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The Option Clause in Scottish Banking

A Comment by George Selgin and Lawrence H. White

A key question raised by the modern literature on laissez-faire money and banking is whether unregulated fractional-reserve banks could protect themselves from bank runs by purely contractual means. If so, banking stability would not require government to provide deposit insurance or to act as a lender of last resort. One possible run-proofing device discussed in the literature is an "option clause" or "notice of withdrawal clause" allowing a bank temporarily to suspend the redeemability of some or all of its liabilities (notes or demand deposits) provided the bank pays a prespecified (penalty) rate of interest on the suspended liabilities. Before the practice was outlawed in 1765, many Scottish banks issued notes bearing option clauses.

In an informative "reappraisal" of the option clause in Scottish banking, James A. Gherity (1995) suggests that his findings contradict other recent discussions. In particular, Gherity disputes three propositions that he attributes to us and others:

1. that option clauses were vital to preventing runs in Scotland;
2. that run-proofing was the purpose that motivated Scottish banks to employ option clauses; and
3. that option-clause notes were accepted by the public without prejudice.

To set the record straight, we note here that we and several other authors Gherity cites have in fact avoided making claims 1 and 2. The conflict between Gherity's view and ours is thus much smaller than he suggests. We would defend claim 3, however, and argue that the evidence Gherity offers against it does not suffice to refute that claim.

1. The Potential and Historical Roles of the Option Clause

An option clause can keep a solvent bank from being run upon by providing a contractual "circuit breaker." By allowing an illiquid bank to suspend for enough time to liquidate assets without fire-sale losses, it prevents a run from forcing a sol-

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vent bank into insolvency, and thus prevents "bubble"-type runs associated with self-fulfilling prophecies of run-caused bank failure. (It does not prevent runs on already insolvent banks.) The possibility of a self-fulfilling or "bubble"-type run is of course the focus of Diamond and Dybvig's (1983) oft-cited model.

Gherity acknowledges that the option clause may *potentially* prevent runs. He denies, however, that the option clauses employed during the Scottish free banking era *actually* provided important protection against runs, a claim he attributes to several writers including one of us. In fact, the writers he cites have avoided making this claim.[1] We and others who have discussed alternative contractual run-proofing devices [for a survey see Selgin and White (1994, pp. 1727–30)] have noted that runs have *not* historically been a problem in relatively free banking systems, including Scotland both before and after 1765 (Selgin 1994). We have attributed the run-proneness of certain other historical banking systems to regulatory restrictions (Selgin 1989; White 1986). Our position has thus been that free banks *could* use option clauses to protect themselves from "bubble"-type runs, but chances are (and evidence from the Scottish system after 1765 indicates) that the banks could also avoid runs without option clauses.[2]

There is thus no conflict between our view of the option clause and Gherity's finding that the decisions to place option clauses on Scottish notes were originally motivated by a concern other than runs, namely the banks' desire for protection against note-redemption "raids" launched by rivals.[3] In fact, at least four of the writers Gherity cites have plainly stated that the Bank of Scotland introduced the option clause in 1730 to protect itself against note raids (White 1984, p. 26; Schuler 1992, p. 25; Selgin 1988, pp. 31–32; and Dowd 1988a, p. 328; 1989, p. 121).[4]

1. Gherity (1995, p. 714) specifically cites Dowd (1988a, 1988b, 1989), Schuler (1992), and Selgin (1988), unfortunately without indicating the numbers of the pages on which he believes them to have made the claim. Although Selgin and Schuler both refer to the *potential* ability of option clauses to avert bubble-type bank runs, their only statements concerning the *historical* role of option clauses in Scottish banking (Schuler 1992, p. 25; Selgin 1988, 31–32) refer to their use in discouraging note raids. In one work cited by Gherity, Dowd (1988a, 330–31) merely states that the evidence "is not obviously at variance" with the hypothesis that option clauses could play a stabilizing role. Elsewhere Dowd (1989, p. 119) does say that the prohibition of option clauses in 1765 made Scottish banks "vulnerable to runs." Given his own recognition elsewhere (Dowd 1988b, p. 34) that runs did not actually become a problem for Scottish banks after 1765, we grant that Dowd should instead have said only "potentially more vulnerable to runs."

