Musings on financial stability issues
An interview with Professor George Kaufman[1]

Prepared by Geof Mortlock, Editor

Professor George Kaufman, the John F Smith Professor of Finance and Economics at Loyola University in Chicago, spent time at the Reserve Bank of New Zealand earlier this year while a Professorial Fellow in Monetary and Financial Economics at Victoria University of Wellington, funded by the Reserve Bank under its visiting academic sponsorship programme. While at the Reserve Bank, Professor Kaufman worked on a range of issues relating to financial stability, focusing in particular on options for dealing with bank distress and failure situations. In that context, the Editor of the *Bulletin* interviewed Professor Kaufman on a range of financial stability issues.

This interview represents an edited version of the interview held with Professor Kaufman and has been approved by him for publication in the *Bulletin*. The views expressed in this interview are those of Professor Kaufman and do not necessarily represent the views of the Reserve Bank.

Editor: *Professor Kaufman, as you know, the Reserve Bank places considerable emphasis on the importance of market disciplines in promoting a sound banking system, including through comprehensive disclosure requirements for banks, maintaining an open and competitive financial system and the absence of explicit government support for banks. What are your views on how market disciplines can be fostered in the banking system, particularly where most of the banks are wholly owned subsidiaries of foreign banks and not listed on the stock exchange?*

George Kaufman: Market disciplines play a major role in promoting a sound financial system by strengthening the incentives for the prudent management of banking risks. The kinds of policies you refer to are all important ingredients in creating the conditions for effective market disciplines. However, as you have observed, there are specific issues that need to be taken into account when considering market disciplines in a banking system heavily characterised by wholly foreign-owned banks, where nearly all of the local banks have no direct public shareholders and are therefore not subject to discipline through the normal equity channel. In the case of wholly-owned subsidiaries, the nature of the market discipline on the subsidiary will depend in part on its size relative to the parent bank. In the case of subsidiaries that are small relative to the parent, the market disciplines are likely to be fairly muted.

One option to strengthen market disciplines on wholly-owned subsidiaries that can be considered is to require such subsidiaries to issue subordinated debt - ie debt that ranks below deposit liabilities and other senior unsecured debt in the wind-up of a bank and thus more likely to suffer losses in a bank failure. This can strengthen the incentives on the managers of bank subsidiaries to manage the bank's risks prudently, given that the pricing of the debt will reflect investors' perceptions of the subsidiary bank's risk profile and quality of management, among other factors, independent of the parent bank.

The design of the subordinated debt will depend on the size and nature of the bank, among other factors, including

1 Professor George G Kaufman, the John F Smith Professor of Finance and Economics at Loyola University Chicago, was the 2004 Professorial Fellow in Monetary and Financial Economics at the Reserve Bank of New Zealand and Victoria University of Wellington. In addition to a distinguished academic background, Professor Kaufman has considerable experience of working in central banks, and has been a consultant to, and visiting scholar at, a number of US public sector and policy institutions. He has also served on the boards of directors of two US banks. Professor Kaufman's recent research has covered issues relating to banking regulation and the management and prevention of bank failures and financial system distress. He has also written on monetary and financial economics, and on a variety of topics relating to the banking and financial systems.

the likely demand for such debt and the depth of financial markets. For example, a large bank operating in a country with deep financial markets could issue subordinated debt periodically in wholesale markets, where trading in the secondary market provides considerable scope for the market price of the debt to change depending on the market's perception of the bank's risks and quality of management. In a smaller market, where there is insufficient secondary trading to establish a reliable price mechanism, it may be desirable to require banks to issue tranches of debt in the primary market at regular intervals.

In general, subordinated debt should not be issued in the retail market, given the possibility that, in a bank failure situation, the government could extend rescue support to retail holders of subordinated debt. It is therefore preferable that such debt be issued to the large, institutional investors in the wholesale markets. In any case, it would be essential that the subordinated debt is structured in a way that makes it unambiguously subordinate to all other debt claims on the bank in question, so that the holders of such debt have strong incentives to monitor the bank issuer and to exert discipline through the pricing of the debt, whether in the primary or secondary markets.

Editor: *Another mechanism for encouraging market disciplines on banks is to require banks to issue public disclosures on a regular basis, covering their financial position, performance and risk positions. Do you have any views on the effectiveness of disclosure as a mechanism for promoting strong market discipline in the banking sector?*

George Kaufman: Disclosure is undoubtedly an important element in promoting effective market disciplines in the banking sector. In a well-functioning market, banks, like other corporations which obtain funds from the market, will have market-based incentives to issue public disclosures, without the need for regulated disclosure. However, where the market operates on the presumption that banks may be bailed out by the government, then it may be necessary to require banks to issue disclosure statements so as to ensure that the market is provided with the information required to assess the risk profile and quality of management of the bank.

