

Response to consultation document: *Financial stability and depositor protection*

by Charles M. Kahn

Theory provides two important roles for bank deposits. 1. They are an incentive device encouraging lenders to keep close watch on a bank's soundness. 2. They are a means for generating, from a bank's illiquid portfolio, an asset liquid enough to be usable in payment transactions.

Nowadays, however, the monitoring aspects of deposits have been separated from the transactions aspects. The monitoring role is largely held by other financial institutions that lend to the bank. No one seriously expects small depositors to provide useful discipline on large complex financial institutions.

If deposits are to continue as a vehicle for providing liquidity to consumers, it makes sense to make them absolutely safe. This does not simply mean guaranteeing that the depositors will eventually get 100 pence on the pound. Since deposits are primarily transactions vehicles, delay of access is nearly as damaging as discounted repayment.

Thus the goal should not be to get a failed bank's customers their funds within a week. Instead it should be to get a troubled bank into a regime where its customers never have to open a new account. In order to defend against moral hazard, moving to the new regime should be costly for owners and management, but it should be as costless as possible for depositors.

The FSA thus needs statutory authority to step in *before* actual default looms: the tripwires (be they capital requirements or liquidity requirements) must be set relatively high. The deposit insurance must be, in effect, a callable debt when covenants are violated: at this point, insured deposits become liabilities of the deposit insurer and all non insured deposits and loans are in line behind the insurance authority. As de facto owner at this point, the deposit insurer has power to make decisions, and should make these decisions in large part with the goal of assuring that depositors receive payments services without disruption.

The specific answers I give will be linked to these fundamental considerations. I begin with the most important chapter of the book, chapter 4. Less detailed responses for other chapters follow.

4.1. The establishment of a special resolution regime is the most important part of the entire set of proposals.

4.2. Any regulator will be tempted to avoid closing a troubled institution ("regulatory forbearance"). For this reason there should be *two* tripwires, one where the regulator may establish an SRR; and a second, more stringent tripwire where they *must* do so. Both of these tripwires should be quantitative and specific.

Divided responsibility also encourages inaction. The FSA will have responsibility for the FSCS funds. This responsibility reduces regulatory forbearance and gives them the best incentives to be the sole regulator in charge of initiating the SRR. It is unclear why consultation with the Bank of England or HM Treasury is needed. Of course consultation with the other two units should be permitted, with power given to the FSA to share any data it deems relevant to the decision, but it should not be a requirement. If an SRR is to be set up, time used in consultation will be time for rumors to start and public confidence to deteriorate.

4.3. The regulatory guidance material should also make clear that the quantitative guidelines for special resolution will kick in well before insolvency is imminent.

4.4. The tools in the regime are the correct ones. However, it should be possible for the FSA to inject money. In its role as watchdog for the FSCS, the FSA will want to minimize the cost to the FSCS of a bank failure. FSCS funds should be useable if “public monies” are needed in establishing an SRR for a particular bank, because the SRR will reduce the ultimate cost to the FSCS. Recourse to funds should not typically be dependent on HM Treasury; the Treasury should only be brought in if there is danger of exhausting FSCS funds. In these circumstances, FSCS injection should rank higher than all claims except for deposits.

4.5. The abridgement of property rights of shareholders and creditors can easily be justified on a public policy basis. Requirements for safe and sound operation of a bank (and access to attendant privileges) are within the regulatory sphere of the FSA. The tripwires for initiating a SRR are simply part of those regulations. Moreover the costs to the other stakeholders are minimal: if the tripwires are not breached, then the SRR cannot be initiated.

4.6-9. The safeguards and appeals processes must be associated with compensation of stakeholders once the SRR is put in place. There should be no consideration of such processes to block the FSA’s decision.

4.10. The bridge bank approach should actually be thought of as the default approach to SRR. Although sale to healthy private sector banks is clearly the most desirable outcome, the limited numbers of eligible banks and the likelihood that other banks will simultaneously be under financial pressure mean that the regulator must assume that it will take several months to make a suitable deal. Moreover, the ability to operate a bridge bank is a crucial “threat point” in negotiations with potential acquirers; if potential buyers know that the authorities have no ability to keep a bridge bank going, they can demand fire sale prices.

4.11-12. See 4.5-6.

4.14. While new arrangements for bank insolvency are desirable, they are not critical. Insolvency should not be the typical solution, because it inevitably disrupts access to deposits. Clearly the bridge bank structure will have to be used in the case of large, systemically important banks. It might be argued that insolvency will be acceptable in the case of small depository institutions, but such an arrangement will put their deposits at a competitive disadvantage: depositors will prefer banks with de facto guarantees of continuity.

