Banking reform five years on

John Vickers

All Souls College, Oxford

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Banking reform five years on: plan of talk

- How did it all go so wrong?
- Banking reform: where have we got to so far?
- Unfinished business I: capital and loss-absorbency
- Unfinished business II: structural reform
- Some interim conclusions

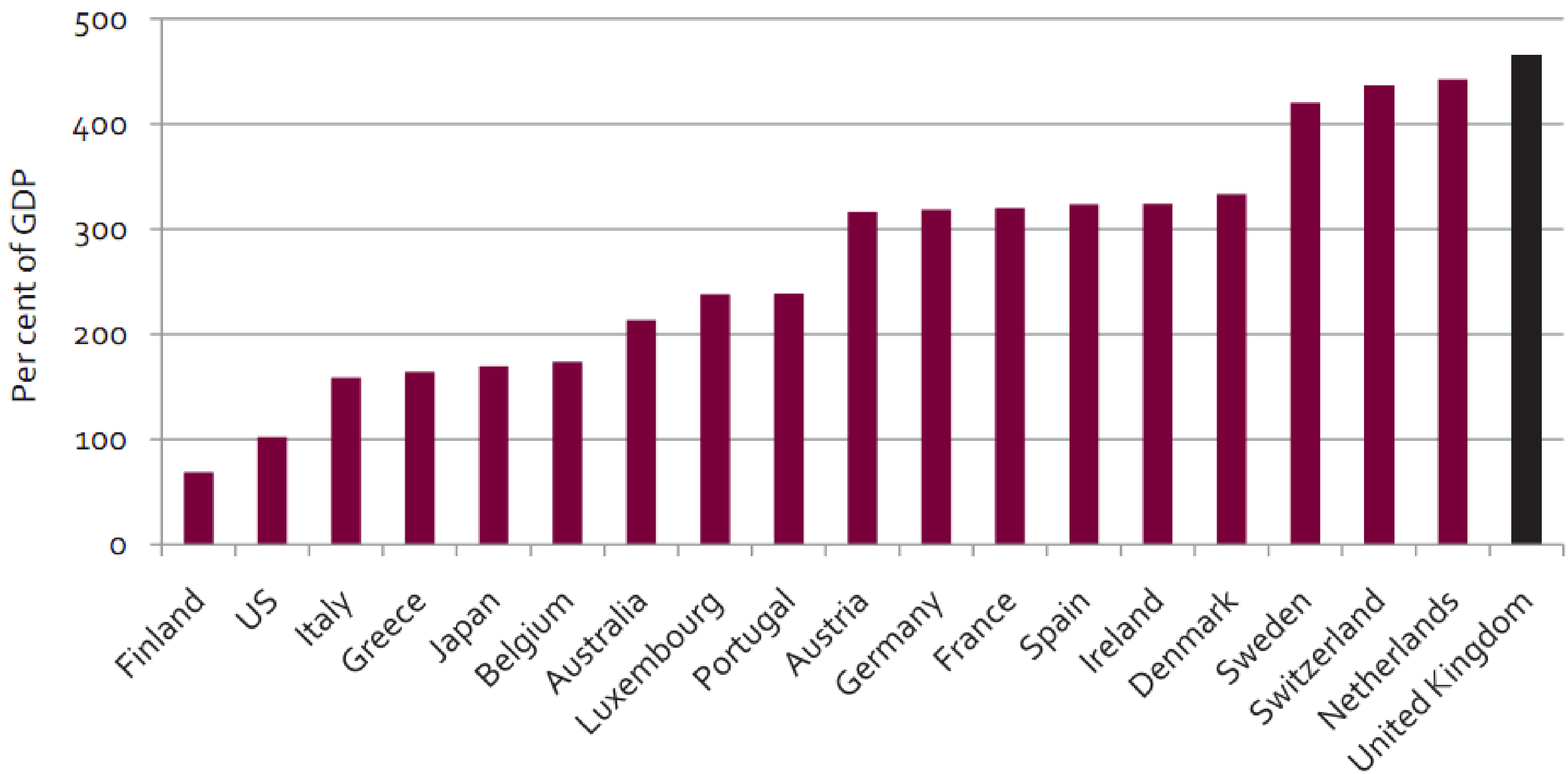
How did it all go so wrong?

