Some Ideas on Bank Size, Structure and Remuneration

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Context
The regulators and policy makers responsible for the design and implementation of the post-2008 agenda of financial reform are frequently taxed over the slowness and limitations of the process. Their reply is to draw attention to the many subjects covered by proposals and measures so far taken. These include more rigorous rules for banks’ capital requirements and risk management (Basel III), which now cover aggregate leverage and liquidity as well as capital in relation to risk-weighted exposures; tighter rules for over-the-counter (OTC) derivatives; proposals for the enhanced regulation of shadow banking (the carrying-out of banking activities in institutions beyond the traditional perimeter of banking regulation); additional control over financial institutions classified as Too Big To Fail (TBTF) so that they will not need government bail-outs in future; and national measures separating retail and traditional commercial from higher risk banking.

Yet critics, including some within the regulatory community itself, remain only partially convinced that the initiatives so far undertaken or on the table have achieved the safety and fairness which should characterise banking. Major targets of critics are the size and complexity of many banks, and what is still widely considered the excessive pay and bonuses of bankers.

Size and complexity are matters for structural reform of banks. At the international level proposals for such reform have consisted mainly of bottom-up measures such as increased capital requirements under Basel III, intensified supervision for larger banks, and resolution regimes (i.e. the regime for insolvent banks). The connection of the latter to ending TBTF banks is that “a necessary requirement is... an effective and credible resolution regime, which allows authorities to expose shareholders and unsecured and uninsured credit of a failing SIFI [Systemically Important Financial Institution] to losses without major disruption. Without such a regime, addressing the problem of ‘too big to fail’ is reliant on a zero-failure regime for SIFIs, which is unlikely to be realistic” (Bank of England, 2013: 40-41).

Except at the level of the EU the international reform agenda has not addressed top-down measures such as capping the size of banks or prescribing institutional simplification. The absence of such measures can probably be explained by the difficulty of reaching international agreement on proposals which would take appropriate account of differences in national conditions and histories regarding banking. At national level there have been legislative initiatives designed to separate legally and institutionally major categories of banking activity. But so far proposals for capping bank size have been few and far between, though in the United States the Federal Reserve recently put forward a proposal which would restrict bank acquisitions which would have the effect of raising the purchasing institution’s liabilities above 10 per cent of the liabilities of the banking system as a whole (Piggott, 2014).

Agreement on resolution regimes for large banks has made progress on transparency and cooperative cross-border procedures but there continue to be difficulties over the way in which the losses of a large insolvent bank should be distributed among the different jurisdictions where it has a commercial presence.

The reliance on capital requirements as a major element of policy towards large banks necessarily raises the question of the adequacy of Basel III. The capital requirements of Basel III have recently been the subject of a series of initiative to strengthen its rules, some by the Basel Committee itself and some at national level. Yet
there remain reservations even within the regulatory community concerning the extent to which Basel III will prove capable of fulfilling the linchpin role accorded to it in the reform agenda.

In the international agenda work on bankers’ pay and bonuses has focussed on connections between performance, risk taking and compensation and has included guidelines on clawback and other mechanisms which reduce bonuses after awards have been made or vested (Financial Stability Forum, 2009; Financial Stability Board, 2014). The EU has introduced its own rules on the maximum ratio between fixed and variable compensation.

This paper illustrates some of the ways in which current reform and reform proposals address bank structure and corporate form as well as bankers’ remuneration. For this purpose it bases itself primarily on recent addresses by Daniel Tarullo, a senior United States regulator, and a comprehensive blueprint for banking reform in the United Kingdom by David Shirreff, a well known British financial commentator.

In one of his addresses, Tarullo covers the way in which the bottom-up approach to bank size will work in the United States. The bottom-up approach relies heavily on supervision of capital and risk management in accordance with standards which vary with bank size. However, Tarullo’s remarks do not tackle questions as to the strengths and weaknesses of the bottom-up approach in comparison with the top-down approach which targets the sector and its constituent firms. Moreover the rules of Basel III are accorded a linchpin role in the bottom-up approach so that Tarullo’s skepticism concerning these rules and his suggestions for amending them are of special interest. In the addresses discussed in this paper Tarullo does not deal with bankers’ remuneration.

