AUSTRALIAN CENTRE FOR FINANCIAL STUDIES

FINANCIAL REGULATION DISCUSSION PAPER SERIES

Britain's Banking Reforms – Is this the future shape of Banking?

FRDP 2012 – 4

August 15, 2012

The recent British White paper[1] *presenting Government plans, based on the 2011 Vickers Report*[2]*, for reforming British Banking involves radical and far reaching changes. They will, no doubt, be opposed by banks (to whom the private cost is estimated in the White Paper at being between four and seven billion pounds p.a.). But the global political and ideological tide has swung sufficiently away from a more laissez faire approach towards banking that it would be surprising if they were not largely implemented, and could be a fore-runner to likely developments elsewhere.*

The proposed retail bank ring fencing reforms of the British Government are based on two general premises prompted by experiences in the Global Financial Crisis. First, the excessive complexity and interdependencies between large financial institutions have led to inadequacies in bank risk management and supervisory capabilities, and to systemic financial stability, problems. Second, implicit government guarantees (particularly of large systemic financial institutions) have been shown to exist and have created costs to taxpayers and distorted competition. In that latter regard, the Bank of England estimated in 2010 that the implicit government subsidy to major UK banks was over 100 billion pounds (although some other studies using different approaches have generated lower estimates).[3]

In dealing with these problems, the UK Government has faced the "British dilemma" of wanting to maintain "The City" as a pre-eminent international financial sector while reducing the exposure of the taxpayer (and the economy) to adverse events emanating therein. Some form of structural or operational separation between "utility" and "casino" banking (as commercial and investment banking are sometimes described) is one solution, and finds reflection in the UK proposals for "ring fencing" of retail banking activities.[4]

[1] HM Treasury *Banking reform: delivering stability and supporting a sustainable economy* Cm8356, June 2012, http://www.hm-treasury.gov.uk/d/whitepaper_banking_reform_140512.pdf
[2] See Australian Centre for Financial Studies, Financial Regulation Discussion Paper 2011-04 *The Vickers Report: Implications for Australia,* 27/09/11.
[3] See, Joseph Noss and Rhiannon Sowerbutts "The implicit subsidy of banks" *Financial Stability Paper No 15, May 2012,* Bank of England*.*
[4] It is worth noting that ring-fencing differs from "narrow banking" which has been also advocated by some as a structural change to reduce banking risk. Narrow banking involves strict limits on the type of assets (cash, government securities etc.) in which holders of a banking licence are allowed to invest deposits.

Other key elements of the plan include:

- increasing bank resilience by requiring much increased capital requirements (or Primary Loss Absorbing Capacity, PLAC) than implied by Basel 3 for some institutions
- introduction of a "bail-in" tool giving regulators the power to impose losses on certain bank creditors before the point of insolvency is reached
- Depositor preference for insured depositors (and the Financial Services Compensation Scheme (FSCS), should it pay out insured depositors)

Retail Ring-Fencing

Ring-fencing is designed with the objective of not limiting the range of activities which a financial group can undertake, but requiring a structure which prevents weaknesses in one part of the organization spilling over into another part which undertakes a specific designated set of activities. Those latter activities are taking deposits from, and providing payments services to, retail and small business customers, and the first ring fencing component involves mandating that only ring-fenced banks can take such deposits.

The second component involves identifying what activities the ring-fenced bank can and cannot undertake. On the funding side, raising debt funds in wholesale markets or (to some limited degree) from other members of the group are permitted. On the asset side, the only, but significant, restriction on lending is to other financial institutions (including group members). Dealing in securities and derivative markets or trading activities, and creation of exposures to other financial institutions, are not permitted except where necessary for managing liquidity, or risk associated with provision of simple risk management products to customers, and provision of payments services.

The third component relates to governance and legal structure. The ring-fenced bank board is required to have at least 50 per cent of independent directors. It is required to be a separate legal entity within the group, with "economic independence" from the remainder of the group and should be able to achieve operational independence if separation is required.

Bail-in Powers

Bail-in powers, which would apply to all banks, differ from requirements for banks to issue contingent capital. The latter are hybrid securities with contract terms which involve mandatory conversion to equity upon certain specified "triggers" being met. Legislating for a bail-in tool (which has been supported by the G20 endorsement of Financial Stability Board proposals) involves giving regulators the power and discretion to determine that the value of certain liabilities of a troubled bank should be written down (or converted to equity) in order to prevent its insolvency and (hopefully) enabling continued operations. Such legislation involves potential alterations to strict seniority rules, since secured debt, insured deposits, commercial claims, and very short term liabilities may be excluded.

Depositor Preference

The introduction of depositor preference also affects the seniority of claims and the consequences of a closed resolution of a troubled bank. Under insured depositor preference, the FSCS stands in place of the depositors it has paid out, and thus has first claim ahead of other creditors on the remaining bank assets. This seniority, and consequent increased recoveries, means that the likelihood of having to impose levies on other banks (and possible contagion that may cause) is reduced. It should, in principle, also increase the monitoring and risk sensitivity of other creditors to the bank.

It is worth noting that this type of arrangement already exists in Australia, with depositor preference (although for all, not just insured, depositors) having been a long-established policy and with APRA standing in place of compensated depositors of a failed bank under the Financial Claims Scheme.

Primary Loss Absorbing Capacity (PLAC)

The British plans are for both ring-fenced banks and G-SIBs to be required to have PLAC of 17 per cent of risk weighted assets. This is substantially above the Basel III minimum requirements, but includes long-term unsecured debt which can be "bailed in".