The financial system and role of banks

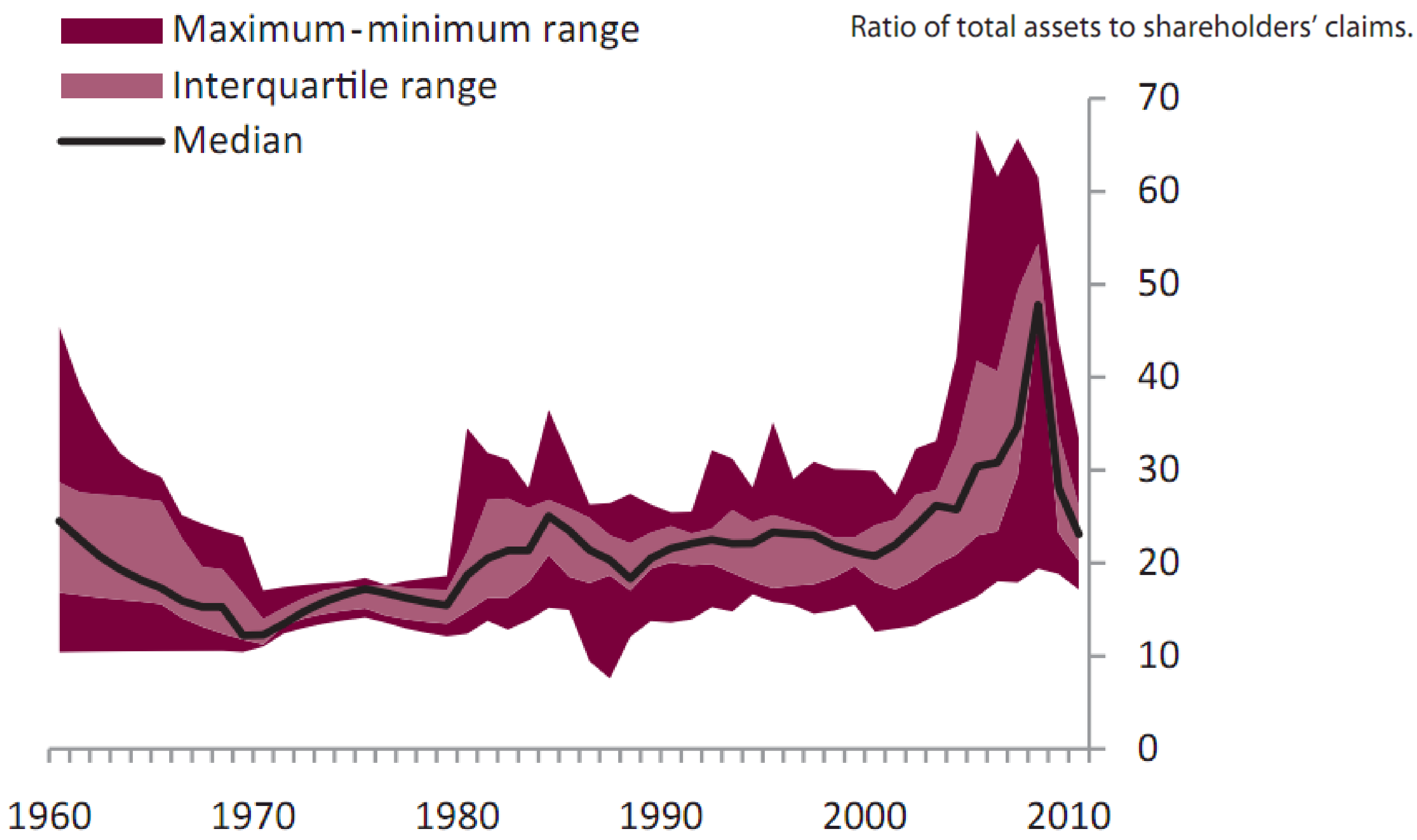
- The financial system supports the wider economy by:
  - providing payments systems
  - providing deposit-taking facilities and a store-of-value system
  - lending to households, businesses and governments
  - helping customers manage risks &c
- Banks play a central role in all of these functions
- Banks can be especially sensitive to economic shocks
  - take on credit risk , market and maturity/liquidity risks
  - operate with (much) more debt than non-financial firms