Shirreff has proposed a comprehensive blueprint of structural reform for the United Kingdom banking sector through changes to the legal framework for different categories of banking activity. His blueprint would have implications for bank size and structure and for bankers’ remuneration. The proposals are more radical than the official agenda. In particular they raise the question of the appropriateness of limited liability for the more risky activities of banks.

A striking feature of the initiatives and proposals discussed in this paper is the prominence in them of reforms involving corporate form. As noted in the final section, this raises questions as to appropriateness of the inclusion of provisions in agreements on international trade and investment designed to restrict policy autonomy regarding changes in corporate form.

Reforms of bank size and structure in the United States

In one of his recent speeches on banking reform in the United States Daniel Tarullo, the pointsman for financial regulation of the Board of Governors of the Federal Reserve System, explains how the new regulations of TBTF and other large banks in response to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 are related the new focus of bank regulation on its macroprudential dimension (Tarullo, 2014b).

The crisis and the government measures taken to contain the turmoil have produced a new consensus around a view, which had previously been accepted by probably only a minority of bank regulators, that prudential regulation should henceforth attribute major importance to the objective of protecting the stability of the financial system as a whole. This objective implies a focus on both banks and non-bank financial institutions as well as on the interrelations and size of these institutions. Tarullo’s speech focuses on the regulatory approach to banks of different size and character adopted in response to the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Banks with consolidated assets of more than USD 50 billion are subject to more stringent regulatory standards than smaller banks, and this stringency increases with size. The baseline for banks in this category include
supervisory stress tests, capital, requirements as to resolution plans, limits on credit exposure to a single counterparty, and a modified version of the Basel III rules concerning the liquidity of the bank’s assets.

Banks with at least USD 250 billion in assets or USD 10 billion in on-balance-sheet foreign assets must also introduce the advanced version of the internal ratings-based approach to estimating capital requirements for credit risk, the full rules of Basel III on holdings of liquid assets, on the leverage ratio of Basel III, and on the countercyclical capital buffer.

United States banks designated as Global Systemically Important Banks (GSIB) are subject to surcharges on their risk-based capital requirements, an enhanced version of the Basel III leverage ratio, tighter limits on exposures to single counterparties, and requirements as to holdings of long-term debt amongst their liabilities designed to facilitate orderly resolution through transformation of such liabilities into equity or the writing-down of their face value.

As mentioned earlier, these rules are an example of a regulatory approach to structural reform of banking sectors through bottom-up measures concerning capital and liquidity, and intensified supervision.

Although this approach is not incompatible with top-down measures such as ceilings on bank size and the institutional separation of different categories of banking activity, supporters of reliance on bottom-up measures point to the inevitability of arbitrary policy choices as to size ceilings and as to the way in which institutional separation is carried out under the top-down approach. However, reliance on the bottom-up approach is itself fraught with problems, whereas the top-down approach has historical precedents in its favour.

An important problem with reliance on the bottom-up approach in the current situation is that it is likely to be gradual, and that the ultimate effects on the structure of banks and financial sectors are partly unpredictable. “Gradual” in this context implies “slow”, and may not therefore meet the continuing political need to dampen public hostility towards big banks and to satisfy public opinion that these institutions are no longer a law unto themselves. Moreover, the argument as to the arbitrariness of top-down policy approaches fails to take account of the reality that the configuration of banking sectors is not the outcome of some process of optimal design but rather of often unrelated decisions in historical time with haphazard outcomes—in the case of countries most affected by the current crisis the outcome partly of emergency decisions as to the merging of weak with strong institutions which have actually increased levels of concentration in banking sectors.

The belief that top-down measures have proved effective in the past has clearly influenced the design of policy initiatives regarding bank structure at national level since the crisis. Of special importance here is the celebrated 1933 Glass-Steagall Act in the United States which largely mandated the separation of banking and securities activities and is credited with having contributed to a long period of banking stability.

