ICB Independent Commission on Banking

# Targeting Bank Subsidies

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# Targeting Bank Subsidies

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- Background
- ICB proposed reforms
- Maximum harmonisation
- Conclusion

# BACKGROUND

# For the size of the country, the UK has a very large banking sector

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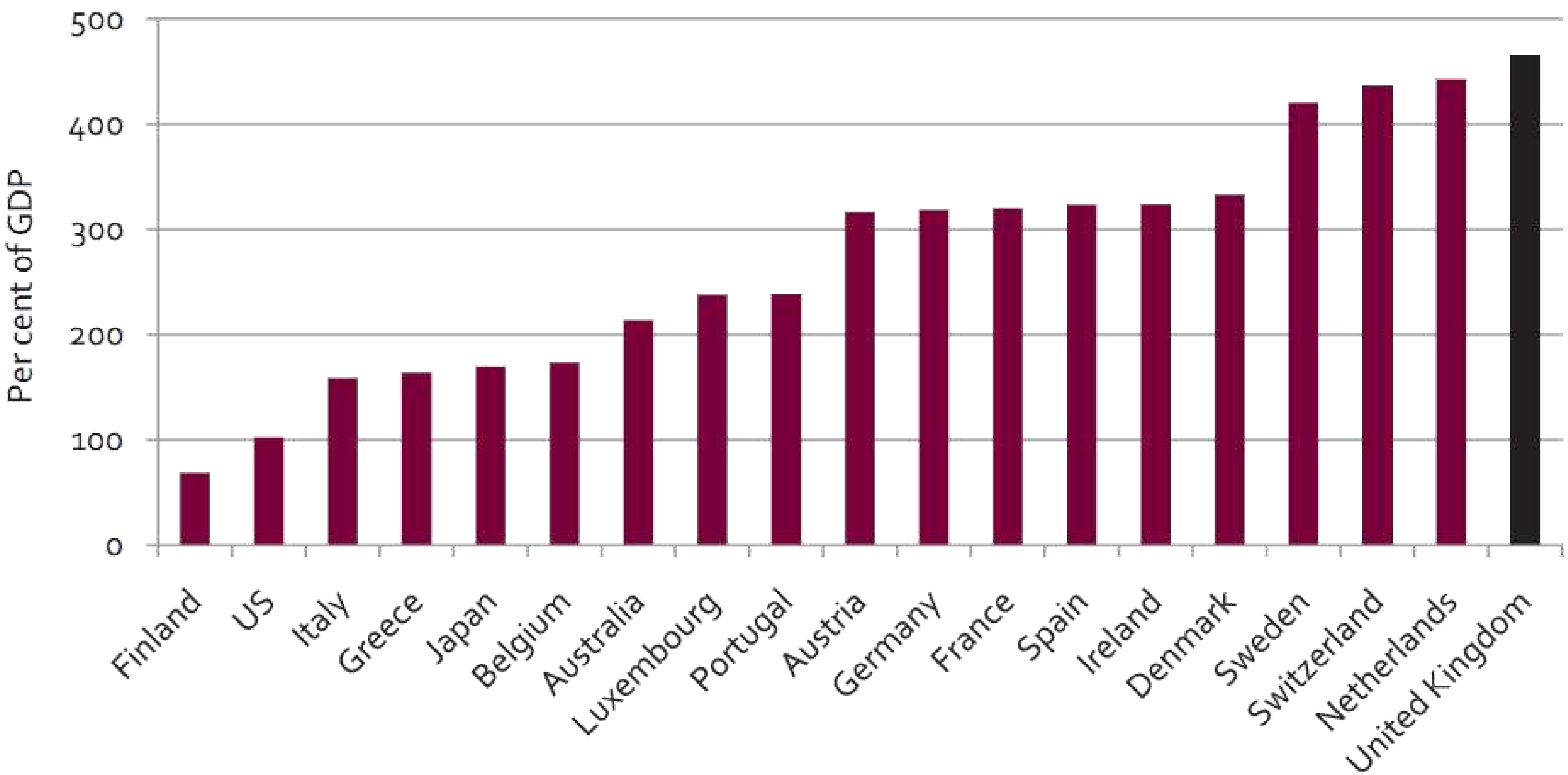
## Domestic banking assets as a percentage of GDP consolidated by nationality of headquarters (2009)



