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Banking reform in Britain and Europe

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US: from Glass-Steagall to Volcker

- Section 20 of the 1933 Banking Act prohibited affiliation between bank and companies “engaged principally” in securities business
- Eroded over time by regulatory permissiveness and market developments
- Repealed in 1999
- Restrictions remain on dealings between banks and their non-bank affiliates – notably section 23 of the Federal Reserve Act

- Dodd-Frank legislation of 2010 includes [a version of] the Volcker Rule prohibition on proprietary trading by banks
- Implementation difficulties

UK: ICB $\rightarrow$ Banking Reform Bill 2013

- Ring-fencing retail/commercial banking to achieve
  - Insulation from kinds of global shock
  - Resolvability and supervisability
  - Domestic resilience + international competitiveness with higher-than-Basel capital standards in retail banking
  - Sound long-run framework for bank lending to real economy
  - Getting taxpayer off the hook
- Ring-fence design
- Ring-fencing one element of package of recommendations on loss-absorbency and competition too

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

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

Structural alternatives and additions

- Why not total separation, like Glass-Steagall?
- Electrification – the reserve power proposed by the PCBS
- Why not Volcker instead?
- What about Volcker as well?

Loss-absorbency recommendations

- Higher (than Basel) capital levels for major UK retail banks
- With accordingly tighter leverage cap [not accepted by Govt]
- Primary loss-absorbency capacity requirements beyond equity
- Bail-in powers
- Depositor preference

- Arguments over whether higher capital requirements are costly to the economy (i) in the long run, (ii) in the short run, and (iii) with respect to ‘UK competitiveness’

EU: Liikanen → ??

- High-level EU expert group reported in October 2012
- Separate trading from deposit bank
- Plus powers to require further separation if needed for resolvability
- Banks should build up a sufficient layer of bail-inable debt
- Need for more robust risk weights and corporate governance reforms

- European Commission deliberating

Liikanen and UK in harmony?

- Remarkably similar on structural reform – strong but flexible separation; don't try to sub-divide trading; structured universal banking, not full split
- On retail 'versus' trading separation, note that fence around the deer park to protect them from the lions = fence to keep the lions away from the deer
- Difference on securities underwriting, which on economic logic should be on trading side
- UK goes further than (baseline) Liikanen in some ways, but Liikanen proposes powers to require wider separation if needed
- Beware one-size-fits-all and note features of UK banking
- (Whether Liikanen and France are in harmony is another question)

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 international objective of curtailing it
- Banking reform is needed whether or not there is banking union, but banking union needs banking reform.

The unfinished reform agenda

"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

Toronto, 25 October 2012