2. Thus Gherity (1995, p. 714) was on the right track when he briefly wondered "whether it is meant that we should understand only that the option clause was *capable*, under certain circumstances, of providing stability."

3. In a note raid, Bank A accumulates notes issued by rival Bank B, until one day it surprisingly presents a large amount for redemption, hoping to drain Bank B of reserves, force it into an embarrassing suspension of payments, and thereby gain market share at B's expense. (When B retaliates in kind, a note *duel* is on.) Deferring such a redemption demand, by means of the option clause, gives Bank B time to liquidate sufficient assets to meet the demand. Meanwhile B can continue to redeem for its regular customers. Because it renders the raiding tactic futile, the option clause can stop raids from ever being launched, and thus can do its job even without being invoked. Because a bank concerned to retain its clientele wants to avoid invoking the option clause except in extraordinary circumstances, the clause does not impede the normal self-regulation of the note issue (as discussed in Selgin 1988 and White 1984).

4. An exception is Dowd (1988b, p. 35), who contradicts his own (correct) statements elsewhere by saying that option clauses were "apparently" adopted by Scottish banks as protection against runs.

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2. Were Option-Clause Notes Willingly Accepted?

The claim that option-clause notes were accepted willingly or without prejudice means that the Scottish public, or at least part of it, accepted at par some notes that carried a risk of becoming postdated interest-bearing claims. They were willing to do this not just because (as Gherity proposes, p. 719) they reasonably believed that the risk of the clause being invoked was low, but because they believed the risk was low *in comparison to the benefit*, namely, security against raid- or run-induced bank failures. The proposition that bank customers willingly accepted the presence of the clause ex ante (as distinguished from the *invoking* of the clause ex post) is wholly consistent with the facts, noted by Gherity, that the option clause was rarely invoked, and that optional Bank of Scotland notes circulated easily for decades even while nonoptional Royal Bank notes were available. It is also consistent with Gherity's evidence that ordinary members of the public did not want to have the clause invoked against *themselves* as individuals, despite the interest they would earn on suspended notes. They accepted the clause because it could be beneficially used against *others* who might drain the bank.

Gherity (p. 719) asks why, if some bank customers did in fact prefer optional notes, so few opposed the prohibition of the option clause in 1765.[5] It is not clear from Gherity's account that the public was well informed in advance that the prohibitory legislation was in the works, so simple ignorance of the pending change may explain the lack of public protest from the clause's potential defenders before the Act of 1765 was passed. Resignation to the change may have prevailed afterward. Furthermore, even if the public had been informed in advance, lobbying efforts against the legislation would have had the character of a collective good—the benefits of preserving the clause would be almost entirely external to any individual customer, and largely external to any single banker—so that each may have chosen to free-ride on the efforts of others.

3. Conclusion

James A. Gherity's investigation of the option clause in Scottish banking usefully reminds us that the clause was originally designed to prevent note raids rather than runs. It incorrectly suggests, however, that those who have recently written about option clauses have failed to recognize this origin, or have exaggerated the historical role of the clause in preventing bank runs. Finally, Gherity does not succeed in rebutting the view that option-clause notes were accepted by the public without prejudice.

5. If the banks benefitted from increased stability, a referee asks, why did they themselves not fight the legislation? The provincial banks in fact expressed eagerness to have the option clause banned. Gherity (p. 723) suggests an explanation: the existing Scottish banks wanted abolition of the clause as a barrier to new entry by less reputable banks. He notes that the option clause helped the notes of new banks to "drive the notes of the genuine bankers out of circulation," that is, to gain a larger share of the circulation. We read this as evidence that the clause made the new banks' notes more attractive (because less raid- and run-prone).

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