WTO Committee on Trade in Financial Services ,
Geneva, 29 June 2010

The government as guarantor of last resort: Benefits, Costs and Premium Setting Issues

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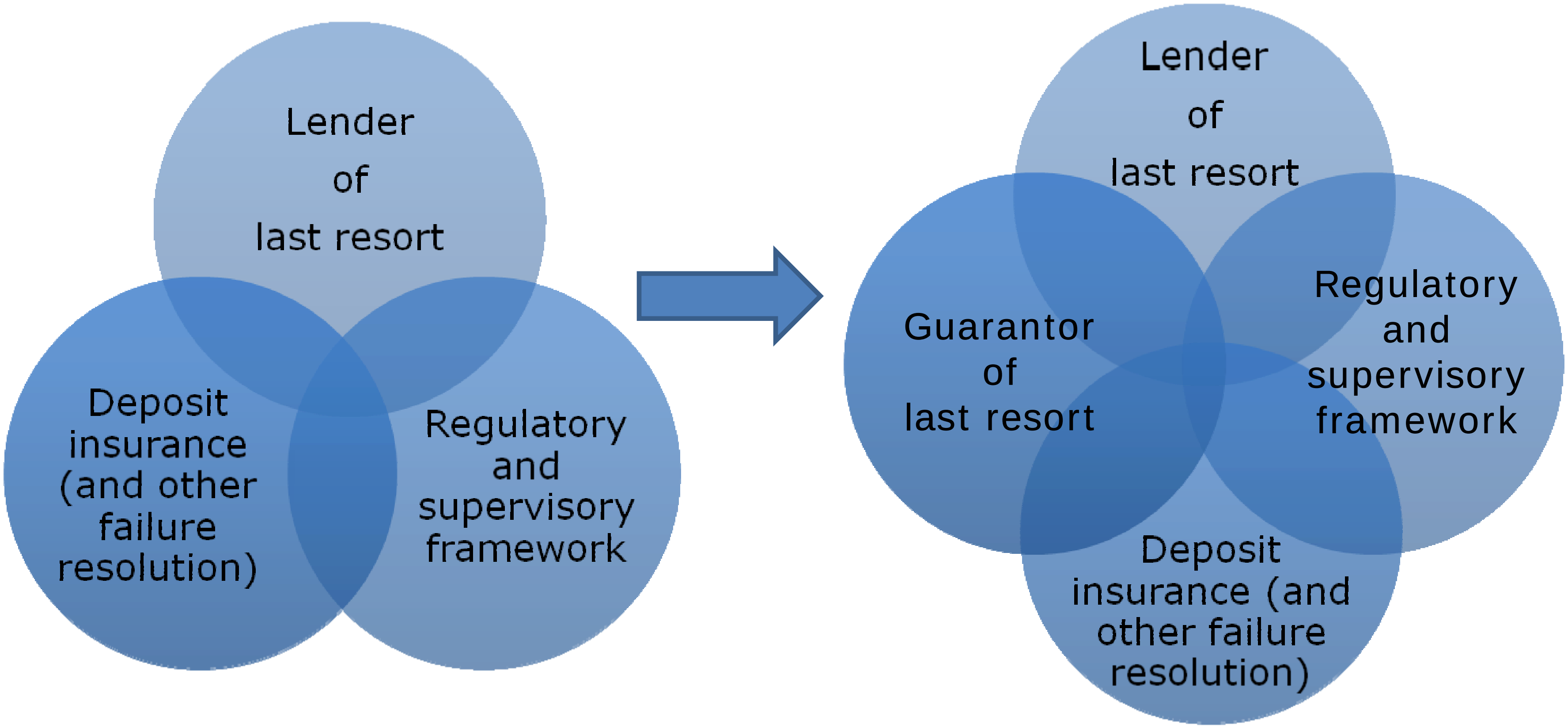
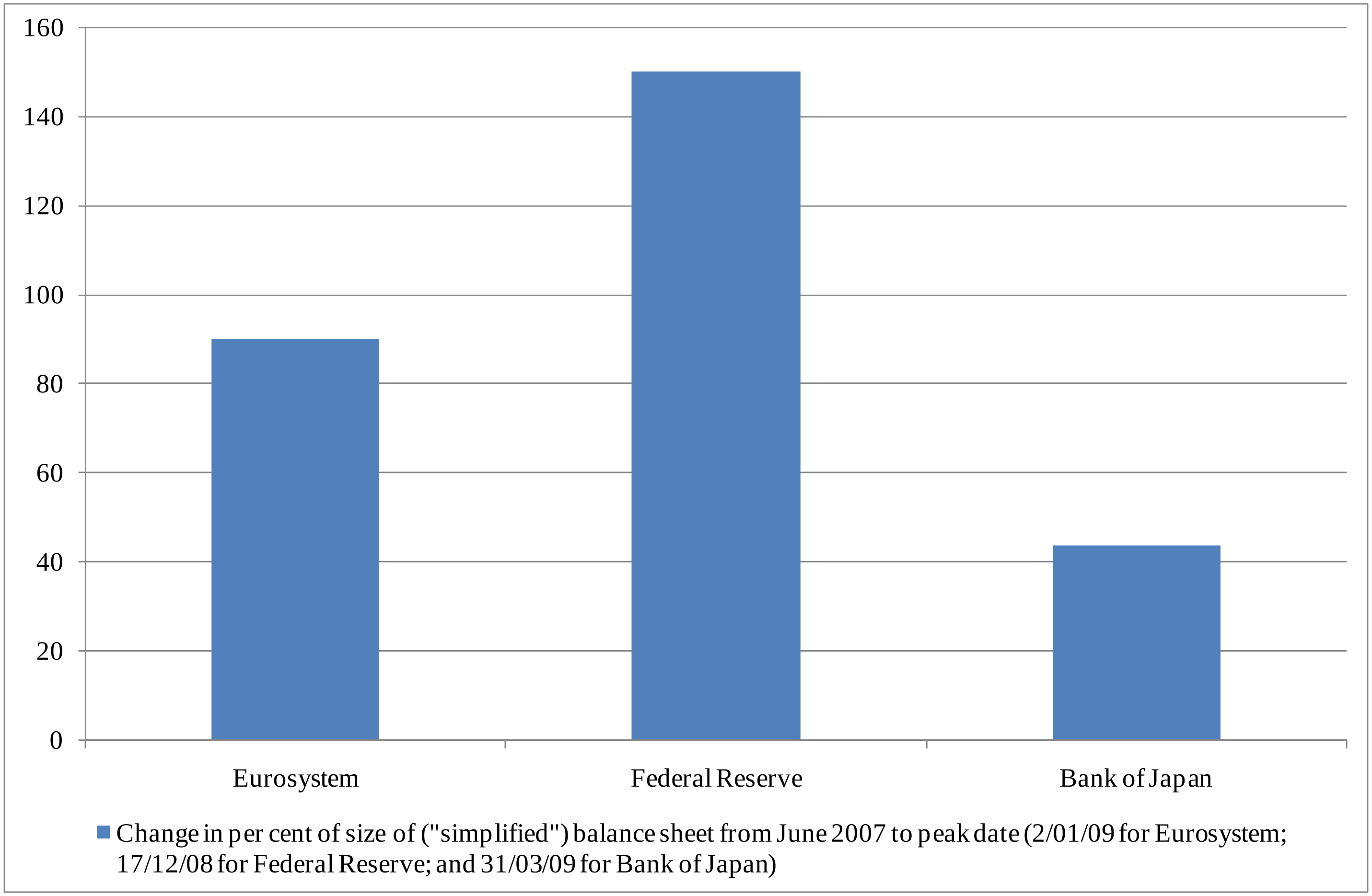
Financial safety net: From traditional to new definition?