This influence is visible not only in the United States but also elsewhere. For example, the Volcker Rule in Dodd-Frank prohibits with limited exceptions commercial banks from engaging in proprietary trading and investing in or sponsoring hedge funds and private equity funds. In the United Kingdom under the Banking Reform Act of December 2013 banks have to “ring-fence” banking services whose interruption would have an unfavourable impact on the domestic economy, in particular on households and SMEs. The Likanen Report of the High-Level Expert Group on reforming the structure of the EU banking sector has recommended the carving-out of proprietary trading and assets, liabilities and derivatives positions and, with limited exceptions, their assignment to separate legal entities. In France and Germany there have been policy initiatives aimed at the partial separation of investment banking and trading activities from institutions taking deposits.
Banks in the United States are subject to antitrust laws designed to limit economic concentration but not to top-down caps on size as such. However, as noted earlier in this article, the Federal Reserve has recently proposed the introduction of a ceiling on the total liabilities of merged banks.

**Tarullo on Basel III**

As already noted, the bottom-up approach to controlling bank size relies on capital requirements. Despite his support for this approach Tarullo has none the less expressed strong reservations concerning Basel III’s rules for capital requirements. Both his criticisms of, and his suggested alternative to, Basel III, are thus of special interest.

Tarullo’s target here is the Internal Ratings-Based (IRB) Approach under which banks themselves provide inputs to their estimates of capital requirements for credit risk and which is to apply to large banks in the United States. The original objective of this approach was to align risk weightings more closely to the quantitative techniques of risk assessment developed by the banking industry itself.

Tarullo subjects this approach to severe criticism: “At the time of its development, the IRB approach seemed intended to result in a modest decline in risk-weighted capital requirements, a goal that the financial crisis revealed to be badly misguided. But even with the higher capital ratios required by Basel III, the IRB approach is problematic...The IRB approach contributes little to market understanding of large banks’ balance sheets, and thus fails to strengthen market discipline. And the relatively short, backward-looking basis for generating risk weights makes the resulting capital standards likely to be excessively pro-cyclical and insufficiently sensitive to tail risk. That is, the IRB approach...does not do a very good job of advancing the financial stability and macroprudential aims of prudential regulation.” To such macroprudential aims, it will be recalled, Tarullo attributes an important role in the regulation of TBTF and other large banks.

As an alternative Tarullo proposes supervisory stress tests (computer simulations designed to identify the effect on a bank of unfavourable or crisis economic scenarios) like those developed by the Federal Reserve. These “do not rely on firms own loss estimates [but] are based on adverse scenarios that would affect the entire economy and take correlated asset holdings into account. As we gain experience, we have been enhancing the macroprudential features of the annual stress test exercise...the disclosure of the results helps inform counterparties and investors, thereby increasing market discipline”. Under this alternative banks would continue to be expected to practice sound quantitative risk management, using for this purpose internal models and other techniques.

Tarullo acknowledges the complications of applying capital requirements based on standardized risk-weights and supervisory stress testing in place of the IRB approach of Basel II and Basel III. The complications include the difficulties over “the likely appropriateness of applying the different adverse scenarios for different parts of the world and the challenges in conducting a peer review...of supervisory stress tests by member countries [of the Basel Committee]”. Moreover – a point not addressed by Tarullo - stress testing is extremely costly, and thus unlikely to be welcomed as an internationally agreed requirement by the emerging-market countries represented in the Basel Committee.

Work is currently under way on strengthening the Basel capital framework, and its abandonment is difficult to envisage in view of the huge intellectual and political capital already invested in it. But this does not exclude the introduction by regulators of supplementary rules – for example, for stress testing. Tarullo believes that the experience of the Basel Committee in its work on problems of consistency entailed by the IRB approach among banks and regulatory regimes would also equip it for the task of creating an oversight and review framework for supervisory stress testing.
Policy initiatives with the aim of simplifying banks through the separation of activities have to confront the problem of separating low-risk from high-risk activities. Moreover, size and risk in banking are related to remuneration. In the public perception of banks, size tends to be associated with what seem to be outlandishly large pay and bonuses received by bankers. However, in the official reform agenda bankers’ remuneration and bank size and complexity are treated under separate headings.

A recent blueprint for banking reform for the United Kingdom tackles the size, complexity, and corporate form of banks in a single package. The blueprint also has implications for bankers’ pay but by a different route than that being taken in the international reform agenda. The author of the proposal, David Shirreff, is a well-known financial journalist who was founder of the industry magazine, Risk, and has been an analyst of financial markets at Euromoney and The Economist. He also wrote the libretto for a musical based on the Euro. His radical proposal for the United Kingdom banking sector has the appropriate title, “Don’t start from here...We need a banking revolution”.

