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The Vickers Report – Implications for Australia

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In this Australian Centre for Financial Studies Financial Regulation Discussion Paper, Professor Kevin Davis outlines key recommendations of the recently released UK Independent Commission on Banking, and considers their relevance to Australia.

The final report of the UK Independent Commission on Banking (Vickers Report, 2011) was released on September 12, 2011, and recommends a number of significant changes in the structure and regulation of banking in Britain. While some are driven by issues specific to Britain, the question arises of how other countries, such as Australia, should react to the Report's more general proposals.

At the risk of oversimplifying (and more detail is given in the Appendix), the proposals can be grouped into three main types.

- Banking sector structure – involving operational and legal separation via "retail ring-fencing" of what are sometimes referred to as "utility" and "casino" banking activities.
- Increased capital requirements for larger more systemically important banks
- Greater failure management powers for regulators and protection of depositors.

Retail Ring-fencing

The structural separation proposal reflects a long-standing idea that "narrow banking" has merit – by virtue of limiting risk-spillovers from other activities typically undertaken within a bank with a broader range of activities.[1] The Vickers report argues that benefits of retail ring-fencing include: insulating vital retail banking services from global shocks; making resolution of troubled banks easier; and facilitating banking competition by allowing different regulatory approaches to domestic retail banking and global wholesale/investment banking approaches. Within the "broad bank", only the ring-fenced bank would be able to provide basic retail banking services, it would be separately capitalized, and have independent directors. While it would be able to share operational services with, and access financial services from, other parts of the broad bank it would be precluded from a range of "non-basic" financial activities.

Can such a separation be done without imposing excessive social costs? Would it have the benefits claimed? Australian experience is potentially relevant here.

[1] In the USA, a variant of this view has been incorporated into the Dodd-Frank Act passed in July 2010 through incorporation of the Volcker Rule (requiring prohibition of proprietary trading and sponsorship of hedge and private equity funds by banks).

Not too many years ago (until changes to the Banking Act in 1989), the major Australian banks operated as structurally separate – but operationally integrated[2] - Savings and Trading Banks with the former historically having been effectively limited to taking deposits from individuals and making housing loans. The State Government owned (and Trustee) Savings Banks were the only Savings Banks allowed to provide payments (checking) services until legislative changes in 1984. While a return to the (very) heavy regulation of those days (which prompted growth of alternative non-bank institutions) needs to be avoided, the historical record does suggest that structural separation is feasible, and not necessarily excessively costly. The continued profitable operation of specialist retail ADIs (credit unions and building societies) also suggests that retail ring-fencing is a viable option.

The history also suggests that limiting the activities of ring-fenced institutions has merit – if it prevents them moving into areas outside their particular expertise and without adequate governance and risk management capabilities. The demise of the State Banks of Victoria and of South Australia at the start of the 1990s, arising from expansion into investment banking type activities are good examples.

But retail ring-fencing in the modern financial sector can create complications. A major growth area for banks is wealth management, involving provision of financial advice to individuals and creation of financial products such as managed funds, margin loans etc for use by those individuals. Where these activities would fit is unclear.

More relevant is the issue of dealing with imbalances in the demand for and supply of funds from the "ring-fenced" retail clientele. While the nationwide branch networks of banks create a form of internal capital market able to smooth out geographical liquidity imbalances, it is far from clear that in aggregate there is a "natural" balance between household loan demand and deposit supply. Indeed, retail loan demand generally far outstrips deposit supply, such that ring-fenced banks would need to obtain funds from other sources, such as via securitizations or loans from their parents or affiliates – thereby indirectly creating counterparty exposures to their "casino" banking activities.

These issues do not seem insoluble, but would require careful regulatory consideration. Such a separation would, most likely, involve limitation of the Financial Claims Scheme deposit insurance to the retail-ring-fenced bank.

It is also worth noting that, some fifteen years ago, the Australian Financial System Inquiry (Wallis, 1997) considered the issue of financial conglomerates. While their focus was more upon entities combining banking, insurance, funds management and securities activities, rather than different types of banking activities, their preference (p346) was for use of a Non-Operating Holding Company structure as the best method for effecting prudentially desired separation. Their Recommendation 49 to permit such a structure was subsequently facilitated by legislation in 2007 and Macquarie Bank converted to such a structure in that year.

[2] For example, cash deposits would be conducted through the same teller and go into the same till regardless of whether the account to be credited was at the Savings or Trading Bank!

Capital Requirements and Loss Absorbency

The Vickers report proposes higher capital requirements for large retail ring-fenced banks, and particularly for non-ring-fenced systemically important banks. An important consideration arises here of whether this is a matter best dealt with via regulation (such as implied under the Basel III proposals for SIFIs) or via supervision. In Australia, APRA operates a graduated approach to supervisory intensity of individual institutions based upon its PAIRS and SOARS framework. In principle, assessments of the severity of micro and macro - prudential risks arising from that framework can lead to imposition of higher, and tailored, capital requirements for SIFIs, rather than a specified regulatory requirement of “x” per cent.

