



Stability and Competition in UK Banking

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Plan of talk

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- Background
 - The Commission
 - Financial Stability
 - Competition
 - Conclusion

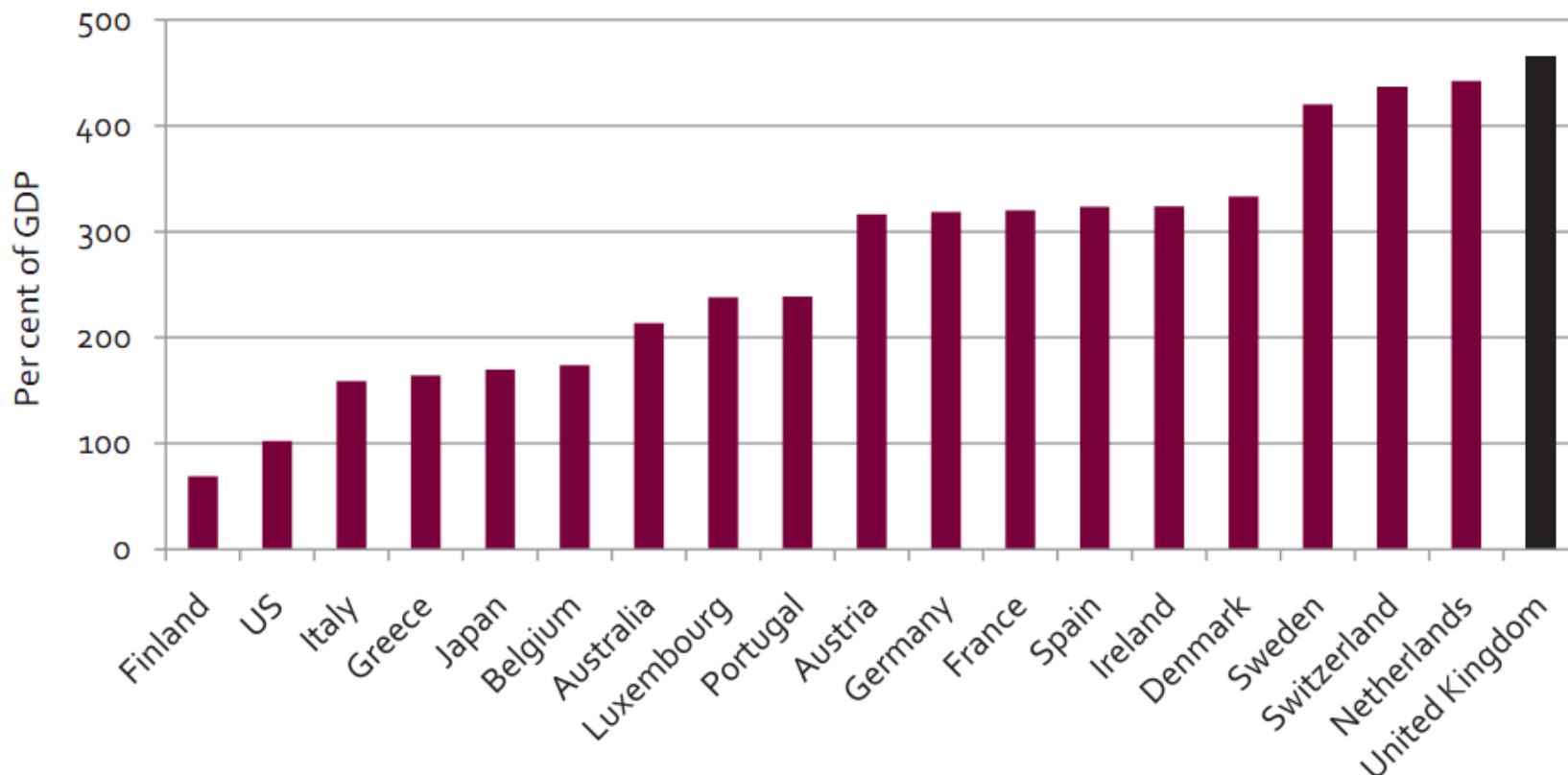
BACKGROUND

The financial services system and role of banks

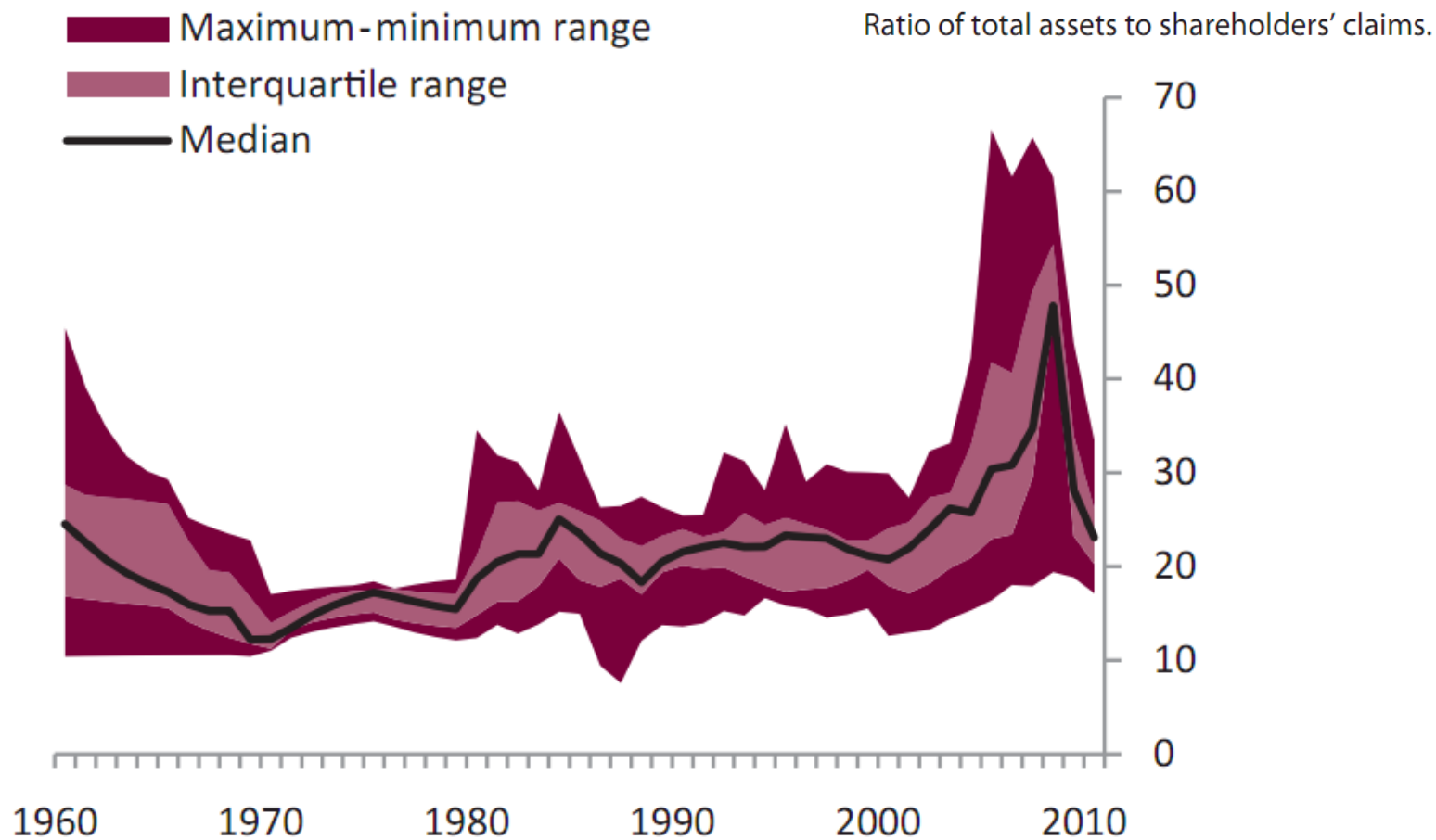
- The financial system supports the wider economy by:
 - Providing payments systems
 - Providing deposit-taking facilities and a store-of-value system
 - Lending to households, businesses and governments
 - Helping households and businesses manage risk over time
- Banks play a central role in all four of these functions
- Banks can be especially sensitive to economic shocks
 - Take on risk credit, market and maturity/liquidity risks
 - Operate with more debt than non-financial firms