An Assessment

The British proposals can be assessed on a number of criteria, including effects on banking sector competition, financial stability, economic efficiency, effectiveness of regulation, and restrictions on "economic liberty". It is important to note that the consequences can be considered at both a societal and a bank level. To the extent that banks have received uncompensated benefits from taxpayers (the implicit government subsidy referred to earlier), a reduction in those benefits is a cost to bank shareholders, but a warranted redistribution from a societal perspective. If the changes affect bank behavior there could be net social benefits (less financial crises) or net private and social costs (borne by bank shareholders and/or their customers) if efficient intermediation is retarded.

Competitiveness Implications

Perceptions that government will ultimately bail-out stakeholders in a troubled bank have adverse consequences for financial sector competition. Non-bank institutions face a risk premium in raising funds, while larger banks may, if thought to be "too big to fail", have a competitive advantage over their smaller rivals. The objective of retail ring fencing is to limit such perceptions to a subset of financial activities where they are likely to be correct, and with other regulatory changes being aimed at reducing the value of such implicit government guarantees. Higher capital (PLAC) requirements aim to reduce the likelihood of bank failure and demands for government support, while bail-in powers and depositor preference (in the case of ring fenced banks) increase the likelihood that private sector suppliers of funds will bear the cost of resolving a troubled bank.

Consequently, a more level playing field should be created in the market for wholesale funds, since the ability of banks to benefit from implied guarantees and potential bail-outs should be reduced. The potential impact on the market for retail funds is less clear, since the competitiveness of other institutions such as finance companies issuing (risky) retail debentures etc., will depend upon how much the risk reduction benefits of ring fenced deposits are counterbalanced by the costs and restrictions imposed upon their issuers.

The consequences for competition in loan markets appear minor, because there are no restrictions upon types of institutions that can undertake particular forms of lending.

Financial Stability

Threats to financial stability, involving contemporaneous problems in multiple banks can arise either from common exposures to shocks, spillovers through inter-bank financial linkages, or from contagion. None of the proposals prevent potential exposure to common shocks, although it is to be expected that loan portfolio composition and other exposures including market risk would differ significantly between ring-fenced and other banks. The ring-fencing requirements aim explicitly to prevent spillovers by severely limiting exposures of ring fenced banks to other financial institutions and capital markets. The FSCS aims to reduce the risk of contagion for ring fenced banks.

Whether ring fencing increases or reduces the risk of failure of a financial conglomerate is an open question. Without ring fencing, adverse shocks to one part of the institution may be moderated by offsetting positive shocks to the other part, thereby reducing the risk of institutional failure. However, should failure occur, it is of the whole institution. With ring fencing, any such moderating influences on the non-ring fenced part are not permitted. While this may increase the risk of failure, it is failure of the non-ring fenced part of the institution, not of the whole institution. The ring fenced bank component will not fail – although its longer run ability to maintain and attract customers following the failure of its associated entities is open to question.

Economic Efficiency

Ring fencing, as opposed to complete structural separation, does not prevent bank owners from having investments in the full range of banking activities through equity holdings in the financial group. It does, however, limit the potential ways in which various banking activities can be interrelated. It precludes retail deposits being used by non ring-fenced banks to support their lending activities, both directly and indirectly (via restrictions on ring-fenced bank exposures to other financial institutions).

It is conceivable that such restrictions could inadvertently bias the pattern of flows of funds. That would be the case if restrictions on the use of funds by ring fenced banks were severe – such that deposits could only be used for certain types of lending. The British proposals have, at this stage, avoided such restrictions.

To the extent that ring fencing reduces the coverage of implied guarantees, the pricing of funds flowing into non-ring fenced entities could be expected to be more risk sensitive, leading to better allocation of funds.

There are undoubtedly operational costs arising from ring fencing requirements, including information technology costs. How significant these would be is unclear.

Regulatory Effectiveness

Perhaps the most difficult question is the practical one of whether ring fencing can be made to work in practice. Ring fenced banks need to engage with financial markets and other institutions for the purposes of managing liquidity and interest rate risk and hedging exposures created by transactions with customers. Identifying whether transactions (such as those in foreign exchange and derivative markets) are for these purposes, or involve creation of exposures and proprietary trading may be problematic. This is also an issue facing implementation of the Volcker Rule in the USA. And whether regulators and politicians will actually allow failure of important non-ring fenced banks remains a moot point.

Economic Liberty

Ring fencing does not, necessarily, mean limiting the range of activities which a financial conglomerate (which includes a ring-fenced bank) can undertake through its other arms. So any claims which might be made about interference with economic liberty are somewhat specious. The taking of retail deposits, without the prospectus requirements facing other institutions raising funds and with equal seniority of existing and new depositors, is already limited to licensed banks. Ring fencing limits the uses of those funds, and requires particular organizational and operational structures. Those restrictions can be seen as a *quid pro quo* for the rights to take deposits, to operate under the protection of limited liability, to be highly levered (even with the increased PLAC requirements), to participate in the deposit insurance scheme, have access to Central Bank liquidity facilities, and, arguably, benefit from an implicit guarantee from government.

Conclusion

Overall, the British ring-fencing proposals for retail banking attempt to improve financial stability and competition while minimizing certain costs for financial institutions and for economic efficiency. Of course financial institutions will observe significant costs in the form of reduced benefits from implicit government guarantees, but removal of any such uncompensated transfers of value from taxpayers to bank shareholders is good policy.

Whether ring-fencing can be implemented effectively in practice remains to be seen? But if it can, it may serve as a template for changes world wide by financial regulators who are all dealing with an acknowledged problem of implicit guarantees and expectations of government bail-outs of failing financial institutions.

This FRDP was prepared by Kevin Davis, Research Director of the Australian Centre for Financial Studies.

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