Banking reform in Britain

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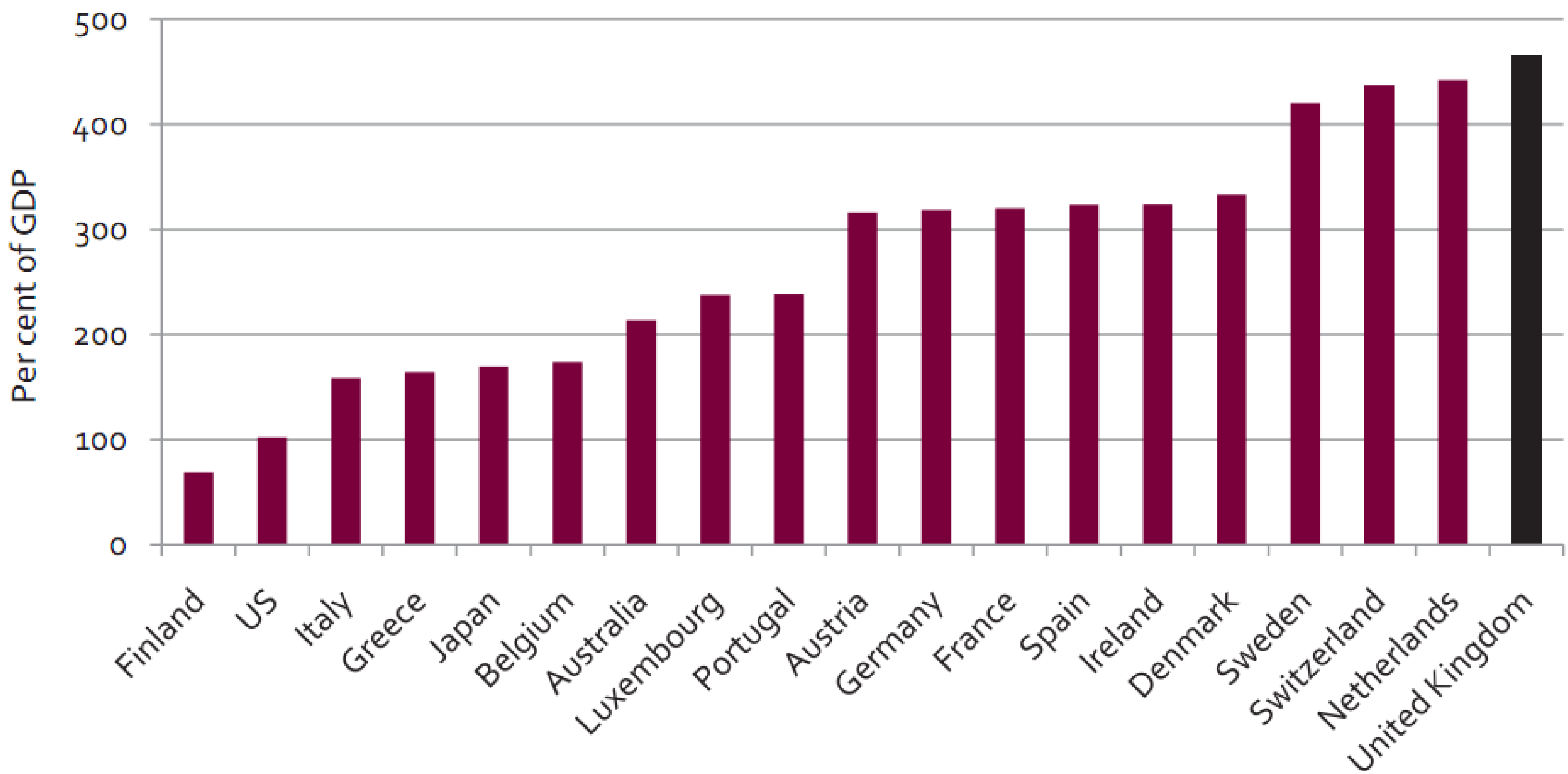
Relative sizes of banking sectors

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



Big hit to UK economy from the crisis

- Unemployment rose but then returned to 5%
- But GDP fell 5% and has been slow to recover (compare US)
- UK GDP is about 15% below extrapolation of pre-07 trend
- How much of the shortfall is due to the crisis?

