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How can we test whether its use lessened the incidence of crises?

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SPECIAL PAPER 169

LSE FINANCIAL MARKETS GROUP PAPER SERIES

November 2006

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Assume that you are a sociologist interested in examining the conduct of marriage. Would you think it sensible to proceed by focussing almost entirely on those cases of marriages which failed, and went through the divorce courts? I would not be surprised if the worst, and most disturbing, divorces are those in which the wronged partner went on suffering abusive behaviour for many years before coming to the divorce court. But would that necessarily lead to the conclusion that forbearance in the face of wrong-doing by a partner in a marriage is necessarily wrong? I do not think that it should. Yet in the field of financial regulation, much of the research concentrates on studying the events of financial crises. These have generally found that financial crises are in many, or in most, cases worse where there has been regulatory forbearance beforehand. Yet such studies do not, or very rarely, compare cases where stresses have eventually led to financial crises, with similar cases where there has been as bad, or worse, stresses, and these have not resulted in similar financial crises. Perhaps as a result, it is asserted as an accepted fact that forbearance always leads to greater losses. Let me quote from a recent paper by my friend, Bob Eisenbeis; he writes, “The longer an insolvent institution is kept open, the greater are the losses that both uninsured creditors and the deposit insurance scheme must absorb.”

Let me ask you to consider what was the most potentially dangerous financial crisis of the last fifty years. Let me give you my answer. The most perilous occasion was in

1982, when the near-default of Mexico, Argentina and Brazil led to many, possibly most, of the city-centre banks in New York, and major banks elsewhere in the western world, becoming either insolvent or perilously short of capital. Surprisingly, given the enormous potential effect and salience of the 1982 crisis, the effect on the Western banking system has not been fully written up to the best of my knowledge. One reason may be the reluctance of the commercial banks, which have of course survived, to reveal in any detail exactly what straits they were in at the time. And this raises a more general point, which is that, after failure, the gory details are usually available to students and economists in some detail; whereas when a crisis is averted, and the financial institution(s) continues, there is very considerable reluctance on behalf of the commercial banks involved to reveal what really happened. Moreover, the 30 year rule, now in existence with respect to most official activities, does not hold in this case; because it is a customer/client relationship, and the period of confidentiality in such cases reaches back 100 years. As a result there is far less information about crises which have been averted, than about those crises which exploded. So, it is far easier to analyse crises that occurred than crises that did not occur.

Simply looking where the light is does not, however, necessarily direct you always to the truth. Even so, some cases where crises have been largely averted have emerged, for example the general ethnic bank crisis in the UK after the failure of BCCI in the early 1990s; it is perfectly clear from the results published by the Bank of England that this was a case of contagion. I know of numerous other cases of contagion, for example the first research that I ever did related to the 1907 US crisis, when there was a run on the whole set of trust companies following the, in fact unwarranted, refusal

of a National Bank to clear for the Knickerbocker Trust Company. And there are many others; for example the Ohio State Savings and Loans banks in the 1980s.

Those who deny contagion, simply do not try to look for it. If you look for it, you will find it.

Almost by definition, however, most averted failures that we know about have involved some degree of forbearance; but forbearance can take many forms, ranging from forbearance to make the condition of the endangered bank public, to forbearance over the accountancy practices being used, a subject to which I shall revert, to forbearance to close a bank which is clearly at that current time insolvent on a mark to market basis. Just saying that forbearance should be avoided is a misuse of language; one needs to define in much more detail exactly what forms such forbearance have taken on certain past occasions and in some detail what kinds of forbearance should be avoided in future, and when and why. This is rather similar to the common misuse of the generic term 'bail-out', when there is frequently insufficient detail of exactly who is being bailed out by whom in what form. Are the shareholders being rescued? The managers who took the decisions? Those holding subordinated debt? Those holding various kinds of deposits, including interbank depositors, or just the retail depositors who have insured, or partly insured, deposits.

The main exhibit in the case against forbearance is the Savings and Loans crisis in the United States towards the end of the 1980s; though, in my view, the 100 percent deposit insurance bears as large, or larger, share of the blame than any forbearance by regulators. I always enjoyed the story of the American depositor who sought out consciously the most crooked S & L management that he could find in order to place

his deposit with them. Why did he do it? He did so because the real crooks usually had to pay a quarter percent, or so, above the going rate, because they were known to be so dishonest. But with 100 percent deposit insurance through the FSLIC, such dishonesty did not matter to a potential depositor, even when it was patently apparent. Under these circumstances S & Ls could always get funding and obtain sufficient liquidity to meet their debts, even when their risky assets were collapsing in value. So long as such crooked institutions could find bent accountants to claim that they remained solvent, they could continue.