Relative sizes of banking sectors

Domestic banking assets as a percentage of GDP consolidated by nationality of headquarters (2009)



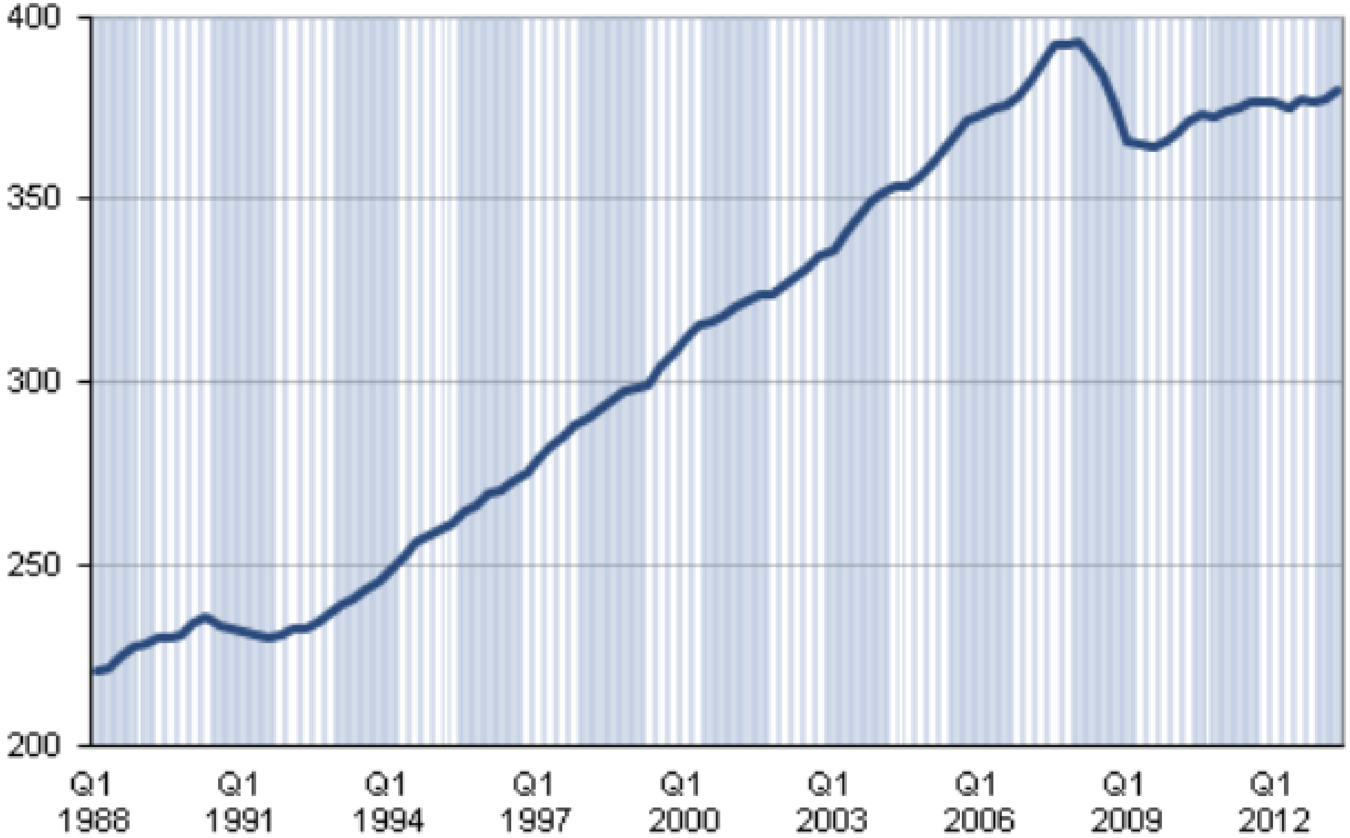
Increase in UK bank leverage in the past fifty years



