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Financial Crisis Containment and its Implications for Institutional and Legal Reform

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Abstract

This article analyzes financial crisis containment from a governance perspective. It depicts containment decision making by governments as a complex technical process of different stages. Deviating from the existing well-worn paradigms, the article argues that efficient crisis containment requires a clear allocation of responsibilities with explicit objectives and powers, proper channels of accountability and more transparency. It models a governance framework, the core of which is a crisis containment council. Shared responsibility and accountability on the part of the council members as they seek crisis containment would incentivize them to collaboratively decide on containment policies that correspond to the greatest degree possible with the interests of social welfare.

Keywords: Governance, financial crisis, crisis management, crisis containment, systemic risk

JEL classifications: G01, G18, G28, K23, K40

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I. Introduction

‘The United States entered this crisis without an adequate set of tools to contain the risk of broader damage to the economy (…).’

Just like many of its predecessors, the financial crisis that started unraveling in mid 2007 confronted governments in different parts of the world with a dilemma. Facing financial turmoil of perhaps unparalleled intensity and complexity, governments were prompted to step in and back their financial markets to prevent the financial system from collapsing. Politicians and policy-makers realized that government action was needed to forestall much greater social cost. The question remained, however, of how that action should work and who should be responsible. Because the governance arrangements for systemic financial crisis situations turned out to be inadequate or simply inexisten, governments responded immediately and in part unorganized to defend financial stability. The existing Memoranda of Understanding did not keep their promise of properly distributing the share of crisis responsibilities among the supervisory authorities, the central bank and other government agents. Unmatched objectives and powers made some agents reluctant to act and caused others to act beyond their designated mandates. Meanwhile, the representatives of the legislative branch, feeling chronically suppressed by executive activism, did their best to second-guess the measures taken. Finally, inadequate funding

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1 Timothy F. Geithner, U.S. Secretary of the Treasury, Speech Before the House Financial Services and Agriculture Committees (July 10, 2009).
arrangements led to a shift of containment policies onto central banks’ balance sheets and thus largely out of the realm of public oversight. Even where agency collaboration was eventually engineered despite lacking governance arrangements, governments have been accused of insufficient transparency and communication.

Although often considered surprising, financial crises—even those with systemic implications—are not an unusual phenomenon on a global scale.\(^2\) In recent years, along with soaring financial liberalization and integration, financial crises have become even more frequent and more devastating in their implications for financial stability and economic growth.\(^3\) As the statement by Secretary Geithner quoted at the outset of the article implies, today’s governments need to be increasingly prepared to weather systemic financial crises appropriately. The experience of this most recent systemic financial crisis has provoked intense discussions of the possible features of a statutory regime that could adequately respond to a financial crisis. At the core of the debate is the question of


whether there should be special resolution mechanisms for systemic financial institutions. The debate has culminated in proposals, first and foremost by the Obama Administration in the U.S.,⁴ to provide the government with emergency authority to manage the failure of large and interconnected financial institutions if the stability of the financial system is threatened. However, while the proper handling of failing or distressed systemic financial institutions is undoubtedly an essential aspect of crisis management, it is not the only tool for containing financial distress. In fact, crisis containment begins much earlier, at the very moment in which the government begins to realize that the horses are galloping in the wrong direction and that it is left with the pivotal responsibility of bringing them back on track.⁵ This article thus takes a step back and views governments’ endeavors to contain financial crises from a broader perspective.⁶ It expands the focus of the existing proposals to a point further back in the history of a crisis, when the right way forward has yet to be determined. At this point in the timeline, a colorful set of potential policy actions is on the table.

⁴ For the details of the proposal, see Department of the Treasury, Financial Regulatory Reform – A New Foundation: Rebuilding Financial Supervision and Regulation, White Paper (June 17, 2009).

⁵ However, deliberately or not, measures adopted to contain a crisis often remain part of the longer-term crisis response. Poor crisis containment can thus threaten fast and successful recovery from the crisis; see LAEVEN & VALENCIA, supra note 2, at 7.

⁶ The article only refers to financial sector crises—i.e., those at the level of financial institutions—not to currency or debt crises affecting governments themselves. However, the analysis is not confined to banking crises as narrowly understood as in Richard Baldwin, Calomiris on Historical Crisis Lessons, VoxEU.org (Nov. 9, 2009); instead, it includes, e.g., asset-price bubbles.
Within this setting, the article assumes a novel perspective. It proposes shifting the attention away from the everlasting debate about the economic rationale and efficiency of particular containment measures and towards good governance in crisis containment—an aspect that has so far been widely neglected by both scholars and policy-makers. With this focus, the article adds to previous research. While perhaps criticizing insufficient governance arrangements for financial crisis containment, previous studies have mainly tackled the tendencies of governments as they relate to containment policy without referring to the framework under which they should be acting.

This article claims that efficient crisis containment relies on appropriate governance arrangements, which diverge in many ways from existing administrative settings. The following sections will show that the situation with which governments are confronted when making crisis containment decisions is indeed unique and not necessarily comparable to other emergency situations (such as war or natural disaster). The reasons why financial crisis containment should be embedded in a framework that ensures compliance with certain principles of good governance are straightforward. Authority over crisis containment means bearing the responsibility for the restoration of financial stability, an indispensable premise of social welfare. It also involves the power to allocate public resources among various constituents. At least in democratic

7 See also Anna Gelpert, Financial Crisis Containment, 41 CONN. L. REV. 493, 504-505 (2009).
government systems, such authority inevitably raises concerns of legitimacy and accountability. Furthermore, the price of failure is simply too high for the government to leave the authority over crisis containment to the wrong agents or not to provide the responsible agents with the right incentives to exercise their authority in a way that mirrors the public interests.

Nevertheless, different streams of objections against the establishment of a governance framework for financial crisis containment have been introduced. First, opponents of an *ex ante* framework for crisis management or containment mechanisms often argue that it would provide financial institutions with the undesirable confidence that they will receive government support if they come under severe financial pressure, and thus that it would fuel moral hazard. However, moral hazard is not really a problem of whether there exists a framework for government crisis containment. Rather, moral hazard derives from feelings of certainty that the government would step in if a crisis threatened to spread across the system.⁹ Second, opposition could also evolve from the argument that financial instability and the threat of systemic financial crises are increasing at a global level. As a solution to the dilemma of progressively integrating financial markets in a world of nation-states, many scholars propose delegating crisis management authority to a global ‘financial stability instance.’ However, while the importance and ultimate necessity of global crisis management or containment mechanisms cannot be neglected, the political feasibility of an international crisis

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⁹ One could even conclude that it is, in fact, a duty of the state to shelter its people from the disaster caused by a systemic financial crisis.
management authority is quite limited for the foreseeable future.\(^\text{10}\) As long as this authority gap persists, the establishment of sound crisis containment frameworks at the national level seems to be the more promising way forward.\(^\text{11}\)

The proposals made in this article are not tailored to a specific jurisdiction but provide guidelines that would be appropriate irrespective of the particular political, legal and institutional setting. Nevertheless, the picture is biased to some extent towards rich countries with developed financial sectors and relatively stable political environments, especially as the article implies that governments possess the political and fiscal means to take containment action. Still, the proposals are meant to be universally applicable and thus contain a considerable degree of abstraction.

The remainder of the article proceeds as follows. Section II sets the stage by depicting financial crisis containment decision making as a rather technical process with three stages: the initiation stage, the design stage and the implementation stage. In section III, the core implications of this process for good governance in crisis


\(^{11}\) This does not imply that the transnational implications of crisis containment can or should be ignored. At a minimum, nation-states must coordinate their efforts to stabilize the system at an international level. While during the current financial crisis the G-20 seemed to be the main platform for transnational cooperation in crisis containment, the newly molded Financial Stability Board (in addition to the more or less informal information sharing and cooperation between the heads of the central banks) may stand in for a political network in the medium term.
containment are outlined. Section IV then models the cornerstones of an institutional and legal framework for containment policy. Section V concludes.

II. Containment Decision Making

What exactly is financial crisis containment? While there seems to exist widespread agreement that managing financial crises, amongst other policy actions, involves the containment of financial distress (although it is not necessarily termed that way), no generally accepted concept of financial crisis containment has been established to date. In the literature, containment is usually referred to as a set of measures taken in the early phases of financial crises. Other authors describe it more as the attempt to keep financial crises from spreading internationally. In a recent study, GELPERN identifies financial crisis containment as a separate category of policy measures—in addition to (and as opposed to) crisis prevention/resolution and financial regulation—that aims to ‘stop the spread of untold economic damage, akin to containing a fire or infectious disease.’ A similar approach is taken by LAEVEN and VALENCIA, who describe financial crisis containment as immediate reactions ‘aimed at restoring public confidence to

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12 See, e.g., DAVIDOFF & ZARING, supra note 8, at 67; LAEVEN & VALENCIA, supra note 2, at 7; David S. Hoelscher & Marc Quintyn, Managing Systemic Banking Crises (International Monetary Fund, Occasional Paper No. 224, 2003), at 11-18.

