restore confidence in the financial system and to prevent the crisis situation from spiraling out of control. Presumably behind this course of action, there are economic calculations that suggest that this is the optimal economic response. However, since there is rarely any sort of honest and objective assessment after any financial crisis of how well it had been handled, one can only conclude that the actions taken at the onset of the financial crisis are motivated more by political rather than economic considerations. As such, these actions are unlikely to represent optimal economic response to the crisis, thus increasing the costs of resolving current and future crises by increasing moral hazard and other risks.

But, is there an alternative to blanket guarantees? Fortunately, the answer is yes, and one example is provided by the study by Kane and Klingebiel (2004). According to Kane and Klingebiel (2004, p. 32), there are three phases in the management of a crisis: (1) immediate damage containment; (2) medium-term industry restructuring; and (3) a long aftermath. Mismanagement of the early phase imposes additional costs on the later phases. Central to the damage containment phase is several days of "banking holiday". This allows banking officials and regulators to assess the depth of the problem, determine which banks are viable, which banks are insolvent, what assets are good and what are bad. A credible plan is devised to enable the viable banks to continue to operate, while the insolvent banks are restructured. Throughout this phase, transparency is utmost important since it could restore public's confidence in the banking system, while preventing "zombies" banks to continue to operate. This improves the efficiency of managing the crisis and protects the tax payers who ultimately must bear any or most of the costs of a restructuring. In addition to transparency, Ergungor and Cherny (2009) also discussed several other characteristics of a successful crisis resolution. They are: (1) the importance of having a politically and financially independent agency to handle the crisis management; (2) the importance of maintaining market discipline by adopting "market-mimicking" policies; and (3) the need to restore credit flows to creditworthy borrowers. Thus, economically efficient crisis management alternatives to blanket guarantees are available. The real question is "do we have the political will to implement them"?

What shall we do in the future? Unfortunately, like business cycles where we have yet to find a way to prevent them, financial crisis will bound to recur. Thus, we must both try to prevent it and prepare for it. The following are some suggestions:

1. Do not rush to pass legislations to regulate the financial sector in the name of "preventing future crisis" or "providing stability to the financial system". The worst thing that we could do is a "knee-jerked" reaction to the current crisis by rushing into passing more regulations. Such actions are more than likely politically motivated and thus would provide little or no protection to our financial system, but would increase the costs to tax payers of resolving future crises. Instead, when the crisis receded, appoint a politically independent commission to examine the causes and effectiveness of how the crisis was handled. The commission should then recommend a course of actions that are designed to both improve the functioning of the financial system and also a contingency plan to handle the next crisis.

2. Again, transparency is important in the post-mortem. This and a contingency plan can serve to reduce moral hazard risk. For the contingency plan to have credibility, it must be rehearsed, to the extend possible. For example, rehearse assembling the equipments and manpower necessary to contain a crisis during the "banking holiday" in the containment phase of a crisis.

3. Since studies have shown that maintaining market discipline can lessen the overall costs of managing a crisis, it should be clear therefore future legislations should aim to foster market discipline. To this effect, I echo Sebastian's suggestion of giving risk-based insurance premium serious consideration.

4. Again, I echo Sebastian's suggestion of the need for greater international cooperation in crisis management so as not to put a particular country in competitive disadvantage.

Finally, I enjoyed reading Sebastian's paper. While Sebastian takes no position on the appropriateness of management of the current crisis, I choose to offer an alternative.

Literature Cited

Ergungor, O. Emre, Cherny, K., 2009. Effective practices in crisis resolution and the case of Sweden. Economic Commentary of the Federal Reserve Bank of Cleveland, (February).

Kane, Edward J. Klingebiel, D. 2004. Alternative to blanket guarantees for containing a systemic crisis. Journal of Financial Stability 1, 31 – 63.