For the size of the country, the UK has a very large banking sector

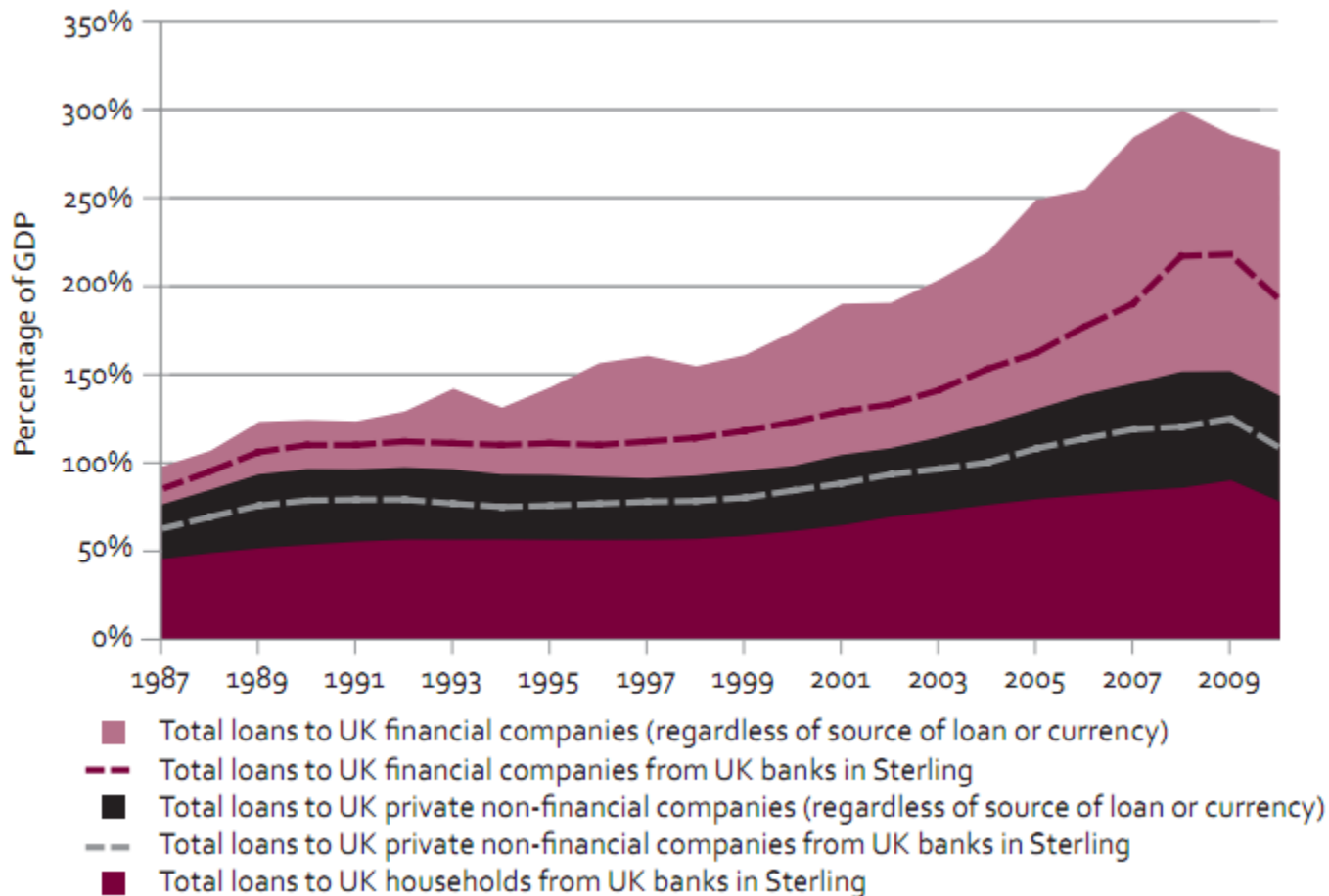
Domestic banking assets as a percentage of GDP consolidated by nationality of headquarters (2009)