13 See, e.g., TARULLO, supra note 10, at 614; Candace C. Archer, Responses to Financial Crises: An Evolutionary Perspective, 23 GLOBAL SOCIETY 105, 110 (2009).

14 GELPERN, supra note 7, at 495.
minimize the repercussions on the real sector of the loss of confidence by depositors and other investors in the financial system.\textsuperscript{15}

Based on this understanding of the term, we can note that containment seeks to limit damage caused by financial crises that are unfolding or have already materialized and that pose a threat to the system at large. Therefore, containment applies on an emergency basis when established policy measures have proved to be insufficient or inappropriate. However, this description fully reflects neither the complexity of financial crisis containment nor its importance. Efficient crisis containment requires that the government makes a number of intricate and politically delicate decisions within due time, perhaps making this one of its most challenging tasks.

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\begin{itemize}
  \item Stage 1: Initiation
    \begin{itemize}
      \item Nature/scope of a crisis
      \item Timing
    \end{itemize}
  \item Stage 2: Design
    \begin{itemize}
      \item Type of containment measures
      \item Welfare considerations
    \end{itemize}
  \item Stage 3: Implementation
    \begin{itemize}
      \item Scope of application
      \item Time limits and exit
      \item Conditionality
    \end{itemize}
\end{itemize}
\end{minipage}
\caption{Containment decision-making process}
\end{figure}

\textsuperscript{15} LAEVEN & VALENCIA, supra note 2, at 7.
This section presents a step-by-step analysis of governments’ crisis containment decision making, subdividing it into three stages: the initiation stage, the design stage and the implementation stage (Figure 1). During the initiation stage, the government decides whether it must step in to contain an unraveling systemic crisis. The design stage involves governmental judgment regarding what would be the best measures for containing a crisis. During the implementation stage, the government must then come to terms with certain more formal aspects of the envisaged measures. For each of these stages, the article outlines the challenges and complications with which governments are confronted.16

A. Initiation Stage

The containment decision-making process is initiated by a government’s decision to adopt crisis containment measures. This decision involves an assessment of the nature and intensity of financial turmoil in the system. Intrinsically associated with the assessment of the unraveling crisis is the question of the proper timing of government intervention, although there may be other factors besides the evolution of the crisis that influence the government in its decision regarding when to intervene.

16 In contrast to DAVIDOFF & ZARING, supra note 8, who describe the U.S. government’s early response to the current financial crisis merely as a negotiation-focused approach to dealing with individual financial institutions, this article considers financial crisis containment as a purely technical process, ignoring to a great extent the potential influence of the private financial sector on government decision making.
1. **Systemic Nature of a Crisis**

Financial crisis containment is not the same as fighting financial distress in general. It does not aim to save particular financial institutions but instead targets the financial system at large. The term ‘containment’ implies that the financial crisis government intervention is geared toward addressing is contagious—i.e., likely to spread across the system—and that it needs to be stopped to prevent greater macroeconomic damage. Measures to contain a crisis become necessary if market disruptions are of a certain enhanced seriousness in terms of their scope and/or path and pace. The decision to take containment measures hence necessarily involves, as a first step, the determination of whether a crisis is of a systemic significance or not.

There are no quantitative ratios or rules for determining when a crisis is to be considered systemic. The literature has sought to identify several types of crises that are likely to threaten the financial system as a whole. These types of crisis depend on the event by which they are triggered, including (1) large institutional failures—be they mass failures or the failure of one major player with contractual or institutional linkages to many others; (2) the sudden loss of depositor confidence leading to bank runs (which may or may not be caused by institutional failure); and (3) financial or macroeconomic...

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17 Hoelscher & Quintyn, supra note 12, at 3.
18 Gelpertn, supra note 7, at 500-502.
19 Carl-Johan Lindgren, Pitfalls in Managing Closures of Financial Institutions, in Systemic Financial Crises – Containment and Resolution (Patrick Honohan & Luc Laeven eds., 2005), 86.
disturbances, so-called ‘common shocks’ affecting every financial institution simultaneously, though not necessarily uniformly.\(^{20}\)

LAEVEN and VALENCIA define systemic banking crises as situations in which ‘a country’s corporate and financial sectors experience a large number of defaults and financial institutions and corporations face great difficulties repaying contracts on time.’ Such a situation is mostly triggered by ‘a general realization that systemically important financial institutions are in distress.’\(^{21}\) While this broad definition may also include times of distress that have not yet culminated in a systemic crisis, it highlights that the systemic nature of a crisis greatly depends on the financial institutions it affects.\(^{22}\) To assess the potential impact and course of a crisis, the government may thus have to determine whether the struggling financial institutions are ‘too big to fail’\(^{23}\) or ‘too connected to fail’ without further increasing financial instability. Whether a crisis is triggered by institutional failure or not, the determination of which crises are contagious and consequent systemic risk is a difficulty inherent in the containment decision-making process.\(^{24}\)

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\(^{20}\) See, e.g., GELPERN, supra note 7, at 501-502; HOELSCHER & QUINTYN, supra note 12, at 4.

\(^{21}\) LAEVEN & VALENCIA, supra note 2, at 5.

\(^{22}\) Steven L. Schwarcz, Systemic Risk, 97 GEO. L.J. 193, 200 (2008), however, argues that with the growth of disintermediation, systemic risk more often stems from capital markets than from individual financial institutions.

\(^{23}\) See Benton E. Gup, What Does Too Big to Fail Mean?, in TOO BIG TO FAIL - POLICIES AND PRACTICES IN GOVERNMENT BAILOUTS (Benton E. Gup ed., 2004), 29-48, for a comprehensive explanation of the term.

\(^{24}\) See also TARULLO, supra note 10, at 613, 666.
2. **Timing**

Linked with determining the nature of a crisis is the question of when the government should intervene. The efficiency of crisis containment policy depends, to a great extent, on the timeliness and vehemence of government action.\(^{25}\) In the literature, there exists little agreement on the right timing for containment action. While some authors favor the general rule of ‘the sooner the better,’\(^{26}\) others take a more differentiated approach.\(^{27}\) Some have further stressed the danger of precipitous government action—either because it bears the risk of an undue shift of powers towards the executive branch\(^ {28}\) or because it may be accompanied by a misdiagnosis of the problems underlying financial turmoil.\(^ {29}\)

The problem begins with the question of when a crisis starts. Most financial crises arise from multiple sources that amplify each other mutually. Apart from analyzing crises that accompany the business cycle,\(^ {30}\) attempts to identify the anatomy of

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25 Hoelscher & Quintyn, supra note 12, at 3.


30 According to the Minsky model of financial crises (see Hyman Minsky, Stabilizing an Unstable Economy (1986)), a crisis is generally preceded by a phase of speculation and credit expansion (the
a typical financial crisis are therefore of limited use in solving the problem. Market corrections do not form based upon a common pattern; they may occur with a big bang, but they may also evolve more gradually over time. Moreover, systemic implications are not necessarily limited to the beginning stage of a financial crisis; containment measures may have to be taken at various occasions throughout the life cycle of a crisis.

GELPERN argues that the timing of containment action may in fact not depend exclusively on economic necessity; considerations of legal and political viability are almost equally important. In many cases, the government will indeed know that it faces a crisis with systemic implications before it finds the capacity or political will to address it. Overall, adopting containment policy in the nick of time is a balancing act; as KINDLEBERGER and ALIBER put it, ‘Timing is an art. That says nothing—and everything.’

B. Design Stage

Once the government has come to the conclusion that the financial system is teetering at the brink of collapse and that it is time to take action to contain systemic distress, it will have to determine more precisely how it seeks to do so. The differences between the containment strategies adopted in the past in part derive from the fact that governments

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31 HOELSCHER & QUINTYN, supra note 12, at 4.

32 GELPERN, supra note 7, at 503-504; see also HOELSCHER & QUINTYN, supra note 12, at 11.

33 KINDLEBERGER & ALIBER, supra note 27, at 242.
pursue different objectives, including the varying degree to which they consider the fiscal costs of containment produces. Nevertheless, some measures have been applied with remarkable consistency across a wide range of systemic crises.