# The UK banking system was ill-prepared for global financial crisis

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- The banks were huge and unable to withstand severe economic shocks
- Financial system was highly interconnected – both within and between systemically important banks
- Governments were unable to let whole financial system fail, so forced into providing unprecedented levels of support
- Even with this support, the disruption in economic activity had a huge and lasting effect on economic growth

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# PROPOSED REFORM

# Need for a package of measures

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- Our primary financial stability recommendations were:
  - Ring-fencing retail banking
  - Increasing the loss-absorbing capacity of banks, through additional equity, loss-absorbing debt and depositor preference
- Helps insulate vital UK retail banking services – where continuity of service is essential – from global financial shocks, which is of particular importance since major UK banks combine retail banking with global investment banking
- Would make it easier and less costly to resolve banks – whether retail or investment banks – that got into trouble

# Ring-fence design

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**Mandated**

- Deposits and overdrafts to individuals and SMEs

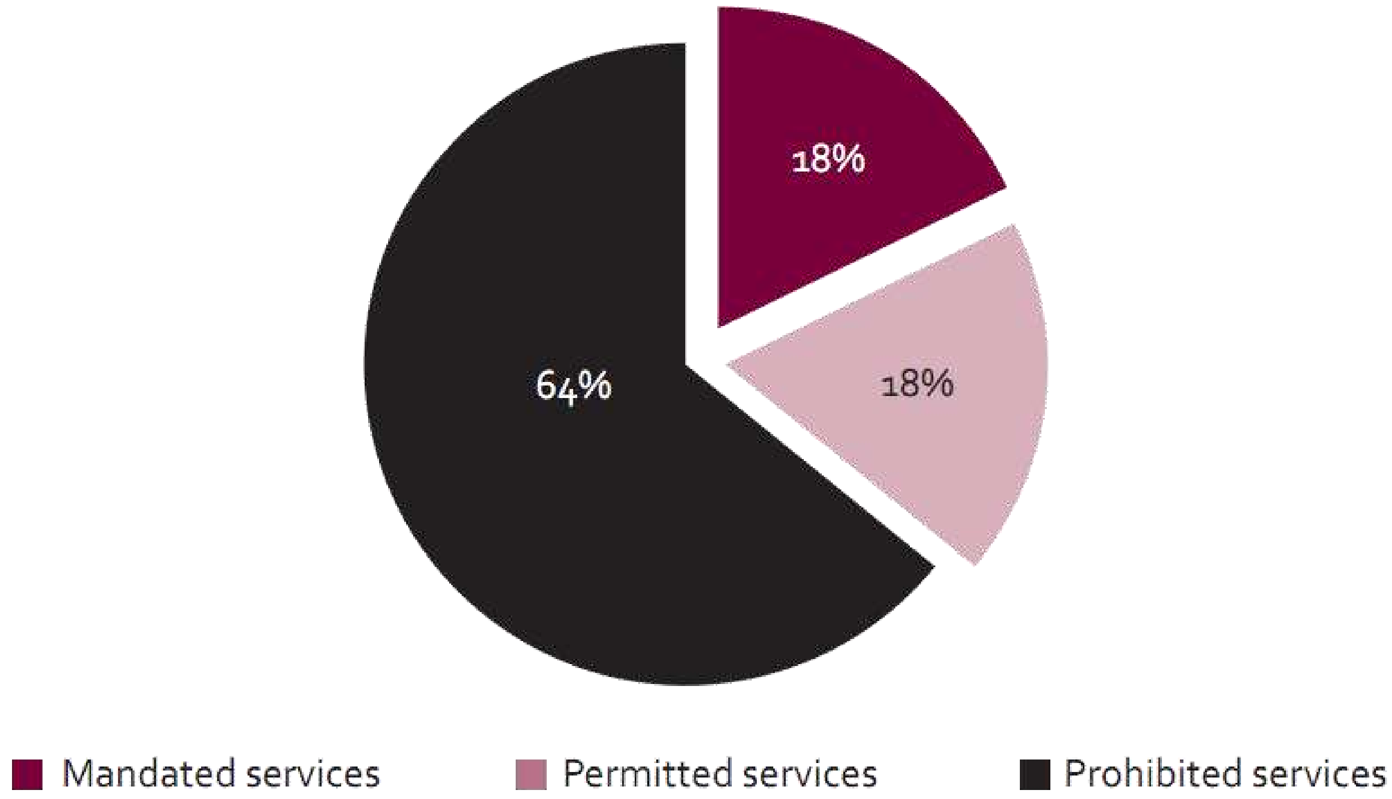
**Permitted**

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

**Prohibited**

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

# Ring-fence asset split



# Independence of ring-fenced entity

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- The ring-fenced bank should be able to stand alone
