

FIGHTING THE FIRE: GOVERNMENTAL EMERGENCY RESPONSES TO THE FINANCIAL CRISIS

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Introduction

What began with a minor concern sparked by the rise in defaults on subprime mortgages in the United States (US) in summer 2007 soon developed into a crisis precipitated by the collapse of investment banks Bear Stearns and Lehman Brothers in March and September 2008, respectively, and has since spun out of control, sending financial markets around the globe into meltdown. The liquidity crisis resulting from a lack of sufficient funding to refinance short-term debt has led to a systemic banking crisis which has been affecting the world economy to an extent not seen since the end of the Second World War. As a result of the degree of globalisation of financial institutions, the interconnectedness of the international money, credit and capital markets and the complexity of modern financial products, the cold caught by regional subprime lenders in the US has infected financial centres in all parts of the world with a speed and magnitude much greater than its initial impact on the real economy. The systemic risk inherent in the liquidity problems suddenly faced by major banks has provoked a number of international governmental interventions in order to smoothen the probable ‘domino effect’ of, inter alia, the bankruptcy of Lehman Brothers, and to avoid a repetition that might eventually lead to the collapse of the world financial system (as foreshadowed by the demise of the banking system in Iceland). This article provides a brief review of the various instruments with which governments have attempted to extinguish the fire of the crisis. It will be argued that their pragmatic emergency responses have so far successfully prevented the implosion of the world financial system but that we now need the establishment of national ‘bad banks’, followed by further structural and regulatory reforms, in order to enable banks to regain their independence and the confidence of the market as the basis for a fresh start.

I. Liquidity Support: Emergency Loans

The global banking crisis began as a liquidity crisis. It originated in the US with defaults by the so-called ‘NINJAs’ on their mortgages.¹ These defaults in turn had an impact on the rating and the value of large numbers of mortgage-backed securities and their bundled relatives known as ‘collateralised debt obligations’. Such instruments were commonly held and

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¹ ‘NINJA’ is an acronym for debtors with no income, no job and no assets.

used by banks as collateral for funds borrowed in the interbank money market to refinance their lending operations.

Maturity transformation is one of the main functions of banks in their role as financial intermediaries.² Banks borrow, in the form of accepting deposits or issuing debt securities, money from customers and other banks for relatively short periods of time and on-lend these funds to private or corporate clients for a longer term. *Ceteris paribus*, short-term credits carry less interest than long-term credits because the risk of default tends to increase with the term of the loan. Hence, the interest margin earned on the conversion of funds borrowed in the short-term money markets into long-term loans lent in the credit markets is an important driver of banks' profits. This business model is, however, dependent on the bank's ability to periodically refinance, or 'roll over', its short-term borrowings in the money markets. Beside the commercial paper market, the interbank money market provides a platform for banks holding excess liquidity to lend their excess cash to other banks with a current, often overnight, funding need. Usually, the borrower has to post collateral to the lending bank in the form of marketable securities.

The rising rate of defaults on subprime loans began to substantially weaken the quality of mortgage-backed securities as collateral in the summer of 2007. This led lending banks to demand additional collateral from borrowers (margin calls) and/or gradually to reduce their exposure to individual counterparties. Repeated margin calls, coupled with the reputational damage caused thereby, diminished the level of trust between market participants and eventually led to an almost total seizure of liquidity in the interbank market by autumn 2008.³

The effective closure of the interbank money market due to the lack of counterparty confidence put many banks, not just those who had been offering mortgage-backed securities as collateral, in great difficulties to obtain the funds necessary to refinance their maturing short-term debt.

This development prompted central banks around the globe to step in and effectively act as a substitute for the private money market lenders that had fallen away. For example, on 20 October 2008 the Bank of England introduced the 'Discount Window Facility' to provide liquidity assistance to banks for periods of up to 30 or 364 days.⁴ Under this scheme, banks can swap, at a discount, eligible collateral for government bonds against which the banks can then raise cash in the market; in other words, banks can

² M. Bitz, *Finanzdienstleistungen*, Munich: Oldenbourg 2000, pp. 30-31.

³ See William D. Cohan, *House of Cards: How Wall Street's Gamblers Broke Capitalism*, London: Allen Lane 2009, pp. 1-149 for a graphic account of the incremental loss of Bear Stearn's reputation in the overnight interbank market.

