Independent Commission on Banking

Structural Reform in Banking

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Plan of talk

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- ICB context
- Financial stability recommendations for the UK
- Some reflections on structural reform in Europe

ICB CONTEXT

Relative sizes of banking sectors

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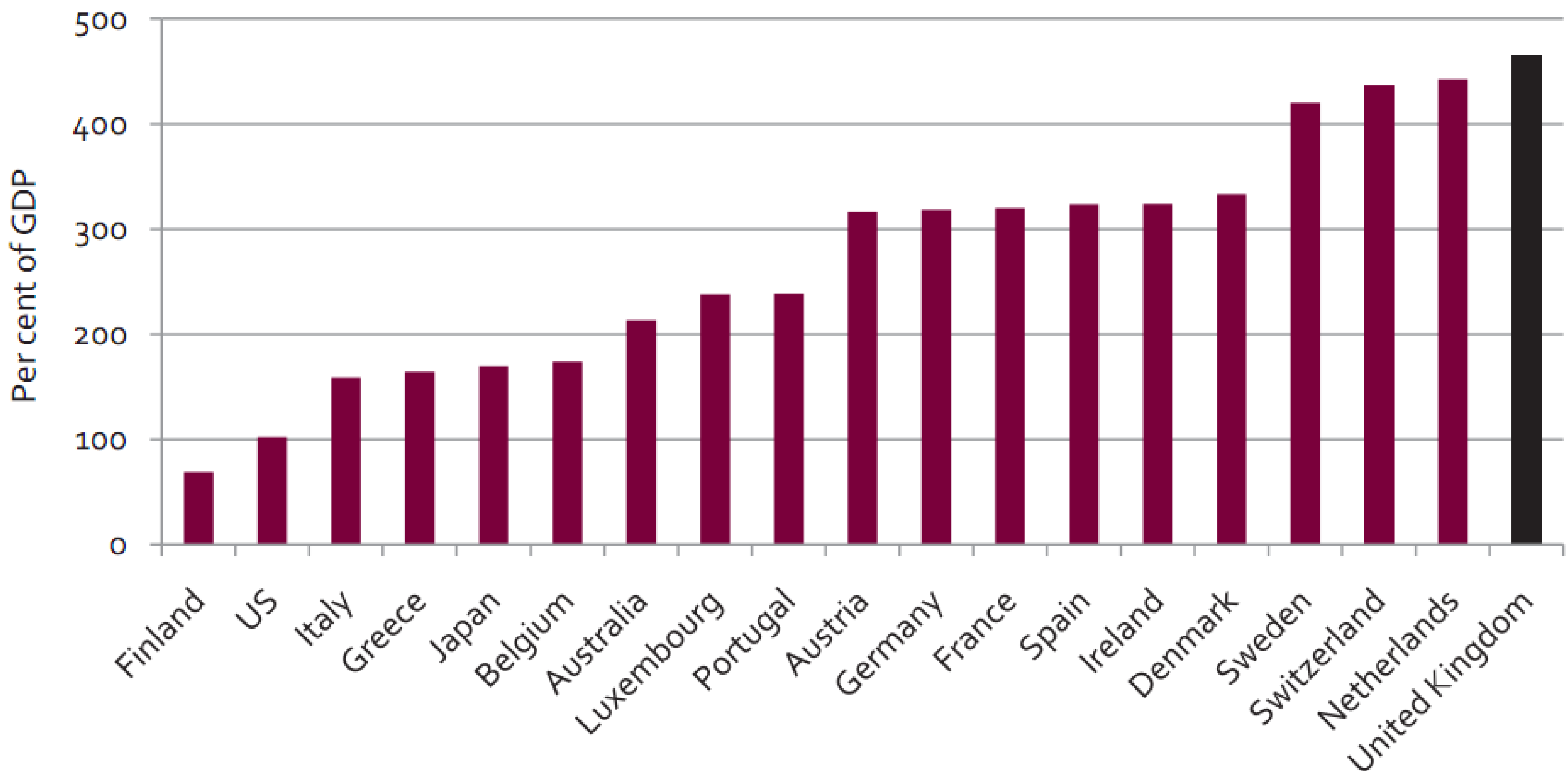
Domestic banking assets as a percentage of GDP consolidated by nationality of headquarters (2009)



