Banking crises

Econ 4335

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Plan for the lecture

- Typology, prevalence
- An example: The Kristiania Crash 1899
- Why so many banking crises?
- The aftermath of banking crises
- Some aspects of the recent crisis
- Crisis handling

Typology

- Individual banks
- Systemic crisis
- Liquidity crisis
- Solvency crisis
- One leads to the other
- Twin crises

Prevalence of systemic crises

- 114 "national" banking crises 1945 - 1986
- 10 "global" banking crises since 1890, 6 since 1945
- Developed and emerging economies equally affected
- Argentina and UK 4 since 1945
- Norway in banking crisis 16 per cent ! of time since independence (1905?), US 13 per cent since 1800
- Norway, 1 since 1945, 5(?) before
  - 1899, **1921-28**, 1931-32, **1987-93**

Reinhart and Rogoff: *This time is different. Eight centuries of financial folly.* Princeton Univ Press 2009

The Kristiania crash 1899

- 7 banks closed
- several others received support
- huge losses on mortgages, loans to property developers and investors in shares
- Norges Bank lender of last resort, huge losses

Hanisch: *Om valget av det gode samfunn*. Høyskoleforlaget (1996), kap 2 (Hanisch og Ryggvik)

The Kristiania crash, the run-up 1894 - 99

- Speculation in apartment buildings for rent
- House prices up 72 per cent (or 150 H & R)
- Construction boom
- Tripling in new apartments
- Infrastructure investments
- Immigration, construction workers
- Initial real forces

- Six new banks established
- Rapid credit expansion
- Interbank lending provided liquidity
- Banks borrowed heavily abroad
- Rapid increase in share prices
- Share purchases financed by borrowing, also bank shares
- Interest rates low for too long?

The Kristiania Crash, the turning point

- The discount rate was increased in 1898 (and reduced in early 1899)
- Bankruptcy in a big export firm in June 1899 brought down the first bank and created "panic"
- Foreign banks started to withdraw their credits
- Credit contraction
- Demand for new housing depended on steady inflow of new construction workers, which again depended on *increasing* construction activity

The Kristiania Crash, the aftermath

- House prices down 27 per cent 1900, 59 per cent to 1904
- Twelve per cent of apartments empty 1904
- Net emigration 25 000 to 1905
- Drain on gold reserves

Why so many banking crises?

- Borrowing short, lending long, runs
- Low equity
- Deposit insurance
- Too big to fail
- Too interconnected to fail
- Banks often lose when competitors fail

- Moral hazard
- Lack of market discipline
- "This time is different"

Do banks fail more often than other firms?

Known risk factors 1

- Rapid increases in asset prices,
  - commercial property, land, housing, shares, ...
- Rapid credit growth
- Large current account deficits

USA 1929, 2007, Japan, 1992-97, Ireland, now, Spain now
Japan: non-performing loans 10-20 per cent of GDP, 35 per cent of loans still non-performing in 2002

Known risk factors 2

- deregulation
- expansion to new markets
- financial innovation,
- increased competition
- high international capital mobility

- Nordic crisis ca 1990 (Norway, Sweden, Finland)
- Asia / Emerging market crisis 1997-99
- US Savings and Loans 1980s

Known risk factors 3

- Falling price levels, rapid disinflations, US 1930s, Norway 1920s, 1987-93
- Macro-shocks leading to abrupt increases in interest rates or unemployment, Finland and the end of the Soviet Union, German unification affecting Nordic crisis

Risk control

Risk factors occur frequently, banking crises more rarely.

- Charter value
- Capital requirements
- Accounting rules
- Supervision
- Staff incentives
- Good banking practices

The aftermath of severe banking crises

- Longer and more severe recessions
  - output down 9 per cent
  - unemployment up 7 per cent
- Fall in real house prices
  - 35 per cent over 6 years
- Fall in real equity prices
  - 55 per cent over 3.5 years
- Increased government debt
  - 86 per cent

Reihart and Rogoff (2009, article

Mechanisms behind real effects

Financial accelerator

- Increased lending margins
- Credit rationing
- Higher costs of capital for banks
- Risk perceptions and precautionary behavior outside of banks
- Fall in asset prices

- Cause or effect?
- Direct effects when bubbles burst
- Direct effects of news

Fire sale

Sale of assets below fundamental value

Simple explanation:

- Cannot wait to sell
- Takes time to find buyers
- Potential buyers have strong liquidity preferences

Distinguish from low prices because of previous over-investment

The latest crisis

- Subprime crisis, banking crisis, debt crisis?
- Breakdown of bond markets and interbank markets
- The deep global impact
- Contagion and parallel developments
- Country differences
- Loan losses on mortgages to homeowners

The markets for bonds issued by private institutions

- Securitization, risks remained with banks (and turned up in surprising places)
- Rating bureaus, outsourcing of evaluation of credit risk
- Liquidity for the individual bank, but not for the banking system
- Market organized by a small number of investment banks with conflicting interests, low transparency
- Failures of investment banks
- Bond markets froze
- Only fire-sale transactions in many markets

Crisis handling

Bagehots advice:
For solvent but illiquid banks: Lend freely against good collateral and at punitive interest rates For insolvent banks: Let them fail

Why give banks special treatment?

- The role of banks in the payment system
- Banks as creators of liquidity
- Banks as source of financing for SMBs

Takeover may be cheaper than let go!

Individual bank in crisis

Option for deposit insurance fund:

- Find bank in goods shape that will take over
- Subsidize takeover if cost efficient
- Move guaranteed deposit to another bank
- Sell assets of failed bank as best you can
- Bankruptcy proceedings

Norway: Special bankruptcy proceeding "administrasjon"
Systemic crisis when you cannot find banks big and solid enough to take over

Who should suffer?

- Shareholders
- Junior bond holders
- senior bond holders
- other banks with deposits
- ordinary depositors without guarantees

Moral hazard?

Limiting contagion

- Guarantees for bank debt
  - all debt = disaster risk
  - new debt
  - increased ceiling for deposit insurance
- Establish rescue fund
- Bad bank
- Government takeover

No giveaways!

Liquidity support

- lend freely against collateral
- accept collateral of lower quality?
- loans with longer maturity
- Gullkortet

Measures may need government approval