⁴ See <http://www.bankofengland.co.uk/markets/money/discount/> (last accessed on 8 April 2009). Similar facilities have been made available by the Federal Reserve in the US (see <http://www.federalreserve.gov/monetarypolicy/bst.htm> (last accessed on 8 April 2009)) and the European Central Bank (ECB) for the Economic and Monetary Union region (see <http://www.ecb.int/pr081015.en.html> (last accessed on 8 April 2009)).

indirectly replace the creditworthiness of issuers whose securities are, rightly or wrongly, no longer regarded as suitable collateral with the creditworthiness of the government. The (indirect) substitution of the state as a 'lender of last resort' for private money market lenders has proved to be a vitally important first measure to maintain the immediate solvency of banks. However, the provision of emergency liquidity cannot address the underlying questions of how to revitalise the interbank money market and what to do with the unmarketable securities and troubled credits on banks' balance sheets, which have since come to be known as 'toxic' assets.

II. Credit Support and Counterparty Protection: State Guarantees

What is needed to re-open the interbank market is a sustained restoration of trust between the parties. One way to address this issue is the 'risk umbrella' which European governments have spanned over various troubled banks in order to resurrect their standing in the market and incentivise counterparties to lend to them again. The state guarantee effectively allows the covered bank to swap its own credit default risk for the risk of default by the relevant government.⁵

For example, on 8 October 2008 the UK government announced the introduction of a 'Credit Guarantee Scheme' pursuant to which it offers to guarantee eligible debt instruments such as commercial paper, certificates of deposit and unsecured bonds, issued by, among others, Abbey National, Barclays, HBOS, HSBC, Lloyds TSB, RBS and Standard Chartered.⁶ The German government has likewise established a 'risk umbrella' of up to Euro 400 billion to guarantee debt instruments issued by, among others, Bayerische Landesbank, HSH Nordbank and Commerzbank.⁷

State guarantees have so far proved an effective and efficient instrument to help revitalise the market. They are effective because the governmental backing re-enables investors to do what they were effectively barred from doing when, partly due to the complexity of the underlying products and increasingly due to the distortion of the markets, the rating of financial collateral and the assessment of the creditworthiness of the borrower became impossible. A lender or investor now only needs to do due diligence on the government that is guaranteeing the debt but no longer on the borrower and

⁵ It remains to be seen whether, in view of the sheer volume of funds made available by governments not only to stabilise the banking system but also to finance various economic stimulus packages, the risk of government defaults will continue to be regarded as negligible. Yet, the yields on bonds issued by the US, the UK and many western European governments have significantly fallen in recent months, probably due to the rapid lowering of interest rates by the Federal Reserve, the Bank of England and the European Central Bank. Conversely, credit default swap spreads on bonds issued by emerging market countries have been on the rise, suggesting that their debt is perceived as more risky than before the start of the financial crisis.

⁶ See http://www.hm-treasury.gov.uk/press_138_08.htm (last accessed on 8 April 2009).

⁷ See http://www.soffin.de/leistungen_garantien.en.php (last accessed on 8 April 2009).

the collateral offered. This significantly reduces transaction costs and supports the orderly issuance of new or roll-over debt.

State guarantees are also efficient because they do not constitute an immediate drain on governmental (and hence taxpayers') funds since they impose only a contingent obligation. This reduces the pressure on, and the (perceived) danger of, 'toxic' securities because a lender benefiting from a state guarantee does not need to concern itself with the true value of the securities. Indeed, only time will tell whether all of the financial products that are currently regarded as 'toxic' are actually worthless. The state guarantee will only be called upon, and will only then transfer the burden of the 'toxic' securities to the taxpayer, if and to the extent that actual defaults on those instruments will cause a covered bank to default on the repayment of its own debt.

Nevertheless, buying time can only ever be a temporary solution. State guarantees cannot repair the balance sheets of banks which have been so badly affected by large-scale writedowns on their 'toxic' assets and have forced them to report enormous losses and suffer a significant erosion of their regulatory capital base.⁸ A more sustainable solution is required in the medium term to enable banks to stand on their 'own feet' again. This can only be achieved by helping them regain the confidence of the market.

III. Cleaning the Balance Sheet: Purchase of 'Toxic' Assets by 'Bad Banks'

One of the most controversial questions is whether, and to what extent, governments should help banks dispose of their 'toxic' assets, or whether this should instead be left to the self-healing powers of the market.⁹

The most effective way to restore the market would arguably be the establishment of national 'bad banks' that would acquire, manage and either resell or hold until maturity banks' 'toxic' assets. It is submitted that the creation of 'bad banks' could provide a viable means of enabling banks to 'clean' their balance sheets from the risk of further substantial writedowns and losses on 'toxic' securities and credits, and to stabilise their regulatory capital position. The combined effect would be the resurrection of market confidence in banks' balance sheets and an increase in the amount of regulatory capital available to support new lending activities. The latter point

⁸ E.g., The Royal Bank of Scotland has posted a record loss of £24 billion for the financial year 2008.

