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YPFS Lessons Learned Oral History Project: An Interview with Daniela Klingebiel

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Introduction:

The Yale Program on Financial Stability (YPFS) interviewed Dr. Daniela Klingebiel to discuss her time at the World Bank, and her experience and knowledge on financial crises, on which she has written extensively.\(^2\)

During the Global Financial Crisis, Dr. Klingebiel was Principal Portfolio Manager, World Bank Pension and Endowment Department, Hedge Funds. There, she was responsible for the team that built and managed a private credit portfolio and emerging market equity portfolio.

Dr. Klingebiel is currently the Manager of World Bank's Reserve Asset Management and Advisory and Management Partnership (RAMP) which provides advisory and training as well as asset management services to central banks, public pension funds, and sovereign wealth funds.

[This transcript of a phone interview has been edited for accuracy and clarity.]

Transcript

YPFS: You have written many papers on financial crises, including *Managing the Real and Fiscal Effects of Banking Crises*,\(^3\) in which you compare and analyze different approaches taken by countries to address financial crises. Can you please discuss a few of the policies that countries deployed in response to Global Financial Crisis of 2007–2009?

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\(^1\) The opinions expressed during this interview are those of Dr. Klingebiel, and not those any of the institutions for which the interview subject is affiliated.


\(^3\) The study provides two recent analyses, spurred by the recent East Asian crisis, of government responses to financial distress, and also presents a comprehensive database on systemic, and borderline banking crises. Klingebiel, Daniela; Laeven, Luc [editors]; Claesen, Stijn. “Managing the real and fiscal effects of banking crises.” (English). World Bank discussion papers, no. WDP 428 Washington, D.C.: World Bank Group.
Klingebiel: The Global Financial Crisis was really a crisis that started in the US and emanated out from the US. It was not a crisis in emerging market economies, but it affected emerging market economies. At that point in time, some emerging market economies were doing relatively well, but in the US, it was a different matter. If I look at the US and focus on the US, I actually think that the crisis started much, much earlier. I was managing a portfolio of hedge funds, and one could clearly see that something was happening in August of 2007, when European banks started to withdraw money from their Asian counterparts and equity markets saw wholesale liquidations of long and short equity positions. The wholesale liquidation of trades adversely affected trading books of long, short market neutral trading books.

At the same time, as liquidity started to tighten in Asia, the market grew more concerned about the subprime mortgage market, specifically about the credit quality of collateralized debt obligations (CDOs) and collateralized loan obligations (CLOs.)

A number of commentators said that the '08 financial crisis was a complete surprise, but I think that is actually not true. If you looked at early indicators of financial crises, even very simple ones, such as expansion of credit versus GDP, they were increasingly flashing red.

Then, during 2008, policymakers in the US further complicated and compounded the crisis by behaving inconsistently and initially adopting a piecemeal approach to solving or mitigating the crisis. (If you look at historical crises, this is what often happens. There appears to be a period of denying the extent of the crisis and the hope that the crisis can be contained by small measures.)

So, a downgrade by one of the credit agencies of Bear Stearns’s mortgage-backed securities triggered a run on the bank. After initially saying that they would not intervene, policymakers stepped in with liquidity support and sold the bank to JP Morgan. This “bailout” seemed to suggest marketing participants that there is a lender of last resort or a provider of solvency of last resort and that they do not really have to be that concerned. At the same time though, supervisors and policymakers did not seem to step-up supervision of the other banks and market participants. They also did not seem to have thought about what measures they would do if another bank experienced problems and runs if their balance sheet came under pressure. Nor did they seem to have fully anticipated what a failure of a bank with global exposures would mean in times of an interconnected global financial system.

And then in September of the same year, the regulators and policymakers decided to allow Lehman to fail, suggesting that they simply lacked the right tools and mechanisms to prevent Lehman from going into bankruptcy. And as regulators had bailed out debtors of Bear Stearns by selling it as a going
concern to JP Morgan, market participants had relaxed and had not curbed risk and exposures.