Structure of presentation

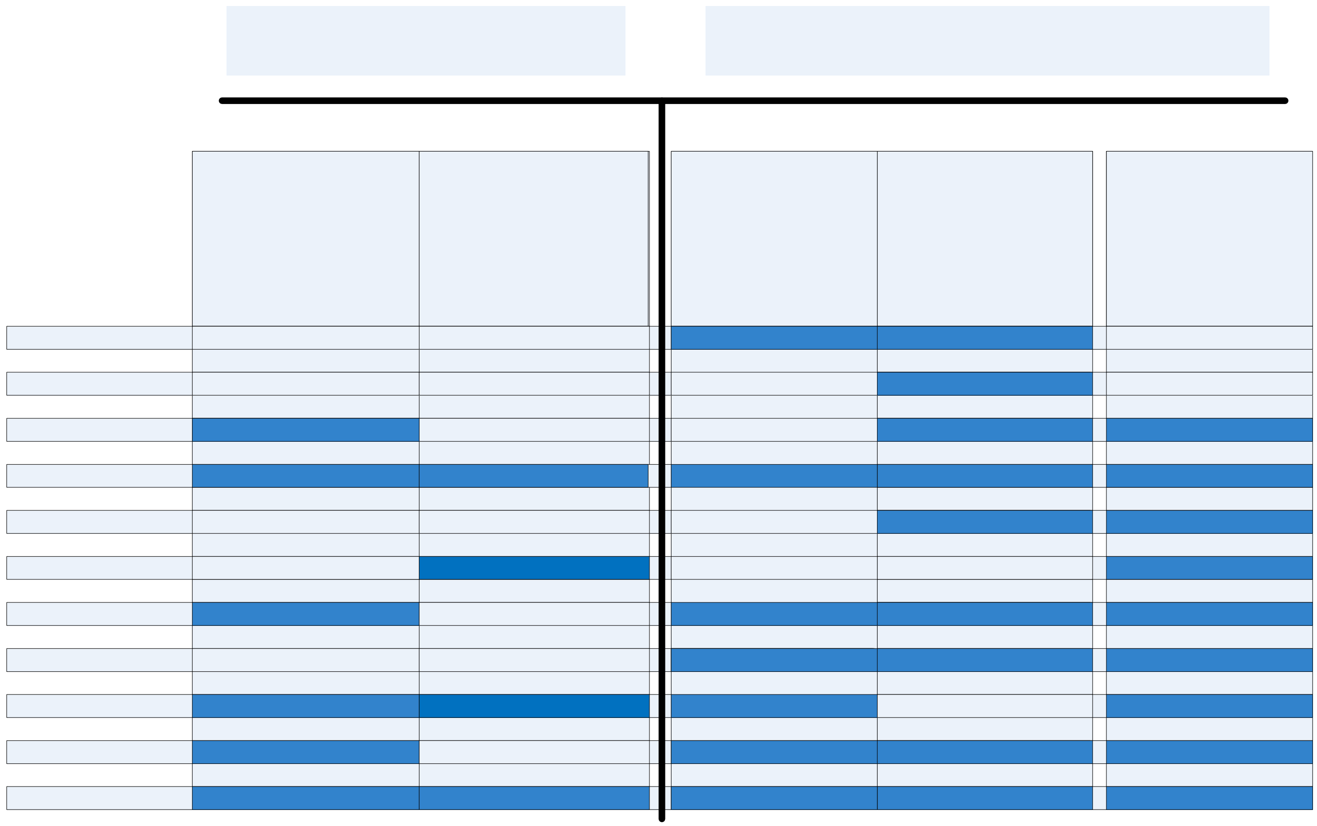
- (1) Overview of policy responses, with special emphasis on expansion of government-provided guarantees
- (2) Benefits and costs of such guarantees
- (3) Premium setting issues

Central bank balance sheet expansion (from June 2007 to peak date)



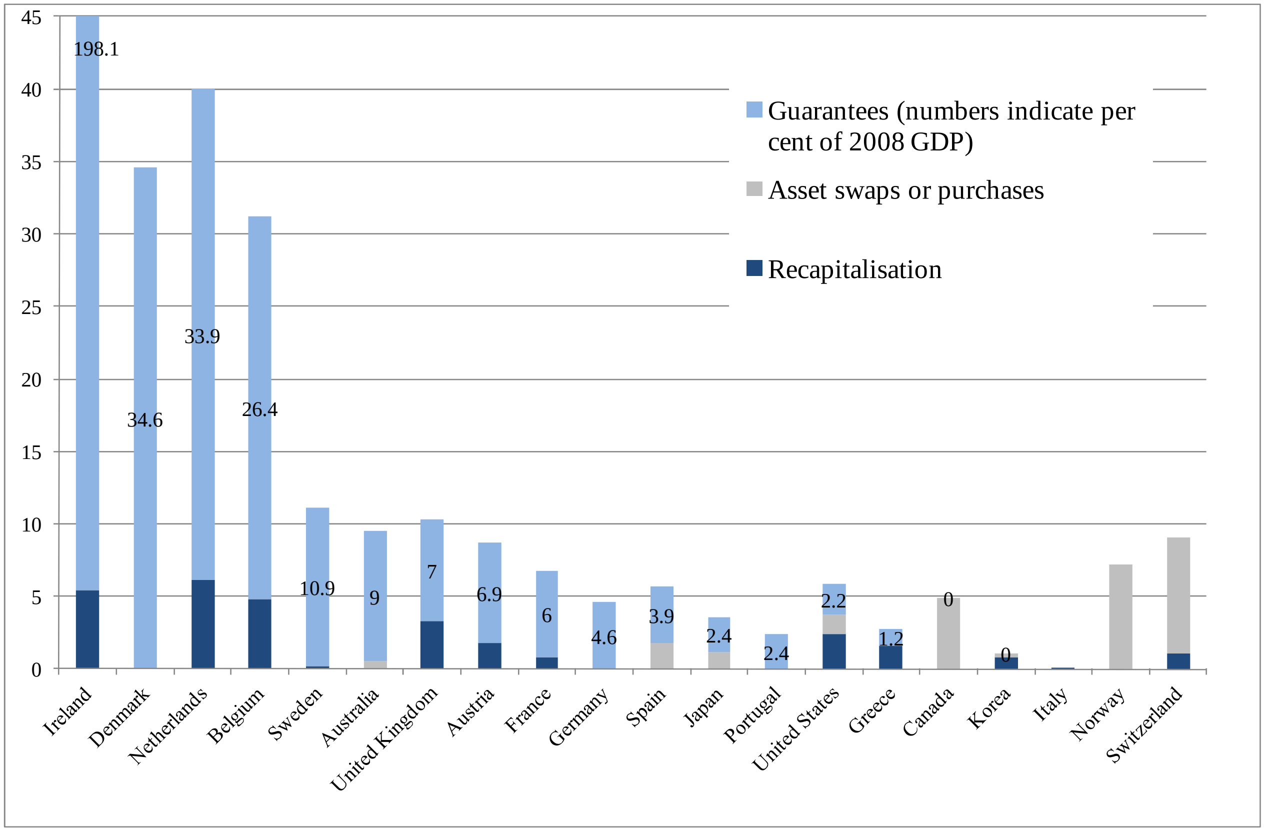
Source: ECB Monthly Bulletin, October 2009.