The structure proposed by Shirreff is not binary and is thus unlike that of the national reforms and proposals discussed earlier in this paper. Rather, the structure involves the separation of banking activities under three headings, retail, corporate and wholesale, and pure investment. Although banking in the United Kingdom is the target of this blueprint, the framework proposed contains many ideas which arguably are of broader application and have implications for national and international reform agendas.

Shirreff’s account of the causes and antecedents of the financial crisis is sweepingly comprehensive but carefully tailored to highlight features related to his reform proposals.

He starts from the 1986 Big Bang in the United Kingdom and the repeal of Glass-Steagall by the Gramm-Leach Bliley Act of 1999 in the United States. Both paved the way for an increase in financial conglomerates, the first by allowing banks to integrate banking and securities activities, and the second by removing most of the residual obstacles to the consolidation of different categories of banking activity in single holding companies.

From the 1990s, financial engineering became an increasingly self-serving activity of the financial sector. Financial derivatives, which were originally designed to enable the hedging of financial risk, became increasingly complex, opaque, and remote from their economic rationale, while none the less being temptingly lucrative for their arrangers.

Much of the increase in trading associated with these developments was aimed at profiting from arbitrage and speculative opportunities, and was self-referential in that both the arbitrage and the speculative opportunities were part and parcel of the very increases in transactions undertaken to exploit these opportunities. The bloating of the United Kingdom financial sector, applauded in political circles, led to a rise in the share of GDP accounted for by financial services.

These developments were also accompanied by increases in the size and complexity of financial institutions but not by economies of scale. The lower funding costs enjoyed by these behemoths appear to reflect primarily perceptions in financial markets that they enjoyed the status of TBTF.

Financial engineers eventually turned their skills from the modelling of price and interest-rate risk to the modelling of credit risk, and the resulting innovations included credit default swaps, which separated returns on assets from the risk exposure to them, and collateralised debt obligations, which were bundles of debt instruments sliced and diced to meet different investors’ appetites for risk and return. The resulting tranches often received what were eventually to prove excessively favourable ratings from the credit rating agencies.
After initial misgivings regulators accepted the use of credit risk modelling in the rules for capital requirements for credit risk in Basel II and Basel III. They had already accepted such modelling as the basis for estimates of capital needed to cover the risks of banks’ trading activities. The results of the incorporation of risk modelling in the measurement of banks’ risk-weighted assets were often striking: assets unweighted for risk of £1,405 billion for Barclays were transformed into risk-weighted assets £157 billion as of September 2013, and assets of EUR 1,649 billion for Deutsch Bank into risk-weighted assets of EUR 355 billion as of December 2013.

The ability of banks and other financial institutions to achieve greater financial leverage through balance-sheet manipulation, combined with the availability of credit on easy terms, helped to produce the conditions which led to the financial crisis.

Changes in corporate form led to a new breed of banker. The partnership was still common on Wall Street and in the City of London until the 1980s. Partners whose personal wealth is tied to the fortunes of their financial institution through unlimited liability can arguably justify paying themselves as much of the firm’s revenues as they think it can bear. But the adoption by most of these firms of limited-liability was not accompanied by a corresponding change in bankers’ culture of entitlement and remuneration. The employees and directors of such institutions may indeed be shareholders. However, they are not partners so that the most they can lose are their jobs and their stake in the firm’s equity. In the new regime of limited liability bankers still felt it appropriate to reward themselves with roughly 50 per cent of the banks’ revenues – revenues, not profits –, much of which were generated by risky activities. Thus in the new regime the bankers took a large share of the upside, while leaving the downside for others.

The dangers inherent in these developments were increased by financial institutions’ interconnectedness. The search for higher volumes of business led to mutual exposures on both sides of balance sheets due to short-term financing which left institutions vulnerable to troubles which might originate in one firm but could quickly spread to others. Fears of the resulting systemic risk were behind governments’ rescue operations in 2008-2010.