If you looked at positioning, leverage, etc.—at any indicators—there was a lot of leverage in the system and financial products with significant implied leverage. Allowing Lehman to go bankrupt without providing initial support and guidance on what Lehman’s bankruptcy meant for markets and other institutions led to a panic among market participants, given the importance of Lehman as credit counterparty and globally operating financial institution.

After that failure, the US authorities became much smarter about addressing the financial crises more fully and signaling to market participants that there was a backstop to the system. However, at the same time, in the rush to not have a meltdown of the system, policymakers had to make a lot of ad hoc decisions as time was of the essence and they did not have a playbook (the savings and loan crises in the US was a long time ago and had a different origin, and the banking crises of the ’30s was a long time ago too).

I also think in some of the decision-making, they were leaning too much towards bailing out market participants believing that this was the best to calm markets. They bailed out AIG, which in turn bailed out all those counterparties that AIG had sold credit hedges to. With respect to the banks that received capital support, they should have considered writing down capital or injecting equity in the institution and becoming a shareholder. Policymakers shied away from injecting public capital and therefore allowing the government to partake in the gain as these institutions’ share prices recovered. Other countries affected by the crisis did this differently, for example, Britain.

Writing down shareholders’ capital also has an important signaling effect as losses are imposed on those actors that took on too much risk. Early on in my career, I studied many financial crises that occurred worldwide since the 1970s. One important lesson that I took away from analyzing the origins, scope, and resolution mechanisms of these global crises is that regulators and policymakers need to impose losses on actors that took too much risk. If you bail them out, you are just setting yourself up for another crisis and subsequent bailout. And in the end, given its funding mechanisms and balance sheet, banking is a confidence game. I know JP Morgan felt that everything was fine with them, but again, would JP Morgan have been able to signal to market participants that they were different from the rest of the banks? And in the end, they also benefited from the fact that AIG was bailed out.

I think the Obama administration did not want to appear too left leaning (and they needed congressional approval) and therefore, they did not seem to want to go down the road of injecting public capital in the banks. Nor did they bail out borrowers of underwater mortgages.
In hindsight, I think the Obama administration did all the right things when they were forced to, in general and with a broad brush. But when it comes to the details, for example, of how to structure the support and whether mortgage holders should also receive support, I think they could have made different decisions. Absolutely.

In the end, the government bailed out Wall Street and protected the financial institutions, given their critical importance for a functioning economy. But, by not thinking through the support for those whose mortgages were underwater due to the significant fall in house prices, many people not only lost their houses but had to go into bankruptcy and sell their own homes at fire sale prices. From an equity perspective, they could have handled it a bit better.

Again, this is where it gets really tricky. The US had not had a financial crisis of these proportions in quite a while. The savings and loan crisis were a very different crisis; it was a crisis in a certain segment of the financial market. This, however, obviously was the heartbeat of the global financial system and I think it scared the hell out of everyone. So, under these conditions, you make decisions that may not be “beautiful.”

European countries were affected by the 2008 crises to varying degrees. While my own home country’s banking system was less affected by a home-grown banking crisis, German banks had significant exposure to the US and other countries with falling real estate markets. German institutions had recycled their savings surplus into an array of financial products with exposures to these other markets.

From a research perspective, it may be interesting to contrast how the U.K. dealt with its financial crises in comparison to the US.

As I mentioned before, I come from the research side and looked at a lot of the crises. What you sometimes fail to understand as a researcher, is that, in the end, relationships matter and access to information matters in these crises. I spoke to a person in the hedge fund community in London who held the strong belief that the only reason that Lehman was allowed to fail was because of personal animosities. Obviously, it will be difficult to truly assess to what extent this mattered in the end.

Letting Lehman fail the way US authorities allowed it to fail was perhaps the biggest mistake that the authorities made at that point in time. I wonder whether there would have been a way to treat Lehman as a going concern which would have significantly lessened the panic that ensued with Lehman’s collapse. Obviously, supervisors have learned their lessons as large banks are now required to have plans for if they run into financial difficulties.

