Banking reform in Britain and Europe

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"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

Introduction

An international discussion on the structure of banking has taken a long time to get going. In the United States, the structural debate since the crisis has focused on how to implement the Volcker rule, which prohibits banks from engaging in proprietary trading that is not customer related. In the United Kingdom, the discussion has concentrated on ring-fencing—the separation within banking groups of retail and investment banking. France and Germany are developing the mild hybrid of ring-fencing some proprietary trading. The first international consideration of structural reform was the Liikanen (2012) report for the European Union, which, like the U.K. approach, recommended separation, within bank holding companies, between deposit banking and trading.

How are these structural reform initiatives related? What do they seek to achieve? This paper will consider these questions, but first it puts structural reform in the context of banking reform more generally.

Structural Reform in Context

The case for structural reform of banks is not that it solves the too-important-to-fail conundrum by itself. Rather, it is that structural reform is an element in the optimal policy package, at the heart of which must also be much greater capacity by banks to absorb losses.

A pure structuralist argument might run as follows: (1) retail banking is low risk and essential, (2) investment banking is risky and inessential, (3) separation between the two confines the public safety net to the low-risk and essential activities, leaving market forces to discipline risk-taking in investment banking.

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[1] All Souls College, Oxford, and formerly chair of the United Kingdom's Independent Commission on Banking (ICB). I am grateful to ICB colleagues for many helpful discussions on the topics in this paper, which provided background to my remarks at the IMF's *Rethinking Macro II* conference in Washington, D.C., on April 16–17, 2013. A fuller discussion of the economic issues in the paper is in Vickers (2012).

If only things were so simple. In reality, unless defined so narrowly as to exclude all lending, retail banking is risky, contrary to (1). Lending involves credit risk, much of which is linked to property values, which can go down as well as up. And as to (2), even if it is separated fully from retail banking, the occurrence of investment banking risks can, through various channels, jeopardize essential banking services.

Banking reform – both for retail and investment banking—must therefore have greater loss-absorbency at its core. The crisis exposed a double problem with banks' loss-absorbency. First, banks had nowhere near enough equity capital—so far, too much leverage—for the risks they were running. Second, after the thin equity layer had gone, bondholders bore remarkably little loss. They would bear loss in bankruptcy, but to preserve continuity of essential services, governments staved off bankruptcy by providing taxpayer support. So bondholders generally came out whole, with the public purse bearing losses that they should have taken. Moreover, where depositor preference is absent, in bankruptcy bondholders would have had legal rights to be treated on a par with ordinary depositors.

Under the Basel III agreement, which is to be implemented by 2019, banks will need to maintain equity capital of at least 7 percent of risk-weighted assets, or up to 9.5 percent for banks of global systemic importance. But risk weights, which were such a failure in the run-up to the crisis, are typically well below unity, so these ratios allow bank balance sheets still to be a large multiple of equity capital. A backstop limiting leverage to 33 times capital is proposed to address this.[2]

On a commonsense view, 33 is a lot of leverage, and way above corporate norms in the rest of the economy. Remember too that this is for the *post*-reform world. It is true that many banks were much more leveraged precrisis, so the Basel III capital reforms, which also address issues about risk weights, represent a fundamental shift from where things were. But given the scale of the crisis their intended destination is hardly ambitious, and might not be reached if implementation falls short. It is seriously open to question whether it is wise to operate market economies with banking systems as lowly capitalized as the Basel reforms will still allow.[3]

A partial remedy to this problem might come from bail-in debt. This is debt that is required to convert to equity, or be wiped out, once low capital triggers are breached. Thus the regulator "bails in" bondholders rather than, as tended to happen in the crisis, taxpayers bailing them out. But for this to be credible, the debt subject to regulatory bail-in needs to be unsecured, to have significant time (for example, at least a year) to maturity so as not to be prone to run risk, and to be junior to other debt, particularly retail deposits. And for bail-in

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[2] The definition of capital for this leverage cap is wider than equity capital, so this allows closer to 40 times leverage in relation to equity capital.

[3] An economic case for very much higher capital requirements than Basel III is made by Admati and Hellwig (2013).

debt to make a major contribution to loss-absorbency, banks need to have enough of it in addition to equity (or else far more equity than the Basel minima). The international debate has so far been silent on how much bail-in debt to require, which is currently an important missing piece of international policy on loss-absorbency.