Increase in UK bank leverage in the past fifty years

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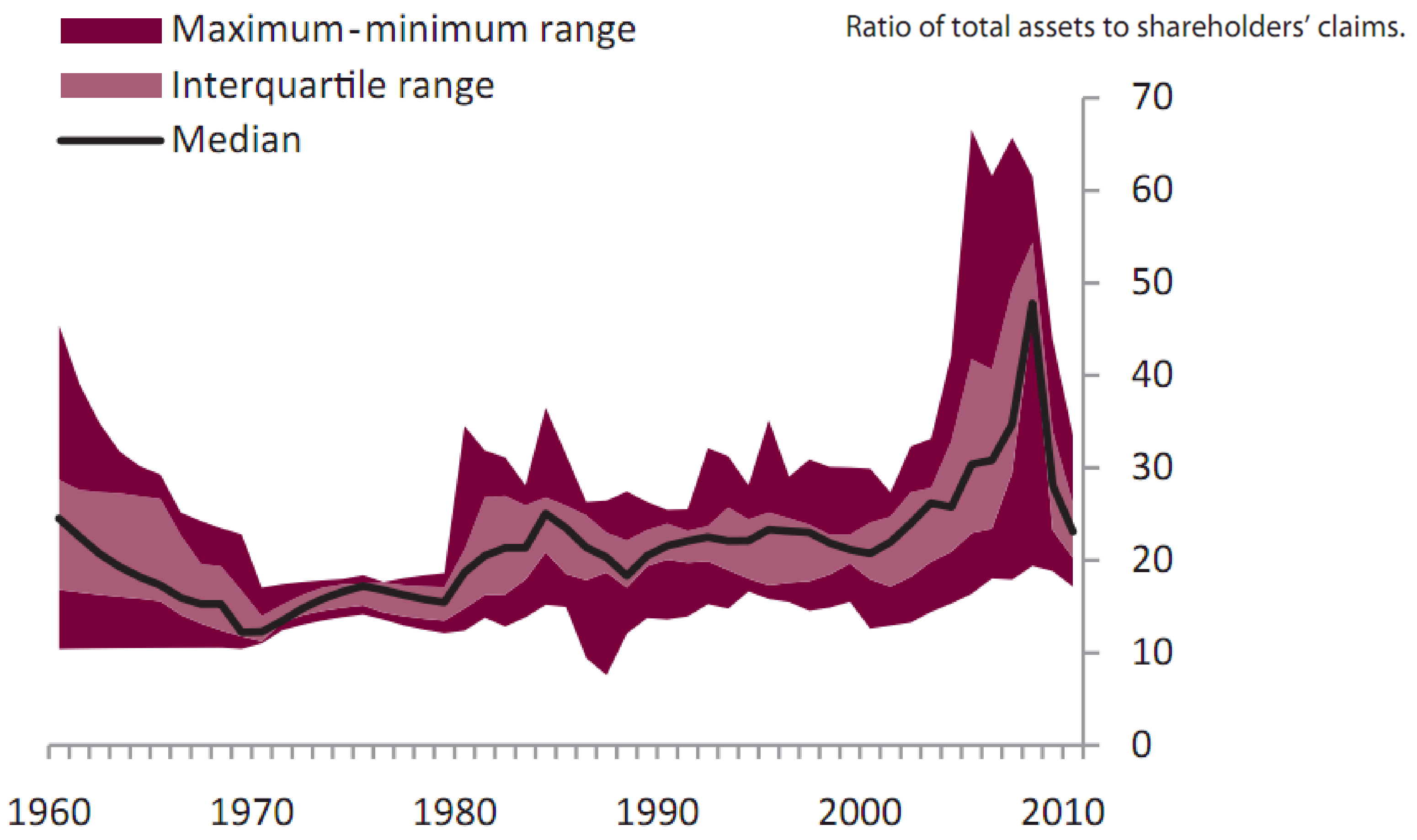