Of course, one desideratum in such cases is for the authorities to be able both to put their own forensic accountants into a 'bad bank', and to close it before its capital is completely exhausted, and it is revealed as insolvent. But these are radical measures, and without strong evidence and legal support are likely to lead to law suits. The legal support given to the authorities to enforce either recapitalisation or closure on an insufficiently capitalised bank in America by FDICIA does not have a counterpart, yet, in Europe. It is, at least, arguable that forbearance is a necessary concomitant of the application of standard bankruptcy laws to banks, and that any significant move away from forbearance would have to be accompanied by a major legal initiative to reformulate the way in which bank distress is handled, along the lines of FDICIA. Robert Bliss and George Kaufman have a good recent article on this topic.

Let me digress for a moment on deposit insurance. There is not nearly enough distinction in the literature between 100 percent effective insurance, and other forms of deposit insurance which are limited, capped, and involve a degree of co-insurance, perhaps even for those depositing relatively small sums. The first, American, 100

percent deposit insurance is in my view clearly damaging and counterproductive, with an unacceptable degree of moral hazard, as I indicated in the case of the US S & Ls.

The second, involving a degree of coinsurance, should on the other hand help to facilitate bank closures, by reducing the political fallout from the loss of value of the deposits of the poor, widows and orphans. Yet far too much research in this field involves using a dummy variable taking the value one when there is deposit insurance, without taking account of differentiation between kinds of deposit insurance. If you do that, without differentiation, the econometric results are not likely to be very reliable.

Let me, however, get back to my main theme of how to deal with crises. Financial panics and illiquidity are closely interrelated; illiquidity helps to cause crises, and panics lead to illiquidity. In such cases, asset prices are often driven well below fundamental equilibrium, as occurred, for example, in October 1998. Though note that the 1998 autumn crisis has been pervasively misinterpreted. The initial cause of that crisis is almost invariably attributed to the Russian default, a case of governmental misdeed, when the commercial banks were perhaps behaving imprudently, but were the victims. In fact, however, as Mardi Dungey and I have documented, the main cause of the 1998 crisis was the losses made by many commercial and investment banks in a failing speculation to force the Hong Kong government to devalue towards the end of August in that year. The financial institutions which made the failing speculation and lost a considerable amount of money are, not unsurprisingly, very reluctant to reveal any of the details of what happened. It is more convenient to blame what occurred on Russia, than on their own actions in Hong Kong.

Anyhow, the decline in asset prices in such circumstances below fundamental equilibrium is not irrational. Markets are indeed rational, but in these circumstances they are rational somewhat in the same sense that wolves and piranhas are rational. When they scent somebody wounded, bleeding, and having to sell under forced conditions, they go in for the quick kill by selling in front of such forced sellers.

I understand that the virtual failure of the hedge fund Amaranth a couple of months ago was of a similar form. It was known that Amaranth had a large bull position in energy prices. Then it became known that one of their positions was sufficiently under-water to force them to meet a margin call. Once that margin call became public knowledge, it quickly led others to enter the market to force prices down, in order to put Amaranth under even greater pressure.

So, when there are panics, this is very frequently accompanied by illiquidity. Markets for less liquid, riskier assets tend to dry up; spreads and price differentials widen dramatically. In such a context Walter Bagehot is frequently misquoted and misinterpreted. It is commonly stated that he claims that a central bank should lend only at a penalty rate. This is not so. He never used the word 'penalty' in this context. Instead he said that the central bank should lend at a high rate. But he made it clear that this should be high against the comparison of the normal state of the market, not the state of pure panic. Again, Bagehot suggested lending only against good collateral, but again 'good' has to be interpreted in the context of normal conditions, not of panic conditions. Thus a central bank should lend against assets which would be acceptable as collateral under normal circumstances.

If we really had full information on all the relevant fundamentals, it is quite hard to see that panics would ever occur, or that central bank lender-of-last resort actions would ever be necessary. But we are never in receipt of full information, and particularly not so at times of crisis or potential crisis. For example, Continental Illinois was rescued largely because of concern about the very large number of sizeable inter-bank deposits that it held for its correspondent smaller banks in the Middle West of America. Of course, we now know that Continental Illinois was able to repay something like 98 or 99 cents in the dollar. But that was not known at the time. Given the uncertainty about what Continental Illinois could repay, there was a danger that depositors at the banks holding inter-bank deposits with Continental Illinois might just take the safer and easier choice of withdrawing their deposits from such correspondent banks in a rush. Of course, an alternative, and possibly much better, alternative might have been for the Fed to promise assistance to all the correspondent banks. There is a general argument that a central bank should allow the first bank running into difficulties to fail, in order to encourage the rest and prevent moral hazard, but then stand ready to inject large quantities of liquidity into all banks in a similar position, or who have close links with the initial failing bank, in order to prevent a subsequent contagion.