Increase in UK bank leverage in the past fifty years



Total loans to different economic sectors as a proportion of UK GDP



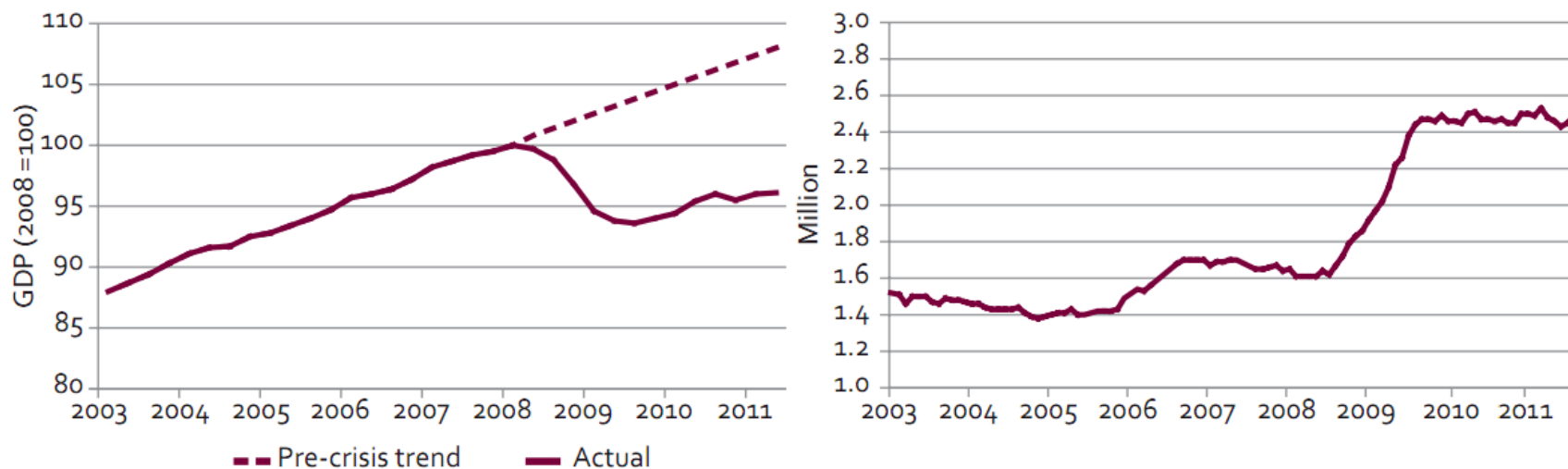
The UK banking system was ill-prepared for global financial crisis

- Individual banks were both huge and unable to withstand severe economic shocks
- Financial system highly interconnected – both within and between these systemically important banks
- Governments unable to let whole financial system fail, so forced into providing unprecedented levels of support
- Even with this support, the disruption in economic activity had a huge and lasting effect on economic growth

The crisis significantly weakened the UK economy

- The output loss relating to the crisis is already worth more than 25% of GDP
- Eventual cost will be a multiple of that. Associated fiscal hit.

UK output (left) and unemployment (right) 2003 – 2011



THE COMMISSION

Establishment of ICB

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- Interesting political context of banking reform
 - Commission created by the Chancellor on the 16th June 2010
 - Members
 - Clare Spottiswoode
 - Martin Taylor
 - John Vickers (*chair*)
 - Bill Winters
 - Martin Wolf
 - Supported by fourteen officials
 - Reported to Government on 12th September 2011
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- Structural and related non-structural measures to promote stability and competition for the benefit of consumers and businesses
 - To include consideration of retail-investment bank split
 - Also having regard to:
 - Legal, operational and practical requirements, e.g. EU Law
 - Ongoing EU and international regulatory change
 - Pace of economic recovery
 - Consumer choice
 - UK competitiveness
 - Fiscal risk

How we approached task

- Meetings with industry experts, regulators, officials
- Public events
- Two rounds of hearings with banks
- Data questionnaires
- Reporting
 - Issues Paper (Sep 2010)
 - Interim Report (Apr 2011)
 - Final Report (Sep 2011)



FINANCIAL STABILITY

Reform options for financial stability

		Structural reform	
		Mild	Radical
Loss-absorbing capacity	Mild	Fails to solve stability problem	Taxpayer 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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- We believe the best way to achieve our aims is by combining moderate measures on loss-absorbency and structure, rather than taking extreme measures on any one front
 - Our primary 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 regulatory developments elsewhere

Benefits of ring-fence

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- Helps insulate vital UK retail banking services – where continuity of service is essential – from global financial shocks, which is of particular importance given the way that major UK banks combine retail banking with global investment banking
 - Would make it easier and less costly to sort out banks – whether retail or investment banks – that still got into trouble despite greater loss-absorbing capacity. This is all part of getting taxpayers off the hook for the banks
 - Good for competitiveness because UK retail banking can be made safer while international standards apply to the global wholesale and investment banking activities of UK banks

