Off the hook

PETER WILLIAMS LISTENED AS THE INDEPENDENT COMMISSION ON BANKING INTRODUCED ITS INTERIM REPORT ON THE REFORM OPTIONS FOR THE BANKING INDUSTRY.

Whatever the final recommendations of the Independent Commission on Banking (ICB) there is no doubt that the cost to corporates, as well as individuals, of borrowing from UK banks is set to rise substantially. In its interim report the ICB reckons that in the case of systemically important banks the implicit (and, for some categories of debt, explicit) government guarantee "cheapens bank funding by considerably in excess of £10bn per year".

The members of the ICB have made it clear that UK taxpayers should no longer be "on the hook" for the banking industry when (and the ICB made clear that it is "when" and not "if") another banking crisis arrives. Instead, bank shareholders, the banks themselves and in many respects the banks' customers are expected to go on the hook in place of the taxpayer.

The chairman of the commission, Sir John Vickers, says: "Like it or not, investment banks have implied support from the UK taxpayer, and that implied taxpayer support is a very large number. Now we want to move to a position where we are explicit over the non-support of the taxpayer."

On the question of whether the extra cost to the banks will be passed onto the banks' customers, Sir John says: "The primary purpose of the reforms of the kind we are looking at is to get the taxpayer off the hook. It is bound to be the case that if the taxpayer is off the hook then the banks will face higher capital requirement and higher funding costs.

"It is hard to say at this stage how the cost of the increase to the banks will feed through to the customer." But Sir John adds that it is possible to say that there are only three ways those higher costs can be absorbed: by lower profits accruing to the banks, by lower remuneration for those working within the banking sector, or by greater cost to the customer.

There is no way of knowing by how much borrowing costs are likely to increase. In an annex about the cost-benefit analysis of financial stability reforms, the report says: "Higher capital requirements raise banks' costs as they have to substitute some higher-cost funding (e.g. equity) for lower-cost funding (e.g. senior debt). But such a shift in funding, by reducing risk, will to some extent lower the return banks need to pay suppliers of finance."

Commenting on its estimate of the £10bn a year government support currently in place, the ICB says: "To the extent that higher capital requirements raise funding costs, the cost will be passed through to bank customers in the form of higher lending rates, unless they are absorbed elsewhere in the banks' cost structures."

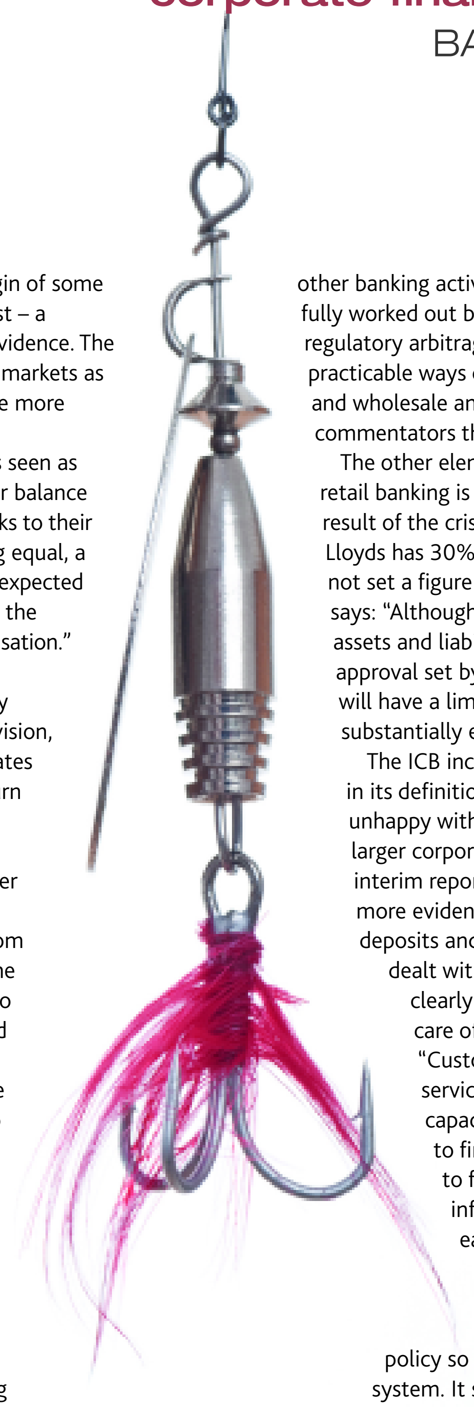
The interim report goes on to say that this increase in the price of credit will tend to make investment funded with bank debt more expensive and so reduce the capital stock and output relative to a hypothetical crisis-free scenario.

As well as acknowledging the price of credit will rise for corporates, the ICB tried to determine the state of competition in wholesale and investment banking markets. The ICB noted the conversations it had with the ACT, among others, although it did not receive many representations in this area – a fact that surprised the commission. The ICB has concluded that there is a lack of transparency and that prices are very high for fee-based security underwriting and M&A advice as well as for services such as lending and cash management. The report states: "Competition between banks does not appear in all cases to focus strongly on price, with services being selected as much on the basis of established relationships, provider reputation and non-price (i.e. quality or capacity) elements."