Overview of policy measures taken in selected OECD countries



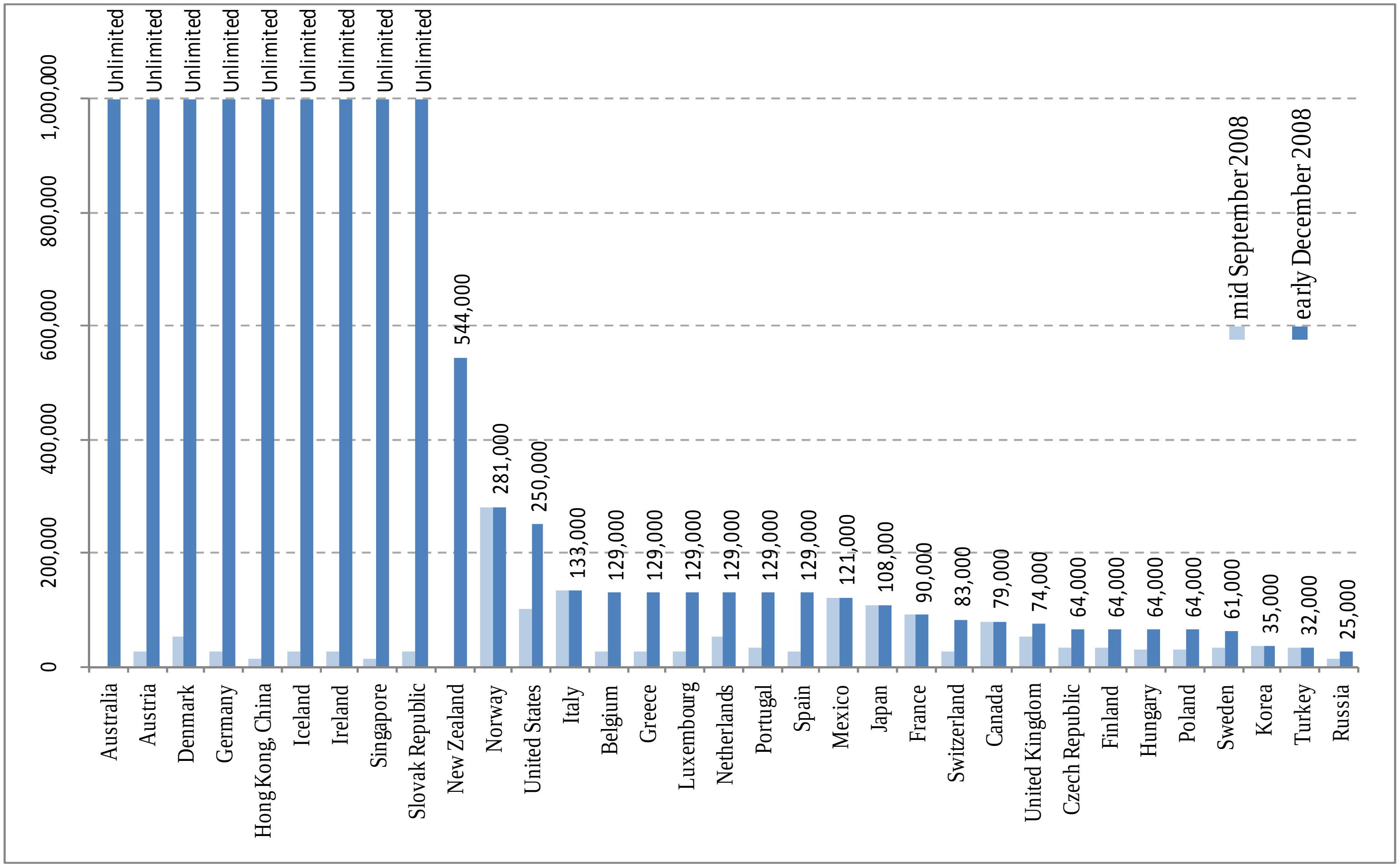
© Author’s estimates based on Panetta et.al. (2009) and Schich (2009).