Be that as it may, in all cases where financial institutions go to the authorities in search of some assistance and additional liquidity, there is a need for the authorities, in particular the central bank, to use discretion and judgement. Will the markets and banks recover? What is the likelihood of success in the support, or recapitalisation, process? That should not be taken as a disguised call for forbearance in all cases; far

from it. Eddie George was right to let Barings go. The Bank should have let Johnson Matthey go. The case for support, on account of the London gold market, was not, in my view, persuasive.

Obviously, there is some incentive on the authorities and central bankers, to defer enforcement of closure. Well publicised and newsworthy failures lead to penalties on the regulatory officials involved. In my own country, Jim Keogh took the can for the Fringe Bank crisis, and Peter Cooke's career was not improved by the Johnson Matthey Bank failure. But how far is forbearance actually possible in the real world? The likelihood of leaks of the adverse position of a financial institution goes up by a power function of those in the know, and the number of those in the know tends to increase quite rapidly. Moreover, no one can keep a bank open if it cannot meet its payment obligations. It is often very difficult to keep the weak position of a bank, or a financial institution, secret from the market. Unless repairs can be made very rapidly, market forces will drive the institution to the wall anyhow, whatever the central bank may do.

That takes me back to accounting, because what is necessary to keep a financial institution in operation are two criteria. The first is sufficient liquidity, and the second is a published balance sheet which appears to show that the institution is solvent. For example, the US City Centre banks in 1982 were largely kept in operation by a process of evergreening, in which they continued, under pressure from the authorities, to make so-called new loans to Mexico, Argentina and Brazil, which money was then recycled back to them as supposed interest payments, enabling the US and other banks to claim that their loans to such countries could remain on the books at their

historic value. It was not until quite a number of years later that John Reed of City Bank began to make proper provisions against such sovereign loans. Similarly, procedures of evergreening, and maintaining loans in balance sheets at historic costs, was a means of keeping the Japanese banking system going through the 1990s, and indeed the Chinese banking system continuously. Let me ask, what should have been done with the Japanese banking system in the 1990s? By 1992, on a mark to market basis, probably most, if not all, of the Japanese banks were bust. It might have been preferable to treat them as was done in Scandinavia, by kicking out the management of all such banks, and having them properly recapitalised by central government, with the introduction of new management. But this would have required very considerable capital injections, fully acknowledged in the national accounts, of taxpayers' funds; and the political will in Japan for that to occur was simply not present.

Indeed, rather than making a blanket criticism of forbearance, what is needed is a much more careful study of the interaction between accountancy practices and potential financial crises. What we have done in recent years is to take advantage of a period of extraordinary stability to move the accounting framework of virtually all financial institutions towards a mark to market basis; that is the implication of IAS 39. But the more that you eschew forbearance, and alongside that, the more that you seek to abandon evergreening and historic cost approaches, the more that one is likely to increase the incidence of financial crises, especially should the 'great moderation' of the last decade and a half come to an end.

So, what should we do if we do indeed become beset by more financial crises, (recalling that the prior possibility of forbearance which involves accountancy

stratagems, such as evergreening and historic cost, is becoming no longer viable)? As earlier indicated, a general maxim might be to let the first bank running into difficulties fail, as was the case with Barings, ‘pour encourager les autres’, but then move in to save the rest. I have to warn that such an approach may, on occasions, require massive injections of liquidity, possibly far more than if the central bank moved at the outset to snuff out the whole problem by saving the initial financial institution in difficulties.

The potential greater instability of the financial system, following the recent adoption of a combination of Basel II and IAS 39, may well require acceptance of a greater need of central banks to vary liquidity very considerably indeed, in order to maintain systemic financial stability. Would such very large scale fluctuations in liquidity necessarily be inconsistent with the maintenance of central banks’ prime responsibility for maintaining price stability? Probably not so, in my view, so long as the injections and removals of liquidity are done symmetrically, that is if the central bank is as ready and quick to withdraw excess liquidity, when times get better, just as easily and as rapidly as it stands prepared to inject additional liquidity on occasions of potential crisis.

So, my final conclusion is that, if central banks can no longer smooth over varying conditions of financial stability by employing forbearance and accountancy methods, such as evergreening and historic costs, they will have to do it instead, by being prepared to have much larger fluctuations in the provision of liquidity to financial markets.