Against this background, what can structural policy—forms of separation between retail and investment banking—add? There are three potential contributions. First, structural reform can help contain, but cannot wholly prevent, kinds of within-bank contagion from investment banking shocks to vital retail services, the continuous provision of which is an economic and social imperative. An external shock, such as that in 2008 from U.S. subprime mortgages and related derivatives, directly jeopardized ordinary domestic High Street banking in universal banks lacking internal structure (for example, RBS). Separation provides an internal firebreak, together with independent loss-absorbency for retail banking. Separation also creates the possibility of different loss-absorbency requirements as between retail and investment banking.

Second, separation helps crisis management and resolution. Unlike in 2008-09, it would allow policymakers to pursue different policies for retail and investment banking rather than an indiscriminate policy for the entirety. Thus separation helps resolvability, which is universally acknowledged to be an essential ingredient of banking reform. Indeed, it is hard to see how resolution plans for large and complex institutions can be credible without ex ante separation measures.[4] For related reasons, separation can assist bank supervision in normal times.

Third, by curtailing the implicit taxpayer guarantee, separation together with higher loss-absorbency requirements improves ex ante disciplines on risk taking. In particular, if investment banking can no longer be funded by (government-insured) retail deposits, it will face more risk-reflective funding costs, just as it should, and government funding costs will benefit correspondingly. Depending on the design of separation, this in turn should promote lending to the real economy being funded by, among other things, deposits including insured retail deposits.

Structural Reform Options

In broad terms the structural reform of banks involves two issues. One is "where to draw the line" (or multiples lines) between different kinds of banking activity. The other is how strong the separation should be.

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[4] This is so whether the resolution strategy involves a "single point of entry" (that is, typically into parent company by home regulator) or "multiple points of entry" (for example, by several regulators on a geographic or functional basis).

United States

The United States provides a useful benchmark for comparing current reform efforts in Britain and Europe. From 1933 through the 1990s, U.S. law had the Glass-Steagall *prohibition* of affiliation between deposit-taking banks and companies "engaged principally" in securities business. This provided for total separation between retail/commercial banking and investment banking. Over time, regulatory permissiveness and market developments led to the effective erosion of the prohibition, ahead of its repeal in 1999. Since then, affiliation has been allowed, but a substantial body of law provides for regulation of how deposit-taking banks may and may not deal with their investment banking affiliates, notably section 23A of the Federal Reserve Act and its implementing Regulation W. These regulations were not always applied strictly in the past, and the Dodd–Frank Act of 2010 makes provision for them to be tightened.

Thus, the repeal of the Glass-Steagall prohibition was not a move from separation to unstructured universal banking. On the contrary, it was a move to universal banking with structural regulation.

The Volcker rule, which is also and famously part of the Dodd-Frank legislation, is an *addition* to that kind of structural regulation. Like the Glass-Steagall legislation of old, it is a prohibition. Its aim is to prevent institutions that do banking from engaging in speculative proprietary trading—that is, trading that is not customer-related. The rule likewise prohibits substantial bank ownership of hedge funds and private equity. Its purpose is not to prohibit banking groups from doing customer-related proprietary trading such as market-making, which is among the exemptions from the rule. It is, however, proving difficult to distinguish in practice between kinds of proprietary trading, and implementation of the rule is behind schedule.[5]

Britain

Britain had a bad banking crisis, and is suffering severe economic and fiscal consequences, in part because of the size of its banks in relation to the economy—roughly five times its annual GDP. In response, the U.K. is enacting a far-reaching reform program, following the report of the Independent Commission on Banking (ICB; 2011).[6]

The ICB was asked to make recommendations on structural measures—"including the complex issue of separating retail and investment banking functions"—and "related non-structural measures" to promote financial stability and competition. Competition was another casualty of the crisis but is not considered further here beyond noting that the too-

[5] Duffie (2012) provides a critical analysis of the issues.

[6] I chaired the commission, which worked from June 2010 to September 2011. The other members were Clare Spottiswoode, Martin Taylor, Bill Winters, and Martin Wolf.

important-to-fail conundrum, if unsolved, is a problem for competition as well as for financial stability and the public finances.