Banking system ill-prepared for global financial crisis

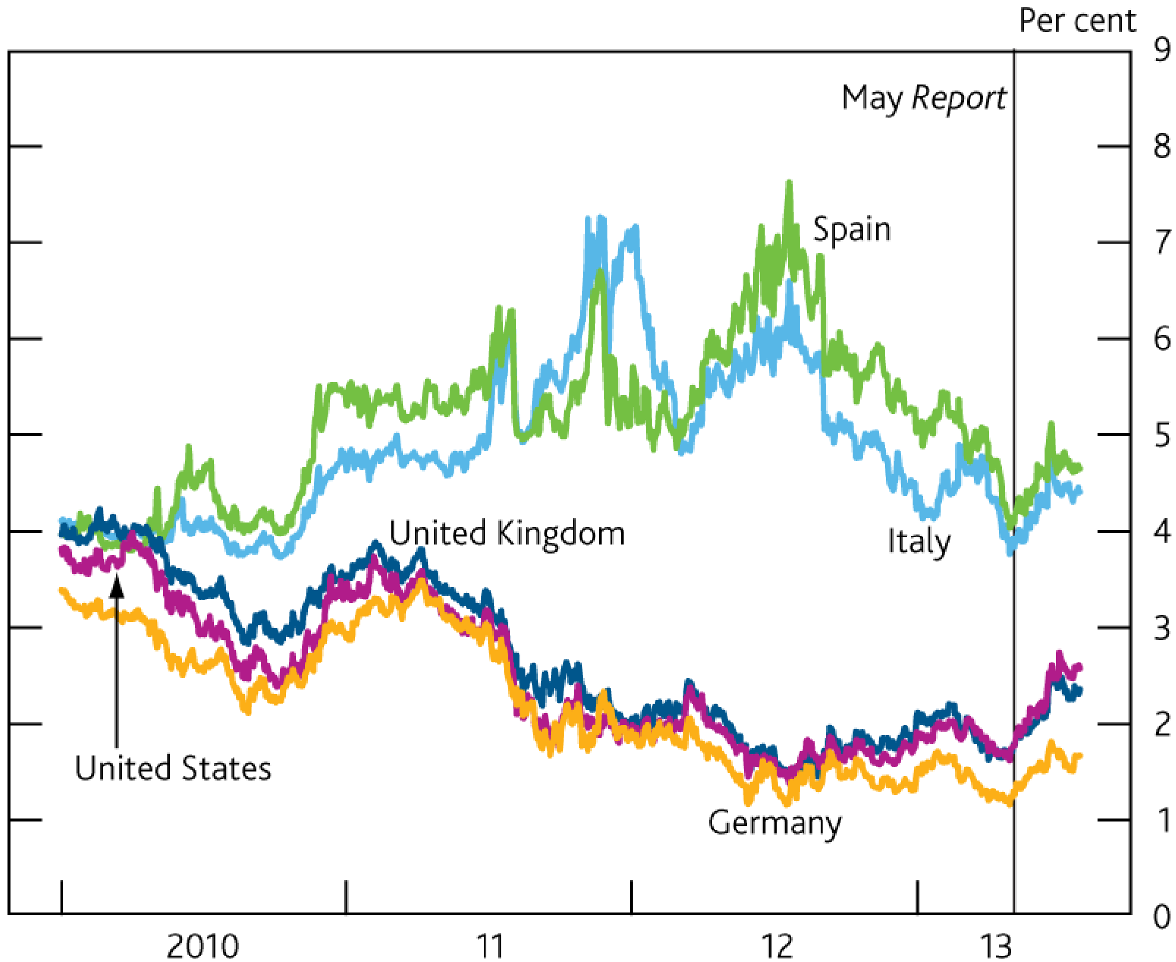
- Individual banks were huge yet unable to withstand severe economic shocks – thin equity, debt not loss-absorbent
- The bulk of losses of UK banks were overseas
- Financial system highly interconnected – both within and between systemically important banks – no fire breaks
- Core banking services had to be maintained, so governments forced into providing unprecedented levels of support – taxpayer massively on the hook
- Even so, the disruption in economic activity is having a huge and lasting effect on economic growth and the public finances
- … leading to debt crises in the Eurozone

Slump in UK output (and productivity and public finances)



UK real quarterly GDP. Source: ONS August 2013 GDP release

Eurozone sovereign debt crisis followed



Ten-year yields. Source: Bank of England, August 2013 *Inflation Report*, Chart 1.4

Banking reform: where have we got to so far?