- Ring-fence banks operating as subsidiaries should be able to meet liquidity, funding and large exposure rules on a standalone basis
- The permitted extent of relationships with other parts of the group should be no greater than regulators generally allow with third parties
- Strong independent governance
  - Separate board, with majority of independent directors (including chair)
  - Reporting and disclosure as an independently-listed company

# Are higher capital requirements costly?

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- Not in a Modigliani Miller world, but …
  - Costs to banks (but not the economy) from loss of some tax and implicit subsidy advantages of debt – this argues for less capital, but only from the private perspective of the banks
  - Effects on bankruptcy probabilities – this argues for even more capital
  - Effects on incentives – this also argues for even more capital
- Important for risk to sit with investors, not retail depositors or taxpayers
- Case for higher capital is overwhelming

# Are higher capital requirements costly?

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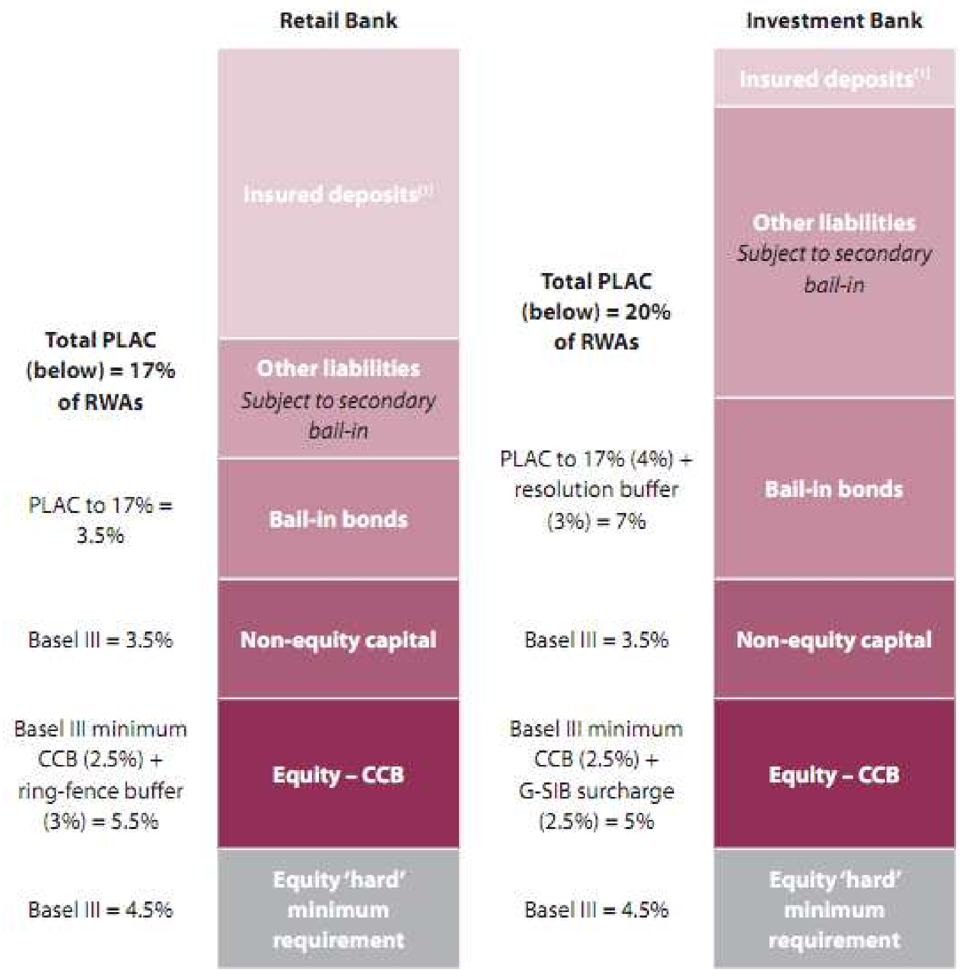
- The costs are grossly exaggerated. Take a worst case:
  - Suppose that one raises the leverage ratio all the way from 3 per cent to 10 per cent, that the cost of equity is 15 per cent a year and the cost of junior debt is 8 per cent a year
  - The additional cost of funds would then be 49 basis points
  - But this includes the effect of two massive subsidies: the tax benefits of debt and the risk-bearing by taxpayers, which lowers the cost of debt
  - The true cost would probably be close to zero. The benefits of reducing the chances of a systemic crisis would be huge

