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News release

26 October 2012

On being the right size – speech by Andrew Haldane

In a speech at the Institute of Economic Affairs, delivered on 25 October 2012, Andrew Haldane – Executive Director for Financial Stability and member of the Financial Policy Committee – reviews the initiatives taken to solve the too-big-to-fail problem. He concludes that, while existing change initiatives are right in direction, they may be insufficient in degree. He then considers what supplementary policy options might be necessary to ensure that banking is “the right size”.

Andrew Haldane explains that the size of banks has increased dramatically over recent decades, accompanied by an equally-dramatic rise in banking concentration. That has created expectations of state support: “These expectations generate lower funding costs, in particular for the largest banks, which in turn encourages further expansion and concentration, worsening the too-big-to-fail dilemma.” Estimates of the size of the resulting implicit subsidy for the world’s banks – up to $700bn per year in 2009 – imply that “...Too-big-to-fail had become hard-wired into the structure and pricing of the financial system.”

He notes that “systemic surcharges” of additional capital on the world’s biggest banks tackle the implicit subsidy by reducing expected system-wide losses from big bank failure. Surcharges represent, he says, “...a practical step in the right direction”. But he provides estimates of their impact on expected system-wide losses which indicate that, at currently proposed levels of the surcharge, a large part of the implicit subsidy would remain untouched. He concludes that: “If too-big-to-fail is the problem, then systemic surcharges seem to offer only a partial solution.”

Andrew Haldane says that the second strand of the reform debate – effective resolution regimes – is designed to reduce the collateral damage associated with the failure of large banks. But while it is “...striking how much progress has been made in so short a space of time on so complex an issue”, he highlights two reasons for caution. First, it could increase concentration in the banking sector, creating “...ever-larger too-big-to-fail banks”. Second, the credibility of resolution regimes could be tested when a large bank fails and policymakers incline towards the safer, certain, option of state bail-out. That is concerning, he argues, because evidence suggests that recent bail-outs have increased government debt to levels that “... may be a significant drag on medium-term growth”.

He explains that one way of lessening policymakers' dilemma "...is to act on the scale and structure of banking directly" through structural reforms. Recent proposals, such as the ring-fence proposals from the Vickers Commission in the UK, share a common motivation: separation of certain investment and commercial banking activities. Andrew Haldane says that, to avoid cross-contamination of risk and resources from the investment bank to the retail bank, "...full and faithful implementation of the spirit as well as the letter of the Volcker, Vickers and Liikanen plans" will be needed. Truly achieving a separation of culture and capital, and the elimination of implicit subsidies and too-big-to-fail will, he argues, "require entirely separate governance, risk and balance sheet management on either side of the ring fence...Only time will tell whether cultural separation can be achieved under the existing structural reform proposals."

Andrew Haldane concludes that, despite real progress being made, current reform initiatives may be insufficient to eliminate the systemic externality caused by too-big-to-fail. He outlines several more radical proposals. Re-sizing the capital surcharge to a level several times higher than the current upper limit would "...reduce materially expected system-wide losses". Limits could be placed on bank size. A full separation of investment and commercial banking – "a modern-day Glass-Steagall Act" – would lessen the risk of basic banking activities being starved of human or financial capital. Finally, enhanced banking competition through reduced barriers to entry would reduce the degree of banking concentration, and with it too-big-to-fail.

A counter-argument to these proposals is that they could erode the economies of scale and scope associated with large banks. But Andrew Haldane presents evidence to show that, once an allowance is made for the implicit subsidy, there is no evidence of economies of scale at bank sizes above $100 billion: "...implicit subsidies may have artificially boosted the privately-optimal bank size. Subtracting this subsidy, removing the state crutch, would suggest a dramatically lower socially-optimal banking scale."

Key Resources

http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech615.pdf

Full speech by Andrew Haldane