YPFS: How about Iceland? They handled the crisis very differently.
Klingebiel: Iceland faced a significant crisis not dissimilar from Ireland. Here you had two countries that have outsized financial systems relative to their respective GDP, and that had offered very attractive deposits rates to foreign investors to attract capital. So, you could argue they should have just been able to impose losses on these depositors. But at the same time, there was significant political pressure from foreign governments not to impose losses on these groups of depositors. And there might have been concern about these financial systems' ability to attract foreign depositors in the future.

When I started my career in research, I wrote a paper with Herbert Baer (former Federal Reserve Bank of Chicago, World Bank research group)⁴. We looked at what happened in the aftermath of financial crises when depositors suffered losses. Given the fact that banks have fractional reserves (only a fraction of bank deposits are backed by actual cash) even solvent banks can become insolvent if they experience a bank run as they will be literally running out of cash. Given this “inherently unstable nature” of deposit taking financial institutions, many academics and policymakers have suggested that losses cannot be imposed on depositors as this would trigger systemwide bank runs and a potential financial panic with significant adverse consequences. Baer and I investigated this assumption and looked at five financial crises globally in which policymakers did impose losses on depositors. We came to the conclusion that, if policymakers impose losses on large depositors and signal credibly to market participants that the rest of the system is safe and the government backs the remaining institutions that are allowed to continue to operate—or example with a guarantee that could sunset—policymakers can indeed impose (some) losses on large depositors.

The US response in 1933 can be used as a poster child in this regard. When policymakers understand the origins, scope and type of financial crises, formulate an approach that addresses comprehensively and credibly the weaknesses in the financial institutions (in the 1930s this was done through a relicensing exercise and deposits at institutions allowed to continue operating were guaranteed through a newly instituted deposit insurance scheme), empirical evidence suggests that governments can impose losses. Governments may have to extend guarantees to depositors but here again, evidence suggests that these can be time-bound during which period prudential regulation and oversight can be strengthened as well as capital buffers if deemed necessary.

I have not followed the events in Iceland nor Ireland too closely. Nevertheless, there are similarities but also important differences between these two instances. While Ireland issued an unlimited guarantee on all its deposits, Iceland nationalized its main banks and imposed losses on shareholders and

foreign depositors. Given the size of the Icelandic banking system relative to its GDP, Iceland had no choice but to impose losses. With respect to Ireland, the bailout of all depositors imposed significant fiscal costs on the Irish economy and resulted in significant fiscal debt overhang.

It would be nice to compare the policy responses in these two crises (which may have been done already) and see how the different policy responses affected the economic recovery and debt burden of the two countries over the medium term. (Obviously, one would have to also account for the fact that Ireland is part of the Eurozone).

My previous research has shown that it is tough for government officials to make tough decisions that ultimately significantly affect not only economic recovery but also—as the 2008 crises have shown— income distributions and income inequality. And in the case of smaller countries that are heavily financed by outside depositors, they also face political pressures from foreign governments to be lenient towards their depositors. And further complicating the matter, may also be that losses imposed on foreign depositors may adversely affect its own economy.

YPFS: **It sounds like all the countries had some political constraints and they acted according to them. But is there one country that handled it most effectively?**

Klingebiel: I was in the financial markets in 2008 as an investor so I was not following all the developments in all of the countries affected. I followed those markets I needed to follow. I would not want to say unilaterally, there was not. I just think it is really tough to get policy responses to financial crises right. And one has to take into account, as financial crises are not high frequency events, that governments and supervisors do not have a lot of training or agreed playbooks on how to respond effectively.

At the same time, policymakers now have a long history of banking crises worldwide. Studying these and drawing up a set of effective government responses is a worthwhile exercise. There are also now various international supervisory fora aimed at focusing on identifying financial system vulnerabilities and formulating policy responses. But even if one has blueprints, these will obviously still need to be adapted to the situation as it evolves. Formulating policy responses requires adaptability and creativity, and courage to go against the grain.