Financial sector support
(actual use, in per cent of 2008 GDP)



Notes: As of August 2009. Excluding deposit insurance provided by deposit insurance agencies.
Source: Blanchard, Cottarelli, and Viñals: "Exiting from Crisis Intervention Policies", IMF, 4 February 2010 and updates based on information provided by CMF delegates.

Deposit insurance ceilings widely raised, especially where previously low



Note: Deposit insurance limits as of December 2008, in USD, following Schich, OECD *Financial Market Trends*, Volume 2008/2. Authors' estimates of probabilities based on simple probit regression on pre-crisis ceiling levels.

Costs and benefits (1)

- Guarantees for banks have helped stabilise the financial system,
  - raising the likelihood that depositors and creditors continue to provide a stable source of financing,
  - providing the kind o safe investment so much sought after in the flight-to-safety episode.

- And they have done so at limited upfront fiscal costs.

Costs and benefits (3)

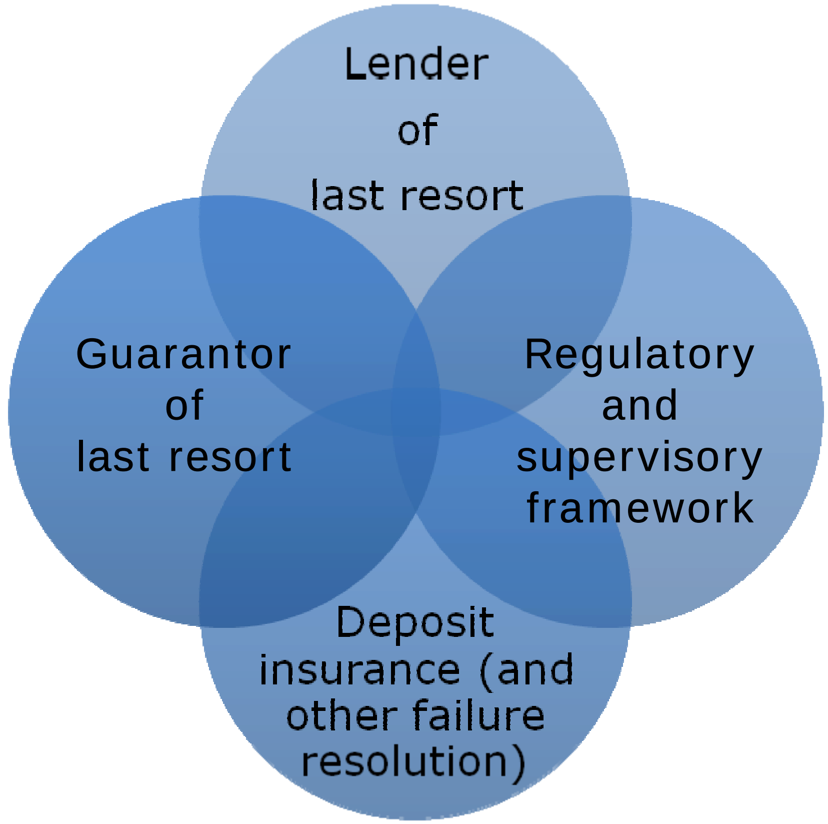
- But there are also potential costs associated with such guarantees:
  - Large contingent fiscal liabilities
  - Competitive distortions
  - Moral hazard

Costs and benefits (4): Moral hazard

- Several programs have expired, but can expanded guarantees can ever be fully withdrawn?

- There is a time-inconsistency problem in a systemic crisis, as long as tools are unavailable to let even large institutions fail.

- Guarantor-of-last resort function may *de facto* have become part of the financial safety net.



Premium setting issues (1)

- Ideally, to limit distortions to competition and incentives,
  - risk-based premiums need to be specified,
  - with premium adjustments consistent across borders.

- Results in this regard have been mixed in actual practise, however, with the track record differing depending on the specific type of guarantee.

Premium setting issues (2)

- Fees for *asset liability guarantees* risk-based, with details (necessarily) institution-specific.