1. Type of Containment Measures

Efficient containment must be attuned to the nature of a crisis, the channels through which it spreads and the immediate damage it causes. An important question, repeatedly mentioned in the literature, is whether the crisis mainly derives from liquidity problems or rather from solvency problems (notwithstanding their close interconnection). Less popular but equally critical is the disentangling of economic fundamentals and panic.

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34 See LAEVEN & VALENCIA, supra note 2, at 3.

35 For detailed studies of different support measures in times of financial distress, see, e.g., Charles W. Calomiris, Daniela Klingebiel & Luc Laeven, Financial Crisis Policies and Resolution Mechanisms: A Taxonomy from Cross-Country Experience, in SYSTEMIC FINANCIAL CRISSES – CONTAINMENT AND RESOLUTION (Patrick Honohan & Luc Laeven eds., 2005), 31-72; HOELSCHER & QUINTYN, supra note 12, at 11-17; GUP, supra note 23, at 38-42.

36 See also Patrick Honohan & Luc Laeven, Introduction and Overview, in SYSTEMIC FINANCIAL CRISSES - CONTAINMENT AND RESOLUTION (Patrick Honohan & Luc Laeven eds., 2005), 8.

37 For example, TAYLOR, supra note 29, at 14-16, claims that the U.S. authorities misdiagnosed the increased spreads in the money market from August 2007 onward as a problem of liquidity rather than one of counterparty risk and thus prolonged the financial crisis with a policy response focused on providing liquidity.
Crisis containment is limited to measures that can be adopted at very short notice. Measures that require the establishment of special institutional settings, such as the purchase of illiquid or non-performing assets locking financial institutions’ balance sheets through the provision of a ‘bad bank,’ generally extend beyond the horizon of containment policy.

At the core of almost every financial crisis is a sharp decline in overall market liquidity accompanied by increased refinancing costs for financial institutions. Lender-of-last-resort lending by the central bank or direct government loans can substitute for a lack of market liquidity and provide the authorities with the necessary time to identify the causes of a crisis and determine the measures to counteract them.  

Emergency liquidity support in the form of reduced reserve requirements, open market operations and discount windows or instruments such as repos is therefore often the first line of defense in financial crisis situations.

To reestablish confidence and prevent bank runs, governments may decide to introduce public guarantees for certain or all liabilities of financial institutions. If

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38 In principle, there exists broad agreement that liquidity support should be limited to fundamentally solvent financial institutions—a notion that goes back to Bagehot’s classic principles regarding a true lender of last resort; see WALTER BAGEHOT, LOMBARD STREET: A DESCRIPTION OF THE MONEY MARKET (Wiley Investment Classics 1999) (1873). However, in a deteriorated market environment, liquidity problems very quickly become solvency problems. It is therefore no mean feat to establish in advance whether liquidity support will help to prevent potential future losses or whether it will instead finance additional losses; LINDGREN, supra note 19, at 91.

39 HOELSCHER & QUINTYN, supra note 12, at 11.
successful, such guarantees can buy the government the time that it needs to adopt a more comprehensive containment (and eventually a resolution) strategy.\textsuperscript{40} While many countries have established means of depositor protection, it is common to increase the amount of the guaranteed deposits in times of financial crisis or to extend it to other bank liabilities through supplementary \textit{ad hoc} guarantees.\textsuperscript{41}

Apart from providing liquidity and/or capital,\textsuperscript{42} the government may also intervene with financial institutions as an administrator. One form of administrative intervention is the temporary assumption of management powers by government officials. Governments may also seek to save potentially systemic financial institutions from

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  \item \textsuperscript{40} \textsc{Laeven & Valencia}, \textit{supra} note 2, at 10; \textsc{Hoelscher & Quintyn}, \textit{supra} note 12, at 13; see also Luc Laeven & Fabian Valencia, \textit{The Use of Blanket Guarantees in Banking Crises} (International Monetary Fund, Working Paper No. 08/250, 2008).

  \item \textsuperscript{41} Previous experience has shown that public guarantees—especially blanket guarantees—can be very costly from an \textit{ex post} perspective. Even if they are effective in containing panic, they tend to cause the socialization of the costs of financial institutions’ solvency problems; see, e.g., \textsc{Honohan & Laeven}, \textit{supra} note 36, at 9. Furthermore, public guarantees are only credible if governments have the political and fiscal means to actually honor them if needed; see \textsc{Lindgren}, \textit{supra} note 19, at 96.

  \item \textsuperscript{42} The recapitalization of financial institutions by injecting equity is generally viewed as a measure of crisis resolution rather than as one of crisis containment; see, e.g., \textsc{Laeven & Valencia}, \textit{supra} note 2, at 12-16; \textsc{Calomiris \textit{et al.}}, \textit{supra} note 35, at 64-72. However, at least since the ongoing crisis, which has prompted governments to inject capital into financial institutions for the primary purpose of strengthening confidence in their ability to absorb losses, the distinction has seemed blurred. If the failure of an insolvent financial institution threatens to have contagious effects, it cannot be properly determined whether capital injection primarily serves containment or resolution purposes.
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failure through assisted mergers and sales. In disrupted markets, private sector solutions may not be possible without government mediation.\textsuperscript{43} In the case of assisted sales, the government will often have to pay the purchasing institution for the difference between the (perceived) value of the purchased assets and the liabilities of the particular institution.\textsuperscript{44}

As a final measure to counteract the devastating effects of collective action problems, governments may consider the merits of a standstill mechanism. Standstills are cooling-off periods for financial institutions to use to take stock of their actual liquidity and solvency situation and their level of risk exposure, for the government to signal its commitment to stepping in where necessary and for calm to return to the financial markets.\textsuperscript{45} They can occur as actual bank holidays, through the suspension of certain contracts or contract clauses\textsuperscript{46} or, most commonly, through regulatory

\textsuperscript{43} GUP, supra note 23, at 41, accurately termed this type of administrative intervention ‘persuasion’ because it is often accompanied by public funding aimed at ‘persuading’ the absorbing or purchasing party to agree to the deal; see also Martin Čihák & Erlend Nier, The Need for Special Resolution Regimes for Financial Institutions – The Case of the European Union (International Monetary Fund, Working Paper No. 09/2009, 2009), at 17.

\textsuperscript{44} LINDGREN, supra note 19, at 79.

\textsuperscript{45} For a discussion of standstills in the context of sovereign debt crises and the role of the International Monetary Fund, see TARULLO, supra note 10, at 672-679.

\textsuperscript{46} See GELPERN, supra note 7, at 513-517. In the recent financial crisis, which has its roots in the U.S. subprime mortgage market, government intervention to support securitized subprime loan modifications was proposed by Christopher Mayer, Edward Morrison & Tomasz Piskorski, A New Proposal for Loan Modifications, 26 Yale J. on Reg. 417 (2009).
forbearance. Forbearance is pursued if the strict enforcement of micro-prudential regulation (especially accounting, capital adequacy and loan provisioning rules) would work pro-cyclically and would thus exacerbate the effects of a crisis.47

2. Welfare Considerations

Containment measures can result in direct and indirect costs, and they often cause both. While direct costs consist of the taxpayer money that is spent on assistance to the financial sector, indirect costs stem from adverse effects of crisis containment measures on the long-term viability of the financial system.48 Indirect costs include the misallocation of capital, which leads to distortions of competition and moral hazard because financial institutions may be encouraged to abuse government support.49 Other indirect costs may be caused by regulatory forbearance, leading to a loss of confidence in the rule of law. Furthermore, the suspension of contracts may disrupt commercial expectations and impair incentives to perform in the future.50

47 For a critical assessment of regulatory forbearance, see LINDGREN, supra note 19, at 89-90. As forbearance may undermine depositor confidence and make banks prone to runs, it is vital to have an adequate safety net for depositors in place; see CALOMIRIS ET AL., supra note 35, at 29.

48 LAEVEN & VALENCIA, supra note 2, at 3-4; CALOMIRIS ET AL., supra note 35, at 26-27

49 To avoid distortions of sound incentives it is often suggested that crisis containment measures should come at significant costs for the beneficiary financial institutions; see, e.g., Bastian Breitenfellner & Niklas Wagner, Government Intervention in Response to the Subprime Financial Crisis: The Good into the Pot, the Bad into the Crop (Working Paper, Social Science Research Network, 2009), at 13; see also TARULLO, supra note 10, at 656 (footnote 149).