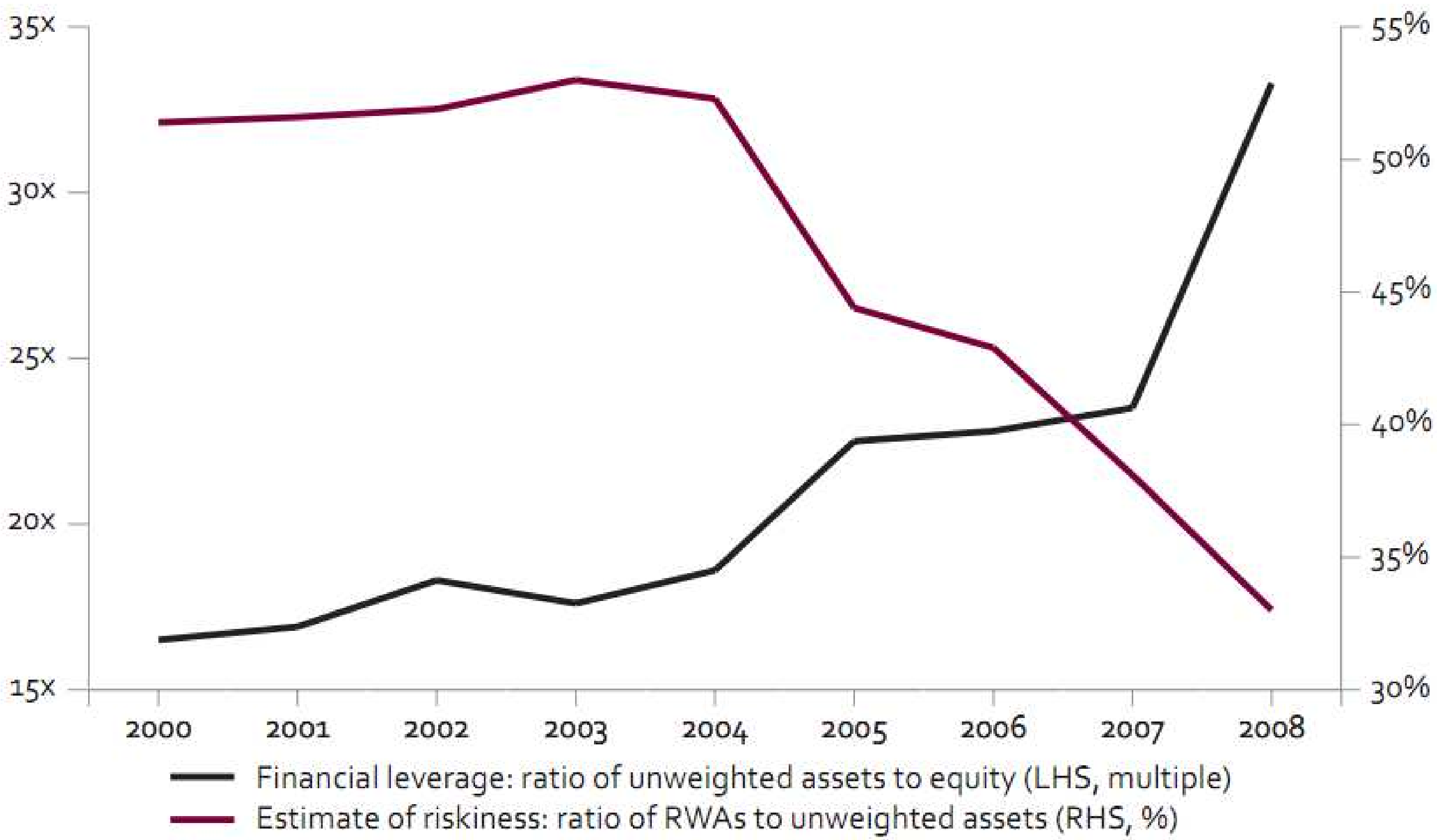
# Need for more loss-absorbing capacity

- Equity of at least 10% for large ring-fence banks
- Primary loss absorbing capacity (PLAC) to reach at least 17% RWAs
- Resolution buffer up to 3% RWAs on top
- Bail-in powers
- Depositor preference also acts to increase loss absorbing capacity of debt



# Risk-weight concerns show need for high leverage backstop

**Ratio of risk-weighted assets to unweighted assets falls as financial leverage increases (aggregated for the four largest UK-headquartered banks)[29]**



# Benefits and costs of stability reforms

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**Benefits**

- Main benefit is reducing likelihood/impact of financial crises, which can easily have NPV cost of 60% of GDP
- Improved stability good for investment
- Removal of distortion good for balance of economic activity

**Costs**

- Loss of diversification benefits? (Not to be confused with removal of implicit government guarantee)
- Loss of operational and customer synergies?
- Cost to banks might be £4bn-£7bn a year
- Cost to economy might be £1bn-£3bn (around 0.1-0.2% of GDP)

Cost-benefit ratio extremely favourable

# MAXIMUM HARMONISATION

# Maximum harmonisation

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- The European Commission has proposed that Pillar 1 (minimum prudential requirements) and Pillar 3 (disclosure requirements) of the Capital Requirements Directive (CRD) should be "maximum harmonised".
- This would prevent Member States from requiring higher prudential or disclosure requirements.
- The arguments for maximum harmonisation are very weak and the argument against it overwhelming

# Maximum harmonisation

- Arguments for maximum harmonisation:
  - This is necessary to complete the single rule book in banking.
  - Raising capital standards would create unfair competition.
