

FDIC Conference 29 October 2008

I am both grateful and I confess surprised to have been invited to speak to this distinguished conference. I am grateful because I am conscious of the very high quality of the speakers who have been assembled and particularly so because any occasion to appear as a member of the cast in a play when the star actor is Paul Volcker, who has long been my candidate for the title of greatest living American, is a deeply flattering occasion. And I am surprised since, whatever the other events that occurred during my time as chairman of the FSA (and there were many), I am only too conscious that the event with which I will long be associated is the fact that it was on my watch that the first run on a British bank occurred for well over a hundred years. I am not quite sure why Chairman Bair so firmly and charmingly pressed me to speak. But here I am: standing between you and a splendid dinner.

2 What I want to do this evening is not to add to the discussion of what went wrong more generally, or the big picture, which was discussed so impressively and thoughtfully this morning. Rather I want to reflect on what in the UK we learnt - rather painfully - and the lessons we have drawn from this experience. These lessons encompass both quite practical issues - the details that make all the difference between a run on a bank being contained or a run developing - as well as questions of the design of a deposit insurance scheme within the larger context of dealing with financial stability questions. I hope that both will prove of interest.

3 Let me start with the practical issues. To understand them, you have to know the outline of the deposit insurance scheme which existed last August when the problems around Northern Rock began to become acute. Let me recap what Loretta Minghella described earlier today. The UK scheme ensured that the depositors in banks were guaranteed 100% recovery of the first £2000 loss, and 90% recovery of the next amount upto £35000 so that the maximum guaranteed was the rather strange total of £31700. The scheme covered banking, insurance, stock and mortgage broking, and asset management. Historically, the main claims on the scheme had occurred in insurance, with small claims being made on the banking side. Its method of operation laid great emphasis on claimants having their claims carefully assessed to avoid improper payments being made, and consequently payments occurred slowly - at least relative to US practice. And it was a scheme which was not well understood by the British public. One aspect of this was that, insofar as the scheme was understood, it was probably misunderstood: the general perception - if one existed at all - was that the scheme covered the amount that you had in your account, whereas in fact it covered the loss a depositor might face. The two could differ substantially depending on the scale of recovery from the failed institution.

4 What happened at Northern Rock? First, it is important to recognise that the news of Northern Rock's problems emerged in an uncontrolled way - ie there was a leak. It is one of those interesting questions of history as to what would have happened if there had been a controlled announcement: a statement that Northern Rock was a sound institution, solvent, supported by the authorities because of a liquidity problem which the authorities were in a well established way dealing with. But that is not what happened: the news of the bank's problems came out against pictures of emergency meetings at midnight at the Bank of England, a (rather dishevelled) deputy governor being driven away from the Bank in the small hours of the morning, and a statement

the day before from the Bank Governor which placed great emphasis on the issues of moral hazard. None of this was conducive to promoting the sense of calm, control and confidence that would certainly have helped and might even have avoided a run developing .

5 At Northern Rock itself, there were a series of practical problems: the branches were small, with no or little room to accommodate extra tellers; explaining exactly what was covered by the deposit insurance scheme took time; the process of establishing that depositors actually were who they said they were and had the sums - calculated net - that they claimed took significant time; the internet capacity was soon exhausted. These factors combined to make it easy for lines to build up in the street - and lines are photogenic, were first filmed and then played on television and led to further anxieties developing. There is a very interesting analysis of the development of the run which shows that crucial to this was the failure of the Northern Rock website (which was swamped for the four days after the story broke and was for most purposes unavailable for the critical period until the government made clear that it stood behind Northern Rock - something which the Chancellor did on 17 September - helped no doubt by the fact that the US Treasury Secretary stood beside him as he did so): most savers were not concerned to withdraw their cash; most wanted information, not their cash back; many of those who queued did so initially for information rather than to make a withdrawal (and - surprisingly - many who eventually got to the front of the queue then accepted a cheque rather than demanding cash, and so extending their period of liability while the cheque cleared); but all were concerned by the lack of information both from the bank and from the authorities.

6 Now I have dwelt on practical questions because there are some obvious lessons which we have learnt. We now require all our banks to have much better practical arrangements to deal with mounting anxieties: broader internet bandwidth and capacity so that they can deal with a peak which is a multiple of the average website traffic; the ability to divert staff, already pre-trained, from other activities to answering customer enquiries when these rise; the staffing up of branches to enable increased withdrawals to occur without lines developing. Few institutions, I am glad to say, have the acute physical limitations on space which were such a significant factor in Northern Rock, where if more than a dozen customers came into a branch office at one time a line developed in the street.

7 I have dwelt on practical issues because they so clearly mattered, and because on a number of other occasions we have coped with developing anxieties much more effectively. But there are also questions of design which we have addressed. I think it fair to say that in the original design of the deposit insurance scheme, which went in its 2007 form back to 1995, questions of avoiding the moral - and actual - hazard of 100% insurance were uppermost. The then scheme designers were conscious of the US experience during the savings and loans crisis, and of the danger that a 100% deposit insurance carries with it that doubtful banks will simply compete for deposits by offering higher rates. This, rather than avoiding both the political damage of lines in the street and the reputational damage to a country's banking system associated with a bank run (both of which can be avoided by a system of 100% insurance and rapid payout), was the basis of the UK system - a point which British officials liked to make in their discussions round the world.