50 GELPERN, supra note 7, at 498.
Welfare considerations are central to designing a containment strategy. While the maximum costs of containment action may be, to some extent, assessable *ex ante*, measuring their net effect on social welfare is no mean feat; it will never be known what the costs would have been of the system collapse that the measures averted. Moreover, it is difficult to estimate separately the impact of particular measures because they are often part of a larger government response intended to restore confidence in the financial system.\(^{51}\)

However, inherent in governments’ decision regarding how to counteract financial instability is a decision about who will eventually bear the losses that may result. Crisis containment necessarily involves an element of wealth distribution as it requires governments to support some constituents over others.\(^ {52}\) Under normal circumstances, losses from financial distress fall on debtors and creditors. In times of financial crisis, however, the common loss-sharing procedures of the bankruptcy regime may not be suitable because they could increase panic and cause runs on banks.\(^ {53}\) To contain systemic disruptions, governments may be forced to (at least temporarily) assume the responsibility for certain losses and to shift losses from both debtors and creditors to

\(^{51}\) For an attempt to explain the impact of the U.S. Troubled Asset Relief Program (TARP), see Timothy F. Geithner, U.S. Secretary of the Treasury, Written Testimony before the Congressional Oversight Panel (Jan. 10, 2009).

\(^{52}\) Gelpern, *supra* note 7, at 518-520.

\(^{53}\) Lindgren, *supra* note 19, at 93.
taxpayers. This phenomenon may appear to be the only way to limit the overall social costs of a crisis. 54

C. Implementation Stage

During the last stage of the decision-making process, the government decides how it intends to implement the envisaged containment measures. We will now move from what so far has been a discussion of the content of financial crisis containment to an assessment of some more formal aspects. The implementation stage of crisis containment includes defining the scope of application of the envisaged measures, their time limits and the government’s exit strategy as well as potential conditions accompanying the measures.

1. Scope of Application

Once the design of the containment strategy is determined, the government needs to define to which circle of financial institutions or parts of the financial system the envisaged measures are to be applied. It can pursue either a case-by-case or a wholesale approach. 55 While the former approach handles each financial institution individually, the latter approach applies to numerous or all financial institutions in a contemporaneous manner (although not necessarily to all to the same extent).

54 If the crisis is great enough, the government’s choices can be constrained by its own fiscal scope; see LAEVEN & VALENCIA, supra note 2, at 13.

55 GELPERN, supra note 7, at 498.
Both approaches have their own intricacies. If the crisis has reached dimensions for which the existing administrative capacity is insufficient, an across-the-board solution may be the only way to effectively contain the crisis.\textsuperscript{56} However, a wholesale approach implies deeper financial distress than a case-by-case solution, possibly challenging the government’s earlier crisis prevention achievements and/or increasing panic. If there is no immediate need for a wholesale solution, governments will thus likely prefer to implement crisis containment on a case-by-case basis and—to use the terminology of DAVIDOFF and ZARING—by ‘making deals’ with individual failing banks.\textsuperscript{57} This approach, however, requires that the government assesses each financial institution in terms of its immediate and potential future financial needs and identifies the ‘promising’ or systemically relevant cases from the pool of struggling institutions. Such triage is not an easy task. The failure to distinguish insolvent from fundamentally sound financial institutions that solely suffer from exogenous problems may significantly increase the social costs of a crisis.\textsuperscript{58}

\textsuperscript{56} LAEVEN & VALENCIA, supra note 2, at 13; GELPERN, supra note 7, at 545.

\textsuperscript{57} DAVIDOFF & ZARING, supra note 8.

\textsuperscript{58} Irrespective of whether a case-by-case or a wholesale approach is pursued, financial institutions may be reluctant to collaborate with the government. In its attempt to reduce the systemic risk emanating from certain ‘uncooperative’ financial institutions, the government may have to impose mandatory containment measures on financial institutions. For example, during the recent financial crisis, enforced government support was practiced in the United States and discussed in Germany.
2. **Time Limit and Exit**

Independent of the particular measures taken, the government is inevitably confronted with the question of the time horizon of its containment engagement and the conditions of its exit. Markets not only react sensitively to the announcement of containment measures but also behave according to the measures’ estimated duration. Even though in many cases a commitment more distinct than ‘as long as necessary’ will be neither possible nor reasonable, the government may want to clearly establish containment as a set of exceptional short-term measures whose necessity and reasonability are constantly reviewed.\(^{59}\) If the government assumes a stake in financial institutions, and especially if this is linked with the assumption of a certain influence over the institutions’ operations, the lack of an exit commitment may foster investor uncertainty, thus lowering the institutions’ chances to return to financial strength without public support.

3. **Conditionality**

Having decided to provide certain or all financial institutions with liquidity and/or capital, a government must determine the conditions under which it will grant that support. When the government injects capital, it may, for example, choose to acquire an explicit shareholder position with the beneficiary financial institution or at least a shareholder-like claim. If possible (although it is often not), the government will provide liquidity funds

\(^{59}\) **GELPERN, supra** note 7, at 510-511, in contrast, stresses the possibility that policy-makers, once the existence of a crisis is acknowledged, may see financial distress as an opportunity to secure far-reaching economic reforms.
at a ‘penalty rate’ to financial institutions with liquidity needs. While these rather technical issues, here referred to as conditionality, may seem like unimportant details up front, a failure to pay attention to them can result in increased public resistance to the government’s containment strategy, which can slow down the crisis management process and eventually increase the social costs of the crisis.

During the current crisis, there has been much debate about the extent to which governments should impose restrictions on beneficiary financial institutions in terms of how to use or how not to use public funds granted to them. This debate reflects two structural problems inherent in current financial market organization. First, individual financial institutions, while of course motivated to protect themselves, do not have an incentive to reduce systemic risk—i.e., the danger of contagion for other financial institutions and the market as a whole. Nevertheless, financial contagion is exactly what the government aims to prevent by supporting a potentially systemic financial institution in distress. This leads to a perverse situation in which, while the market fails to provide incentives to prevent the externalities of systemic failure, the beneficiary may maintain a level of risk exposure that is not correlated with the government’s aim of restoring financial stability.

Viral V. Acharya, Hyun Song Shin & Tanju Yorulmazer, Crisis Resolution and Bank Liquidity (Nat’l Bureau of Econ. Research, Working Paper No. 15567, 2009) show that while liquidity support for failed banks and unconditional support for surviving banks as they seek to acquire failed banks give banks incentives to hold less liquidity, the support to surviving banks that is conditional on their liquid asset holdings creates incentives for banks to hold more ex ante liquidity.

Schwarcz, supra note 22, at 206.
Second, financial institutions that feel secure in the knowledge of their being considered ‘too big to fail’ from a strict economic perspective even have adverse incentives to perform well and to adequately control their level of risk exposure since they are rewarded with additional funds if their distress continues. With these fundamental problems in mind, governments may consider restricting the beneficiary’s risk exposure during the period of public support in a way that takes into account the ultimate reason for the support—the containment of systemic risk.

Further-reaching government influence imposed on financial institutions in exchange for public support may especially include restrictions on management compensation and dividend distribution. The past has shown that these politically sensitive issues should be given due consideration. In the longer run, because they come at significant costs for financial institutions, the restrictive conditions accompanying the government’s containment strategy may also reduce moral hazard and increase incentives to detach from government support as soon as possible.

III. Core Governance Implications

In the previous section, the financial crisis containment decision-making process was conceptualized in an abstract manner. This explanation of the process demonstrates, in

\[\text{\textsuperscript{62} VON FÜRSTENBURG, supra note 28, at 16.}\]

\[\text{\textsuperscript{63} While the Swedish government’s approach during the crisis of 1991-93 is widely considered as a good example of crisis management, bonuses paid to bankers created a substantial challenge for policy-makers; see JONUNG, supra note 26, at 17 (footnote 28).}\]
particular, that a number of intricate and politically delicate decisions are necessary elements of financial crisis containment policy. Making these decisions requires a great amount of technical knowledge, information and expertise. Additionally, the judgments at every stage of the process have to be made under very narrow time constraints.

Acknowledging financial crisis containment as a separate policy category implies that the governance framework for other policy actions needs to be adjusted accordingly. This section discusses the core implications with regard to good governance that we can derive by considering the specifics of financial crisis containment. These include the allocation of responsibilities, the need for clear objectives and powers and the handling of transparency and accountability.