⁹ See e.g. *Frankfurter Allgemeine Zeitung*, 4 April 2009, p. 21, which reports that the German government is opposing the establishment of a national 'bad bank' whereas European Union (EU) Commissioner for Economic and Monetary Affairs, Joaquín Almunia, has been urging the EU member states to help the banks remove 'toxic' assets from their balance sheets as quickly as possible. See also C. Welp, 'Park-Bank für Müll', *WirtschaftsWoche*, 2 February 2009, p. 27 for a discussion of the pros and cons of 'bad banks'. The latest forecast of the International Monetary Fund estimates that the global volume of 'toxic' securities could reach US\$ 4 trillion: see <http://business.timesonline.co.uk/article6047929.ece> (last accessed on 8 April 2009).

is of particular importance as banks have recently been withholding lending to the private sector, either to protect themselves against a further diminution of their capital base or because their remaining regulatory capital is already insufficient to support new lending. If the danger of a further drying-out of the credit supply to the real economy, which is often referred to as the 'lubricant of the economy', materialises, the gravity of the economic crisis will be further exacerbated and many more operationally healthy businesses will likely have to file for bankruptcy only because of a (temporary) lack of liquidity. A partial response to the problem has been the introduction by the Bank of England and the Federal Reserve of a fairly direct form of market intervention pursuant to which they buy high-quality longer-term securities from banks and other financial institutions in the open market and hold them in their own portfolios.¹⁰ Whilst such 'quantitative easing' directly enhances the supply of liquidity to the credit markets, it still leaves unmarketable 'toxic' assets on the banks' books.

There is considerable scope for debate about the structure of a 'bad bank'. This poses three main questions. The first is whether the transfer of assets should be synthetic or in the form of a true sale. For example, on 19 January 2009 the UK government established the concept of 'virtual bad banks' whereby, in return for a fee, the government will assume the risk of future losses on certain 'toxic' securities without actually buying those assets from the banks.¹¹ This structure seems comparable to a credit default swap as it effectively puts a ceiling on the banks' losses on 'toxic' assets. It has the character of a first party insurance policy that can be contrasted with the third party liability insurance provided to counterparties under the state guarantees described in section II above. A synthetic transfer can have the intended effect of freeing up banks' regulatory capital. This is because banks need to underlay assets that are protected by the governmental loss insurance with less capital in order to meet the regulatory requirements of Basel II.¹² The main drawback of this model, however, is that the assets will still remain on banks' balance sheets and generally subject to their management, except for certain control and step-in rights for the government in defined circumstances. It is submitted that an outright transfer to a 'real bad bank' would be more apt to achieve the desired objective as it would send a clearer signal to the market of the genuine removal of 'toxic' assets from banks' balance sheets and also avoid potential conflicts between banks and the

¹⁰ See http://www.federalreserve.gov/monetarypolicy/bst_crisisresponse.htm (last accessed on 8 April 2009) in relation to the Federal Reserve and <http://www.bankofengland.co.uk/markets/apf> (last accessed on 8 April 2009) in relation to the Bank of England.

¹¹ See http://www.hm-treasury.gov.uk/press_07_09.htm (last accessed on 8 April 2009). A very similar model is currently being discussed by the German government.

¹² Basel II is the second of the so-called Basel Accords, which are recommendations on regulatory capital requirements for banks issued by the Basel Committee on Banking Supervision. The European Union adopted the second Basel Accord in the form of EU Directives 2006/48/EG and 2006/49/EG on 14 June 2006, which required the EU member states to implement its provisions by 1 January 2007.

government about the allocation of management and control rights over the assets held in a 'virtual bad bank'. Further, a true sale would enable the government to bundle, and thus administer more efficiently, the 'toxic' assets of all banks in one national 'bad bank' as opposed to establishing a separate 'virtual bad bank' for each eligible institution.