- In most cases no additional fee levied for expanded *retail deposit insurance*.

- Fees for *guarantees of bank bonds* risk-adjusted.

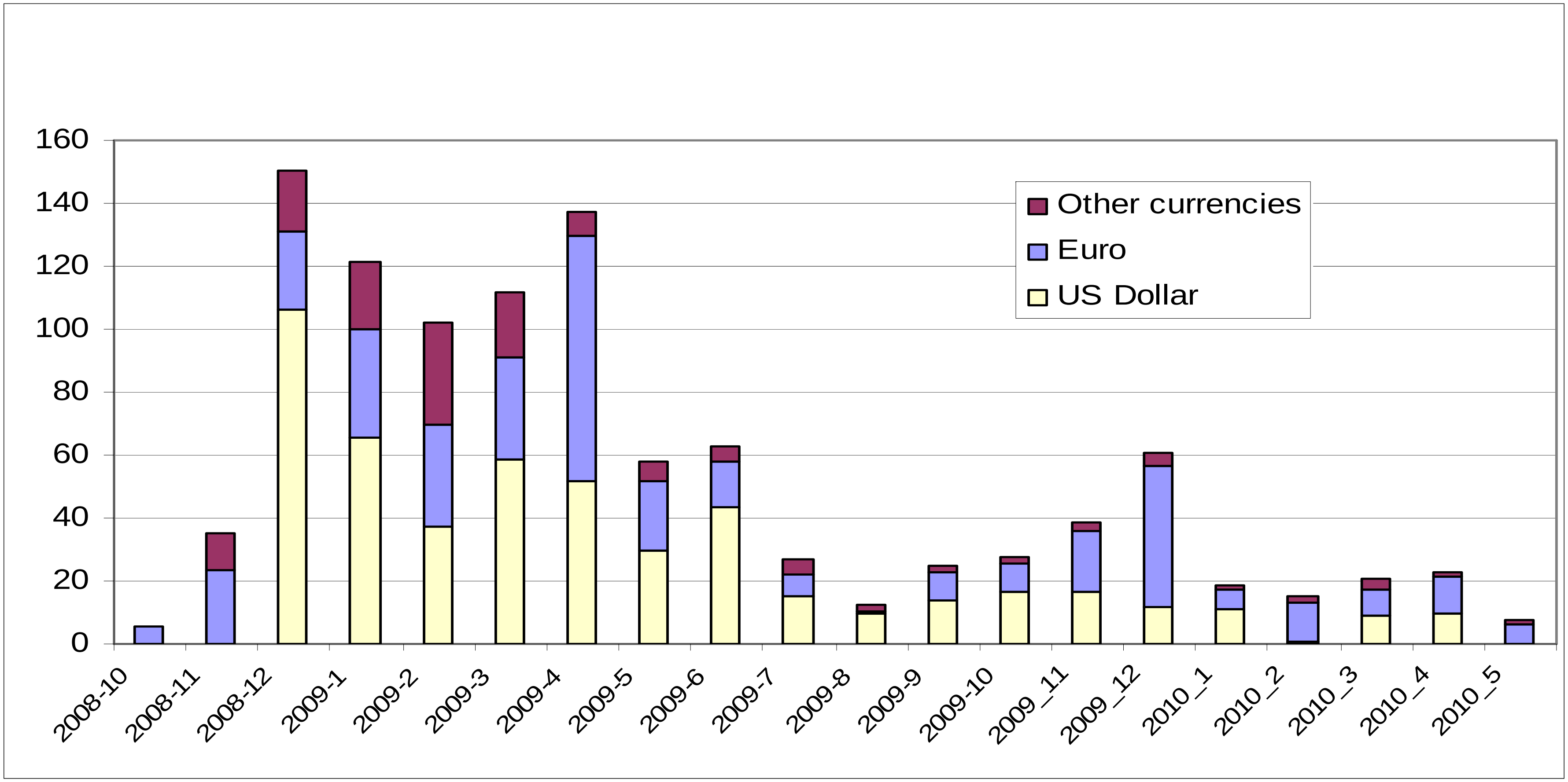
Premium setting issues (3): The example of wholesale funding guarantees

- Most programmes were introduced between Fall 2008 and spring 2009, and many of them will be closed for new issuance by the end of this month.

- Bank bond guarantee programs are not part of the landscape of government-supported guarantee schemes in normal times.

- Perhaps the most tangible form in which the government/sovereign provided the guarantor-of-last resort function for private firms.

Premium setting issues (4): Significant take-up of government-supported bond guarantees



Notes: Billions of Euro equivalents.

