Discussion

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Before discussing Bill's paper, I would like to say a few words about Chuck. Like many others at the Bank of Canada, I have benefited enormously by my association with Chuck. His energy and enthusiasm, his wide-ranging intellectual curiosity, his rigorous approach to understanding issues, his insistence on clear conversations documented in written form, and his deep caring about the Bank and those who work with him make him a truly rare individual. Thank you, Chuck. Now if I had only learned to speak as fast as Chuck, I might be able to make my remarks within the allotted time!

Let me begin by saying how much I enjoyed reading this paper. It is an engaging and wide-ranging study that examines whether changes in financial structure around the world are extending the reach of current components of the safety net. As is often the case when I read a speech or paper by Bill, I found myself wanting to reach for a hard hat in anticipation of an imminent crumbling of important parts of the financial system.

But the paper does raise an extremely important issue for public policy—what mechanisms can be put in place to contain moral hazard when designing safety-net arrangements for the financial sector, both at their inception and in the face of a changing financial system? The paper contrasts the perceived positive role of safety-net arrangements in dealing with a financial crisis versus the longer-run costs associated with the moral hazard of these arrangements. It highlights the need to get these trade-offs right.

I tend to agree with much of what Bill has to say about the financial safety net. That is, the public sector has provided significant subsidies to the private participants in the financial sector through the sometimes questionable design of deposit insurance, banking supervisory arrangements, implicit guarantees, and so on. These subsidies may be

growing, exposing the public sector and taxpayers to the risk of major expenditures down the road as private sector agents respond to the incentives in the safety net.

When I reached the end of the paper, however, I found myself wondering whether much can be done about the situation. In my remaining time, therefore, I would like to focus on a few things that are or can be done from a public policy perspective that may help address some of the concerns raised in this paper and that may reduce the desire to search for our hard hats.

While it is the case that some changes in financial structure may be extending the safety net in undesirable ways, I think that a number of these changes may provide an opportunity to reconsider the design of the safety-net arrangements with a view to reducing the subsidies flowing from the public to the private sector. The following are examples of what I mean.

First, consider the work that has been carried out over the past decade to risk-proof major clearing and settlement systems, a subject that has become near and dear to Chuck's heart. As Bill's paper notes, where a large institution gets into solvency-threatening difficulties, concerns are usually raised about the impact of its failure on payment systems. In these circumstances, public policy makers are often faced with a very painful choice. They could let the institution fail and potentially bring down other institutions through contagion that would be spread through the payment system or other major clearing and settlement systems (and probably destroy these systems as well). Or they can bail out the failing institution, keep these important systems functioning, but face the longer-term consequences associated with the moral hazard of their decision, namely an increased frequency of problems of greater magnitude as the institutions and their creditors become more risk-insensitive as a result of the safety net. It should not be a surprise that public policy makers in these situations typically choose the second alternative, since saving institutions and major clearing and settlement systems at a time of crisis will seem to be worth almost any price. And besides, any longer-term moral-hazard problems associated with this decision are likely to become someone else's problem, making it easy to discount the future costs of the decision.

The risk proofing of major clearing and settlement systems has been, in my judgment, one of the most significant changes in financial structure over the past decade. In virtually every developed country, and increasingly in emerging markets, these systems are built to withstand, at a minimum, the failure of their largest participant. One of the benefits of risk proofing these systems is that it removes the threat that the failure of a large institution would cause these systems to fail because of the contagion effects associated

with the exposures that large institutions have to one another. This, in turn, removes one of the most compelling reasons for public authorities to delay taking action on, or, in the extreme, to bail out, a large institution facing insolvency. That is not to say that public policy makers won't continue to make what many would consider to be short-sighted decisions, and bail out financial institutions for other reasons, but at least the likelihood may be reduced.