Prior to the 2008 crises, many countries had not experienced a financial crisis in a while. There was the Nordic financial crisis in the early 1990s, and the East Asian financial crisis in the late 1990s and early 2000s.

During the initial stages of the 2008 crisis, I remember getting calls from staff at the US Treasury that were researching ways to deal with unperforming
loans. They wanted to know what conclusions I had drawn from my research on how to best deal with non-performing loans as I had written a paper on lessons learned from international experience of asset management companies established by governments during banking crises to resolve non-performing loans.

Now maybe a good time to analyze the different policy responses across countries during the 2008 crisis to learn and understand what seemed to have been effective and what policy action did not appear to have worked.

Currently, I am most concerned about monetary policy and how the Federal Reserve will reverse course if necessary and what effects will this have on markets and market participants. The un-conventional monetary policy and extremely low interest rates [adopted by the Fed] encouraged market participants to take on additional risks. Indeed, a lot of institutional investors had to move out on the risk curve to meet their desired target portfolio return.

YPFS: Based on your papers, can we say that pretty much every single country should come up with their own playbook? That there is no one playbook to solve a crisis for every country and that every country needs to work within their own limitations?

Klingebiel: Yes, thinking through a playbook on what actions policymakers could take is important. At the same time, I also believe it is important for supervisors worldwide to look at early warning indicators of crises and continue to educate themselves about the various new products that financial institutions develop. While a new crisis may have similar origins (a real estate bubble bursting or rapid increase in interest rates), what institutions and banks are affected may be quite different. I also believe it is important for supervisors to understand incentives and behaviors of all financial market participants, including hedge funds and private equity including their term structure and type of their liabilities.

YPFS: You mentioned in your papers that accommodating policies aggravated the fiscal cost and slowed down recovery. You also emphasize that the effectiveness of policies and especially of government-managed programs require a strong, effective judicial regulatory system and the absence of corruption. Can you elaborate on this?

Klingebiel: Let’s go back to the US. When I looked at financial crises, what is typically happening is that they can be divided into different phases. In the initial phase, policymakers and supervisors often do not recognize or do not want to recognize the full scope of the crises and try to solve emerging financial distress on a piecemeal basis, often using stop gap measures. One could call this phase the denial phase. With respect to the global financial crises, the market experienced unusual moves in August 2007 indicating that a number
of institutions were curbing risk and withdrawing risk capital, or the failure of Bear Stearns in March of 2008. What I mean by accommodative policy is a piecemeal approach that often lulls investors and market participants into thinking that the government solves emerging financial weaknesses by bailing out private market participants and therefore, and importantly, does not either create nor impose incentives on actors to curb risk taking and tighten their hatches. Governments may not like to recognize the full scope of the problem because, they may be concerned about triggering an economic hiccup. And if they take a firm approach they may also be concerned about a political backlash from the regulated entities and their supporters.

During the denial phase, policymakers are overly optimistic, make rosy assumptions about recovery and may make inconsistent decisions. During the 2008 financial crisis, US policymakers organized the takeover of Bear Stearns (and therefore while writing down shareholders, the remainder of the balance sheet was preserved and counterparty risk was minimized), but then decided to let Lehman go into bankruptcy (which was a completely untested process at that point in time given Lehmann’s interconnectedness and significance as a market counterparty and custodian). Policymakers that make inconsistent decisions also suffer a loss of credibility as market participants cannot predict their actions accurately.

Often during the initial phase of a crisis, institutions with insufficient capital are still allowed to operate without any restrictions on their risk taking. They may even receive liquidity support. Liquidity support is a very tricky policy tool. It is of critical importance to stem a bank run and a bank failure. But providing liquidity support to a marginally solvent institution is very risky. From an incentive perspective, if the institution is border-line insolvent and if you are not fixing the problem of insolvency, these institutions have incentives to increase their risk taking as they have nothing to lose but much to gain if they continue to “gamble.” If officials are not careful, by the time they realize that this is actually an insolvent institution, the institution has accumulated further losses and the liquidity support provided will likely be lost and have been expended in vain. Then, the question is, "What do we do with marginally solvent or insolvent institutions and who (shareholders and depositors) should bear losses? And obviously, decisions on the imposition of losses affect a country’s fiscal account.

