

## Note to the CMA's retail banking market investigation team

### The Bank of England's proposed framework for the systemic risk buffer

John Vickers, 23 February 2016

#### Introduction

1. On 29 January 2016 the Bank of England (BoE) published for consultation the Financial Policy Committee's proposed [Framework](#) for the systemic risk buffer (SRB) for large ring-fenced banks. Insofar as it addresses too-big-to-fail advantages that would otherwise be enjoyed by larger banks, SRB policy should be pro-competitive in broad terms, in addition to its fundamental importance for financial stability. The BoE states that a number of competition considerations informed the design of its proposal, including facilitation of "competition by mid-ranking and smaller SRB institutions" (page 20).
2. For the reasons set out below, however, there are *prima facie* reasons to suspect that some features of the proposed framework may be detrimental to competition. In particular, the stepped thresholds for SRB rates, and the 'empty bucket' policy towards the top rate, could blunt the incentives of major retail banks to compete for new business, and may even incentivise shrinkage at some points. The effect could be a generalised weakening and/or distortion of competition across retail markets.
3. Not having information on banks' ring-fencing plans, I am unable to gauge the empirical magnitude of any such effects but would encourage the CMA to investigate the issues.

#### The proposed framework

4. The proposed framework is illustrated in the table below.

**Table F** Proposed SRB calibration

Risk-weighted SRB rate	Total assets (£ billions)	
	Lower threshold	Upper threshold
0%	–	<175
1%	175	<320
1.5%	320	<465
2%	465	<610
2.5%	610	<755
3%	≥755	

5. The SRB rate in the left-hand column is the additional common equity capital, expressed as a percentage of risk-weighted assets (RWAs), that systemically-important banks must hold on top of the minimum 8.5% of Tier 1 capital (or 7% in terms of common equity) that all banks must maintain. Under the capital buffers [Regulations](#) the only rate levels that may be specified are those in the left-hand column. The asset threshold ranges in the other columns are in £ billions of total assets (i.e. unweighted for risk). Thus a ring-fenced bank with £400 billion of assets would have an SRB of 1.5% of RWAs. (Memo: UK annual GDP is about £1,900 billion.) The top 3% bucket would initially be empty but “would be applied to the most systemic firms should their assets expand further than those set out in existing data and in firms’ current ring-fencing plans” (page 17).

### *Competition concerns*

6. The competition concerns arise from the fact that equity capital is a relatively costly form of funding from the perspective of banks. (The public interest perspective is another matter altogether.) As a ring-fenced bank crosses one of the critical size thresholds the ‘tax rate’ jumps. Moreover, unlike the income tax system, the higher rate is applied to all assets, not just the extent to which assets exceed the threshold that has been crossed.<sup>1</sup> This creates very high marginal ‘tax’ rates at those points. This could significantly deter growth by banks as they approach critical thresholds.<sup>2</sup> This possibility is recognised on page 17 of the BoE consultation paper, where a reason given for equally-sized buckets is that they “are more likely to deter the most systemic firms from getting even larger”.<sup>3</sup> This suggests that the possibility of the thresholds being barriers to expansion is more than theoretical. Likewise, for a bank that starts just above a threshold there could be a significant incentive to contract. Although such consequences would reduce simplistic measures of ‘concentration’ in UK retail banking, the effect on market competition would clearly be negative.<sup>4</sup>
7. Competition could also be distorted away from the thresholds.<sup>5</sup> Suppose that the financial stability risk posed by a bank rises more than proportionately with its size in a continuous

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<sup>1</sup> Under the Regulations each institution receives a single score according to measurable criteria, and each possible score has assigned to it a buffer rate, which must be 0%, 1%, 1.5%, 2%, 2.5% or 3%.

<sup>2</sup> And/or seriously distort incentives for placing business outside the ring-fence.

<sup>3</sup> Likewise in a letter published in the *Financial Times* on 17 February 2016 two Deputy Governors say that the BoE wants “to put banks on notice that if they become more systemically important they could face higher capital requirements – and avoid giving firms an incentive for further growth”.

<sup>4</sup> Banks considered to be of *global* systemic importance have similar ‘G-SIB buffers’ applied to them, on a similarly stepped basis, under international regulations. The anti-competitive consequences of G-SIB buffers seem less serious than the SRB applied to domestic ring-fenced banks, however, because of the far greater range, both geographically and functionally, of their application. Core retail services in the UK are by contrast quite narrow in range.