- Government deficit was 10% of GDP
- Government debt/GDP ratio has doubled from 40% to 80%
- Eurozone crisis next door

- Political consequences? Brexit?

Banking reform in Britain – the ICB

- ICB established in June 2010. I = independent, not political
- Remit: to make recommendations to promote stability and competition, having regard to UK competitiveness, fiscal risks
- Final report September 2011. Interim reports along the way
- Financial stability recommendations:
  - Structural reform – ring-fencing, a form of structured universal banking
  - Boost banks' loss-absorbency – capital, bail-in debt and tools, depositor preference, against inadequate Basel backdrop
  - Competition recommendations too

Some economics of separation

- Helps **insulate** vital retail banking services
- Makes it easier and less costly to **resolve** banks that still get into trouble
- All part of getting taxpayers off the hook
- Addresses **competitiveness** issue – retail banking can be made safer while international standards apply to global activities
- Sound long-run framework for bank lending to **real economy**

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

- Dealing in investments as principal
- Commodities trading
- Financial institution exposures
- Non-EEA branches and subsidiaries

Banking Reform Act 2013

- Parliamentary Commission on Banking Standards 2012

- Regulatory objectives include the continuity of provision in the UK of core services
- Ring-fencing
- Depositor preference for insured deposits
- Bail-in regime

- Compare Dodd-Frank

Is equity costly?

- To banks, Yes:
  - debt/equity tax wedge
  - equity doesn't get too-big-to-fail subsidy
  - more equity is also good for private sector creditors, but shareholders don't care about that
- To society, No (to a first approximation) :
  - none of the above is a social cost
  - more equity as free insurance, up to a point
  - costly bank equity indicates risky banks
  - risky banks need more equity, not less

Public benefit of more bank capital

- Reduced probability of insolvency crisis
- Less damage in the event of insolvency crisis
- Better discipline on risk-taking incentives in the first place
- Getting taxpayers off the hook is just *part* of the gain
- The benefits of crisis avoidance go much wider and deeper
- Affects investment incentives across the economy

Policy on bank capital

- 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 GSIIs)
  - leverage ≤ 33 backstop
- Progress on loss-absorbing debt and resolution regimes
- ICB recommended 10% (and 25x backstop) for large retail banks plus other measures. Would have gone higher but for constraints
- BoE’s 2016 downward policy shift on bank capital

The BoE's downward capital policy shift

"The FPC's assessment of the appropriate level of capital is substantially lower than earlier estimates of the appropriate level of equity for the banking system, including those that were produced by the Basel Committee on Banking Supervision to inform the post-crisis Basel III standards"

- Effective **resolution** arrangements are assessed to reduce the appropriate equity requirement by about 5% of RWAs
- Effective **supervision** and **structural reform** support resolvability and increase resilience
- The FPC intends to make active use of the time-varying **counter-cyclical capital buffer**

Bank of England *Financial Stability Report Supplement,* December 2015, pages 4-5

The question of the systemic risk buffer

BANK OF ENGLAND

January 2016

The Financial Policy Committee's framework for the systemic risk buffer

A Consultation Paper

BoE's retreat on capital relies on new, untried and untested policies working splendidly

- Counter-cyclical policy
- Resolution
- Uncertainty is itself a reason to favour equity because only equity is surely loss-absorbent
- Capital measures are accounting figures and therefore uncertain themselves …