In many cases, the questions are, do you bail out the small depositors? Bail out large depositors? And what happens to shareholder? How you resolve a financial institution has important signaling effects to shareholders of other financial institutions, their management, boards, and small and large depositors and debt holders (and again, banks are inherently fragile as they are highly leveraged institutions by design).
And, if the financial distress is of a systemic nature, a piecemeal approach will not work and often will result in worsening the financial distress. In the second phase, policymakers and supervisors are then forced to acknowledge the full scope of the crisis and change course. Given that most often, policymakers have already lost some of their credibility, the package of policy measures and financial support often has to be significantly increased to signal to market participants that the crisis can be credibly contained.

Stepping back though, I think that everyone has learned quite a bit as a result of the Global Financial Crisis. Policymakers and market participants now know more about financial crises and the importance of a sound financial system than before 2008.

I do remember that in 2008, market participants, policymakers and politicians would argue that that the Global Financial Crisis was a big surprise. I think that the understanding and knowledge of supervisors and policymakers has improved significantly. I remember commenting on a report of the Financial Stability Board in which the authors were mostly concerned about the leverage and behavior of hedge funds (maybe resulting from the blow-up of fixed income arbitrage funds earlier that decade). I was surprised that there was little analysis about the structured market and holders of structured products, and little understanding about the landscape, composition, and liability structure of hedge funds then.

I am also concerned that regulators and supervisors are overly optimistic about their ability to keep up with market developments and market participants’ financial risk taking. I fear that they will always lag behind as they are not operating in the market. I also think that in many ways, incentives are skewed, and sometimes appear to encourage market participants to take excessive risks as they tend to be bailed out or, at least prior to 2008, traders or CEOs were unlikely to see incentive pay clawed back.

The speed and effectiveness of the restructuring process is critically dependent on the effectiveness and speed of the bankruptcy process and the ability of creditors to take control of a company once it has tripped a respective covenant. The institutional environment matters greatly in the resolution process and that includes appropriate bankruptcy legislation, appropriate processes (including extra-judicial processes with which titles can be secured), and an independent judiciary that allow creditors to enforce their rights.

What happens is, if you then try and think through a resolution mechanism, you just have to take everything into account because it will determine what the correct mechanism is. The crises in the Nordic countries in the early 1990s were painful from an economic perspective. At the same time, the non-performing assets of the affected banks were largely secured by real estate. The
governments decided to set up asset management companies, transferred most non-performing loans to these asset management companies and these sold off the assets relatively quickly. At the same time, Nordic governments nationalized the banks and recapitalized them.

Obviously, there are several issues to resolve when setting up an asset management company including at what price these assets are being transferred to the asset management companies (at market price, or remaining book value) that need to be thought through carefully. If assets are not transferred at market prices, a sale or auction process may be hampered by the fact that as these assets are being sold, and losses are being crystalized. And if assets are not being priced at current market valuations, but at the probably higher book value, financial institutions are being recapitalized through the back door in a rather non-transparent way.

So, from a policymaker's perspective, it is important to have a good understanding of the scope of the problems and of the type of assets that are non-performing. Given the criticality of the financial system for the economy, resolving a widespread crisis quickly and comprehensively is of utmost important to manage the adverse spillover effects on the rest of the economy. The extent to which managers, shareholders, and depositors are being bailed out does matter, including with respect to their impact on incentives for economic actors going forward. A bailout curtails the necessity of economic actors to take as much risk as they deem appropriate, and they can bear. The scope of public financial resources required will also importantly impact a country's fiscal health.

