Targeting Bank Subsidies

• Background

• ICB proposed reforms

• Maximum harmonisation

• Conclusion
BACKGROUND
For the size of the country, the UK has a very large banking sector

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

- 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
PROPOSED REFORM
Need for a package of measures

• 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

<table>
<thead>
<tr>
<th>Mandated</th>
<th>Permitted</th>
<th>Prohibited</th>
</tr>
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<tbody>
<tr>
<td>• Deposits and overdrafts to individuals and SMEs</td>
<td>• Deposits and payments for any EEA customer</td>
<td>• Any non-EEA services</td>
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<tr>
<td></td>
<td>• Non-financial lending, trade and project finance and advice to EEA customers</td>
<td>• Most trading and underwriting of derivatives and debt, asset-backed or equity securities</td>
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<td>• Lending to financial companies</td>
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Ring-fence asset split

- 64% Mandated services
- 18% Permitted services
- 18% Prohibited services
Independence of ring-fenced entity

• 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?

• 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?

- 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)\textsuperscript{29}
Benefits and costs of stability reforms

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
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

– 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

– 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

• 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.