As to the related nonstructural measures, the ICB focused on loss-absorbency and recommended higher-than-Basel capital requirements for the major retail banks, accordingly tighter leverage caps, quantified requirements for primary loss-absorbing capacity (for example, long-term unsecured debt subject to bail-in powers) on top of the equity requirement, and depositor preference for insured deposits.

On structural reform, the ICB considered a range of options and recommended ring-fencing—requiring that retail banking be conducted in an entity separate from investment banking, with self-standing equity and other loss-absorbency, and appropriately independent governance. The retail entity could be part of a wider banking group but with tight restrictions on its dealings with, and exposures to, the rest of the group.

On "where to draw the line" between retail and investment banking, the ICB approach was to identify (1) core retail activities, the continuous provision of which is essential, which could be carried out only in a ring-fenced entity, and (2) prohibited activities, which cannot be carried out in the ring-fenced entity (but are permitted in the rest of the group). Deposits and overdrafts to individuals and small businesses are core activities. Prohibited activities include trading (not just proprietary trading in the Volcker sense), underwriting, derivatives (other than hedging retail risks), lending to other kinds of financial institution, and much overseas business outside the European Economic Area. A wide swath of commercial banking—for example, mortgage lending and lending to larger nonfinancial corporates—is neither core nor prohibited in these terms. On the ICB approach, banks and their customers are free to decide whether or not to conduct such business from the retail entity. In that sense the fence is flexible. But it is strong with respect to independence between the ring-fenced entity and the rest of a banking group to which it may belong.

The ICB considered but did not recommend total separation between retail and investment banking. That would entail considerably higher costs, and for an uncertain financial stability gain. There are circumstances in which total separation would protect retail banking from external shocks more surely than would ring-fencing. But equally there are situations in which total separation would be detrimental to financial stability. It would create a stand-alone intercorrelated domestic banking sector without recourse to support from elsewhere in banking groups in the event of a domestic crisis (for example, linked to a property crash). Such crises are perfectly possible, and might well be more acute if diversification has been lost.

Neither did the ICB favor the Volcker rule as an alternative to ring-fencing. It would have applied to a very small proportion of U.K. bank balance sheets and by itself would have gone nowhere near far enough, on the ICB's analysis, to shield retail banking and the public finances from investment banking risks. Yet it would have been complex to implement.

The U.K. government has accepted the ICB recommendations, including on competition, in very large part,[7] and a banking reform bill is now before Parliament.[8] The draft legislation has been scrutinized by the Parliamentary Commission on Banking Standards, which was established in the summer of 2012 following the London interbank offered rate (LIBOR) scandal. Among other things, that commission has proposed strengthening ring-fencing and its durability by way of "electrification"—reserve powers for regulators, subject to a framework of accountability, fully to separate individual institutions, and even the sector as a whole, in the event that ring-fencing were being undermined. The Parliamentary Commission has also examined the case for *adding* a form of the Volcker rule to ring-fencing, but concluded against legislating for that now, partly in the light of claims by the British banks that they do not engage in such proprietary trading anyway.

The casual observer might think that U.K. reform, with ring-fencing, is on a different track from the United States, which is adopting the Volcker rule. But this is to overlook the fact that the United States already has, and is strengthening, a framework of separation between deposit banks and their investment banking affiliates within bank-holding companies. Thus, the truer picture is one of U.K.–U.S. *convergence*—on structured universal banking. The United States moved from separation to structured universal banking as the Glass-Steagall prohibition eroded and was finally repealed. It is adding a Volcker rule to that model. The United Kingdom is legislating for structured universal banking against a background of a lack of structure. (For the United Kingdom there would be little gain, but some cost, in adding a Volcker rule as well.) Thus, the United Kingdom and the United States have come from different directions to a broadly similar place.

Europe

The European Union is taking forward a variety of financial sector reforms, notably in directives on capital requirements to implement Basel III and on bank recovery and resolution.[9] The question of EU-wide structural reform was opened up in 2012 by the creation by Commissioner Barnier of the high-level expert group chaired by Erkki Liikanen, governor of the Bank of Finland.