Total loans to different economic sectors as a proportion of GDP

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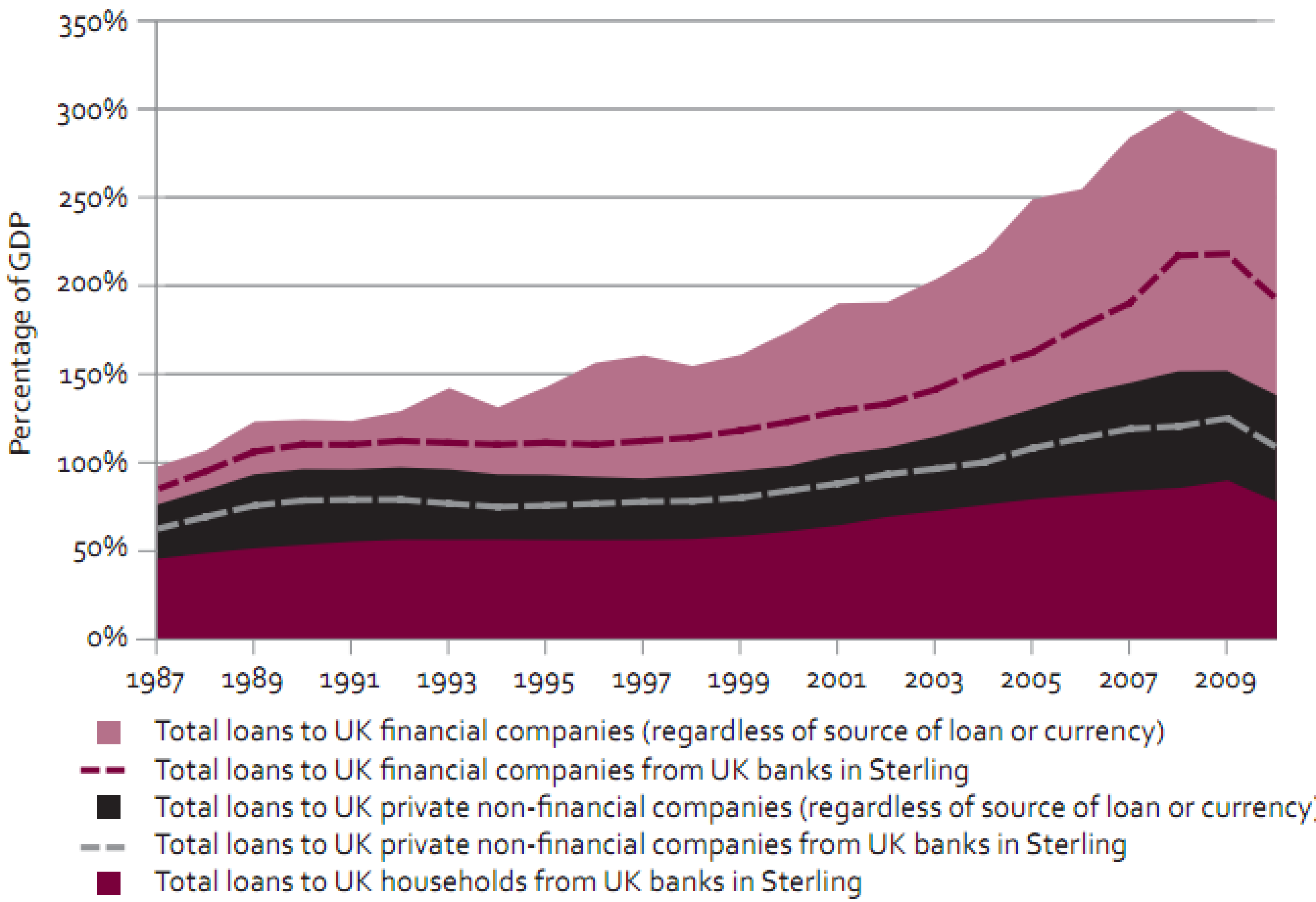