The response to the crisis in the United Kingdom has consisted of banking reform which ring fences banks’ retail operations (while still permitting certain trading activities), and the establishment of an independent body responsible for banking standards. However, neither the United Kingdom’s response so far to the crisis nor the proposed or actual changes in regulation which have been introduced or which are under consideration in other EU countries and in the United States satisfy Shirreff. So what does he propose?

The core of Shirreff’s reformed banking system would be the retail bank. But this institution would be subject to stricter constraints than the retail banks in the other reform initiatives described above. It would not be a strictly “narrow bank” since, in addition to its purchases of liquid financial instruments issued by the government, it might – up to some specified proportion of its deposits – also lend on mortgages and make personal and SME loans. Such a retail bank would benefit from deposit insurance. The returns on the equity of these retail banks would not be high (Shirreff mentioning a ceiling of 6 per cent) but should appeal to conservative investors owing to the institutions’ safety.

Shirreff’s second category, corporate and wholesale banks, would undertake lending to businesses, cash management, and standard foreign-exchange and interest-rate hedging services but would outsource more complex operations to brokers or to investment banks proper. Corporate and wholesale banks would continue to enjoy limited liability but would not be covered by deposit insurance. They would not be permitted to make their balance sheets available to investment banks or shadow banks for the parking of underwriting positions and trading exposures.

The legal form for the third category, “pure” investment and merchant banks, would once again be partnerships under which the partners share unlimited liability for banks’ losses. In addition to advice and
various transaction services to clients these institutions would undertake underwriting the placement of shares and bonds and taking equity and lending stakes in new and existing ventures. Although Shirreff does not himself mention it, this is where banks’ residual pure trading activities would presumably be located. If, as major banks and recent transactions indicate, the cost of equity capital to major banks is in the range of 7.5-10 per cent, “pure” investment and merchant would need to make a return on equity of 15 per cent or more to achieve a rate of return on equity substantially higher than that on retail and corporate and wholesale banking.

Shirreff’s detailed blueprint is directed primarily at the banking sector. Links between the banking sector and non-bank financial institutions such as hedge funds and private equit ywould come from the financing contributed by such institutions to “pure” investment and merchant banks and from collaborative activities.

Shirreff avoids detailed proposals for a regulatory regime for non-bank financial institutions. These would be covered by the law on fraud and by rules concerning their fiduciary responsibilities to their clients. Moreover pension and insurance funds would be subject to rules concerning the proportions of their assets which they could invest in non-bank financial institutions. Shirreff believes that such rules, together with the constraints on their access to financing from the banking sector (which could now only be forthcoming from “pure” investment and merchant banks), would leave non-bank financial institutions “starved of the kind of cheap leverage they have had in the past”. For their equity and their debt financing they would henceforth otherwise have to depend on each other and on sophisticated private investors.

Shirreff combines his proposal for structural reform with others, all broadly directed towards regulatory and operational simplification. He would like to see the scrapping of the Internal Ratings-Based (i.e. model-based) Approach to setting capital requirements of Basel II and Basel III, and instead reliance on broad-brush standardised risk weightings and on an aggregate leverage ratio. He supports caps on the absolute size of banks and a transactions tax to reduce interconnectedness within the financial sector through raising the cost of those transactions which make an important contribution to interconnectedness. He would like writing and trading credit derivatives to be off limits for retail and for corporate and wholesale banks as well as for insurance companies.

It is worth taking a moment to look at some of the implications of Shirreff’s proposed structure for the banking sector:

- The proposal is motivated partly by belief, now widely shared amongst commentators, that the reform agenda is becoming too complex, thus compromising public understanding and leaving banks with continuing opportunities to bypass the rules and to engage in regulatory arbitrage. The tripartite separation of banking activities of the proposal would break up large complex financial institutions into entities which would be easier—perhaps one should say possible— to manage and supervise properly.
- The separation of the less and the more risky activities of investment banking is an alternative to other national initiatives directed at the reforming banking structure which, by allowing the continuance—subject to certain restrictions—of both types of activity within the same institution, blur this distinction with questionable implications for the initiatives’ effectiveness. Arguably the banking sector which would emerge from Shirreff’s blueprint would also be friendlier to retail customers.
- Like other national reform initiatives Shirreff’s tripartite separation of banking activities among different categories of bank would present some difficult problems of legal drafting. But the more clear-cut separation of activities in his blueprint should facilitate the definitions required by the new rules.
The proposed restoration of the partnership form for the more risky activities of investment banking would produce an improved alignment of risks and rewards. It could be expected to affect remuneration not only of the partnerships themselves but also, as a result of its impact on competition for different categories of staff, throughout the financial sector. None the less Shirreff believes that capping remuneration and actually scrapping bonus pools will still be necessary in retail and corporate and wholesale banks. High remuneration will continue to be possible in non-bank financial firms such as hedge funds but, as Shirreff points out, at least the profits of these firms will no longer benefit from implicit subsidisation of their financing costs due to their access to the banking sector as currently structured.