Along these lines, it is possible to view the Basel Capital Accord as a means of trying to control the public sector's liability. Bill's paper notes a rather distressing relationship between bank capital and public sector supervision—bank capital has steadily declined (at least until relatively recently) as public sector supervision of banks has increased. Banks have been able to make their promises to repay creditors credible by relying on the "stamp of approval" from government supervisors. In the absence of such approval, banks would have had to use two more costly devices to demonstrate their credibility—first, building a reputation as a sound institution, which takes considerable time and usually means growing slowly, and second, putting more shareholder money at risk in the business (that is, maintaining higher levels of capital, which can be costly). Government supervision, along with deposit insurance, also likely reduces the risk sensitivity of bank creditors, permitting banks to hold more risky portfolios than they otherwise would have if these safety-net components did not exist. Whatever else one may think about the objectives and results of the current and proposed Basel Capital Accord, it seems to me that one very significant benefit of the 1988 Accord is that it served to halt the declining trend in bank capital ratios, and has slowly resulted in increased ratios. One can see this development as a means of protecting the government from the implicit guarantees associated with banking supervision and deposit insurance by raising the "deductible" before the government may be called on to bail out institutions. In addition, higher required levels of capital will also help better align the incentives of banks and society with respect to the amount of riskiness in banks' investment portfolios, because more shareholders' funds will be at risk. In particular, they help reduce the likelihood of "shoot for the moon" strategies being adopted by institutions with very little capital.

In his paper, Bill highlights the concern that exit policies for financial institutions in many jurisdictions still have a significant element of regulatory forbearance. Forbearance can considerably raise the cost of resolving weak financial institutions. However, even here I think we are slowly learning our lessons. Regimes with elements of prompt corrective action, or what we in Canada call early intervention/early resolution, are now seen as an important tool in limiting the costs to the public sector that

are associated with the existence of the safety net. Typically, these regimes involve early supervisory intervention in the affairs of a financial institution once it violates its minimum capital ratio. This action usually requires the institution to recapitalize itself, merge with another institution, or voluntarily liquidate itself. Ultimately, should these actions prove unsuccessful or not be taken quickly enough, the institution is expected to be closed on a timely basis by the supervisor so that there is sufficient capital to cover all creditor claims and liquidation costs, thus virtually eliminating the payout of deposit insurance.

So much for the cautiously optimistic view. While the examples I have provided might give us hope that we are making progress in limiting the public sector costs associated with the safety net, the evolution of deposit insurance should serve as a reminder that there is still much to do. Deposit insurance in Canada was originally introduced with three objectives: (i) to protect small depositors; (ii) to help reduce the probability of runs by insured depositors; and (iii) to facilitate the entry and growth of new entrants into the deposit-taking business by making their promises to repay deposits credible. It is an interesting question as to whether these objectives and therefore deposit insurance remain valid today. When deposit insurance was introduced, a large share of small depositors' wealth was represented by bank deposits. Today, this does not need to be the case, since small depositors can invest in risk-free government liabilities directly or through the use of mutual funds holding such claims, significantly reducing the need to protect small depositors via deposit insurance. Second, the role of the lender of last resort (LOLR) is well understood now and should be sufficient to discourage, or deal with, runs on institutions that are illiquid but judged solvent. Deposit insurance can deal only with the threat of runs by small depositors when typically the real threat is likely posed by larger uninsured depositors. Third, the use of deposit insurance to promote entry by firms lacking a track record in an attempt to generate competition for the large banks, at least in Canada, has, at best, produced mixed results. Indeed, it can be argued that the existence of deposit insurance probably allowed many small deposit-taking institutions in Canada to grow more rapidly and hold a riskier asset portfolio than otherwise would have been the case, and thus contributed to their failures with the large associated costs for the deposit insurer. Of course, deposit insurance was not the only component of the safety net to have played a role in these failures—the absence of an early intervention/early resolution regime also played a critical role.