Wider reform of financial services

- Regulatory architecture
- Macro-prudential regulation
- Shadow banking
- Market infrastructure
- Accounting standards
- Ratings and ratings agencies

Banking reform

- Supervision

- **Loss-absorbency**
- Liquidity
- Recovery and resolution
- **Structural reform**

- Competition

- Other initiatives – corporate governance, sanctions, pay, taxation, …

Loss-absorbing capacity

- Basel III makes major progress on capital but is unambitious, despite uplift for globally systemic important banks
  - equity capital ≥ 7% of “risk-weighted assets” (up to 9.5% for GSIBs)
  - leverage ≤ 33 backstop
- At least EU did not impose maximum harmonization in CRD4
- Swiss finish
- British finish – ICB recommended 10% (and 25x backstop) for large retail banks plus other measures
- US developments – Fed/FDIC/OCC capital rules set out in July; Brown-Vitter Bill

Structure

- Consensus on need for effective and credible resolvability but little action on structural reform until quite recently

- US: Dodd-Frank including Volcker rule and swaps push-out; Cantwell, McCain Warren Bill
- UK: Banking Reform Bill 2013 to implement ICB ring-fence &c
- France/Germany: ultra-lite Volcker
- EU: Liikanen report

- Internationally? …

"To start, we need concrete progress with the too-important-to-fail conundrum. We need a global level discussion of the pros and cons of direct restrictions on business models ..." – Christine Lagarde, Oct 2012

Unfinished business I:
Capital and loss-absorbency

Some economics of loss-absorbency

- Market system works well only if those who get rewards in good times absorb losses in bad times
- Standard bankruptcy does not work for systemically-important banks because of the core service continuity imperative, deposit insurance &c
- So normal hierarchy of loss-absorption (equity $\rightarrow$ debt $\rightarrow$ …) became equity $\rightarrow$ taxpayer, and with wafer-thin equity
- Huge implicit subsidy and distortion of incentives
- Moreover, with unstructured universal banks, the home taxpayer is on the hook for the lot, and with no firebreaks

Is equity costly? (1)

- Is bank equity costly (1) for banks, and (2) for the economy?

- Yes

- Debt/equity tax wedge – how big a deal?
- Debt overhang
  - spillover benefit to creditors (case for good/bad bank split?)
  - and to public (contingent) creditor in particular
  - especially if equity is thin

- But these aren’t costs to the economy

Is equity costly? (2)

- Is bank equity costly (1) for banks, and (2) for the economy?
- MM logic says No – for given risks in the economy, why would the aggregate value of claims depend on debt/equity mix?
- Reality $\neq$ MM, but …
  - social costs of bankruptcy argue for *more* equity
  - so do incentive reasons, including
  - getting the taxpayer off the hook, which is necessary (but not sufficient) for good economic incentives towards risk
- Beyond a point – where? – net costs to the economy might arise

So what’s the answer?

- ICB recommended 10% minimum equity ratio to RWAs for large retail banks, accompanied by 25x leverage cap. CBA analysis.
- We faced three constraints
  – geographic arbitrage
  – institutional arbitrage from banks to non-banks
  – the problem of transition
- My blue-skies numbers would differ by a factor of two, but the skies are cloudy
- Importance of banks having further ‘primary loss-absorbing capacity’ (e.g. including bail-in debt) well beyond the equity minimum. Also preference for (insured) deposits.

Long-run equity/assets ratios for UK and US banks

Unfinished business II:
Structural reform

ICB overview of reform options for financial stability

		Structural reform	
		Mild	Radical
Loss-absorbing capacity	Mild	Fails to solve stability problem	Taxpayer on the hook for UK retail banking
	Radical	Fails to shield retail banking from risks elsewhere, real risk of geographic arbitrage	Goes further than needed, real risk of geographic arbitrage

Why ring-fence?

