Financial stability and depositor protection: strengthening the framework

Response by Alistair Milne, Cass Business School. 23rd April, 2008

This response contains some further personal comments on the introduction of the new regime, prepared in the light our workshop.

1. The urgent goal of the new reforms is to provide the financial authorities, by February 2009, with the powers that will allow them to satisfactorily resolve the problems of bank threatened by failure. A temporary solution was found in February of this year, with Parliament giving the authorities the power to take such a bank into public ownership, subject to the shareholders receiving a compensation determined by an independent assessor. This allowed Northern Rock to be nationalized. But this is only a temporary solution, since this nationalization bill includes a sunset clause withdrawing those powers from February 2009. A longer lasting solution must be found by then.
2. This does *not* mean that all aspects of the new regime should be settled by February 2009. The experience of several countries, reported at the Cass workshop, shows that there are many elements required in order to have an effective regime for resolving threatened bank failures. An effective regime requires not just legislation but also of setting up appropriately resourced institutional arrangements, with a clear allocation of the responsibility for preparing the eventuality of resolving another UK bank failure, and for further developing the institutional arrangements in the UK for handling such a situation if and when it arises. An additional outcome of the current consultation and consequent legislation should be to establish, in outline, these institutional arrangements and provide the opportunity for their further development.
3. In my judgement this key responsibility – preparing for the eventuality of resolving another UK bank failure – does not belong with either the Bank of England or the FSA (whose key responsibilities in this context are that of avoiding such an eventuality in the first place – whether at the level of the UK financial system as a whole i.e. systemic stability , or at the level of individual institutions, i.e. prudential supervision – not that of taking control of a failing institution) Rather it seems to me that this responsibility can be best carried out by the Financial Services Compensation Scheme. While the FSCS may remain closely associated with the FSA, and close contact with FSA supervisors will help them carry out their responsibilities, the legislation should then establish goals, governance arrangements, and adequate resourcing for the FSCS that will allow them to carry out this task.
4. It is remains an open question whether the FSCS, or other body responsible for resolving a bank failure, should operate under a judicial or administrative process. It may be that an

effective legal framework for the UK can be modeled fairly closely on the existing judicial procedures of existing UK insolvency legislation. As I understand these arrangements (I am an economist not a lawyer) the 1986 insolvency act allows a creditor to go to court, and the court in turn can then appoint an administrator to take control of a defaulting company with the responsibility of recovering as much value as possible. The parallel in the case of a bank insolvency would be for either the Bank of England or the FSA to be able to go to court, in specified circumstances, to ask for the FSCS to become the administrator and resolve the problems of the bank at least cost.

5. The Canadian model, where the body resolving a failing bank has the duty of least cost resolution, broadly defined to include costs of financial instability, appears to work well and could be adopted in the UK.
6. The Cass workshop provided a detailed discussion of the legal constraints, notably those of European human rights law, on the ability to intervene in a bank while it still has economic value as a going concern. The key point here seems to be that such an intervention involves the removal of the usual shareholder rights to control a bank (even though the economic interest of shareholders is retained) and hence whatever action is taken must be subject to ex-post judicial review to ensure that these rights have not been removed arbitrarily and that compensation of shareholders is made where appropriate. Whether the UK process is judicial or administrative, the guidelines under which it operates must be clear enough to satisfy such a review.
7. There is a consensus amongst economists, lawyers, and policy makers that a key aspect of the new regime should be to intervene *early* in a bank getting into difficulties, well before all economic value has been lost. This is for two key reasons (i) the threat of such intervention itself provides an incentive on banks to control their risks (implying that there must be clear guidelines for intervention, no one should be surprised when it happens); (ii) early intervention gives the agency resolving a banks difficulties the fairly long period of time needed to prepare for a reorganization of assets or liquidation, should continuation as a going concern turn out not be possible. This must be incorporated into the new arrangements.
8. This in turn implies that the triggers for intervention, while not necessarily "hard wired" into accounting ratios (as in the US system of prompt corrective action) do need to be publicized and widely understood. The rather vague proposals in the consultation document are not, in my view, sufficiently explicit (and may increase the risk of an intervention turning out not to comply with European human rights law.)
9. I have some specific suggestions about how the intervention can be made more explicit (very little of this needs to be in the legislation, most such detail can be left to rule making power of the authorities):
    - intervention can usefully distinguish (a) early stage interference in the governance and control of the bank, with a range of actions ultimately going as far as a conservatorship where it is the authorities not the shareholders who are in charge of the bank (b) late stage bank sale or closure (whether through an arranged merger, transfer of assets to a third party or bridge bank, or liquidation). Separate and explicit triggers should be in place for both early and late stage.

- the UK authorities could base the intervention regime on the already extant system of minimum, trigger, and target capital ratios. Under this system the FSA sets for each bank a total (tier 1 and tier 2) trigger and target ratios higher than the Basel minimum of 8%. These trigger and target ratios are currently set individually for each bank, vary quite a lot from one bank to another, and can be adjusted over time. Although these ratios are not currently published, I understand that the largest UK banks have trigger ratios of around 9% and target ratios of 10%, with the expectation that they will aim to be around the target ratio and that regulatory intervention in business activities will take place if the trigger ratio is breached. This system can be adapted by announcing trigger/ target ratios should be published for different stages of early intervention. Breaching Basel minimum, or some specified ratio below the minimum, should be a trigger for late stage intervention.
- The application for and provision of emergency liquidity support should itself also be a trigger for early stage intervention, while the necessity of providing this liquidity support for a lengthy period, in excess of say four months, should be a trigger for late stage intervention (in my view the consultation document was mistaken to discuss emergency liquidity provision to an individual institution under chapter 3, when this is in fact an indication that a bank is already at the early stage of failure, such emergency liquidity assistance is more appropriately considered alongside the other measures of intervention discussed in Chapter 4).