The banking system was ill-prepared for global financial crisis

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- Individual banks were both huge and unable to withstand severe economic shocks
- The bulk of losses of UK banks were overseas
- Financial system highly interconnected – both within and between systemically important banks
- Governments could not let the banking system fail, so were forced to provide wide and deep levels of support to banks
- Even with this support, the disruption in economic activity is having a huge and lasting effect on economic growth and the public finances

ICB process

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- Commission announced in June 2010
- Members: Clare Spottiswoode, Martin Taylor, John Vickers, Bill Winters, Martin Wolf
- Task: recommend structural and related non-structural measures to promote **stability** and **competition** for the benefit of consumers and businesses
- Final Report: September 2011

- Government broadly accepted recommendations in December
- White Paper: published yesterday

FINANCIAL STABILITY RECOMMENDATIONS

Reform options for financial stability

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		Structural reform	
		Mild	**Radical**
Loss-absorbing capacity	**Mild**	Fails to solve stability problem	Taxpayer still on the hook for UK retail banking
	Radical	Fails to shield retail banking from risks elsewhere	Goes further than needed, real risk of geographical arbitrage

Need for a package of measures

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- Best way to achieve aims is by **combining** moderate measures on loss-absorbency and structure
- Main financial stability recommendations are:
  - **Ring-fencing** retail banking
  - Increasing the **loss-absorbing capacity** of banks, through additional equity, loss-absorbing debt and depositor preference
- These proposal interlock with and reinforce international regulatory developments – G20, Basel, CRD IV, EU framework for recovery and resolution, etc.

Benefits of ring-fence

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- Helps **insulate** vital retail banking services – where continuity of service is vital – from global financial shocks. So deals with some interconnectedness risks both within and between banks
- Would make it easier and less costly to **resolve** – whether retail or investment banks – that still got into trouble despite greater loss-absorbing capacity. Could also help **supervision**
- This is all part of containing bank risk to **public finances**
- Consistent with global **competitiveness**
- Sound long-run framework for bank **lending to real economy**