- Arguments against:
  - The single market was made for Europeans, not Europeans for the single market.
  - The question is whether allowing countries the right to make their banks safer, if they want, can be harmful.
  - The answer is: no. Unsafe banks are a threat, safe ones are not.

# Maximum harmonisation

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- The European Central Bank has itself argued that "the need for such an arrangement [national autonomy] is justified, inter alia, by the fact that economic and financial crises are not completely harmonised across Member States, and Member States may face different types of systemic risk."
- The crisis – largely the result of the undercapitalisation of banks – has itself fragmented the single market in finance.
- Indeed, the single market does not operate in the presence of national financial crises.

# Maximum harmonisation

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- Fiscal responsibility for dealing with the consequences of crises falls on the individual member states. Those who bear the costs must be allowed to protect themselves.
- Each country will benefit from the soundness of other countries' banks.
- A race to the top on capital would benefit the European economy, not harm it.

# CONCLUSION

# Conclusion

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- Radical reform of banking is obviously needed
- Banks need to be vastly more resilient than they have been
- The ICB proposals are the least that make sense for countries with global exposures in banking, such as the UK
- Higher capital requirements are, in my view, a social benefit, not a cost
- A situation in which taxpayers underpin banks, while bankers make private fortunes, is intolerable. It is the greatest single threat to the survival of the market economy.
- The arguments for maximum harmonisation are entirely unpersuasive.