

Chapter 14 – Addressing Insolvency: Forbearance vs. Government Restructuring

How do regulators address widespread capital inadequacy, or outright insolvency, in a banking system? When the liabilities of numerous banks exceed their assets, the usual approaches to resolving a single insolvency – close it down or find a buyer – are unlikely to work.

Recent history highlights two very different approaches to widespread insolvency: *regulatory forbearance* and *aggressive government restructuring*. The first approach postpones the resolution of insolvent banks. The second speeds it.

Regulatory forbearance occurs when government allows an insolvent bank to continue operating. Put another way, government forbears – refrains from – the application of rules that would resolve the bank quickly. Even though the bank's assets are insufficient to pay off its liabilities, it remains in business.

How can an insolvent bank still operate? Recall that a bank's promise to pay withdrawals sequentially – *first come first serve* – can lead to a stampede when a bank is thought to be insolvent: A depositor who withdraws early gets paid in full; a depositor who waits may receive nothing at all because the bank's assets may run out.

Deposit insurance helps to prevent such bank runs by limiting the losses of patient depositors (see Chapter 14). However, deposit insurance schemes usually do not insure all deposits.¹ To prevent a run on insolvent banks, regulators may have to guarantee all their deposits, and their other liabilities, too. As we have seen in earlier modules, such guarantees undermine incentives for banks and their creditors to manage risks effectively.

Given these poor incentives, why might a government delay bank resolution and choose forbearance? Three factors often play a role. First, closing down a bank can lead to worries about other institutions, triggering a broader bank run. Second, regulators usually cannot sell an insolvent bank without using public funds to cover the excess of liabilities over the value of the assets – the *legacy losses*. Acknowledging the losses and budgeting for them are politically difficult since they suggest failure of the public officials who were supposed to be supervising the bank's activities. Third, governments may hope that banks can become profitable and eventually recover the legacy losses on their own.

¹ During the financial crisis, Congress raised the cap on U.S. deposit insurance to \$250,000 (per account holder at a bank). Even as of March, 2009, however, only 64% of the deposits (equivalent to 35% of the assets) at FDIC-insured institutions were insured. The majority of assets were supported by uninsured deposits and other liabilities.

All three factors contributed to U.S. regulatory policy in the 1980s. Some U.S. commercial banks had suffered large losses early in the decade from emerging market and real-estate-related loans. Regulations at the time did not require banks to mark these loans to market²: if they had, a number of banks would likely have been insolvent. Instead, U.S. regulatory forbearance permitted these institutions to operate for years with low levels of capital. Over time, operating profits did restore the system's capital. But nearly a decade later, in the early 1990s, a lingering capital shortfall still limited banks' willingness to extend new loans.

Similar factors influenced Japan's policy response to its banking crisis in the 1990s. Many Japanese banks suffered as a result of the collapse of the country's equity and real estate bubble at the start of the decade. When land values plunged by as much as 90% after the real estate bubble burst, many bank loans collateralized by land became worthless, or nearly so. But the regulatory rules of the time did not require banks to mark their *non-performing loans* (on which no interest or principal is paid) to market. In some cases, to keep the loans on their books, banks simply added unpaid interest to the loan's principal. The effect was to create *zombie businesses*, just as regulators created *zombie banks*. The walking dead had escaped from the horror movies and invaded the financial system.

Japan's regulatory forbearance in the 1990s is widely perceived to have been a major policy failure. In contrast to the U.S. experience, the profitability of Japan's banks was so low that they were unable to recover from their legacy losses even over many years (see Table 12.4). A decade after the equity and real estate bubbles of the 1980s had burst, Japan's frail banks were still unable to supply the credit needed to sustain economic expansion. Moreover, by sustaining zombie businesses, the Japanese banking system failed in its primary mission of identifying and funding profitable projects that contribute to productivity and economic growth. The inefficient allocation of capital slowed the improvement of living standards for the better part of a generation.

At the opposite end of the spectrum of bank resolution policies, governments can restructure insolvent banks quickly and aggressively. One approach is the so-called *good bank/bad bank* division. In this framework, a government temporarily acquires the insolvent bank and divides it into two parts: a good bank that is adequately capitalized and can earn a market rate of return on that capital through normal operations, and a bad bank that receives the legacy assets which lost value.

The good bank/bad bank approach assumes that the core operations of the failing bank are profitable and that the cause of insolvency was market risk – a plunge in the market value of legacy assets. The good bank can be sold and operate free of the risk that the legacy assets could fall further in value. Meanwhile, the government can either recapitalize and sell the bad bank (at a loss), or operate it directly. The bad

² *Mark to market* is an accounting rule under which a financial instrument is repriced on the balance sheet to reflect its changing market price. A mark-up adds to capital, while a mark-down reduces it.

bank is essentially an asset management company that manages the bad assets in an effort to recover as much of their value as possible.

The most prominent and successful application of this approach in recent times occurred in Sweden, following its 1992 banking crisis. The Swedish government aggressively restructured major banks, and created entities to manage the legacy assets.³ The relatively rapid return to economic growth that ensued limited the costs of Sweden's banking crisis. It also helped the government to sell off the legacy assets and recover part of the losses.

Unlike regulatory forbearance, government restructuring can quickly restore incentives for the good bank to lend to profitable projects, and for the bad bank to foreclose on loans to failing enterprises. In this way it can restore credit supply to healthy borrowers and speed the return to economic growth in the aftermath of a systemic banking crisis. However, taking this route requires that the government have the political will to acknowledge the losses, recapitalize the banking system, and possibly foreclose on bad loans. Such actions are controversial. Even when it limits the economic damage from a systemic crisis, bank recapitalizations and loan foreclosures are very unpopular.

³ For details of Sweden's approach, see Charles Calomiris, Daniela Klingebiel, and Luc Laeven, "A Taxonomy of Financial Crisis Resolution Mechanisms: Cross-Country Experience," World Bank Policy Research Working Paper 3379, August 2004.