- Helps insulate vital retail banking services – where continuity of service is essential – from global financial shocks. So deals with some interconnectedness risks
- Would make it easier and less costly to sort out banks – whether retail or investment banks – that still got into trouble despite greater loss-absorbing capacity. This is all part of getting taxpayers off the hook for the banks
- Good for competitiveness because retail banking can be made safer while (subject to resolvability &c) international standards apply to global wholesale and investment banking activities
- Sound long-run framework for bank lending to real economy

ICB ring-fence design

Core

- Deposits and overdrafts to individuals and SMEs

Permitted

- Deposits and payments for any EEA customer
- Non-financial lending, trade and project finance and advice to EEA customers

Excluded/prohibited

- Any non-EEA services
- Most trading and underwriting of derivatives and debt, asset-backed or equity securities
- Lending to financial companies

Why not a full break-up?

- Ring-fencing retains many of the synergies of a broad banking group, while providing insulation for vital economic functions
- With ring-fencing the parent group could still rescue a failing retail bank
- Full split would create undiversified, correlated, stand-alone UK retail banking sector – stability risk
- Banks might auto-split once they face true funding costs
- So ICB approach favours *structured universal banking*, not ending universal banking – more robust than *un*structured universal banking
- Parliamentary Commission proposal to ‘electrify’ fence

Why not the 'Volcker rule'?

- Proprietary trading should indeed be separated from retail banking
- But that doesn't go far enough to deliver the insulation, resolution, and public finance benefits of ring-fencing
- The bulk of global wholesale/investment banking – and its risks – would still be comingled with everyday retail banking
- Drawing line between market-making/hedging and prop trading is hard, and more controversial with an absolute ban
- Don't view Volcker in isolation – the US is different in respect of regulation (section 23A &c) as well as banking systems
- Add Volcker to ring-fencing? On balance not worth it

Banking Reform Bill 2013

- Regulators' objectives to include the continuity of provision in the UK of core services (notably deposit and overdraft facilities)
- Ring-fencing
  - 'ring-fenced body' = institution that does core activities
  - may not do excluded activities (such as dealing in investments as principal)
  - nor contravene prohibitions (e.g. concerning kinds of transaction, non-EEA branches, ownership stakes)
  - ring-fencing rules made by regulator on transactions, payments, disclosures, board independence, &c
  - plus regulatory power to enforce full separation between retail and wholesale banking in a specified group ('electrification')
- Depositor preference for insured deposits

Liikanen Report on reforming EU banking structure

- Expert group reported in October 2012
- Separate trading from deposit bank
- Plus powers to require further separation if needed for resolvability
- Need for sufficient layer of bail-inable debt and more robust risk weights

- In sync with UK approach – *structured* universal banking, not full split, nor Volcker
- Differences include Liikanen allowing securities underwriting in deposit bank

Structural reform options

Strength fence Location fence	Functional separation 1 (Current requirements)	Functional separation 2 (Stricter requirements)	Ownership separation
"Narrow" Trading Entity/ "Broad" Deposit Entity E.g. Proprietary trading + exposures to VC/PE/HF (PT)	**Option A** ≈ FR, DE (baseline)	**Option B** ≈ US swaps push-out	**Option C** ≈ US Volcker
"Medium" Trading Entity/ "Medium" Deposit Entity e.g. PT + market-making (MM)	**Option D** ≈ FR, DE (if wider separation activated)	**Option E** ≈ HLEG (Liikanen)	**Option F**
"Broad" Trading Entity/ "Narrow" Deposit Entity E.g. all investment banking activities	**Option G**	**Option H** ≈ US BHC ≈ UK	**Option I**

Source: European Commission Stakeholder Consultation, Brussels, May 2013

Eurozone banking union needs banking reform

- A banking union with well-capitalised and safely structured banks has much more prospect of economic and political success than one without
- Otherwise banking union could mutualise, and thereby risk enlarging, the implicit government guarantee to banks, contrary to the shared European objective of curtailing it
- Banking reform is needed whether or not there is banking union, but banking union needs banking reform

Some interim conclusions

- UK: leading on structural reform (but no longer on loss-absorbency)
- EU: what will result from the Liikanen Report?
- US: still much to play for three years on from Dodd-Frank legislation
- Internationally: Basel III is a step forward but badly needs reinforcing, including by a global minimum standard on bail-in debt

- So lots of unfinished business
- Judgement of reform over the past five years will depend on how much is built on it in the next five

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