YPFS: For the emerging market economies, which usually do not always have a strong judiciary and regulatory system, in your paper you suggest that they prefer simpler resolutions to crises. Did I get that right?

Klingebiel: Many emerging market economies have constraints with respect to the number of trained lawyers, auditors, and accountants. In many cases, their judicial processes may take a long time and/or the judiciary may not be independent. To preserve the value of non-performing assets or loans, the speed with which the security or loan is secured or can be seized, tends to have a significant impact of the recovery value of the loan. If a lender has to go through a lengthy judicial process to seize the asset, the delay in obtaining actual ownership of the asset may adversely affect its value. International evidence suggests that policymakers must design the restructuring process for the country in which banks or other financial institutions are in distress to the realities of the country and see whether they can design processes that are simpler. Simplifying process may open policymakers to public criticism of conducting a fire sale of domestic assets, so these often come at a cost for the policymaker.
Policymakers and supervisors need to make a number of decisions. One important one is—How nonperforming loans (NPLs) are handled? Should NPLs be handled by each bank individually? Should an asset management company be set up? What is the ownership structure of the asset management company and at what price should assets be transferred (transfer price)?

Another important decision for policymakers is—should financial institutions that are deemed to have a capital shortfall be closed or treated as a going concern? This may occur if supervisors deem that the institution still has franchise value, for example, because it serves an important set of borrowers that cannot easily access credit and banking services from other information. (This argument may be less pertinent today given the advances in technology and the rise of new providers of financial services, fintech firms, in the financial services industry). If the decision is made to treat the institution as a going concern, then the next question is how the institution will be recapitalized or whether it will be taken over by another financial institution. If the decision is made to close the institution, then again, supervisors and policymakers need to make a decision on how this is to be handled.

The design of the process will ultimately also depend on the scope of the crisis, the number of institutions in distress, and availability of financial and human resources. Here, policymakers need to balance the benefits of speed with their desire to create the optimal process based on perfect information. However, if these resources are scarce, it may further and further delay the resolution and this delay may further increase the ultimate cost of the crisis, both from a fiscal and economic perspective. From my experience, it is important to design a clear and relatively simple process that determines which institutions are allowed to continue to operate and which will be closed. A clear and transparent process which is based on objective valuations is also the best protection against pressure from politicians and influence groups.

In many emerging markets, inconsistent macro policies were often one origin of the crisis. For example, in Thailand, a pegged exchange rate and high domestic interest rates encouraged domestic debtors, including those without a natural hedge (through export earnings, for example) to take on loans in foreign currencies. Unregulated finance companies expanded their lending massively by extending loans to real estate companies. When the real estate bubble burst, and foreign capital withdrew from Thailand, the government could no longer sustain the peg and allowed the currency to float. (To complicate matters further, the Thai government was averse to even adjusting the peg as domestic inflation increased and outpaced inflation in the US as Thailand’s economic growth accelerated on the back of a real estate boom).

The floating of the exchange rate resulted in a significant devaluation of the Baht and pushing a lot of debtors into bankruptcy. The financial health of the finance companies deteriorated significantly as the level of their non-performing loans increased dramatically. The Thai government decided to
transfer the loans backed by real estate to an asset resolution company that it set up. Non-performing loans backed by real estate are typically relatively easy to resolve if the country has a simple extra-judicial process to transfer ownership of the underlying real estate asset to the lender.

If the government determines to transfer these assets to a resolution trust (RT) corporation because policymakers deem that to be the easiest process, then other considerations will come into play. What process should the RT use to find buyers? How are the assets being sold off (via auction or negotiation) and is there a minimum price target? If assets are sold off at the time of crisis, distressed buyers will typically buy them at a steep discount as there is uncertainty when the market will recover and to what extent. Selling off assets at the height of the crisis may help markets to find their bottom and may be efficient and worthwhile to do as it allows the economy and (real estate) markets to recover given that the overhang of real assets is absorbed. At the same time, policymakers need to be transparent and explain why these assets should be sold now, and even to foreign buyers. There can also be recriminations if buyers are perceived to reap outsized profits.