Requiring mandatory public disclosure of financial and risk-related information will be of limited effectiveness unless there are investors, creditors or financial analysts who make use of it. This is where it becomes important to educate depositors and other providers of bank funding that they do face a risk of loss when lending to a bank. But for this to be credible, it is necessary to maintain a framework for dealing with bank distress and failure events which does not involve unlimited government support. Large depositors and other creditors of banks need to be persuaded that they stand to lose some of their money in a bank failure situation. But more on that issue later.

In addition to the need to have a framework for dealing with bank failures where government support is limited, a disclosure-based approach to market discipline also benefits from other initiatives, such as encouraging financial analysts and the financial news media to make use of and correctly interpret banks' disclosure statements. And this is where there is a need for some caution. There is an increasing tendency in many countries to require banks and other corporations to make increasingly comprehensive and complex financial disclosures. This can create a risk of information overload, where key information is buried in a mass of complex detail. I would therefore urge a careful design of bank disclosure requirements, so that a "wood for the trees" problem is avoided. Banks should be encouraged to issue disclosure statements where key financial and risk-related information can be quickly and easily identified, without the need for the investor or creditor to peruse many pages of detailed information.

It is important to bear in mind that, as with any regulatory initiative, disclosure requirements impose costs as well as benefits and should be subject to cost/benefit tests, so as to avoid imposing excessive compliance costs on banks.

Editor: *It is not possible to have a meaningful discussion of market disciplines in the banking sector without covering the issue of deposit insurance. As you are aware, New Zealand is one of the few developed countries that does not have* *deposit insurance for banks or other deposit-taking financial institutions. Professor Kaufman, what are your views on deposit insurance? Do you think the absence of deposit insurance in New Zealand is a positive factor, reinforcing market disciplines in the banking sector, or does it create risks for the banking system?*

George Kaufman: Although New Zealand has no explicit deposit insurance, it is arguable that there is implicit deposit insurance in the banking sector. This stems from the presumption that many depositors are likely to have that the government would not allow depositors to lose money in a bank failure situation. This might be an incorrect presumption, but it is nonetheless likely to influence the way many depositors behave in relation to their banking arrangements. And in a bank failure situation, it needs to be remembered that depositors can exert significant political influence on a government, sometimes leading to the government being pressured into bailing out a bank in distress. For these reasons, it is unlikely that all depositors adequately price banking risk into the deposits they place with banks. This inevitably reduces the market discipline on banks that could otherwise arise from depositors.

Given the political pressure that inevitably applies to governments in a bank failure situation, and the risk that this can lead to a bail-out of all bank depositors, I think it is preferable to have ex ante deposit insurance, but only for small depositors. This offers a number of benefits. It reduces the political risk associated with a bank failure and enables the authorities to resolve a bank failure in an economically sound way with less risk of political interference. It enables a firm cap to be placed on the amount of a bail-out of depositors, such that the insurance applies only up to the maximum level specified in the insurance scheme. It also enables the authorities to more convincingly state that larger uninsured depositors and other creditors will not be bailed out.

In order to give force to the argument that large depositors and other creditors would not be bailed out in a bank failure situation, I think it would be desirable to introduce some very high hurdles in legislation to make it more difficult for governments to protect these claimants at banks in financial distress. This would assist to reduce expectations of bank bail-outs and help to strengthen market disciplines on the banking system. It is the kind of structure that now applies in the United States.

I would further suggest that, where a decision is made to rescue a failed bank and losses are incurred, it may be desirable to require survivor banks to provide all or some of the funding for the rescue. This would reduce the burden on the taxpayer and further assist in strengthening market disciplines in the banking sector. A survivor bank contribution to a rescue support package can be justified on the grounds that survivor banks might derive benefit from such a bail-out, given the reduced disruption to the financial system compared to a situation where a major bank is allowed to fail. However, I acknowledge that the notion of a survivor bank rescue arrangement presents particular challenges in a banking system like New Zealand's, given the fact that it is highly concentrated and that the cost of a bail-out would be spread over only a few banks.

Editor: *If New Zealand were to adopt deposit insurance in the future, careful consideration would need to be given to the design features of the insurance arrangements, such as its funding structure, whether insurance premiums should be risk-based, and the limit of the insurance cover. Do you have thoughts on the se matters?*

George Kaufman: There is a good argument to suggest that the insurance cap should be set at a relatively low level so that it offers protection to those least able to protect their interests and yet minimizes the political tensions associated with bank failures. A low cap helps to limit the adverse effects on market disciplines and moral hazard risk-taking associated with deposit insurance schemes that apply to large-value deposits.

There is probably also merit in designing the insurance scheme to avoid its application to multiple accounts held by the same person or household. For example, there is scope to design an insurance scheme so that the insurance limit applies to deposits on a household basis, with a maximum cover per household.