A. Allocation of Responsibilities

A good governance framework largely depends on the reasonable allocation of responsibilities. Finding an optimal allocation of responsibilities in financial crisis containment can be viewed as a balancing act based on three pillars: namely, leadership, credibility and cooperation.

1. Leadership

Authors in the Keynesian tradition\(^\text{64}\) have continuously pointed out that effective crisis management crucially depends on strong leadership. Past experience has indeed demonstrated that leadership—materialized in the form of swift and cohesive crisis

\(^{64}\)E.g., MINSKY, supra note 30; KINDLEBERGER & ALIBER, supra note 27.
response—is key to overcoming a loss of confidence and market deterioration. Perhaps for this reason, it can be observed that the executive tends to gain power in financial emergency situations. The executive has the necessary means to act swiftly, decisively and, if necessary, on a confidential basis, and it has access to the usually broad expertise and information located in the administrative machinery. For these reasons, crisis management has traditionally been seen as a core and almost natural responsibility of the executive branch.

The situation that the government faces in the wake of a systemic financial crisis differs in many ways from other emergency situations. Importantly, the government has delegated a wide range of responsibilities in the financial and monetary area to more or less independent agencies, the financial supervisory authorities (supervisors) and the

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65 See, e.g., DAVIDOFF & ZARING, supra note 8, at 63-64.
66 POSNER & VERMEULE, supra note 8, at 3.
67 The degree of agency independence differs from country to country; for a cross-country overview, see Marc Quintyn & Michael W. Taylor, Regulatory and Supervisory Independence and Financial Stability (International Monetary Fund, Working Paper No. 02/46, 2002).
68 Countries have adopted a wide range of different supervisory models. If an integrated supervisory approach is taken, one financial supervisory agency is in charge of the supervision of all different parts of financial markets—i.e., the banking sector, the insurance sector and the securities markets. Under a functional supervisory approach, the functional supervisor of the banking sector will in most financial crises be at the center of the interest, with the supervisors of the insurance sector and the securities markets participating as far as their protégées are concerned. In the U.S., a special system applies in which the supervision of financial institutions is distributed among various agencies.
central bank. In the light of this framework of government organization, the executive, often represented by the treasury or finance ministry (treasury), only has limited direct access to information about the developments in the financial and monetary system. In addition, in a crisis situation, the initial ‘alarm’ that financial stability may be threatened will often come from the independent agencies. In its attempt to contain a systemic financial crisis, the executive thus heavily relies on both the supervisors and the central bank. This raises the question of how to combine executive leadership with information and expertise that are asymmetrically distributed and located almost exclusively in separated agencies. The way to do this is by creating means of cooperation.

2. Credibility

Credibility is another aspect that influences the allocation of responsibilities in crisis containment. As the above decision-making process implies, crisis containment requires swift and clear decisions regarding how to proceed. If the public witnesses profound disagreement among government exponents, panic will be further stimulated rather than contained—or, in other words, ‘public trust has economic consequences.’

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69 The article assumes a functional point of view herein. Even if financial supervision is organizationally located within the central bank, it is still functionally separated from the ‘classical’ central bank mandate focusing on monetary policy. In practice, the two functions are often located in different departments within the central bank.

The credibility of a containment strategy can be undermined if it is subject to political party squabbling.\textsuperscript{71} In contrast, political support is also a necessary precondition of credible crisis containment, but political unity obviously cannot be prescribed at the push of a button. The difficulty lies in finding a balance between limiting political interference during the containment decision-making process and ensuring that at the end of the day, the containment strategy enjoys political support and public trust.

Key to this balance is the role of the supervisors and the central bank. After all, crisis containment remains a highly technical issue. Making containment credible thus implies resting it in the hands of a small number of agents who are considered to have the necessary expertise and wisdom. The independence of the supervisors and the central bank limits the likelihood of interference by politicians.\textsuperscript{72} The executive, in contrast, may not be thoroughly impartial in deciding whether and when to intervene to limit the spread of systemic risk because it may fear being blamed for policy failure.\textsuperscript{73} A cooperative approach can help to mitigate political vulnerabilities because it backs the executive’s way forward with expert opinion.

3. Cooperation

The points raised in the previous paragraphs reveal that extreme financial crisis moments require leadership characterized by technical capability and political authority.

\textsuperscript{71} JONUNG, supra note 26, at 7.

\textsuperscript{72} See Sylvester Eijffinger, Adjustments to the Accountability and Transparency of the Central Bank – Note (European Parliament, Committee on Economic and Monetary Affairs, 2009), at 2.

\textsuperscript{73} GELPERN, supra note 7, at 503.
Simultaneously, it is essential to limit direct interference by party politics, which could delay the creation of a cohesive containment strategy and/or destabilize it once it exists. A cooperative approach involving the supervisors, the central bank and the treasury under the auspices of the executive appears to reflect the optimal allocation of responsibilities. These three agents each have their very own perspective on financial markets, crises and crisis management that is influenced by their specific knowledge and level of independence. Their collective contribution to the containment decision making process thus provides a good chance that a balanced solution results.

The leading part in financial crisis management generally rests with the supervisors. This is where most information about the financial institutions is pooled; it is also where people have distinct knowledge about the handling of institutional financial distress. The supervisors provide insight into financial institutions’ risk exposure and have the legal means to oblige financial institutions to open their books.

The central bank is an important partner in the development of the containment strategy. Beyond their role as lenders of last resort, most central banks are mandated in one way or another to contribute to the maintenance of financial stability. Their perspective is indeed unique in the sense that they are able to picture the crisis and its implications in a broader context. The interbank market provides the central bank with information regarding the interconnections between the individual institutions and their importance for the overall macroeconomy. The central bank is also in a position to consider macroeconomic factors that may influence or be influenced by the disturbances in the financial sector (including the factors it has set itself). This perspective enables the
central bank—more than any other government agent—to assess the extent and transmission of financial shocks.\(^ {74} \)

The treasury again has a very different profile with which it can contribute to crisis containment decision making. As a department of government administration, it represents the position of the executive. Functioning in between the political forces within the executive branch and the independent supervisor and central bank, it constitutes the intersection of technical knowledge and political viability.

In times of financial crisis, the supervisors, the central bank and the treasury have been using more or less informal channels of information sharing and coordination. However, because the failure of these agents to work together actively can have devastating effects for financial crisis containment, it should not be left to their discretion whether they actually cooperate or not. In the case of a financial crisis being a threat to the system, cooperation should be a clear legal mandate.

B. Objectives and Powers

Responsibilities represent the interaction between objectives and powers. On the one hand, agents will not feel responsible for fulfilling the objectives they are mandated to fulfill if their power to do so is insufficient or opaque. On the other hand, if they have

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\(^ {74} \) To strengthen this ability of the government in a general way is exactly what macro-prudential supervision aims to do. For a discussion of the similarities of and differences between the macro-prudential approach and financial crisis containment, see GELPERN, supra note 7, at 506-507.
powers that do not correspond to clear objectives, agents cannot be held responsible when they use their authority in an inappropriate manner.

In financial crisis containment, it is particularly important that the objectives and powers of the agents involved be properly aligned. Those agents who are considered capable of addressing the difficult task of crisis containment must be given the authority (including the necessary financial resources) to react swiftly. The clear definition of objectives and powers also increases accountability. The more clearly their mandate is defined, the easier it is to monitor the performance of the agents. Finally, acknowledging crisis containment as a cooperative mandate also means that how cooperation influences the responsibilities of the individual agents must be defined. Confusion about who is responsible for what delays the containment process and increases panic or—even worse—leads to no action being taken at all.

C. Accountability and Transparency

Given the tight time constraints that an unfolding systemic financial crisis imposes on government agents, standard accountability procedures become inadequate for financial crisis containment.\(^\text{75}\) The large body of literature on accountability in general\(^\text{76}\) and on


that of the central bank in particular \textsuperscript{77} is therefore only of limited use in this particular context. However, financial crisis containment involves the distribution of losses among various constituents for the sake of financial stability and is thus of great social significance. Laying the power to distribute wealth in the hands of just a few government agents requires proper channels of accountability.\textsuperscript{78}

Accountability can be defined as a condition in which an agent is obliged ‘to justify and explain its own actions and decisions, and [can] also (...) be held responsible for them.’\textsuperscript{79} The key problem in the context of crisis containment is two-fold. First, there exists no single generally accepted measure of financial stability, nor is there an unambiguous strategy for counteracting financial instability once a systemic crisis has materialized. Making financial crisis containment decisions thus inevitably involves qualitative judgments. Second, because there is only limited time to adopt measures to contain an unfolding crisis, containment decisions will often lack a complete informational foundation. The process of disentangling financial fundamentals from panic may extend beyond the containment time horizon—especially because financial institutions tend to be reluctant to come to terms with their actual losses. Therefore, a containment decision that seems wrong from an \textit{ex post} perspective (once the crisis has


\textsuperscript{78} Gelpern, \textit{supra} note 7, at 499.