During the East Asian crisis, the Korean authorities sold a number of financial institutions to foreign investors. A year later, the validity of the sales was tested in Korean courts and put both the supervisors and foreign buyers in a very uncomfortable position. The plaintiff claimed that Korean authorities had sold the assets too cheaply. This example highlights that it is not an easy task to design a resolution process and it is critical for the authorities to find ways to use outside validation mechanisms to minimize the risk that the process itself is discredited.

Going back to the US during the 2008 crisis, the government did not buy a capital stake in any of the financial institutions. Banks were recapitalized through a variety of programs (TARP etc.) and the government also supported asset markets through the significant purchases of mortgages securities by the Federal Reserve. At the same time, borrowers that could no longer service their mortgages and that were underwater did not receive government assistance, which in the end contributed to public disenchantment. The perception was that rich bankers were being bailed but not borrowers (the “little guy”).

Policymakers therefore need to also consider the broader political and social ramifications of the resolution process that they design.

Learning from past crises may help policymakers and supervisors in designing resolution processes that can withstand the test of time and not just from an
economic perspective. I think that the effort that Yale is making in capturing experiences of past crisis is of critical importance here.

YPFS: **What are the most important lessons that we can draw from the Global Financial Crisis of 2008 and 2009? And have government officials actually act upon those lessons?**

Klingebiel: The crisis of 2008-2009 was, not a crisis that originated in emerging markets. It happened in a period of time when emerging markets were actually doing well. The origins of the crisis were manifold and at least some part can be attributed to the sub-prime market and the unfettered development of derivative credit instruments. As many have observed, the crisis came on the heels of deregulation. It came on an insufficient understanding of regulators about products in the markets, the amount of leverage of various investors, and the off-balance sheet activities of many financial institutions.

What I noticed in the run up to the crisis is that supervisors globally were very concerned about the leverage in hedge funds. They were not necessarily focused on the implied leverage of banks’ off-balance sheet activities. I spoke quite often to traders of mortgage products, and they were concerned about the risk that some financial institutions were taking on and what would happen if real estate valuation deteriorated. The proliferation of new mortgage products (much has been written about this) and the complexity of some structures made it difficult to assess the riskiness of some of these products.

Maybe this is unfair, but I do not think that regulators stayed abreast of these developments. I think the understanding of both leverage and financial instruments is much better now and regulators have put better tracking systems into place that allow the monitoring of various exposures.

Notwithstanding that, as I stated before, despite all the progress being made and the strengthening of prudential regulations, including capital requirements, I believe that regulators will always be a step behind market participants in their understanding of new market developments and products. Therefore, I have warmed up to a “narrow bank” concept. When I started out, I did not like it; I thought it was too constraining. Today, I have a lot of sympathy with this narrow bank concept, because I think it creates clarity and limits implicit government guarantees (acknowledging that it may be in the end less efficient)— “If you play in this sandbox, we are willing to do X, Y, and Z and outside, we are not supporting you.”

Supervision always seems to carry an (implicit) government guarantee (complementing deposit insurance schemes aimed at protecting small depositors) and, in the end, regulators must make tough decisions. Regulators in turn report to politicians who have powerful interest groups that might
push them one way or another. So, a lot of things must go right for governments to make the right decisions in crisis scenarios. I am not sure that regulators are willing to say what they can and cannot do. I also think that many policymakers appear too concerned about market volatility assuming that too much volatility is detrimental. While this is certainly true, suppressing volatility resulting in calm markets only lulls market participants into taking on a lot of risks (which can turn against them when markets invariably become more volatile again).

Given that policymakers tend to largely bail out risk takers (for a variety of reasons, including concern about the economy, going against politically powerful groups, group think, and concern about imposing losses on depositors), I am of the view that a form of narrow banking should be considered.