Mandated

- Deposits and overdrafts to individuals and SMEs

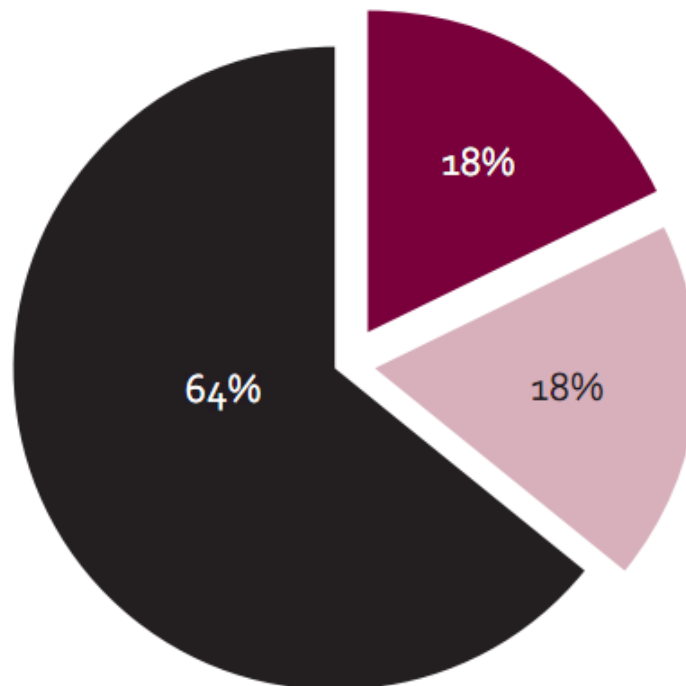
Permitted

- 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



■ Mandated services

■ Permitted services

■ Prohibited services

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?

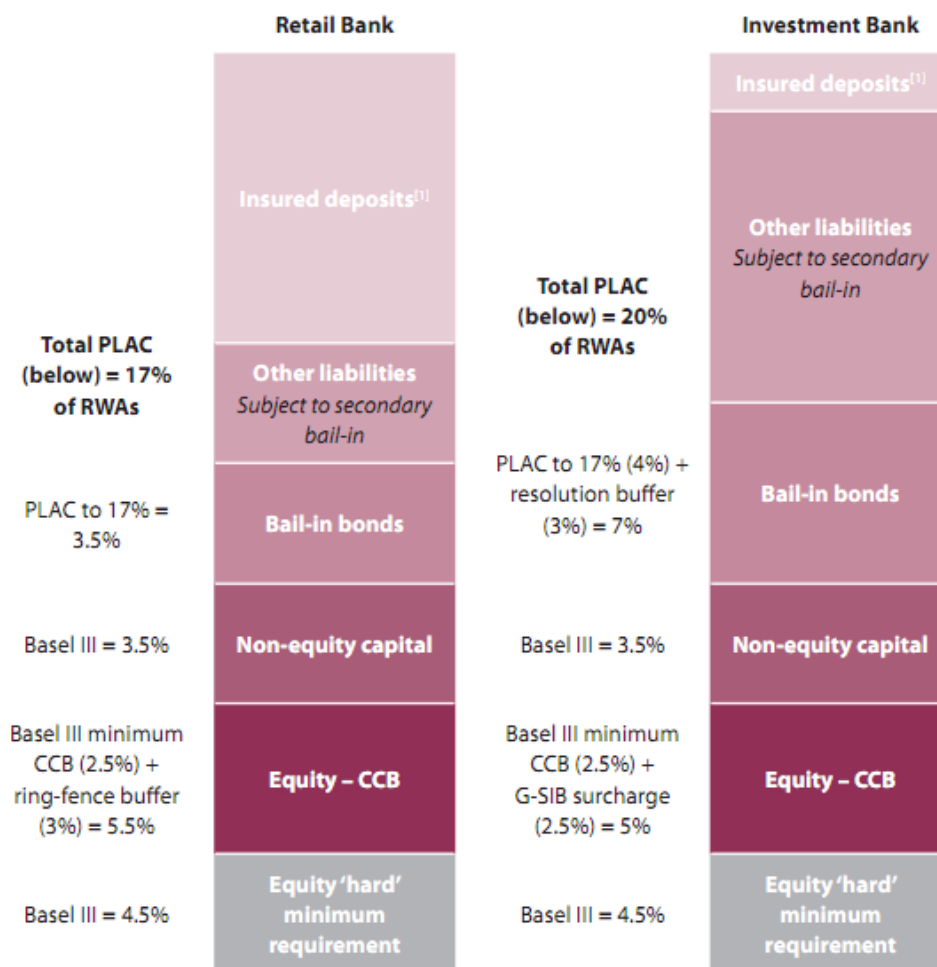
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- Ring-fencing retains many of the synergies of a broad banking group, while providing insulation for vital economic functions
 - Ring-fencing leaves the possibility that the parent group could rescue a failing retail bank
 - Hard to enforce a full legal split in the context of EU law

