Managing banking crises in emerging market economies[1]

Executive summary

Emerging market economies (EMEs) have made much progress on enhancing their crisis management frameworks. Many of these countries have bank resolution frameworks mandating designated authorities to protect financial stability and safeguard, as much as possible, public funds. Many also have inter-agency bodies that help authorities coordinate as they prepare for, and manage, banking crises. Notwithstanding some differences among them, many EMEs have or are developing escalation processes to help them manage the uncertainties around the point of failure, including coordination of emergency liquidity assistance (ELA) and resolution frameworks. Progress has also been made in the area of cross-border cooperation, although work remains to be done to fully integrate EME authorities in cross-border decision-making.

Despite this progress, challenges remain regarding the strategies authorities may apply to resolve a crisis and how to fund them. These challenges concern the characteristic features of banking sectors in EMEs. Typically, banking sectors and bank ownership are more concentrated in EMEs than in advanced economies (AEs). Moreover, bank funding in EMEs is usually dominated by deposits, rather than capital market instruments. As a result, banks in EMEs have lower levels of debt that can reliably absorb losses. They are also less likely to increase their loss-absorbing capacity through more market-based funding practices, as domestic capital markets are much less developed in EMEs than in AEs.

The funding model of EME banks limits authorities' strategic options. The major regulatory innovation since the Great Financial Crisis (GFC), bail-in, is difficult to implement in EMEs. Bail-in relies on banks' having sufficient layers of debt that authorities can use to recapitalise a failing bank. That condition can typically be met by AE banks that can access international capital markets, and it is further ensured by the total loss-absorbing capacity (TLAC) standard. However, the strategy is less credible for banks, such as those in EMEs, with deposit-dominated balance sheets. Moreover, if EMEs were to require banks to issue bail-in eligible debt to prepare the ground for bail-in strategies, these issuances would typically have to take place offshore given the limitations of domestic capital markets. This may further increase already high funding costs in EMEs and aggravate existing vulnerabilities from external, foreign currency-denominated indebtedness.

In consequence, risks for public finances are usually greater in EMEs than in AEs. Authorities in EMEs are more likely to find themselves in a position where they are forced to use public funds to maintain financial stability. Yet governments' internal revenues may not be sufficient, forcing them to add to their already rising external indebtedness. This consumes limited fiscal space in EMEs and increases governments' debt servicing burden, especially if domestic currencies depreciate. In consequence, the aggregate cost of banking crises, relative to national GDP, is significantly higher for EMEs than for AEs.

Authorities in EMEs therefore have a strong incentive to improve their funding arrangements for crisis management. The two main areas of improvement should probably be an efficient use of banks' residual loss-absorbing capacity, including by leveraging, in cases of dominant shareholders, shareholder funds beyond equity, and availability of external sources of funding such as

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deposit insurance systems (DIS) and resolution funds. Improved funding can support transfer and recapitalisation strategies. In addition, prudential policies on profit retention and stringent capital conservation may help increase banks' resilience and loss-absorbing capacity.

To make such alternative strategies fully credible, resolution frameworks could be enhanced in various ways. In order to make transfer powers a more effective tool, there is scope to modify creditor hierarchies towards general depositor preference, to de-rank funds lent by dominant shareholders, to broaden DIS mandates and to make caps on any DIS support more flexible. Similarly, recapitalisation strategies are easier to implement the lower the risk for the provider of capital that injected funds are used to absorb losses but do not convey control over the recapitalised entity. To achieve this, stringent conditions on prior writedowns of at least shareholder equity, and potentially other shareholder claims, are needed. Bail-in powers can be a helpful ingredient of all such strategies.

Alternative strategies can mitigate risks for public finances, but do not eliminate the need for public backstops. The key is to maximise recoveries in case public backstops are used. Authorities should have powers to recoup from the banking sector the expenditures that they incurred under a public backstop. In some EMEs, DIS or resolution funds are administered by central banks and public backstops are provided as a central bank facility. In such cases, the central bank is in a good position to secure recoveries if netting arrangements exist between its facility and the claims of DIS member banks.

Resolution planning and crisis preparedness are key. Resolution planning helps authorities to familiarise themselves with the business and structure of a bank. Crisis preparedness increases the confidence of authorities and their staff in their ability to make forward-looking decisions under pressure. The cost of discretion may well be greater in EMEs than in AEs, so bolstering confidence in authorities' abilities to exercise discretionary powers in an equitable manner will probably translate into a reduction in the cost of crisis management. A good way to enhance crisis preparedness is crisis simulation exercises, which allow authorities to test their frameworks and practise crisis management skills.