The funding arrangements for a deposit insurance scheme also warrant careful consideration. Deposit insurance can be funded ex ante or ex post. An ex ante funding structure would involve a deposit insurance scheme charging a fee for deposits on an ongoing basis with a view to building up a fund to meet the costs of any future insurance payouts. An ex post funding structure would involve no ongoing fees, but would require banks (and any other deposit-takers covered by the scheme) to make payments into the scheme to meet any insurance claims on it. A third option would involve a combination of ex ante and ex post funding arrangements.

Arguments can be made for and against ex ante and ex post funding arrangements. For example, it is generally agreed that an ex ante funding structure involves greater administrative expense and imposes greater ongoing costs on depositors. There may also be a temptation to use any fund that already exists to protect claimants that may not occur if the funds had to be raised from scratch. Equally, however, an ex post funding structure could prove to be expensive in the short-term for survivor banks following the collapse of a major bank. In addition, the guilty parties escape payment as they have disappeared from the scene.

Much has been written on the issue of whether the deposit insurance fee should be risk-based or simply a flat fee regardless of risk. Again, there are arguments for and against risk-based fees. In theory, a risk-based deposit insurance premium can help to strenghten the incentives for prudent risk management by rewarding banks with lower risk profiles and penalising banks with higher risks or poorer quality risk management capacity that are more likely to lead to insurance losses. But I do see some difficulties associated with risk-based fees. For example, risk-based fees tend to be backward-looking rather than forward-looking, and therefore do not necessarily create the kinds of incentives that one would wish them to create. Moreover, there is almost inevitably a degree of opacity associated with a risk-based fee, making it difficult for depositors and others to interpret the reason why one bank's fees are higher or lower than another's.

What ever fee structure is adopted, I think it is important that the structure is relatively simple, transparent and understandable. For example, one option could be to base a deposit insurance fee on the interest rate on a bank's subordinated debt or uninsured senior debt. A fee could, in theory, be based on a bank's credit rating, but this raises inevitable questions about the reliability of credit ratings and the objectivity and independence of rating agencies.

A further difficulty with risk-based fees is that they tend to ignore the fact that some of the risks associated with banks are endogenous and able to be influenced or controlled by the insurance agency or banking supervisory authority. Thus, losses from insolvency are not independent of the length of time after insolvency that the regulator waits before imposing statutory management or receivership. It could also be argued that a risk-based fee raises some conflicts of interest for the insurance agency or supervisory authority. Higher risk fees could be seen by some as an indication that the insurance agency or supervisory authority has failed in its task of encouraging sound risk management practices within banks.

Editor: *Can we now turn to another issue of interest in the area of managing financial system distress – prompt corrective action. In the United States and some other countries, prompt corrective action frameworks have been introduced, such that supervisory authorities are required to take particular actions when a bank's financial condition deteriorates. Professor Kaufman, do you have views on prompt corrective action frameworks?*

George Kaufman: I see some important benefits in a regulatory prompt corrective action (PCA) framework. PCA can help to simulate market discipline in the banking sector, especially in countries where market disciplines in the banking sector are relatively weak. PCA forces the supervisory authority to take the kinds of actions that the market would typically take in a situation where a government rescue of a bank is not expected - including imposing restrictions on the activities of an under-capitalised bank, restricting distributions to shareholders and requiring the bank to take steps to restore its capital level to an acceptable position. In situations of extremely low or negative capital levels, PCA forces the authorities to resolve a bank, which is a parallel to what the market would do in the absence of implied government support. There is evidence to suggest that PCA helps to reduce both the number of failures and the expected level of loss in bank distress or failure situations.

PCA also provides an opportunity for a troubled bank to be turned around, giving it a greater chance of resurrection than in the case of a bank allowed to drift along in a weakened state. PCA reduces the scope for regulatory forbearance. This is important, given that banking crises around the world have revealed a strong tendency for supervisory authorities to delay taking corrective action in situations where they have had the flexibility to indulge such delays. This has often resulted in greater costs to the taxpayer than would have been the case had early corrective action been taken.

In the United States, PCA is based primarily on the level of a bank's total and risk-weighted capital ratios. The PCA framework involves two kinds of sanctions for banks - those of a discretionary nature and those that are mandated by legislation. Both apply at pre-defined points of capitalisation. Although the PCA framework was met with a sceptical reaction upon its introduction in 1991, it is now generally recognised as a positive development and has been accredited with reducing the cost of bank failures and restoring a measure of regulatory discipline to the US banking system.

I know that the New Zealand supervisory arrangements include a limited PCA framework and that this is based on a bank's level of risk-weighted capital. Although this is a useful framework, I think there is scope to increase its effectiveness. For example, it might be desirable to have some supervisory actions triggered by events other than a bank's level of risk-weighted capital. I also see merit in increasing the number of capital trigger points for supervisory responses. It would also be desirable to consider the merit of requiring a bank to be legally failed when its capital falls below a pre-specified level, so that the discretionary element is largely removed, and to incorporate a requirement for more rigorous supervisory examination of a bank, either by on-site examination by the supervisor or through a third party, when a bank's financial condition deteriorates to a specified low level.