Ring-fence design

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Mandated

- Deposits and overdrafts to individuals and SMEs

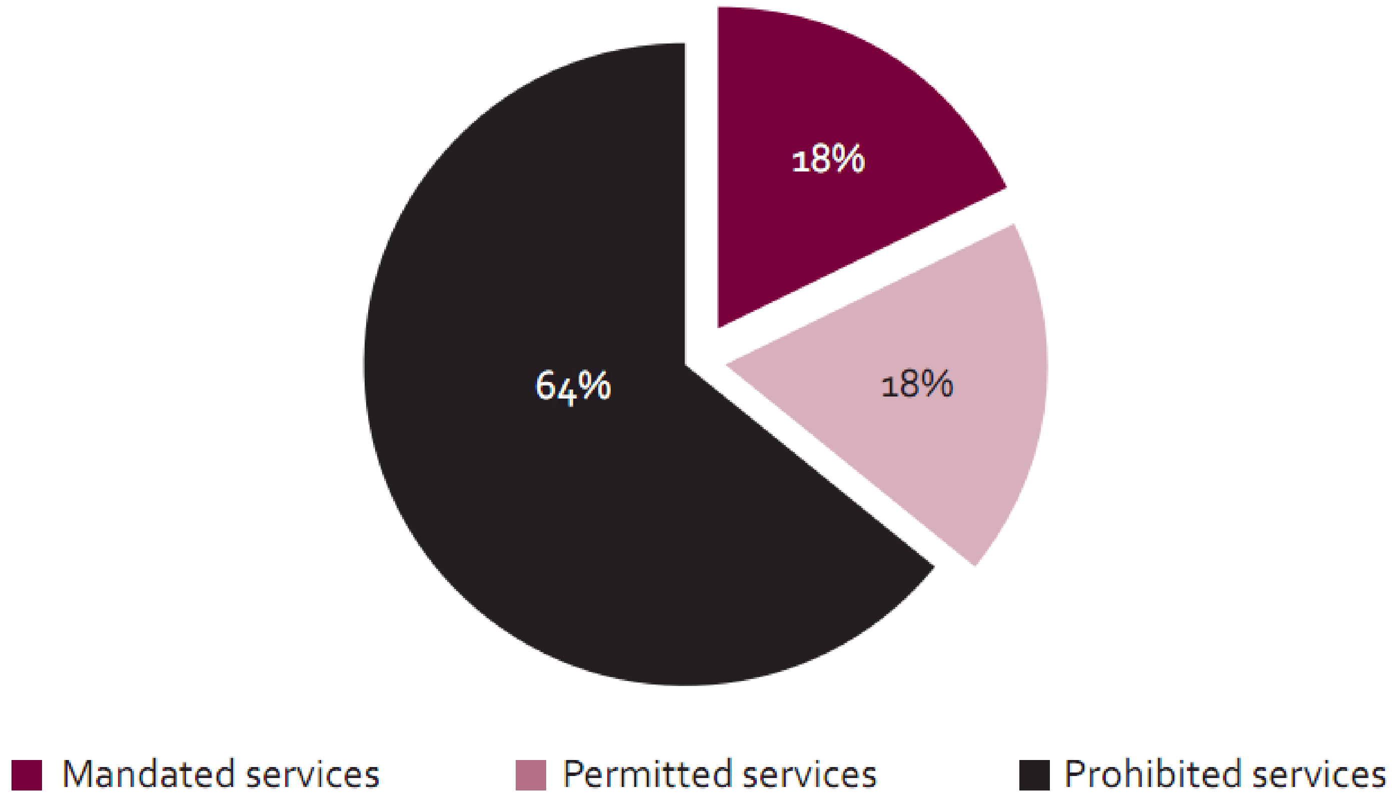
Permitted

- 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 its 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

Why not a full break-up?

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- Ring-fencing retains many of the synergies of a broad banking group, while providing insulation for vital economic functions
- With ring-fencing the parent group could still rescue a failing retail bank
- Full split makes ‘boundary disputes’ highly controversial
- May be hard to enforce a full legal split in the context of EU law

- So we favour allowing **structured universal banking**, not ending universal banking
- More robust than **un**structured universal banking

Why not 'Volcker' for the UK?

- Completely agree that proprietary trading should be separated from retail banking
- But that alone would not go far enough to deliver the insulation, resolution, and public finance benefits of ring-fencing
- The bulk of global wholesale/investment banking – and its risks – would still be comingled with everyday retail banking
- Drawing line between market-making/hedging and prop trading is hard, and more controversial with an absolute ban
- Don't view Volcker in isolation – the US situation is different from that in the UK (and rest of Europe) in respect of regulation as well as banking systems

CONCLUDING REFLECTIONS ON STRUCTURAL REFORM IN EUROPE

Banking reform and current macroeconomic stress

- Macroeconomic and sovereign debt crises have widened and deepened
- No reason for avoiding bank reform – quite the reverse
- Stronger bank capital is not detrimental to economic growth in the medium term; most leverage growth was not lending to the real economy anyway
- Basel timeline allows appropriate space for adjustment
- What policy-makers and law-makers do in the next few years will set the framework for the next few decades
- ‘Too-big-to-fail’ must not become ‘too-delicate-to-reform’

So what should Europe do?

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- Banking stability is a public good for Europe so national efforts should be welcomed (and certainly not thwarted)
- Implicit subsidies distort single market and contingent bank liabilities threaten public finances
- Danger to Europe is national watering down, not beefing up
- Facts vary from country to country
- So ensure strong baselines but beware ‘one-size-fits-all’
- Common end need not mean common prescription

- So no claim that all should adopt precisely the ICB package
- However, all should secure its objectives …

So what should Europe do?

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- As in the UK, many banks in the rest of Europe have too little capital, their debt is insufficiently loss-absorbing, their structures expose them to unnecessary interconnectedness risks, they are not yet resolvable, they are unduly reliant on taxpayer support, and run large fiscal risks
- The problem is not universal banking
- It is **undercapitalised** and **unstructured** universal banking
- The ICB package addresses this (European) problem for the UK
- The importance of sound banks for Europe's economic future requires that policy-makers and law-makers across Europe seize the opportunity that now exists for fundamental reform