This discussion underscores the importance of a point in Bill's paper about getting the underlying conditions right before introducing deposit insurance. One of the underlying conditions surely has to be a prompt corrective action regime. Indeed, with such a regime and a well-designed LOLR, it is

arguable that deposit insurance is not needed at all. I am not sure that I would go quite that far. I think that a small amount of deposit insurance may help governments recognize that, in the event of an institutional failure, they will likely pay out small depositors for political or social reasons, and thus a deposit insurance scheme with small limits can provide a means to manage that liability. But instead of seeing proposals to limit the scope of deposit insurance by reducing coverage or to make it more incentive compatible by introducing such things as co-insurance, we are currently seeing proposals to expand the amount of coverage in Canada and the United States to levels that go well beyond anything that could be considered necessary to protect small depositors, as well as the spread of deposit insurance to many more countries without all of the necessary underlying conditions. Now this may not be serious if governments get the supervisory and LOLR regime designed correctly, since in this case, deposit insurance would amount to nothing more than a protection against totally unexpected losses (such as fraud) or supervisory failure that led to institution failure. Otherwise, it could turn out to be quite expensive.

I would like to close with a brief comment about two other subjects raised in Bill's paper. The first concerns the use of the phrase "constructive ambiguity," or perhaps I should say the misuse of the phrase, with regard to LOLR lending. The paper notes that central banks seem to be using constructive ambiguity as a means of dealing with the moral hazard associated with LOLR loans. As conceived, this was probably true—central banks wanted to keep *individual* banks a little uncertain about their access to emergency liquidity assistance. The uncertainty would depend on the judgment by the central banks of the solvency of the borrowing institution and in some countries, perhaps its systemic importance. But surely constructive ambiguity or central bank discretion cannot be intended to mean that there is a randomness to the central bank's policy, as is suggested in the paper. Used in this fashion, the term would permit inconsistent behaviour by the central bank. This would run counter to one of the three principles that Bill endorses in the design of the safety net, namely transparency, which is, in part, necessary to promote accountability by those who administer this portion of the safety net. Central banks that place a high weight on constructive ambiguity are typically very reluctant to publicly disclose the nature of their emergency liquidity assistance policies. This makes it difficult to assess the policies and hold central banks accountable for their behaviour, which may be the real appeal of this notion.

The second area is the importance of designing a *coherent* safety-net arrangement for the financial sector. Bill's paper correctly places considerable emphasis on the need to consider the interaction of the various components of the safety net, and, as is obvious from my earlier remarks,

I strongly agree with this approach. The basic criteria that Ed Kane has put forward and that Bill endorses (that is, safety-net arrangements should address moral-hazard problems with incentives for prudential behaviour; the arrangements should be transparent in design and operation; and costs should be limited, with the public officials in charge of these arrangements being held accountable) strike me as necessary. But I wonder whether they are sufficient. Some of the work we have been doing at the Bank under Chuck's guidance suggests there are at least three other questions one should ask before the public sector intervenes in the financial sector. First, the public sector should not introduce safety-net arrangements except in response to identified market failures. Second, the public sector action must have a high expectation of resolving the market failure. Third, the benefits of taking action must exceed the costs associated with the action. This third criterion is very important and should force public policy makers to consider both short- and long-run benefits and costs in a non-crisis atmosphere. Had public policy makers spent more time doing this in the past, the frequency of the crises cited by Bill might well have been considerably reduced.

Furthermore, these tests should be applied not only at the time the safety-net arrangements are designed, but also on a continual basis. For, as Bill's paper amply demonstrates, changes in the financial structure may well change the benefit-cost assessment of various parts of the safety net.

The paper raises important issues for public policy makers to consider in the design of safety-net arrangements. Policy-makers and researchers need to focus on how to contain and manage the exposures of the public sector created by the safety net in a financial world of growing complexity and blurring distinctions. Bill identifies a variety of crises, some of which may have had their origins in poorly designed safety-net arrangements or in safety-net arrangements that no longer meet their original targets and may be having unintended consequences as the financial sector changes. His paper does not provide a lot of comfort about the future, leaving the impression that both the frequency and severity of financial crises are likely to increase. While I largely agree that a number of factors can be cited to support this view, I think there are also reasons for cautious optimism with regard to the likelihood and nature of future crises. That said, however, I think that I will still keep my financial hard hat close by.