THERE ARE ONLY THREE WAYS HIGHER COSTS CAN BE ABSORBED: BY LOWER PROFITS ACCRUING TO THE BANKS, BY LOWER REMUNERATION FOR THOSE WORKING WITHIN THE BANKING SECTOR, OR BY GREATER COST TO THE CUSTOMER.

Bank reform: the ACT perspective

John Grout, ACT policy and technical director, praises a "very sober" report that "reasonably strikes all sorts of balances". He adds: "It is important to see the report in the context of all the general reregulation going on, including not only higher capital requirements for banks, but liquidity requirements and overall leverage limit on unweighted assets and, from 2018, a 'net stable funding requirement' that makes banks use more long-term funding sources. Together, these are radical step changes in banking."



The ICB notes that customers feel the high margin of some services is offset to an extent by lending at low cost – a sanguine view that it believes is at odds with the evidence. The ICB approves of more derivative trades going onto markets as a way of increasing transparency. It would welcome more evidence on wholesale competition.

Increasing the amount of equity held by banks is seen as crucial as banks with more common equity on their balance sheets can remain solvent in the face of larger shocks to their assets. The interim report says: "Other things being equal, a better capitalised banking system can therefore be expected to encounter solvency crises less frequently. This is the principal social benefit of higher bank equity capitalisation."

The ICB quotes two recent studies into capital requirements – a joint one by the Financial Stability Board and the Basel Committee on Banking Supervision, and another by the OECD – that suggest lending rates will need to rise by 13 basis points to keep the return on equity unchanged.

The ICB has identified two separate strands of reform: the first is to demand that banks hold higher amounts of capital, the second to call for some measure of ringfencing to protect retail banking from wholesale and investment banking. According to the available evidence and analysis, the ICB says that to achieve greater loss absorbency banks need to hold more equity relative to their assets and that those creditors – including bondholders – should take the losses if necessary. Basel III has a 7% baseline ratio of equity to risk-weighted assets. The ICB says that a 10% equity baseline should become the international standard for systemically important banks and that figure should apply to large UK retail banks. The interim report adds: "The capital standards applying to wholesale and investment banking businesses of UK banks need not exceed international standards provided that those businesses have credible resolution plans (including effective loss-absorbing debt) so that they can fail without risk to the taxpayer."

On the issue of the failure of debt to absorb losses in the crisis, contingent capital and debt capable of so-called "bail in" might contribute to improved loss absorbency in the future. Loss absorbency and stability might also be improved by ranking the claims of ordinary depositors higher than those of unsecured creditors.

The ICB wants international agreement on a more orderly and efficient resolution of failing banks, especially wholesale and investment banking operations. These highly complex entities span many different countries and present a danger to the wider financial system if they fail.

Most of the headlines on the interim report have focused on the retail operations. The ICB has suggested a form of ringfencing, with retail bank operations carried out by a separate subsidiary within a wider group. This would require universal banks to maintain minimum capital ratios and loss-absorbing debt for their UK retail banking operations, as well as for their businesses as a whole. Subject to that, the banks could transfer capital between their UK retail and other banking activities. However, these plans have not been fully worked out by the ICB, which says: "While mindful of regulatory arbitrage possibilities at the boundary… there are practicable ways of distinguishing between retail banking and wholesale and investment banking." However, some commentators think that erecting a firewall won't be easy.

The other element that the ICB is trying to address in retail banking is competition, which has been reduced as a result of the crisis. Following its acquisition of HBOS, Lloyds has 30% of current accounts in the UK. The ICB has not set a figure for market share or bank branches but says: "Although Lloyds is required to divest a package of assets and liabilities to satisfy conditions for state aid approval set by the European Commission, this divestiture will have a limited effect on competition unless it is substantially enhanced."

The ICB includes small and medium enterprises (SMEs) in its definition of retail operations. As noted above, it is unhappy with the evidence on banking competition for larger corporates and has withheld judgement in the interim report. But, treasurers should note, it calls for more evidence on how medium and large corporate deposits and lending ("commercial banking") should be dealt with in the wholesale/retail divide. The ICB clearly believes that large corporates can take care of themselves. The interim report states: "Customers of wholesale and investment banking services… generally have greater choice and capacity to look after themselves. But it is vital to find ways for the providers of these services to fail safely; strengthening market infrastructure and limiting banks' exposure to each other will help."

To make the system safer the ICB says part of the answer is better macro-economic (including "macro-prudential") policy so there are fewer and smaller shocks to the system. It says making the banking system safer requires three elements: putting banks in a position where they are better able to absorb losses; making it easier and cheaper to sort out banks that get into trouble; and curbing incentives for risk taking. The ICB hopes its proposals will end the "too big to fail" problem and remove the unwarranted competitive advantage that some banks have that encourages too much risk taking.

The ICB is keen to stress in the interim report that it is still open to persuasion based on the strength of the arguments. It denies suggestions by the media that it is being lent on by the government or by the banks. The final recommendations are due in September, at which point the ICB can hand over the issue to the government, which will have to decide what action to take.

Peter Williams is editor of The Treasurer.
editor@treasurers.org

For ICB news and publications, go to http://bit.ly/ifSOiG
The members of the ICB are Sir John Vickers, Clare Spottiswoode, Martin Taylor, Bill Winters and Martin Wolf.