Mr Meister reviews the subject of bank insolvencies and moral hazard

Statement by Mr. Edgar Meister, a member of the Directorate of the Deutsche Bundesbank, at a symposium hosted by the University of Frankfurt on 1/2/99.

One of the pillars of our market economy is the fact that entrepreneurs are personally responsible for their business activities. Generally, this principle also applies to banks. However, banks, as financial intermediaries and providers of financial services, play a special role in an economy. A crisis of one major bank, let alone the whole banking system, would have a serious impact on economic activity, and this also goes for the real sector. But then again, the special role of banks must not be interpreted to mean that bank boards can count on government support in emergencies. If they could, the risk of a precarious situation in the banking sector would increase even more. This would create a "moral hazard", which would result in banks taking excessive risks in order to obtain higher returns, in the confidence that they could rely on government support in the event of a failure.

Banking supervisors must try to prevent both scenarios — serious external effects of bank insolvencies, for one thing, and moral hazard, for another — from happening. The crisis in South-East Asia has shown that government guarantees and expectations of international assistance — which were met in the end — can lead to serious misalignments in a crisis situation (To quote Tietmeyer: "Do not display too much money in the shop windows").

Avoiding crises must be the prime concern. Efficient banking supervision can make an essential contribution to this objective. Supervisors should be guided by the principle: "As much entrepreneurial leeway as possible, yet as much state supervision as required". There have been some recent proposals to confer more supervisory tasks to the private sector (G30). In principle, increased mutual monitoring among the banks, and hence a strengthening of market discipline, is a welcome idea. Nevertheless, conceptual and practical problems should not be overlooked. For instance, more self-regulation by the market participants implies a transfer of legislative powers, but it does not mean that responsibility for resolving systemic crises would also shift to the private sector.

State supervision will remain necessary as long as systemic risks exist which cannot be limited sufficiently through preventive measures or eliminated within the context of market control. Besides, the self-regulation model, *inter alia*, assumes that the financial sector is highly transparent for the market, e. g. regarding in-house procedures, which is hardly feasible.

Allow me to briefly outline the German prudential approach:

- Banking supervision is guided by the principle that a bank's management is responsible for its business decisions. Therefore, banking supervision in Germany does not actively intervene in banking activities, i. e. by making specific recommendations.

- From the central bank's perspective, I would like to stress that it cannot be the task of a central bank to bail out insolvent credit institutions. The Ministry of Finance would be responsible for that, if tax revenue were required for assistance measures. But even cases such as financially sound institutions merely having liquidity problems should, if possible, be resolved with the help of private or semi-private lenders before reaching the gates of the central bank. The Liquidity Consortium Bank in Germany is such a "lender of penultimate resort". In addition to the three categories of credit institutions, the Bundesbank also has a stake in this Consortium Bank, and it provides refinancing against collateral. Apart from that, the Bundesbank has not committed itself in a binding manner to take action in the event of a crisis. It would also be desirable if a liquidity consortium bank or comparable institutions were established in other European countries.

- If it were not possible for the creditworthiness of an institution to be restored either by other institutions or with the help of the deposit guarantee scheme, having that institution exit the market would, in general, be a feasible consequence. However, if such a step posed a serious threat to the stability of the banking system, i. e. if the institution in question were “too big to fail”, a joint solution would have to be found by all the private market players and public bodies concerned. Already the number of institutions we must consider to be “too big to fail” has risen in the recent past, and further mergers will cause this number to keep rising. Mergers of global players do not only raise new questions in banking supervision. They also pose the risk that size leads to moral hazard effects. For precisely this reason, each crisis must be assessed individually. The key principle is that the government's response must not be predictable and that private market players should be involved in potential rescue operations to the greatest possible extent.

- The recent financial crises have been increasingly drawing attention to international crisis management. In my opinion, the aforementioned principles should be applied in this context, too: there should be no explicit or implicit government guarantees regarding the solvency of the respective banking system; temporary liquidity crises should be resolved, wherever possible, before government intervention becomes necessary; the private sector should be comprehensively involved both in crisis management and in loss-sharing.

- International support measures must always remain an exception and never become the rule. Under no circumstances should private investors be able to rely on public bodies to assume their losses in the end. Instead, I believe it would be desirable to create an international liquidity safeguarding fund made up of the major global players, which would also have the most to gain from a largely deregulated and sound financial system. This will not be an easy undertaking, since there seem to be few incentives for a bank to assume other institutions' risks. Nevertheless this road should be taken in order to strengthen market discipline. I believe that membership in a club comprising the major global players would be a special quality which could actually become attractive for those institutions. Besides, it seems quite conceivable that banking supervision might be willing to grant those institutions more self-regulatory powers.

The case of the Hedge Funds LTCM proves that the private sector can find solutions without having recourse to public funds. At that time, the Federal Reserve Bank of New York was only acting as an intermediary to bring national and international financial institutions together, which then provided the necessary funds.

The same principle applies both nationally and internationally: moral hazard problems can only be prevented by emphasising and requiring that responsibility be taken by financial market participants, and by limiting the intervention of public bodies. Avoiding moral hazard will also increase the stability of the system and improve crisis management.

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