\textsuperscript{79} De Grauwe & Gros, \textit{supra} note 75, at 14.
further developed and more information has been revealed) may have appeared appropriate based on the limited information available *ex ante*.

The first step towards appropriate channels of accountability is designing a reliable institutional setting for financial crisis containment, including the clear allocation of responsibilities, objectives and powers. The next step is controlling the way in which the responsibilities are exercised. This can be achieved through mechanisms of mutual control (among the agents), political control and legal control.

Transparency is often viewed as a function complementary to accountability.\(^80\) It describes the extent to which information related to the different stages of containment decision making is disclosed. Transparency enables the political authorities and eventually the public to scrutinize the policy actions taken and makes accountability enforceable. Again, however, the situation may look somehow different with respect to crisis containment. In a destabilized financial market, the discussion of government intervention may *per se* further stimulate panic and worsen the crisis. Transparency with regard to government action taken to counteract a systemic financial crisis may therefore make the latter more likely to occur.\(^81\)

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\(^80\) *See, e.g.*, DE GRAUWE & GROS, *supra* note 75, at 16, 25-30, who provide a summary of the respective literature.

\(^81\) *E.g.*, TARULLO, *supra* note 10, at 653-654 (footnote 143); GELPERN, *supra* note 7, at 503; in fact, this has been the very argument that both the Bush and the Obama administration has used to justify not thoroughly disclosing the motivation and facts that led to the containment decisions made during the recent financial crisis.
While this potential effect of public transparency should be taken very seriously, it is questionable whether speculations about the government’s strategy are less panic stimulating. As the case may be, the market may anticipate government action, and confidentiality may actually make things worse. It appears that the proper way to handle transparency in crisis situations depends very much on how financial turmoil evolves.

IV. Modeling a Framework

That cooperation is crucial to crisis management is not big news. However, most of the previous studies have failed to provide explanations regarding how a single point of cooperation for crisis management (and for crisis containment in particular) might be institutionalized. The same is true for accountability in crisis containment. This section engages with the question of governance implications, as discussed in the previous section, translating them into a framework for crisis containment policy.

A. Crisis Containment Council

Cooperation can be enacted in many different ways, in organizational terms as well as with regard to the intensity of the collaboration. This article proposes the statutory establishment of a crisis containment council under the auspices of the executive. Membership in the council would be limited to the heads of the supervisory authorities, the central bank and the treasury to provide for rapid and clear-cut functioning. However, the council would have the option to appoint representatives of other government agencies and, if necessary, individuals from the private sector as participants.
on a consultative basis, depending on what further information and knowledge were needed.

1. **Individual Responsibilities Become Collective**

What are the consequences of establishing a crisis containment council with regard to the responsibilities of the council as a whole and its individual members? The council would be required and given the authority to address crisis containment, and the members of the council would be collectively responsible for fulfilling this mandate. One way of introducing collective responsibility is to designate the tools necessary to address crisis containment to the council itself. In such a case, the council would need a separate working group that would be in charge of preparing and eventually executing the containment strategy that the council had decided to adopt.\(^82\)

This article suggests a different approach. In many countries, most of the measures of crisis containment are within the existing scope of authority of either the executive or the supervisors and the central bank.\(^83\) The easiest way is therefore to let the measures be executed by the administration of the particular agent that bears the individual responsibility. However, having a crisis containment council would require that the decision to adopt certain containment measures be made by the members collectively. To that extent, responsibility would become collective.

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\(^{82}\) *See* proposal of Kawai & Pomerleau, *supra* note 10.

\(^{83}\) *See also* Gelpen, *supra* note 7, at 548.
Just like any other ‘special purpose regime,’ the proposed approach entails the inherent difficulty that it must somehow specify a threshold that, when crossed, signals for the members of the crisis containment council to meet and execute their financial crisis containment responsibilities collectively. There are numerous ways in which a threshold can be defined. A soft threshold leaves the agents with discretion to appraise the situation at hand; it necessarily involves an element of judgment. For the establishment of the crisis containment council, a soft threshold could, for example, amount to a test of whether financial markets are experiencing disturbances of a potentially systemic nature. A hard threshold, in contrast, provides clear-cut instruction (often in the form of numerical triggers) as to when the special regime applies. This latter approach has the advantage that it reduces the likelihood that the agents will circumvent the special regime.

As can be derived from the containment decision-making process outlined in section II, discerning which crises threaten to create contagion is not an easy task, nor is the definition of hard thresholds that imply systemic disturbances. An appropriate solution may combine the soft and the hard approach. To limit the discretion of the council members, further criteria (e.g., large deposit withdrawals or significantly increased demand for lender-of-last-resort funds) could be introduced to indicate when disturbances have potentially systemic implications.

A regime based on collective responsibilities would ensure effective cooperation in financial crisis containment among the supervisors, the central bank and the treasury

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and establish an environment of mutual challenge. Judgmental errors would be reduced because different agents (and not just one) would have to assess the need for and viability of a containment strategy. Simultaneously, however, this arrangement would affect, to a certain extent, the sacred notion of supervisory and central bank independence. Shared responsibility for financial crisis containment involves not only information sharing but also giving an account for the individual actions taken. While, for example, the central bank maintains the responsibility for operating its lender-of-last-resort function, the supervisors and (perhaps more delicately) the treasury would be able to use the crisis containment council as a forum to exert pressure on the central bank with regard to the means and extent of its lender-of-last-resort lending.

However, such pressure is also likely to rest upon the central bank outside the formal scope of a crisis containment council.\textsuperscript{85} With a crisis containment council structure, political influence would at least be transparent and thus controllable. Importantly, as far as monetary policy is concerned, the central bank should not be exposed to influence by the crisis containment council, nor should it end up in a situation in which its containment activities conflict with its monetary policy mandate. An

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\textsuperscript{85} For example, a number of voices in the literature and from the practical side claim that the U.S. Fed conducted fiscal policy on behalf of the executive branch during the recent financial crisis; see, \textit{e.g.}, VON FÜRSTENBURG, \textit{supra} note 28, at 26-30; Edward Harrison, \textit{Plosser: The Fed Must Stop Qualitative Easing}, RGE Monitor (Oct. 21, 2009).
important means of limiting the pressure on the central bank is the establishment of adequate funds for crisis containment outside the central bank’s balance sheet.\textsuperscript{86}

2. Financial Resources

Financial crisis containment inevitably causes financial expenditures. In the literature exists remarkable consensus regarding the fact that these expenditures (notwithstanding the funds made available to financial institutions through lender-of-last-resort lending by the central bank) should be borne by the fiscal budget.\textsuperscript{87} Past experience, however, has shown that the operational independence of the supervisors and the central bank does not translate into authority to access additional fiscal resources in the event of a crisis without their having to undergo an often lengthy political process.\textsuperscript{88}

However, crisis containment powers are feckless and containment actions non-credible if they are not accompanied by corresponding funding arrangements. As long as no depoliticized access to containment funds exists or as long as the funds are insufficient, the crisis containment council will be biased in its decision on the right way forward in containing a crisis. For example, it will choose to burden the central bank’s balance sheet by expanding liquidity support rather than employing a recapitalization

\textsuperscript{86} In contrast, making crisis containment a cooperative issue is likely to reduce its spillover effects on monetary policy because it allows one to take into account the consequences of any measure for price stability more explicitly; \textit{see} Eijffinger, \textit{supra} note 72, at 2.

\textsuperscript{87} \textit{E.g.}, Kawai \& Pomerleano, \textit{supra} note 10; Harrison, \textit{supra} note 85.

approach that, although considered more efficient, would mean undergoing the protracted process of requesting funds from the legislative branch. This could not only undermine containment efficiency but also threaten central bank independence.\textsuperscript{89}

As far as the legislative branch delegates responsibilities in financial crisis containment, it should also make available the budgetary means to meet them effectively. An efficient way to do so is the creation of a pre-funding system in which contingency funds are established in advance of need.\textsuperscript{90} The pre-funding system could be accompanied by a short-term funds facility that would provide additional funds if the contingency funds were insufficient. The advantage of this system is that it makes crisis containment expenditures transparent (at least \textit{ex post}) for the taxpayers, who ultimately bear the costs. In some ways, the proposed pre-funding system resembles the proposal of LIPTON regarding a new funding arrangement for lender-of-last-resort lending by the International Monetary Fund (IMF). LIPTON suggests creating a trust fund fed by the Special Drawing Rights (SDRs) allocated to a specific group of large countries, as a ‘last line of defense (...) to defend the international financial system in times of dire threat.’\textsuperscript{91} Similar to LIPTON’s trust fund, the pre-funding system proposed in this article would have

\textsuperscript{89}See VON FURSTENBURG, supra note 28, at 26-30.