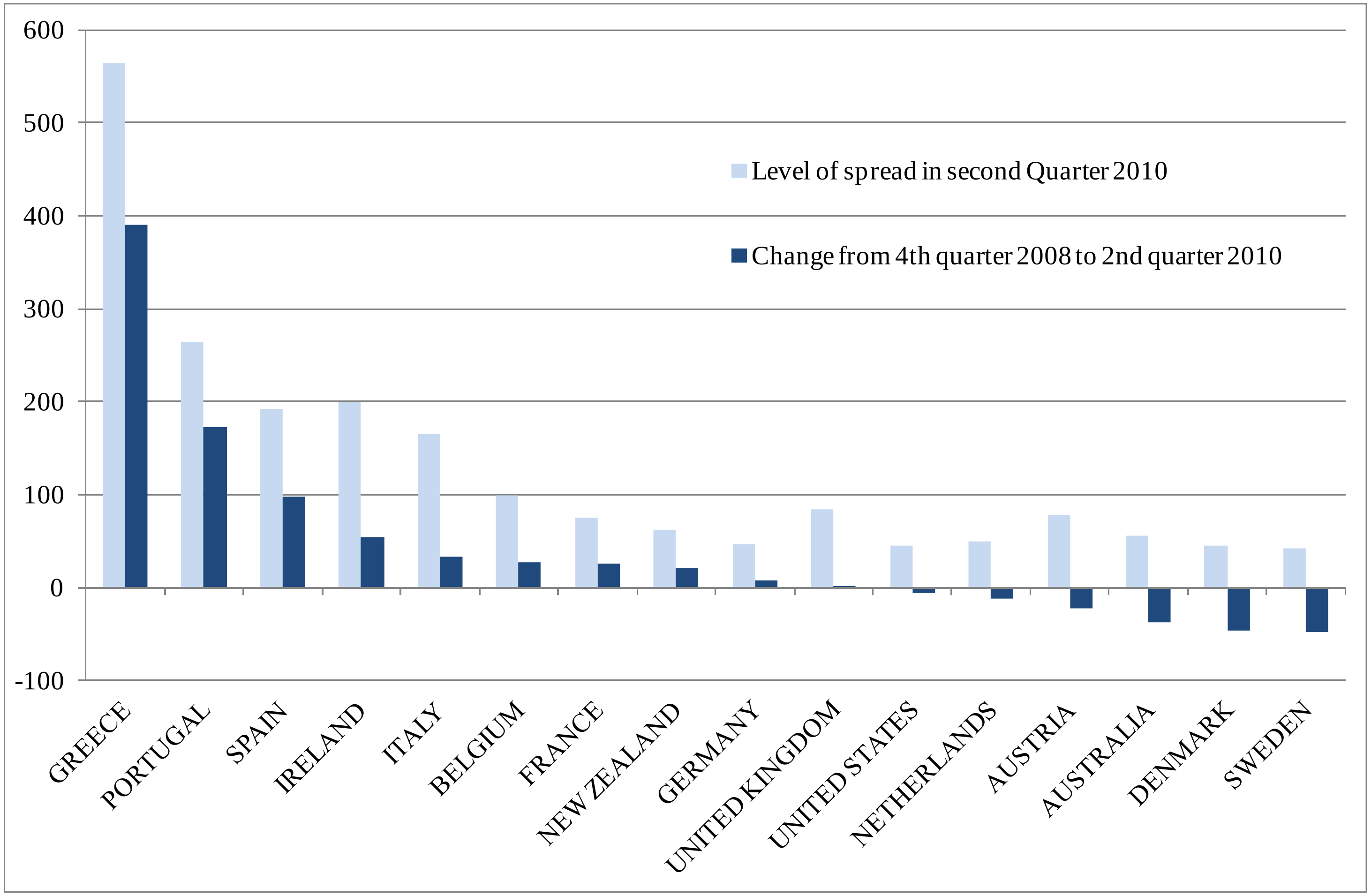
Premium setting issues (5): Convergence of fee setting structures

- The actual costs of guarantees for the bond issuer consist of the sum of *fees* and *issuance spreads*.