Compliance with international standards suggests that there is limited scope for not adopting the Basel III regulatory proposals for large banks. However, the Vickers structural separation proposal would, arguably, enable a supervisory approach towards the retail ring-fenced entity while applying Basel III regulatory requirements to the non-ring-fenced entities.

Failure Management Powers

The Vickers report proposes the implementation of “depositor preference” arrangements for the ring-fenced bank whereby depositors are senior to all other claimants in the event of bank liquidation. Australia is one of a relatively small number of countries where depositor preference already exists – although it is in the process of being slightly weakened to enable issuance of “covered bonds”, and its rationale somewhat reduced since the introduction of deposit insurance via the Financial Claims Scheme.

Depositor preference arguably increases the cost of other (wholesale market) funding for banks – because of its subordinated status in bank liquidation. In this regard, the Vickers proposals of structural separation and limitation of depositor preference to the retail-ring-fenced bank would provide the opportunity for Australia to remove depositor preference from the non-ring-fenced banks.

Another of the Vickers proposals is to provide the authorities with “bail-in” powers, such that long-term unsecured debt (“bail-in” debt) of a bank requiring resolution could be subject to some degree of write down by the authorities.[3] Such powers may enable an open resolution to take place rather than having to place the bank into liquidation. The dilemma with such a power is the uncertainty it may create unless potential bail-in arrangements are clearly specified, and thus the consequences for the costs of debt.

While “bail-in” debt seems unlikely to garner much support in Australia, it is worth noting that New Zealand, having decided against continuation of explicit deposit insurance after the end of 2011, is considering such arrangements as part of the Open Bank Resolution proposals on which the Reserve Bank of New Zealand is currently consulting. A particularly noteworthy feature of those proposals is that “bailing-in” or “haircuts” would also apply to depositors. (Deposits would be written down to some level consistent with the solvency of the bank, and the remaining

[3] “Bail-in” debt is different to contingent capital (which has also been proposed as a regulatory requirement) in that the latter involves specific defined trigger events at which the debt converts to equity according to pre-specified arrangements.

balances government guaranteed to prevent outflows while the open resolution (eg by takeover by another bank) was effected). Since New Zealanders can place funds in the parent Australian banks (in AUD) and get the protection of the Financial Claims Scheme, any preference for doing so, rather than maintaining deposits at risk in the New Zealand banks in any future period of uncertainty, may create additional liquidity problems for the NZ banks.

REFERENCES

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This FRDP was prepared by Kevin Davis, Research Director, Australian Centre for Financial Studies and Professor of Finance, University of Melbourne.

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APPENDIX: Vickers Report Main Recommendations

The main recommendations of the Report relating to prudential and systemic risk issues (ignoring those specific to Britain) can be summarized as follows[4]:

- *Retail "ring-fencing".* This involves requiring that certain *mandated* financial services and products can only be offered by a "ring-fenced" bank - which is not permitted to engage in a range of other *prohibited* financial activities. *Mandated* activities are deposit taking from, and lending to, individuals and small businesses. *Prohibited* activities are those which create undesirable exposures to global capital markets and other financial institutions and increase the complexity of resolving a troubled entity. Many of these are activities typically carried out by investment banks – but also included are those which involve exposure to market risk and existence of trading books and which are currently found in most banks. Some limit on the proportion of funding obtained from wholesale markets is also envisaged.
- *Legal structure of ring-fenced banks.* While ring-fenced banks can be part of a group structure (which might include investment banking for example) there must be (a) a legal separation (such as through a separately capitalized subsidiary), (b) ability to obtain ongoing access to outsourced services in the event of other parts of the group failing, (c) transactions with other members of the group must be on an arms-length basis, and (d) "independent" governance arrangements generally involving a majority of independent directors.
- *Loss-absorbency*. Large ring-fenced banks (risk-weighted assets greater than 3 per cent of GDP) should have a minimum ratio of equity capital to risk-weighted assets of 10 per cent, with smaller banks having a requirement lying between 7 to 10 per cent depending on size. The minimum leverage ratio (set at 3 per cent by the Basel Committee) should be higher, and linked to size, for larger banks.
- *"Bail-in" of unsecured creditors.* Regulators should have power to impose losses on unsecured creditors when resolving a troubled bank (including in open resolution processes).
- *Depositor Preference*. Depositors should have higher priority than other creditors when a bank fails (ie is insolvent).
- *Primary Loss-absorbing capacity.* Required equity capital and "bail-in" bonds relative to RWA should increase (with systemic importance and/or size) on a sliding scale from a minimum of 10.5 per cent up to 17 per cent for non ring-fenced systemically important banks and large ring-fenced banks headquartered in the UK. Regulators should also be able to apply a further *resolution buffer* requirement of up to 3 per cent where felt necessary.

[4] In addition to these recommendations, there is a proposal for banks to be required to provide customers with no-cost arrangements for account switching (to another bank).