\textsuperscript{90}It is of course unclear how the almost inconceivable sums potentially necessary for financial crisis containment can be set aside \textit{ex ante}. Some scholars and policy-makers suggest establishing a pool financed by the financial industry to pay for bailouts of systemic financial institutions.

a governance structure with decision-making powers on the part of the crisis containment council that would permit activation to restore financial stability but prevent activation to support favored institutions.

B. **Mechanisms of Control**

The accumulation of power, if uncontrolled, carries the inherent danger of irresponsible and unreasonable usage. Good governance not only refers to the need for a reasonable organization of the agents but also means that the agents should not exercise their powers thoroughly uncontrolled. This chapter now turns to the question of how channels of control can be created to give the agents involved in financial crisis containment the right incentives to perform their tasks in the best interests of financial stability and social welfare.\(^9^2\)

The ability to establish efficient mechanisms of control despite the dire time constraints related to crisis containment is determined by three criteria. Critically important is the relationship between the members of the crisis containment council—which should be, as this article proposes, one of shared accountability. Oversight by the legislative branch (and to a limited extent by the courts) complements the arrangement of shared accountability. Finally, legal controls in the form of statutory principles help constrain the agents’ discretion.

\(^9^2\) See also LINDGREN, supra note 19, at 103.
1. **Mutual Control: Shared Accountability**

The crisis containment council’s primary aim is to conflate the expertise and wisdom of the heads of the supervisors, the central bank and the treasury in an attempt to provide an informed and balanced diagnosis of the situation. Yet it is also a forum, although small, of mutual challenge.

The ways in which high-level agents can be challenged are obviously limited. It therefore seems reasonable to establish means of ensuring that the members of the council themselves, each of them sufficiently knowledgeable, challenge each other’s opinions. While it is important to pull together, it is dangerous to pull in the wrong direction. The shared accountability of the council members for the containment decisions that they make likely has a positive impact in two different ways: it ensures that the council members pull together, and it increases the probability that they will pull in the right direction. Shared accountability incentivizes them not only to work together actively but also to identify a containment strategy that has the support of all council members. It is hard to imagine the council members not achieving agreement on such strategy; not taking action is not a viable option in crisis containment. Sharing the responsibility for the restoration of financial stability, the members will ultimately have to determine a collective solution, even if it requires certain compromises. The question is therefore how long it will take to reach a consensus rather than whether this will occur at all.

Shared accountability obviously has its limits where the head of the executive overrules the decisions made by the council. In these supposedly rare cases, the
independent members of the council—i.e., the heads of the supervisors and the central bank—would release themselves from accountability by reporting their ‘expert opinions’ to the legislative branch or a special sub-committee, respectively.

2. **Institutional Control: Checks and Balances**

The extent to which checks and balances are part of the government crisis containment decision-making process is likely to affect the outcome substantially. In fact, one would expect that the speed of government action and the way in which this action is designed directly correlate to the number of players involved in crisis containment decision making and that multiple decision makers are less efficient. However, in contrast, checks and balances (because of their association with a more complete representation of social interests) may play an important mitigating role in crisis containment in that they may reduce the potential of overreaction to a crisis and ensure the pursuance of moderate goals.

So far, this article has suggested limiting the influence of the legislative branch on the containment decision-making process by laying it into the hands of a crisis

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containment council whose members share the responsibility and accountability for their containment decisions. The proposal is based on the general assumption that the executive (as well as the supervisors and the central bank) are more interested in defending the stability of the financial system than are the representatives of the legislative branch. The crisis containment decision-making process is thus, to a great extent, depoliticized, as direct interferences by the legislative branch are limited.

However, there are certain channels through which the legislative branch can exert an implicit influence on containment decisions. First, accountability can only be effective in a system that provides adequate checks and balances. After the storm has abated, the crisis containment council should have the statutory obligation to release a report to the legislative branch in which it reveals its decision-making criteria, evidence and other input into its decisions. Even if the legislative monitoring is reactive in that it takes place after the containment measures have been implemented, its sheer availability is likely to affect (albeit imperfectly) the incentives of the crisis containment. With regard to the decisions that fall within the scope of the operational independence of the central bank and the supervisors (although they should be part of the final report to the legislative branch) legislative monitoring and sanctioning powers are of course limited.

96 An alternative would be to provide the legislative branch with summary minutes of the council’s meetings that contain, without attribution, the key arguments. The publication of verbatim records of the meetings would likely constrain the council members from freely expressing their views and ideas; it would, in fact, undermine the notion of shared accountability.

Second, if time constraints allow for it, the legislative branch should be given the opportunity to respond to the envisaged containment strategy before it is implemented. In hearings—held confidentially if necessary—before a small sub-committee of preferably knowledgeable representatives of the legislative branch, the crisis containment council could learn about the relevant political costs and benefits associated with its envisaged measures.98 The legislative branch, in contrast, could ascertain that the crisis containment council ‘knows what it does’ in that it has the relevant information to make decisions and is able to reason its strategy. It could also ensure that the members of the council act in good faith. While such hearings could obviously only take place at very short notice and on a rather informal basis, they might be a valuable platform for the exchange of information and idea-sharing.99

Finally, the involvement of the legislative branch in crisis containment is important not only for control purposes but also to establish the credibility of the containment strategy. If the financial crisis containment program lacks the support of the legislative branch, it is unlikely to be effective in mitigating uncertainty in the market.100 To gain more political credibility and legitimacy, the crisis containment council or the

98 See McCubbins et al., supra note 97, at 258.

99 See also Gelpen, supra note 7, at 547.

100 E.g., Lindgren, supra note 19, at 103-104.
head of the executive may also decide to underpin certain containment measures by legislative action.\textsuperscript{101}

The role of the judiciary branch in crisis containment is more ambiguous. In the political science literature, many authors favor a larger role for the courts and view procedural constraints as a necessary supplement to the ‘dialogue model’ that determines the monitoring by the legislative branch.\textsuperscript{102} Judicial review is undoubtedly an important means of examining the conformity of an agent’s decision with its mandate, with the rights of individual constituents and with democratic values.\textsuperscript{103} In contrast, in the context of crisis containment, the efficiency of judicial review is limited. The judiciary system in general lacks the capacity to handle a potentially great number of cases within a very limited period of time. In terms of feasibility, judicial procedures will thus often simply prove too slow to actively influence the course of crisis containment.\textsuperscript{104} Perhaps worse, judicial review during the crisis undermines the effectiveness and credibility of the crisis containment strategy. Furthermore, the courts lack the technical ability to second-guess

\begin{footnotesize}
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\item For an analysis of the reasons why the Bush administration sought congressional approval for its crisis containment and resolution plan, eventually passed as the Emergency Economic Stabilization Act of 2008, see Posner & Vermeule, supra note 8.
\item E.g., McCubbins et al., supra note 97; Jean-Jacques Laffont & Jean Tirole, The Politics of Government Decision Making: Regulatory Institutions, 6 J.L. Econ. & Org. 1 (1990); see also Quintyn & Taylor, supra note 67, at 30.
\item McCubbins et al., supra note 97, at 245.
\item Gelpern, supra note 7, at 547.
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the crisis containment council’s containment strategy with regard to aspects that go beyond procedural issues.

The implications of these limits to the judicial review of crisis containment policy are quite straightforward. The courts should not be able to halt a containment action that is sought by the crisis containment council and should only be able to review *ex post* whether adequate procedures were followed. In many countries, this will mean excluding certain legal remedies (especially temporary restraining orders) that would normally be appropriate. The interests of individual constituents whose rights are potentially harmed by the crisis containment actions must be subordinated to the government’s efforts to protect the stability of the financial system (which can be viewed as a matter of public interest). In addition, the *ex post* review should only seek to determine whether the crisis containment council has acted within the limits of the law and should not allow the court to reassess its exercise of discretion, notwithstanding manifest errors of fact or clear cases of abuse of power.