The second main issue concerns the pricing and the precise allocation of risks and rewards between transferring banks and the government. It is submitted that the transfer should occur at a price which, insofar as is reasonably practicable, reflects the true value of the asset. This of course poses a difficult challenge where, as in most cases, trading in 'toxic' securities has ceased so that a 'market' price is not readily available. To address this problem one could perhaps deploy a variety of valuation tools including both backward-looking historic trading price models for comparable assets and forward-looking discounted expected cashflow models, compare the results and come up with a blended price that is perceived to be 'fair' in a world of uncertainty.¹³ The transferring bank would then drop out of the picture and the downside risk as well as the upside potential of the 'toxic' securities would rest with the 'bad bank'. Alternatively, the transfer price could be fixed at either the face value or the book value of the assets in question whilst the downside risk would be divided between the transferring bank and the 'bad bank' by keeping the transferring bank exposed, to an equal or a lesser extent, to the performance of the assets. Notwithstanding its practical difficulties, the first approach appears favourable because it would truly free the banks' balance sheets from their 'toxic' assets and yet constitute the most market-conform solution given that the 'bad bank' (and hence the taxpayer) would not pay more than the true value of the assets and benefit from the upside potential of the 'toxic' assets.

The third main question concerns the funding of 'bad banks'. One option would be to capitalise them entirely with government money. The state would become the carrier of the bank and provide the funds necessary for the purchase of the 'toxic' assets. This approach would help to achieve a clear split between the banks' balance sheets and the 'toxic' assets. It would, however, constitute a significant immediate charge on taxpayers' funds. The alternative would be to fund 'bad banks' with money contributed by private investors.¹⁴ Yet another solution would be to make all the banks (or their shareholders) incorporated in one state pay, in the form of a compulsory levy, a contribution towards the capitalisation of 'their' national 'bad bank'.

¹³ The US\$700 billion 'Troubled Assets Relief Program' established by the US government was originally intended to function like a 'bad bank' but this plan was, among other reasons, hampered by difficulties encountered in the valuation of the 'toxic' assets. See A. Henry, 'Die Suche nach dem richtigen Weg', *WirtschaftsWoche*, 2 February 2009, p. 25 and Cohan 2009, *supra* note 3, pp. 446-447. Also, a transfer of 'toxic' assets at their true value, if lower than their current book value, would force banks to make further writedowns and thus post additional losses.

¹⁴ This is currently being discussed in the US: see C. Tigges, 'Obama sucht privates Kapital für Banken', *Frankfurter Allgemeine Zeitung*, 8 April 2009, p. 13.

The benefit of the latter two options would be that they would not result in a direct externalisation of the cost of unwinding the ‘toxic’ assets. It is doubtful, however, whether a model that would envisage the banks contributing equity or loans to the ‘bad bank’ for the purchase of their own ‘toxic’ assets could fully achieve the purpose of the ‘bad bank’ because the funding would continue to eat into the banks’ regulatory capital base due to their remaining economic exposure to those assets. A combination of the possible solutions could perhaps help to achieve the two opposing aims: If funds made available by banks and/or other private investors received the benefit of a state guarantee to reimburse the investors (or at least the banks) for all or part of any future losses resulting from actual payment defaults on the transferred ‘toxic’ assets, the banks’ regulatory capital could be freed up and the burden on the taxpayer would be a contingent liability only, entirely dependent on the future performance of the ‘toxic’ assets.

IV. Strengthening the Capital Base: Regulatory Capital and Nationalisation

Repeated writedowns on ‘toxic’ assets pursuant to the ‘fair value’/mark-to-market accounting principle for assets held on banks’ trading books under the International Financial Reporting Standards (IFRS) have depleted the equity and thus the regulatory capital base of many banks to such an extent that governments in the US and in Europe have had to rescue various banks from closure and insolvency by injecting new equity into their capital structure. Prominent examples are Citigroup, Commerzbank/Dresdner Bank, Fortis, Lloyds TSB, HBOS and The Royal Bank of Scotland. However, the sheer size of the banks’ losses, no doubt exacerbated by the procyclical effect of the revised regulatory capital regime introduced by Basel II, has due to the effective closure of the equity capital markets called for repeated capital increases that had to be funded by the state. Given the amounts at stake, governments have increasingly demanded (or converted their positions into) straight equity as opposed to non-voting hybrid capital instruments such as preference shares or convertible bonds. Eventually, the state is no longer only a minority shareholder but holds the majority of the voting capital – the bank is (part-)nationalised.¹⁵ In February 2009, the UK government introduced the ‘Special Resolution Regime’ which replaces temporary legislation enacted to enable the nationalisation of Northern Rock in February 2008 and empowers the Treasury, the Bank of England and the Financial Services Authority to transfer a troubled bank to a private sector purchaser without the use of public money, or to a government-owned bridge bank, or into temporary public ownership, coupled with far-reaching powers to modify or override contractual arrangements with counterparties and/or property rights in certain circumstances.¹⁶

¹⁵ Examples are AIG and The Royal Bank of Scotland.

¹⁶ See <http://www.bankofengland.co.uk/financialstability/srr/index.htm> (last accessed on 8 April 2009) for more detail.