The recommendations in the Liikanen (2012) report have much in common with the U.K. reforms outlined above, despite the fact that the group's remit was pan–European Union. It recommended that for banks above certain-size thresholds, trading should be separated from deposit banking, but they can coexist within bank holding companies. In addition,

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[7] But not entirely. For example, the government has not accepted the recommendation that banks subject to enhanced capital requirements should have correspondingly enhanced leverage constraints.
[8] See HM Treasury (2012, 2013).
[9] In Europe beyond the European Union, reform in Switzerland is noteworthy. Like the United Kingdom, Switzerland has (two) very large banks in relation to GDP, and established a commission on banking reform. The Swiss Commission recommended much higher capital requirements than that for the Basel III baseline.

there should be powers to require further separation if judged necessary for resolvability. It also made a number of recommendations on loss-absorbency, for example on bail-in debt and risk weights.

Especially considering the wider geographical scope of the Liikanen review, it has a remarkable amount in common with the U.K. reforms. Both envisage a move to structured, rather than unstructured, universal banking. (Separating trading from deposit banking is essentially the same as ring-fencing retail/commercial banking, just as building a fence to separate lions from deer is the same as building one around a deer park to keep out the lions.[10]) Neither favors adding a Volcker rule, still less adopting that instead of ring-fencing. And like the ICB, Liikanen stressed loss-absorbency, and its interrelation with structural reform.

There are differences, some of which reflect the different geographic scope. Thus, for example, a common European approach to trading book risk weights makes sense, whereas a single-country approach could have detrimental consequences for geographic arbitrage. A more surprising difference concerns securities underwriting, which Liikanen would allow with deposit banking. Besides the historical observation that this is the opposite of Glass-Steagall, economic logic suggests that securities underwriting belongs with trading, as it involves writing large put options. Corporate customers could still obtain a comprehensive array of banking services, including underwriting, from a single bank, but with the risk lying outside the deposit bank entity.

Whereas the Liikanen and U.K. approaches are largely in harmony, legislation before the French and German parliaments takes a minimalist approach to structural reform. In essence, it requires that major banks conduct speculative proprietary trading in a separate subsidiary. Very little of the balance sheet of the affected banks—perhaps 1 percent or so—seems likely to be affected, yet if the U.S. experience with the Volcker rule is a guide, the definitional and implementation difficulties are likely to be considerable. Still, these are steps in the direction of structural reform. It remains to be seen whether the more far-reaching Liikanen reform will be adopted across Europe. The report is currently being considered by the European Commission in Brussels.

Its importance is heightened by the wider question of banking union for the euro zone, which is widely seen as crucial for future euro zone macroeconomic performance. Whether or not banking union—of a form that entails a degree of mutualization of the contingent liabilities of euro zone banks by common deposit insurance or otherwise—is a good idea depends very much upon the future resilience of the banks in question. Banking union has large potential advantages if they are well- capitalized and sensibly structured, but could be a mistaken enterprise if not. Indeed, a union among unstructured and thinly capitalized

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[10] A metaphor by Martin Taylor.

banks could make the too-important-to-fail conundrum worse, and put more euro zone taxpayers more on the hook for more banking risks.

Conclusion

The financial crisis began more than five years ago. The prolonged macroeconomic and fiscal costs of financial crises are manifest to all. Yet the progress of banking reform has been mixed, and much unfinished business remains. On loss-absorbency there are concerns that the Basel III capital requirements are unambitious and liable to be watered down in application. On the other hand there are voices, including in the United States, calling for substantial stiffening beyond Basel III. There has been surprisingly little public discussion, outside the United Kingdom and Switzerland, of the complementary issue of how much bail-in debt major banks should be required to have.

An international debate on structural reform nearly didn't happen at all but is now under way. Structural reform initiatives in the United States (the Volcker rule) and the United Kingdom (ring-fencing) might appear to contrast, but the deeper truth is that both are converging, albeit from different directions historically, on structured universal banking. Adoption by the European Union of the Liikanen recommendations would further promote international convergence, as well as being wise for Europe, especially with banking union on the horizon. More resilient banks—with greater loss-absorbency, safer structures, and lower contingent taxpayer dependence—are moreover a global public good.

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