Market valuations call regulatory numbers into question

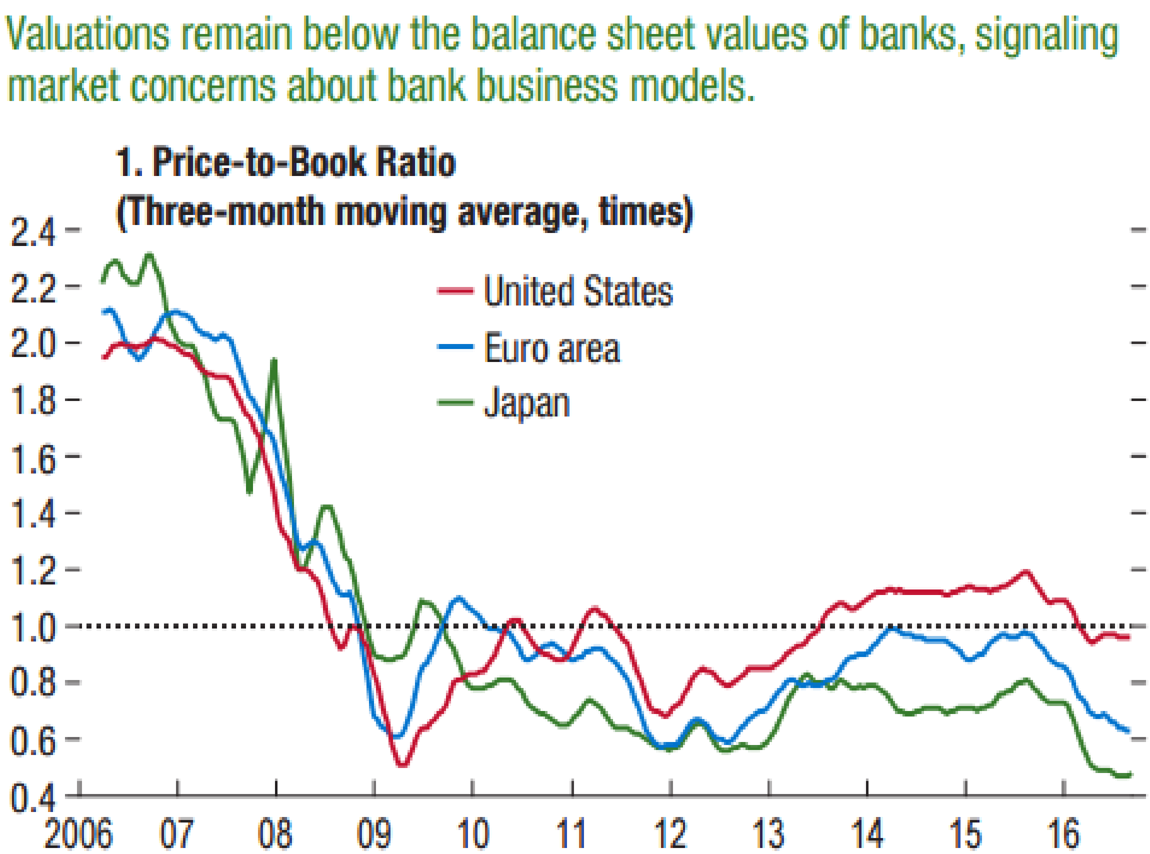
- "Market valuations of major UK banks remain, in aggregate, well below their book value. These appear in particular to reflect challenges to future profitability" (BoE, Sept 2016)

- But the expected profitability of future business > 0

- Major question mark over accuracy of book values

- But these are the basis for regulation, stress tests &c

Bank price-to-book ratios are low



IMF, *Global Financial Stability Report*, October 2016, Figure 1.11

Recent price-to-book ratios of major UK banks

Date	Barclays	HSBC(b)	Lloyds Banking Group	Royal Bank of Scotland	Average
Pre-crisis (1 Jan. 2007)	2.00	1.70	2.66	1.25	1.90
1 Jan. 2016	0.62	0.83	1.12	0.66	0.81
July *Report* (5 July 2016)	0.38	0.64	0.78	0.34	0.53
Latest	0.60	0.82	0.91	0.45	0.70

Bank of England, *Financial Stability Report*, November 2016, Table B1

Proposal to run parallel stress tests on market-value basis

- My 5 December letter to Governor Carney

- His 19 December response:
  - regulatory values are after deductions
  - beware double-counting
  - beware pro-cyclicality
  - risk of confusing communication

- My 3 March submission to the Treasury Committee

Banking reform: job done?

"The job is now substantially complete"

– Mark Carney to G20 Leaders, November 2014

- Ring-fencing is happening in the UK, but
- Basel III is much too weak, e.g. on leverage
- BoE has retreated on capital requirements

- Brexit result has heightened risks

- Review of Dodd-Frank