It can be expected that the fear of *ex post* legal harassment has detrimental effects on crisis containment in that it intimidates the members of the crisis containment council and prevents them from taking decisive action. For decisions that they have made in good faith, the members of the council should therefore be given immunity from civil

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liability. Instead of their being held accountable in that way, a system of government liability could grant monetary compensation where the containment actions conflict with the rights of individual constituents without proper justification.

3. Legal Control: Flexibility on the Means, Consistency in the Principles

At the core of efficient crisis containment is the ability of the crisis containment council to react quickly and flexibly to emerging systemic financial crises. Rules for how to deal with the complexity of containment and the frequent novelty of the economic circumstances surrounding it may prove impractical and counterproductive and are likely a liability when a crisis hits. In contrast, the limited possibilities for ex ante legislative and judicial control could be compensated for, at least to some extent, by legal constraints guiding the course of containment decision making.

The difficulty of finding the right balance between legally binding the crisis containment council to pursue a policy that serves the public interest and providing it

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107 E.g., LINDGREN, supra note 19, at 103; ČIHÁK & NIER, supra note 43, at 19; see Ross Delston, Statutory Protections for Banking Supervisors (World Bank Group, 1999) for a summary of statutory protections for banking supervisors based on a survey of 20 countries (Australia, Canada, Denmark, Ecuador, Germany, Hong Kong, India, Ireland, Japan, Malaysia, New Zealand, Norway, Philippines, Singapore, South Africa, Spain, Sweden, Switzerland, the United Kingdom, and the United States).

108 I take this phrase with apologies from Damien Gerard, who introduced it in his article on the EU Commission’s approach to handling the numerous bailout packages implemented by the member states at the outset of the recent financial crisis with regard to state aid regulation; see Damien Gerard, EC Competition Law Enforcement at Grips with the Financial Crisis: Flexibility on the Means, Consistency in the Principles, REVUE DES DROITS DE LA CONCURRENCE, at 46 (2009).
with the necessary flexibility to adapt to the particular circumstances of a crisis is tied to the broader debate on rules versus discretion.\textsuperscript{109} The choice between a rule-based system and a discretionary approach resembles the trade-off between hard and soft thresholds for the application of ‘special regimes’ as outlined in chapter 1 of this section. Just as it is impossible to define a hard threshold indicating the systemic nature of a crisis (at least based on current knowledge), it appears impossible (and unreasonable) to create a set of mechanical instructions for containment policy. Just as a soft threshold may prove too vague to prevent the agents from circumventing the special regime, broad discretion may not ensure that the crisis containment council acts according to the public interest.

Again, the solution that this article proposes constitutes a combination of the two approaches. The legal framework should clearly define the public policy objectives (the ‘principles’) that the crisis containment council must pursue while executing its mandate, such as the restoration of financial stability, the protection of taxpayers and the reduction of moral hazard. It should also indicate the hierarchical order of the objectives. The principles, as McCUBBINS ET AL. put it, ‘stack the deck’\textsuperscript{110} in the crisis containment council’s decision making by determining the interests that are to be considered. Thereby, they can influence the distributive outcomes of crisis containment policy. The result is what BERNANKE ET AL. call ‘constrained discretion’\textsuperscript{111} in the sense that the crisis

\textsuperscript{109} See generally TARULLO, supra note 10.

\textsuperscript{110} McCUBBINS ET AL., supra note 97, at 255.

\textsuperscript{111} BEN S. BERNANKE, THOMAS LAUBAUCH, FREDERIC S. MISHKIN & ADAM S. POSEN, INFLATION TARGETING: LESSONS FROM INTERNATIONAL EXPERIENCE (1999), 6.
containment council has flexibility in the means it adopts to contain a crisis but simultaneously has to provide its overseers with convincing reasons for the policy choices that it makes.

C. Communication

In contrast to reporting, which concerns the internal information sharing between the crisis containment council and the legislative branch, communication refers to the information that is provided to the outside world. What information to share with the public during the ongoing decision-making process, if any, is a delicate procedural question because the reaction of the market to the information provided cannot be estimated in advance. The news that the crisis containment council has met to discuss potential containment actions may enhance awareness of dire market conditions and thus increase panic. Still, it could also mitigate evolving panic as market participants become more confident that the worst will not come to pass if the government takes counteractive measures.

Whether they want to inform the public about their initial meetings and assessment of the situation should be left to the members of the crisis containment council. Especially if they disagree in their diagnosis of the crisis, obeying an obligation to work transparently at any price may make things worse. However, as soon as an agreement is reached regarding the general way forward, confidentiality should be limited to circumstances in which public transparency undermines the council’s endeavor
to contain a crisis. For example, the prior announcement of a deposit freeze would
unavoidably lead to bank runs instead of hindering them.

During the overall process of crisis containment, the consistency of information
(or non-information) is essential. Furthermore, the envisaged containment strategy and
especially the reasons for the decisions made must be explained in a way that makes them
comprehensible to different audiences.\(^\text{112}\) To limit the exposure of the members of the
council, an external well-informed spokesperson could be designated and entrusted with
the task.

V. Conclusions

In the literature and in policy-making, financial crisis containment enjoys much less
popularity than crisis prevention.\(^\text{113}\) Crisis containment is considered to refer to policy
actions that should not have become necessary to begin with. However, the reality looks
different. Crisis prevention mechanisms, although increasingly sophisticated, have in the
past proven insufficient to prevent the emergence of systemic financial disturbances.
Once these disturbances culminate in a crisis, governments must have adequate
mechanisms at hand that facilitate clear-cut containment action.

The quotation at the outset of the article addresses this core lesson of the most
recent financial crisis. However, while Secretary Geithner refers to the containment tools
at the government’s disposal, this article has focused on the argument that efficient crisis

\(^{112}\) See Lindgren, supra note 19, at 106-107.

\(^{113}\) See also Gelpern, supra note 7, at 504-505; Archer, supra note 13, at 106.
containment requires a governance structure. In particular, it has outlined the cornerstones of a framework for crisis containment policy. At the core of the proposals is the establishment of a crisis containment council whose members (the heads of the supervisory authorities, the central bank and the treasury) share the responsibility for containment decision making. The aim of the council approach is two-fold. On the one hand, it reduces judgmental errors. On the other hand, it turns crisis containment decision making into an extensively depoliticized process, awarding broad authority to those government agents that have the interest and necessary knowledge to restore financial stability. With regard to control mechanisms, this article has suggested that shared accountability, paired with (albeit limited) oversight by both the legislative and the judiciary branch, give the council members the right incentives to collaboratively decide on a crisis containment strategy that best possibly corresponds with the interests of social welfare.

The proposed framework challenges some well-worn paradigms of crisis management policy. In its attempt to designate clear statutory responsibilities to certain agents, the proposed framework is a countermand to those who still profess abiding faith in the alleged insurance provided by more or less mandatory Memoranda of Understanding aimed toward aligning the responsibilities of the supervisory authorities, the central bank and other government agents in crisis management. Furthermore, in proposing various mechanisms of control, it raises an objection against those who claim that there is no room for accountability in crisis containment policy.
One important question that remains is whether the cooperative approach to crisis containment should become part of a permanent financial stability infrastructure—for example, a financial stability council with a separate working group as KAWAI and POMERLEANO suggest, or rather, whether it would apply on an ad hoc basis. The advantage of the ad hoc approach is its simplicity. The drawback is the uncertainty about when ad hoc applies. In any case, the proposed framework is not to be understood as standing alone. With many countries reconsidering their overall financial stability frameworks, crisis containment—although perhaps the most politically delicate aspect of financial policy—constitutes only one piece of the puzzle. Nevertheless, precisely because its distributive nature continuously provokes so much public debate, crisis containment should be given due consideration in the (re-)design of financial stability frameworks.

A core implication of the suggested governance arrangements for crisis containment is perhaps that financial stability should not be dependent on the authority of one single agent. While the ongoing attempts at supervisory reform tend towards a clear separation of responsibilities between the different agents, financial stability may actually benefit from overlapping responsibilities even if they entail additional compliance costs for the financial institutions and additional costs to ensure adequate means of information-sharing and coordination. (This comment has benefited from discussions with Katharina Pistor). Another implication may be that both the supervisors and the central bank can act as a counterweight to executive leadership. The Obama administration’s proposal for

114 KAWAI & POMERLEANO, supra note 10.
a new resolution regime for major banks incorporates both of these implications, requiring consensus among the executive, the Fed and the appropriate federal regulator. Other proposals are expected to come—and crisis containment should play its part.