In Germany, the government is implementing a law pursuant to which the state will be able to expropriate the shareholders of Hypo Real Estate as a means of last resort if a public takeover of the troubled bank fails.¹⁷

Legislative measures of this kind create a clear legal framework within which the government can operate when dealing with a bank in serious difficulty. This is especially so when, as in the UK and Germany, an extensive consultation exercise is performed before the implementation of the legislation. Also, it can be argued that stakeholders and market participants should be aware that emergency action by the government may have an impact on their legal rights because of the unique systemic risk of the failure of an important banks. A statutory framework can limit the unintended consequences of such action.

However, the ability to preserve systemic stability by compulsorily nationalising a bank needs to be weighed against the consequences of varying or extinguishing the rights of shareholders and creditors and entrusting the state with the management of banks. It is debatable whether, and to what extent, the shareholders of nationalised banks should be compensated for the loss of their shares. In the case of Northern Rock, the English High Court effectively ruled that shareholders should get not more than the quota they would have received if the bank had been put into insolvency.¹⁸ In the author's view, this approach reflects the commercial risk of an equity investment; once the losses have wiped out the value of the equity, the position of shareholders (as opposed to that of depositors) should not be improved by a government-funded emergency bail-out.

On the other hand, the nationalisation of banks should only be a transitory emergency response specifically aimed at reducing the risk of the 'domino effect' that is likely to result from the collapse of a systemically important institution. As soon as the markets have shaken off their current paralysis and confidence in the stability of the banking system has been restored, – which, as has been argued above, seems crucially dependent on the establishment of 'bad banks' – governments should seek an exit from nationalised institutions and 'return' them to the market. As the example of the German Landesbanken, which have been just as much affected by the financial crisis as their private competitors, shows, the state is not the better banker but should rather concentrate on its core competence in the medium term, namely the maintenance of an effective regulatory framework. This is not to say that an exit by the government should be at any price. On the contrary, a re-transfer of nationalised banks to the market should occur on arms' length terms, not only to address state aid and competition law concerns, but also, where applicable because a successful turnaround has

¹⁷ See http://www.thebanker.com/news/Hypo_prepared_for_nationalisation.html (last accessed on 8 April 2009).

¹⁸ *SRM Global Master Fund Lp & Ors, R. (On the Applications of) v. The Commissioner of Her Majesty's Treasury* [2009] EWHC 227 (Admin).

been achieved, to reward the state (and hence the taxpayer) for stepping in and putting its money at risk to save the financial system.

Conclusion

The combination of the emergency responses provided by governments around the globe in the form of liquidity facilities, state guarantees and capital injections has proved effective to limit the gravity of the crisis and stave off the collapse of the world financial system. What is needed now are measures (a) to return the markets to a normal state in the short to medium term and (b) to guard against future meltdowns of a comparable size in the medium to long term. It has been argued that (a) could be achieved by the establishment of national 'bad banks' which can help banks to clean their balance sheets from 'toxic' assets and regain the trust of counterparties in order to revitalise lending in the interbank market and gradually to reduce their dependence on governmental funding. More structural and systemic changes will be required to achieve (b): a stricter regulation especially of mortgage markets, structured financial products and off-balance sheet operations, more international cooperation between national regulatory authorities, a clearer focus on safeguarding the liquidity of banks, limitations on the 'originate and distribute' business model by requiring banks to retain some economic exposure to the products they sell, revised banker remuneration models that provide a better balance between short-term gains and medium/long-term risks, tighter regulatory capital requirements with a counter-cyclical effect to help reduce the volatility of the banking system and delever banks' balance sheets, a review of the 'fair value'/mark-to-market accounting principle, more control over the role of and the standards employed by rating agencies, and the introduction of a clearing and settlement system for credit default swaps and other standard over-the-counter derivatives.¹⁹

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¹⁹ See Lord A. Turner, *The Turner Review: A regulatory response to the global banking crisis*, London: Financial Services Authority 2009, http://www.fsa.gov.uk/pubs/other/turner_review.pdf (last accessed on 8 April 2009) for a blueprint for regulatory reforms. See also B. Schulz, 'Ein steiniger Weg zu einer neuen Finanzmarktarchitektur', *Frankfurter Allgemeine Zeitung*, 31 March 2009, p. 14. On 2 April 2009 the Financial Accounting Standards Board relaxed the 'mark to market' accounting principle in the US in relation to 'toxic' securities in order to ease the pressure on banks to make further writedowns: <http://www.fasb.org/action/sbd040209.shtml> (last accessed on 8 April 2009).