Are higher capital requirements costly?

- Not in MM world, but ...
 - Costs to banks (but not the economy) from loss of some tax and implicit subsidy advantages of debt
 - Effects on bankruptcy probabilities
 - Effects on incentives
- Important for risk to sit with investors, not retail depositors or taxpayers

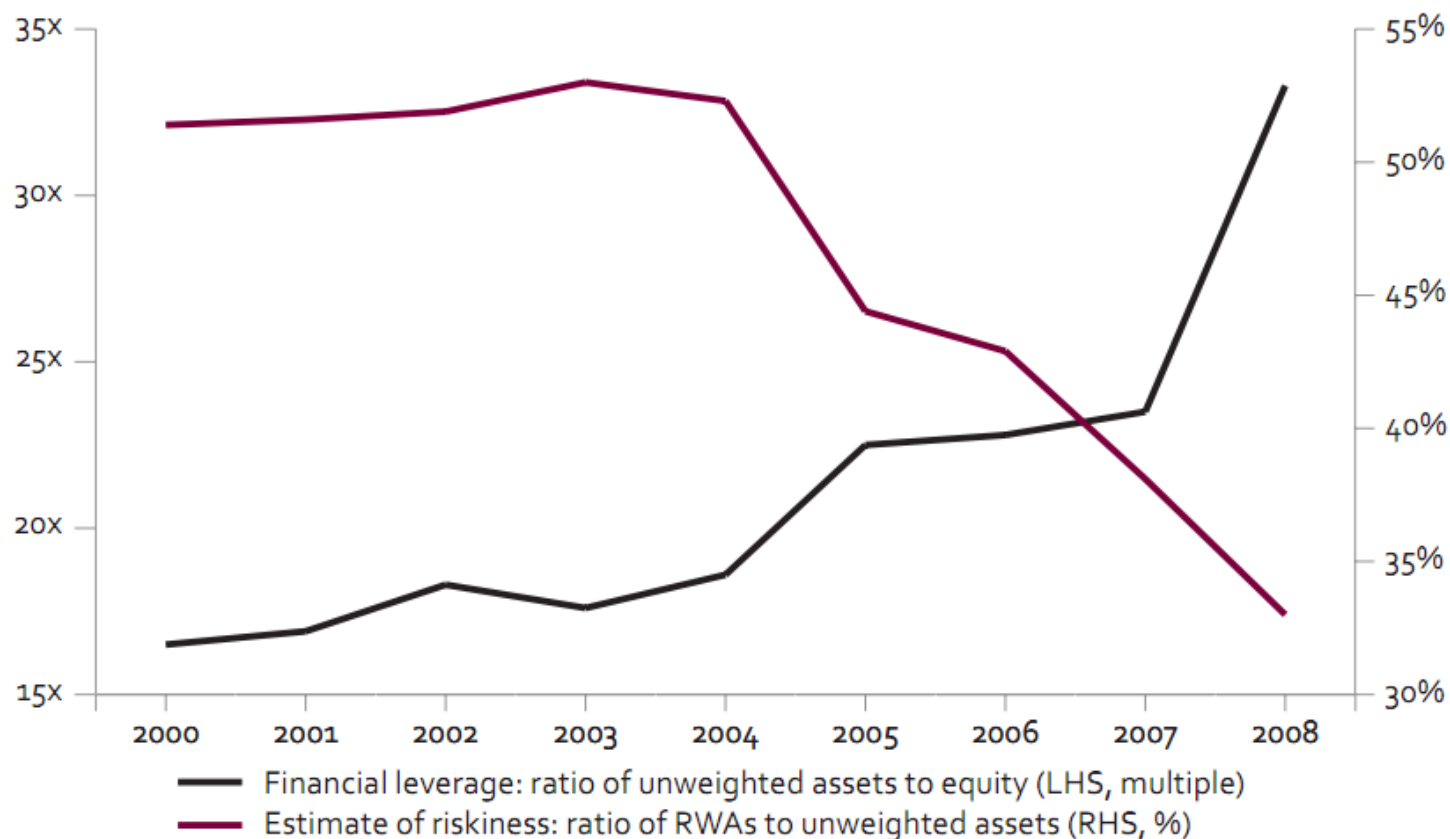
Need for more loss-absorbing capacity

- Equity of at least 10% for large ring-fence banks
- Primary loss absorbing capacity (PLAC) to reach at least 17% RWAs
- Resolution buffer up to 3% RWAs on top
- Bail-in powers
- Depositor preference also acts to increase loss absorbing capacity of debt



Risk-weight concerns show need for leverage backstop

Ratio of risk-weighted assets to unweighted assets falls as financial leverage increases (aggregated for the four largest UK-headquartered banks)²⁹



Benefits

- Main benefit is reducing likelihood/impact of financial crises, which can easily have NPV cost of 60% of GDP
- Improved stability good for investment
- Removal of distortion good for balance of economic activity

Costs

- Loss of diversification benefits? (Not to be confused with removal of implicit government guarantee)
- Loss of operational and customer synergies?
- Cost to banks might be £4bn-£7bn
- Cost to economy might be £1bn-£3bn (around 0.1-0.2% of GDP)

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- Improved stability good for:
 - UK competitiveness
 - Other EU countries (CRD IV debate)
 - The City of London, which is an entrepôt, not a home for national champions
 - Will have costs for some banks, especially outside the fence, but that is no justification for costly and risky implicit subsidy
 - Ring-fencing gives sound basis for long-term credit supply in UK economy

COMPETITION

The crisis also damaged the levels of competition in UK banking

Concentration levels in personal and SME banking as measured by the HHI rose dramatically as a result of the crisis

- Personal current accounts (PCAs)
 - HHI of 1,470 in 2000
 - Driven down to 1,290 in 2008 by challenger banks
 - Rose to 1,830 in 2010 as a result of exits and acquisitions, most notably Lloyds/HBOS
- SME banking
 - 1,690 in 2007
 - 1,950 in 2009

Creating a strong and effective challenger

- Challengers an important aspect of competition since 2000
 - Offered better rates on overdrafts and deposits