Lastly Shirreff’s separation of banking into three categories of institution might well weaken the political pressure which is exerted by the banking lobby by dividing it into groups whose interests frequently do not coincide. The United States banking scholar, Adam Levitin, draws attention to a little noted effect of Glass-Steagall: “Glass-Steagall broke up the political power of the financial services industry. Not only were each of the ...major branches of the industry less powerful than the industry as a whole, but they were also rivals” (Levitin, 2014: 2060-2061). Of course the effects of Shirreff’s proposal would not be the same in the United Kingdom as were those of Glass-Steagall in the United States, but there should be some pull in the same direction.

Shirreff’s blueprint is likely to remain utopian despite consisting of concrete proposals which, taken on their own, target widely recognised flaws in the banking system. In the event of a new financial crisis more serious consideration could well be given to many of the structural reforms he has proposed.

Additional related issues

A common feature of the reform proposals discussed in this article is the role attributed to corporate form in achieving their objectives. Changes in corporate form have also appeared elsewhere in new regulations introduced since the outbreak of the financial crisis.

For example, the Federal Reserve – in response to a provision of Dodd Frank – has imposed new requirements as to corporate form on large foreign banks. Under these requirements a foreign bank with a significant United States presence must now create an intermediate holding company for its United States subsidiaries which must meet not only capital and leverage standards applicable to United States bank holding companies and various other rules intended to enhance their regulation and supervision but also certify that it meets consolidated capital adequacy standards established by its home-country regulator, which are consistent with the rules of Basel II and Basel III.

This decision has been a source of controversy between the United States and the EU, which objects to the new tightening of the rules applying to large European banks. However, the United States appears unlikely to give way.

In a speech explaining the rational for this decision Tarullo has expressed skepticism concerning constraints on national prudential autonomy associated with international agreements negotiated by officials lacking first-hand contact with bank supervision. Indeed, he has gone so far as to question the desirability of a single global bank regulator “even it were remotely within the realm of political possibility”. He has also stated that “Proposals to include prudential requirements or, more precisely, to include limitations on prudential requirements in trade requirements would lead us farther away from the aforementioned goal of emphasizing shared financial stability interests, in favour of an approach to prudential matters informed principally by considerations of commercial advantage”. This could be read a veiled criticism of trade negotiators’ approach to financial regulation in international trade in services (Tarullo, 2014a).
The use of corporate form in pursuit of regulatory objectives for the financial sector is a rational response to problems highlighted by the financial crisis at the international as well as the national level. Unbridled cross-border branching, for example, which has long seemed to be an objective of both the banking lobby and – with some qualifications – of governments in major developed countries, may lower international banks’ costs. However, it is difficult to identify the benefits of such branching for society as a whole, and the prevalence of the branch form can complicate the task of bank regulators owing to reduced transparency and to the loss of levers of national control.

While the structure, size and corporate form of banks is likely to figure prominently in post-crisis reforms, such a development may still be inconsistent with other headings of policy towards banking services in major developed countries. For example, this would be true of policy objectives still pursued by such countries in negotiations concerning cross-border finance. Removal of limitations regarding corporate form has long been an objective of these countries in negotiations in the WTO on international trade in financial services, which is a term that includes supply of such services through a cross-border commercial presence, as well as in negotiations on bilateral and regional trade and investment agreements. One can hope that the perspective of financial regulators will increasingly prevail across all policies towards cross-border finance, and that the tendency of major governments to press for liberalisation à outrance will be replaced by a more nuanced perspective which takes appropriate notice of lessons learnt during the financial crisis.

References