Of course, in developing a PCA framework, there is a need for a sensible balance to be struck between a framework that requires early corrective action by the supervisor, and avoiding an excessively intrusive approach to the regulation and supervision of banks and the development of an excessively complex set of prompt corrective action triggers. As with any aspect of regulatory design, getting the balance "right" in the design of a PCA framework is important.

Editor: *Can we now turn to the issue of the jurisdiction in which a bank is incorporated. As you know, the Reserve Bank of New Zealand now requires all systemically important banks to be incorporated in New Zealand. We require this for a number of reasons, including that it facilitates more effective supervision of a bank, it provides greater certainty of outcome for depositors and other creditors of the bank, and it better facilitates the management of a bank failure. Do you have any views on this policy?*

George Kaufman: I agree that requiring systemically important banks to be incorporated in New Zealand generally makes good sense from a supervisory perspective. Local incorporation of a bank assists the supervisor to apply supervisory measures on a more effective and meaningful basis than is generally possible in the case of banks incorporated in other countries and operating in New Zealand as branches. It is also likely to be the case that a supervisory authority will have greater capacity to manage a bank distress or failure event where the bank is locally incorporated than when it is a branch of an overseas bank, not least because of the ease with which assets can be moved from the branch to the foreign-based parts of the bank in the case of a bank incorporated offshore and operating in New Zealand as a branch.

Against these benefits of requiring local incorporation needs to be weighed the likely operational benefits of allowing banks to operate as branches, including the enhanced operational efficiency generally associated with a branch.

Requiring banks to incorporate locally can therefore impose efficiency costs on a bank, with potential flow-through effects to the clients of banks in terms of higher costs for some banking services. Another factor that needs to be borne in mind when considering the pros and cons of requiring a bank to incorporate locally is the issue of probability of failure. It is arguable that a bank operating as a branch has a lower probability of failure than a bank subsidiary, primarily because of greater asset diversification. Against that, however, is the greater difficulty in resolving a bank failure when the bank is a branch than when it is a subsidiary, as we discussed a few moments ago.

On balance, I think there are sound reasons to require systemically important banks to be incorporated locally rather than operating as branches of the foreign bank, given the greater scope local incorporation allows for effective ongoing supervision of the bank in the host jurisdiction and the greater capacity for dealing promptly and effectively with a bank failure situation.

Editor: *Having now worked with the Reserve Bank for nearly two months and having acquired a good understanding of the New Zealand banking system and supervisory framework, you are in a good position to give us the benefit of your thoughts as to any future areas of the supervisory framework that you think would benefit from attention. Are there any particular areas you would recommend the Bank give its attention to in the future?*

George Kaufman: There are three policy issues that I think would benefit from further attention in New Zealand.

First, I would encourage the Reserve Bank in its work to further develop its capacity to respond effectively to a bank distress or failure situation. I think it is important that central banks and supervisory agencies have well developed policies in place for dealing promptly and effectively with a bank distress event, including mechanisms for:

- prompt recognition of an insolvency and legal closure of a bank;
- the ability to promptly apply a haircut to large depositors and other creditors to absorb losses;
- the ability to promptly re-open a bank post-haircut, if necessary under temporary government ownership, so that depositors have almost uninterrupted access to the values of their funds and borrowers to their credit lines; and
- prompt reprivatization with a new ownership and capital structure or, in rare cases for small banks, liquidation.

Effective failure management capacity that minimizes long-term costs requires central banks and supervisory agencies to have "plans on the shelf" to deal with a range of different failure situations. It also requires regular training of staff to deal with bank distress and failure situations, including through the use of simulated bank failure exercises. If one waits until the failure is imminent or has occurred, political pressures of the day make it likely that inefficient solutions focusing on minimizing only short-term costs will be adopted.

Second, and related to the above, I would encourage the Reserve Bank to review and expand its prompt corrective action framework so that it has a well-established set of procedures for early intervention in a situation where a bank is experiencing continued reduction in its capital or otherwise showing signs of financial distress. It is important for a supervisory authority to be prepared to intervene at an early stage before the bank is too weak to survive.

Finally, I would suggest that the Reserve Bank could usefully assess whether it might be sensible to introduce limited explicit deposit insurance in New Zealand. I believe the current situation, involving potentially uncapped and unpriced implicit insurance, is not particularly satisfactory and could be very costly to taxpayers and impede the effective resolution of a bank failure situation in the future. I therefore think it would be desirable if serious consideration could be given to assessing the costs and benefits of alternative forms of explicit deposit insurance for small depositors.