YPFS: Now that we are facing another economic crisis as the world faces a very profound health crisis (COVID-19), do you see any differences in the effects on emerging markets versus developed countries? Should the policymakers in these countries be using different resolution methods or can they be the same?

Klingebiel: This COVID [crisis] is a really special one in the sense that you had a synchronized recession because of governments stepping in to limit economic activity to save lives. So, governments’ decisions to at least partially replace the income of those groups that are most heavily hit makes perfect sense. I think when the health crisis started a year ago, nobody was expecting that it would last for so long. Obviously, most developed countries can afford fiscal packages, even with the given rates; they can also afford monetary easing.

On the emerging market side, it is a much more mixed picture. Now, a year into the crisis and with the recovery looming (after the initial shocks and now with the development of a vaccine), I think the crisis is not over. Many developed markets, which were able to provide these fiscal packages, have learned from the 2008 lesson that you do not stop providing a fiscal package. Maybe on the market stabilization side, there is a bit more to learn. For developed markets, there is this big debate as to whether the fiscal packages, including the various packages on sustaining companies, leads to higher losses down the road for highly leveraged companies that should not be in existence (so-called zombies) to survive. So, to what extent does it push out the inevitable and cost more resources than it would if we could just cut to the chase and say, “Well, maybe there is no longer a need for this company because the economy is restructuring?”

That is part of what has happened during COVID. Certain trends that were already in the making were accelerated. The easiest to spot is online shopping. For example, you may have made global, efficient supply chains, but you did
not anticipate that hiccups can happen. You need to prepare for that. For developed markets, there will be questions around this.

For emerging market economies, it really depends; there is not one picture. It is not insightful to group them all in one big pot. You have those that came into the crisis with macro policies that were consistent and in pretty good shape without significant deficits. In most of these instances, they could actually be aggressive on the monetary side and might have had room for fiscal packages. It also depends on whether their [economies] is commodity driven. Those took an initial hit, but obviously with commodities prices now back up, are in a much better situation. For those that rely on tourism, as tourism has not revived, it gets pretty tough.

Then you have health measures. On the one hand, you have significantly underfunded public health systems; on the other, you have advanced economies buying up all the vaccine supply. I think everyone understands that you will not solve [the crisis] if all of the populations of advanced economies are vaccinated, but the virus is still changing and mutating in emerging market economies; some can still come back to bite you. COVID has been really tough, especially on emerging markets. It has been particularly difficult for the poor, and the very poor. There is a lot to be done going forward because unfortunately the crisis is not over.

YPFS: What do you see as the biggest systemic risks in the world today and what can be the trigger for next crisis?

Klingebiel: It is more the idea that you have monetary authorities underwriting risk taking though their very accommodative policies. It is questionable as to how monetary authorities in the US and Europe can get out of these ultra-accommodating monetary policies without triggering a crisis. Then there are also concerns about mounting sovereign debt, particularly in some emerging market economies. Some observers have noted that the overall low level of interest rates allows governments to carry more debt as the interest outlays for governments are affordable. The question though is what happens when interest rates rise and how affordable are the high levels of sovereign debt then?

At the same time, you have important structural changes. For example, deflationary pressures are abating. If you look at China as the current manufacturing powerhouse today, the working population there is no longer growing but will soon even decline. Now, India still has a very young population. Understanding how these structural changes will influence the macro environment and how they will change over the next few years is important.
Obviously, at the same time, I am concerned because we have populism and a significantly lower trust in institutions and in democracy itself. If in the oldest democracy in the world, people can live in their alternative reality and truly believe that the election was stolen, you cannot create a world where you operate from the same facts.

What will create the next crisis? It can come from several directions. I am hoping that at some point the pendulum swings back. It is the first time I can remember when the legitimacy of government is at stake and maybe more so in the US than in some countries in Europe. But you still may be getting a populist backlash because if you have less trust in the institutions and yet, at the same time, you need these institutions and civil servants to solve the next crisis, and you have everyone expecting to be bailed out... That does not look too pretty to me.