8 But the disadvantage of this was that there was very limited comfort that could be given when doubts arose about a particular institution. It was, of course, possible to explain that the bank was solvent, and that if it were not it would have been closed. But it is not possible, without a statement from the government that it will in all circumstances make good the position of the depositors, for anyone else to say that in all circumstances a depositor's money is safe. And the statement that in all circumstances your first £2000 is safe - eventually - and that if you have upto £35000 you would lose at worst only just over £3000 was not a clarion call of comfort.

9 In the light of the Northern Rock experience we have changed this, by introducing a 100% guarantee of an initial sum, which was first raised to £35000 and has subsequently been raised again to £50000. We have, incidentally, changed the basis of calculation of the amount covered from a coverage of loss to what we call a rateable system, which protects the first part of a protected depositor's loss. It results in the possibility - indeed probability on any reasonable recovery assumption - that the depositor will recover more than the nominal £50000 cap in due course. I should add that deposits of £50000 or less account for 98% of bank accounts and 97% of building society accounts by number, and for some 60 % of the amount of deposits, though this is obviously a moving figure as depositors respond to the guarantees and their assessment of risk by spreading their deposits between banks.

10 Beyond the technicalities of the specific scheme we, and other EU countries, have responded to the acute difficulties of the last month by actions which have in practice taken us substantially beyond the scope of the previous deposit insurance schemes. Some countries - Ireland is the obvious example - have given an explicit guarantee for all deposits in named banks; in other countries there are what I would describe as "soft" guarantees. That is the UK - and I think in reality the French and German - position. It is a very long, long way away from the concern that was dominant 18 months ago that the deposit insurance scheme should not promote moral hazard.

11 I wish I could say that these individual national proposals had been coordinated, but it is clear that they represent, for reasons that are understandable, the response of individual finance ministers to the problems that they saw in their own countries, and their own assessment of the need for immediate action to give reassurance. And they are only part of the wider support programme that has been established both to provide capital for banks and to provide guarantees for the lending between banks. As I say, we have come a long, long way from moral hazard.

12 I have no doubt that the very acute - I choose my words with care - problems we now face justify the actions that have been taken. But equally we should recognise that they are justified only by the most pressing of circumstances. Unless - heaven forbid - our present circumstances become the new norm we shall one day, and I hope sooner rather than later, have to face how we reestablish the balance between stability and moral hazard. When we do strike that balance, there will be many practical lessons which we will be able to apply.

13 Let me set out some of the issues which should be considered in this wider context.

14 First, it is clear that, other than when the problem is a relatively small bank which has failed for idiosyncratic reasons (a fraud within the bank is the obvious example), the maintenance of banking services requires a system which provides prompt remedial action which cannot be met by a compensation scheme in isolation, but rather requires another institution to take over the services of the failed bank. For the UK, whose banking system is characterised by the dominance of a small number of very large banks and building societies, this is clearly much more important than it is for the US with the much larger part played by so many local banks. But for all countries it is a fundamental constraint which has to be recognised. It raises obvious competition issues, of the sort that chairman Bair referred to this morning, as the implication is that there will be fewer and larger banks.

15 Second, this places emphasis on the legal powers available to the authorities to resolve a failing bank: how to split the good bank from the bad bank; how to take the bad bank into public ownership; how to transfer the good assets to another financial institution quickly. In the UK a year ago we had none of the necessary legislation to achieve this in place and had to introduce special legislation to deal with Northern Rock when it was - eventually - decided that no private sector solution was forthcoming; this special legislation was used recently for other banks, as Loretta mentioned earlier today; it will be replaced by more general legislation now before parliament. The issues associated with the use of these powers are many: the criteria for use of them, the division of responsibility between the various authorities, the residual rights of the shareholders, and the way in which the bank should be run during its period in public ownership. These in a UK context have been discussed in a White Paper published earlier this year and will no doubt be much discussed as the legislation goes through parliament.

16 Beyond this, there is the looming question of how to return to “normal business”: will this occur, country by country, as occurred with the broadening of guarantees, or will it be done on a coordinated basis, agreed internationally? And what will “normal business” actually mean, since it is clear from recent events that, when the position becomes dire, questions of moral hazard have to take a back seat? How, in these circumstances, is it possible to avoid favouring those institutions - whether they are banks or operate in another legal form - which are believed to be too big to fail? Where, for example, does this leave the doctrine of “constructive ambiguity” so dear to the heart of some (but not all) central banks?

17 My general point is that questions of deposit insurance policy have to be seen in the context of the policy towards financial stability as a whole, and as part of the general legal and administrative arrangements for dealing with a failing bank. Perhaps the most important lesson the UK has learnt from the last year is that deposit insurance is not an incidental activity which can be considered through the prism of moral hazard criteria either solely or even principally, but has to be seen as an integral and important part of the design of the overall financial system. Both the practical and the policy issues which arise from the design and practice of deposit insurance are coming to the forefront of policy makers thinking, as - perhaps belatedly - we appreciate how much they matter. All of which makes your deliberations, and this conference, all the more important.