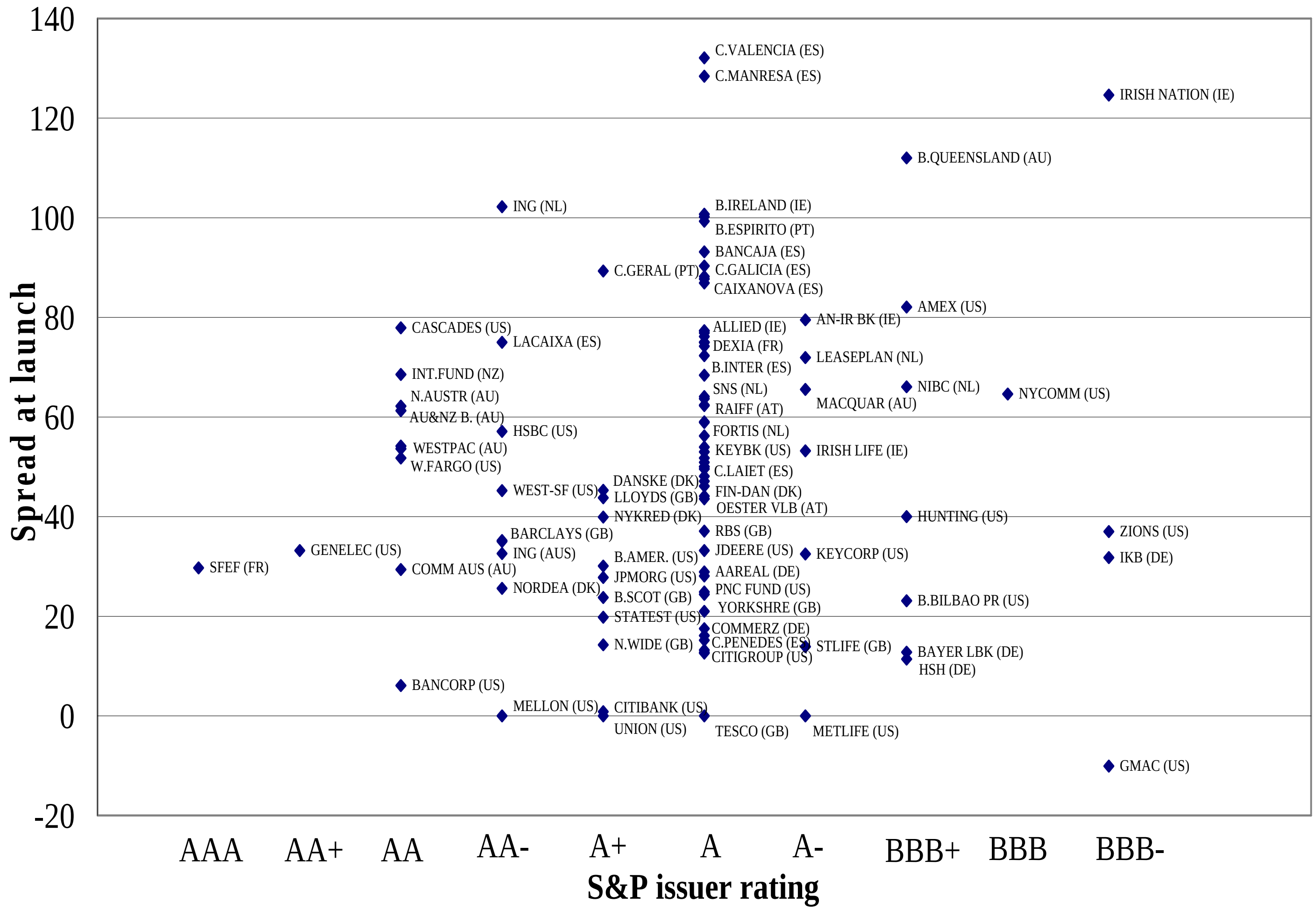
- Some convergence in fee setting structures has taken place, with special efforts towards harmonisation undertaken within Europe (ECB Council recommendation to use CDS history).

- But: Is it desirable to impose similarity of fee structures across countries?

Premium setting issues (6): “Quality“ of guarantors not the same



Premium setting issues (7): Issuance spreads have reflected the identity of the guarantor



Source: Levy and Zaghini, (2010).

Concluding remarks (1)

- A key aspect of the policy response to this systemic crisis consisted of making available the government-supported guarantor of last resort function.

- Helpful, but not without costs (distortions to competition and incentives that are not necessarily reflected in fiscal cost measures).

- Current proposals :
  - Strengthen self-insurance (e.g. requiring larger capital and liquidity buffers, contingent capital)
  - Limit risk-taking (e.g. restricting permissible activities, strengthening supervision, effective resolution regimes)
  - Charging specific (systemic risk) levies

Concluding remarks (2)

- Most of the proposals consist of surcharges on banking activities that contribute to the creation of systemic risk, which, if properly specified, might reduce systemic risk.
- If they do succeed in this respect, the guarantor of last resort function can be expected to be invoked more rarely.
- If they do not succeed and if the function is invoked again, there are some lessons to be drawn regarding the way in which this function is provided that could help reduce associated costs.

Thank you