4.15. If insolvency is only used in the worst cases, continued trading will not be an important consideration.

4.20. Further consideration *must* be given to depositor preference. By placing the deposit insurer low in seniority we may encourage monitoring by the regulator. But we discourage monitoring by lenders. Any loan which ranks equal to or above the deposit insurer is completely safe. Any such lender will never put resources into monitoring a bank. By arranging a loan that is senior to the deposit insurer, the bank and the lender to the bank can shift the monitoring burden onto the regulator. Since the best monitors are likely to be the other financial institutions, this is a serious drawback for the system.

4.26-9. The rules ideally should apply to all deposit taking institutions, mutual or not. My guess is that most of the public make little distinction between large mutuals and non-mutuals. It might be possible to leave very small institutions out of the scheme, though it is unclear what advantage that would give.

4.31. Assessments are appropriate for funding the FSCS (including for the SRR) but since the needs for funding will most likely occur during times of financial crisis, pay-as-you-go schemes are unlikely to be effective, and the regulators themselves will be unwilling to raise the funds from private institutions in those periods.

4.32. Nonetheless, the FSCS is the natural avenue for addressing costs of funding an SRR.

4.33. Large correspondent banks should be required to have a second means of access to the payment system, where “large” is defined in terms of value or volume of traffic. It may be argued that below some critical size banks will find it too expensive to set up duplicate facilities. Thus the Bank of England should consider ways of using CHAPS on an emergency basis in the event of a settlement bank failure. This is possible because 1) the Bank is a member of CHAPS, 2) the Bank holds reserve accounts for almost all banks, not just settlement banks, 3) there is already a facility in place for making transactions by fax in emergency cases. Such a facility could not hope to be flexible enough to handle all payments needs, but it could ensure that clients of the failed settlement bank still had rudimentary access to liquidity.

4.34. The most important would be to structure the bank in such a way that activities insured by FSCS (and systemically important activities) are readily separable institutionally from the other activities. This would facilitate the building of a bridge bank should it become necessary.

Chapter 3

The FSA’s existing powers are sufficient for regulating a bank in normal times. They are insufficient in the case of rapidly changing circumstances, as is the ability to gather information from a bank on short notice. Since the kind of information the FSA will want to gather is information that the bank management should desire on a short notice as well, the costs to a bank ought to be minimal. If the bank claims to be unable to meet these requirements, that in itself should be a sign of concern.

When two institutions have different remits and one gathers information for both, it is practically impossible for the first to judge when the information should be passed along to the second institution. In other words, the second institution must routinely obtain the information and have the ability to access the information immediately on demand. It also means giving the second institution ability to specify additional information to be collected. While a case can be made that some information should not be

passed to the Treasury, in order to insulate financial institutions from government pressures, it is hard to see what justifications there could be for limiting the Bank of England's information.

As a matter of practicality, it must be assumed that information about any liquidity payments will inevitably leak out quickly. To the extent that secrecy is motivated by fear of bank runs by the public, a regime allowing for uninterrupted use of insured funds will make the need for secrecy much less important. And information leaks to other financial institutions will be even more difficult to contain. While useful measures are suggested, such as removing the 'weekly return' reporting requirement, a relic of the days when there was uncertainty about the private vs. public role of the bank, these are of secondary importance.

The question of which institutions should receive the protection is really a question of which institutions offer deposit-like contracts. That means that building societies should certainly be within the regulations for liquidity assistance and deposit insurance. (In particular, Bank of England funds should *not* be counted against a building society's wholesale funding limit). Wherever the line is drawn, however, we can be sure that there will be institutions arising at the edge to enjoy the benefits of regulatory arbitrage. So the boundary will have to be regularly reexamined.

Chapter 5

The compensation limit is not nearly as important as the assurance of immediate 100% repayment.

We do not expect consumers to make detailed comparisons of the safety and soundness of various banks. Compensation limits have no important effect on other aspects of consumer responsibility for financial choice.

FSCS payment should be the exception; again, a bridge bank should be the expected solution. Gross payment should be the standard: there is considerable difference between a mortgage payable over many years and a deposit account accessible day-to-day.

FSCS must be mostly prefunded; initially in order to provide adequate funds, there will need to be a loan from the Treasury to be paid back through annual levies on insured institutions. Alternatively, the arrangement could be made as a standing line of credit from the Bank of England up to a fixed amount.

Above all, financial institutions must be required to emphasize, in advertisements and the like, which of their products (mutual funds, for example) are *not* covered by insurance.

Chapter 6

The proposed "Pushme-Pullyou" structure, where the Bank of England's two responsibilities, monetary policy and financial stability, are directed by two different, independent committees is bizarre. These two responsibilities will inevitably require trade-offs, and this seems to me to require unified decision making at some level of the institution.