 - Gained switchers while large banks lost market share
- Only two challengers left – most have left market
- Lloyds divestment required by European Commission as consequence of aid received from government during crisis
- Divestment funding gap jeopardises its ability to compete
- We recommended that Government seek agreement with Lloyds to ensure the emergence of a strong challenger

Demand-side competition problems

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- Effective competition requires easy comparison and switching
 - Current accounts very difficult to compare (esp. on price)
 - People very rarely switch, despite gains on offer
 - Average customer keeps PCA 26 years
 - Fear of payments failing is biggest switching deterrent
 - Perception that switching is not easy
 - Evidence of misdirected competition such as PPI
 - Recommendations
 - Redirection service to reduce switching risk
 - How OFT and FCA should improve transparency
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- Some long-standing issues will remain such as complex products that are poorly understood
 - Regulation should promote effective competition, especially on switching, transparency and barriers to entry
 - Opportunity to put competition at the heart of financial regulation with new regulator, Financial Conduct Authority
 - Commission recommendation that current wording of the FCA's objectives be changed to secure this aim more effectively

CONCLUSION

Banking reform and current macroeconomic stress

- Macroeconomic and sovereign debt crises have widened
- This is not a reason for avoiding bank reform – quite the reverse
- Reduced bank leverage is not detrimental to economic growth in the medium term
- Implementation timeline allows plenty of time for adjustment
- ‘Too-big-to-fail’ must not become ‘too-delicate-to-reform’

Government response and next steps

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- Government response published on 19 December 2011
 - Legislation for ring fence to be completed by May 2015, with implementation as soon as practically possible thereafter
 - Support for loss-absorbency recommendations: higher capital requirements, leverage cap, bail-in power, PLAC (scope issue), depositor preference
 - Support for all competition recommendations
 - Outstanding issues on international reform agenda