<sup>5</sup> I owe this point to George Yarrow.

way. Then the ideal buffer rate would likewise increase continuously, albeit gradually perhaps. But between thresholds the SRB is flat given the way the Regulations work. So even if – a very big if – the flat rate between thresholds were at approximately the right level, its flatness would not reflect the increasing incremental financial stability risk. The result could even be too much incentive to compete in some ranges.<sup>6</sup> My guess, however, is that this more subtle effect is second-order compared with (i) the ‘cliff-edge’ effects of paragraph 6, and (ii) distortions from the general level of the SRB being sub-optimal.

8. On the face of it, then, these effects could distort the incentives of major retail banks to compete. It therefore seems possible that aspects of the proposed SRB framework, and perhaps the Regulations more generally, are a market feature with potentially adverse effects on competition, to the detriment of consumers. In that case, what remedies would be available?

*Remedies taking the Regulations as given*

9. For a start it would seem unwise to leave an empty 3% bucket within range of what a large ring-fenced bank might otherwise aspire to compete for. An argument<sup>7</sup> that there is a benefit to financial stability from deterring expansion of any bank beyond that point would appear to indicate that the too-big-to-fail problem in relation to that size bracket had been left seriously under-treated – and hence that SRB rate levels are too low. Then the better approach for financial stability, never mind competition, would probably be to apply the top 3% rate to at least the largest banks rather than a lower rate combined with a regulatory deterrent to expansion.
10. For competition among large banks – which is probably the most important dimension of retail competition – the best approach for competition, taking the Regulations as given, might well be a *flat rate* SRB. The optimal level of the flat rate depends on financial stability calculations beyond the scope of this note.
11. There is a problem of how to scale up to a large-bank flat rate without blunting competition from smaller challenger banks. On this, paragraph 4.43 of the [Final Report](#) of the ICB stated:

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<sup>6</sup> For example, if incremental financial stability risk increases with size, a bank in the higher part of a range would have the same SRB as one in the lower part of the same range even though the incremental financial stability risk of its expansion is greater than that of the smaller bank.

<sup>7</sup> See footnote 3 above.

“However, a situation in which a bank operating just below a size threshold has no ring-fence buffer<sup>8</sup> and a bank operating just above it has the full equity ring-fence buffer of 3% of RWAs would in itself create an anti-competitive discontinuity (although this will be less of a problem to the extent that smaller banks are in any case required to operate with higher capital ratios).”

The ICB recommended a sliding scale approach to meet this point (see paragraph 13 below).

#### *Remedies relating to the Regulations*

12. The Regulations would be less detrimental to competition if the progression of the ‘tax’ rate were incremental, like income tax. That is to say, the first £X billion would be at one level, and the next £Y billion at another. But then, unless size thresholds were radically reduced<sup>9</sup>, the *average* SRB level would fall considerably, contrary to financial stability objectives.
13. An additional way to make the Regulations less detrimental to competition would be to introduce a sliding scale of higher SRB rates so as to avoid the ‘cliff-edge’ effects that arise from discrete rate levels. This was the ICB’s recommended approach, with a zero buffer for banks with a ratio of RWAs-to-UK GDP of 1% or less, and increasing the buffer linearly so that it reaches 3% for banks with RWAs-to-UK GDP of 3%.<sup>10</sup>

#### *Conclusion*

14. There are grounds to suspect that features of the proposed SRB framework may be detrimental to competition in retail banking. Part of the difficulty appears to lie with the Regulations. But even taking them as given, there may well be less anti-competitive ways of implementing the Regulations without detriment to financial stability objectives. I hope the CMA will investigate whether or not these competition concerns are likely to be important in fact.

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<sup>8</sup> The ‘ring-fence buffer’ was the ICB’s name for what is now called the SRB. The ICB recommended a buffer of 3% of RWAs for ring-fenced banks with RWAs greater than 3% of GDP. Depending on the average risk weight, that threshold might equate to at most £160 billion of total assets (cf. the Table in paragraph 4 above).

<sup>9</sup> As the ICB recommended.

<sup>10</sup> The ICB Report (paragraph 4.44) illustrated this calibration in Table 4.2. It also acknowledged that “[t]here is a drawback, however, in that for the same increase in RWAs, a smaller bank would have to increase its absolute level of equity by more than a larger bank. Depending on the equity-to-RWAs ratios that smaller banks are in practice required to maintain, it might be appropriate for the scale proposed ... to be modified to minimise any anti-competitive effect”. Footnote 21 on page 93 of the ICB Report has a worked example that is on point.