New City Agenda

Sir John Vickers: How Much Capital Should UK Banks Have?

18 May 2016

Introductory Remarks

The Right Honourable Lord McFall

Chair, New City Agenda

Good morning, everyone, and welcome to this New City Agenda event with Sir John Vickers on 'How Much Capital Should UK Banks Have?' Sir John's and the New City Agenda's aims are one in that many years ago there were a number of us involved with the New City Agenda produced the Future of Banking Commission which the coalition government convened in 2010 accepted. Their first move as a result of that was to appoint the Independent Banking Commission under the chairmanship of Sir John and have others like Martin Wolf on that Committee.

In the run up to the crisis the central banks and regulators thought that financial innovation made banks less vulnerable to shocks, thereby making the financial system more resilient. Years were spent on negotiating an international capital framework, which only weakened the capital requirements. However, the UK banks were very comfortable in that their capital ratios exceeded the minimum requirements, so they thought that everything was fine.

Then the financial crisis hit and billions of pounds were injected into the banks and success thereafter depended not on how prudently the banks were run or whether customers were treated fairly, but to access to government bailouts and subsidies.

The financial crisis led to the reassessing of the levels capital banks needed to hold and the question that still pertains today is: is that far enough? Some of you will have been here last September when Professor Anat Admati from Stanford University spoke. She said, 'Yes, the banks have tripled their capital ratios; but they have tripled them from almost nothing, so it is still a very small number.' Before that, central banks could have been accused of being too optimistic on that front, but also on their ability to wind down the banks if they got into difficulty through the introduction of living wills..

Have central banks been too optimistic in that? If you read some of the press regarding the situation in the US you will find that maybe that is the case. Sir John will give us his insight into that, as well as into the capital for banks. Sir John's report was very influential in that it did recommend the increasing of capital requirements, but also the concept of ring-fencing; and as a member of the Parliamentary Commission for Banking Standards which met for two years, I was very much involved in that. All I can say on that, Sir John, is that your insight was profound, but you gave us a hell of a lot of work to do over that two-year period.

What has happened as a result of that is we have the Banking Reform Act 2013, so the focus is on the implementation by the Bank of England and the Financial Conduct Authority. I for one feel that Parliament still needs to monitor that situation and ensure that the recommendations of Sir John and his colleagues on the ICB, and his very worthy recommendations, are not chipped away at. From a Parliamentary point of view we have to have a very keen eye on that now and in the future.

How Much Capital Should Banks Have?

Sir John Vickers

Warden of All Souls College Oxford, former Chairman of the Independent Commission on Banking (ICB)

I. Introduction

First of all, thank you very much indeed for the invitation to be here this morning, and to all of you for coming. My plan is to speak for half an hour at most, so we have at least half an hour's time for questions and discussion. I will broadly do it in two parts. I will begin with some fairly broad brush remarks about the bank capital question, especially as it pertains to us now in the UK; and then, by reference to the handout which I hope you all have, there are some more technical and quantitative issues which I will speak to in the second half of these remarks.

This question about how much equity capital is a very big question in general – we are talking about the shareholders' capital that banks should have in their funding structures. In terms of how any market commonly runs, banks remain at the centre of the financial system and their resilience and equity capital is the first and best guarantor of their resilience. It really matters, so it is a big question.

I am sure that in September when Anat Admati was here she will have spoken in very broad and global terms about that question of how we should think about it and what the appropriate levels should be. Here in the UK the question has come back to the forefront because the last big piece of the picture of post-crisis financial reform is about to be decided by the Bank of England and its Financial Policy Committee; and that is the question of the systemic risk buffer. This is how much capital over and above that which applies to banks generally should all banks that are systemically important for the UK economy have? What extra amount? Ring-fencing, which you have kindly mentioned, Lord McFall – that is at the implementation phase; legislation happened some time ago. I would say that that is broadly on track.

However, there is this big, live question at the moment about the systemic risk buffer, and that is what I will come to more particularly.

II. Preliminary Remarks

As I have said, we are talking here about how much equity or shareholders' capital banks ought to have as a minimum in their funding structure. I have a few clarificatory remarks.

Disappointingly, in much of the debate, people speak as if the capital that banks have is something that is locked up in some box for a rainy day and it is not used in a productive way for the economy. That is entirely the wrong way to think about it. Bank capital is one element of a bank's funding structure, along with debt finance and deposits, whether those are retail or corporate deposits. This is about what minimum proportion of the funding structure should take the form of shareholders' capital. There are separate issues about the asset side of banks' balance sheets.

One of the extraordinary things which far too few people were aware of 10 years ago, and I plead guilty to this, is just how small the proportion of banks' loan exposures, derivative positions, trading positions, and all the rest were matched by bank capital. We had leverage levels for most of the post-war period of around 20; in other words, shareholders' equity capital of around 5% of liabilities. If you knew nothing about this, you would say, 'That's not very much. It does not have to be very bad and quite a lot of that could get wiped out.' However, in the pre-crisis decade, those leverage levels went sharply up from a factor of 20. Some perfectly regular or reputable high-street names went to levels of 40 or 50. As a way to run a market economy that seems to be an extraordinarily hazardous thing to do.

Moreover, when the crisis hit – when the shock hit that affected different parts of the world, property prices slumping and all the rest of it – the problem was not just the thin layer of equity capital. It was that the debt finance, which in theory, in the textbooks, would then bear loss, in practice, with some exception, it did not. It was therefore the public finances – the taxpayer – that had to come in right behind the equity holders. What that has done to the public finances, we all know about; what it has done to the economy generally we know about too.

The importance of avoiding a repeat of that or at least minimising the probability of a repeat, because you cannot look at financial history and think that we will never have another one, really is of the first order of importance and this bank equity capital question is fundamental to it.

Why is it controversial? It is controversial because from banks – not just British banks, but banks everywhere: continental Europe, the US and so on – there is a very strong dislike of higher equity capital requirements. So there is a dichotomy where the banks, and I think they are not diverging from their equity holders' interests, do not favour larger amounts of equity capital in their funding structure whereas with public interest, as I have already indicated, it is tremendously important.

Why do the private and public interests of the banks go in different directions on this? It is partly that the private interests of the banks do not incorporate the enormous social costs of crises happening, but there are other factors too. It is an ironic feature of the tax system that tax considerations favour debt finance over equity finance; there is a tax wedge which is part of it.

However the much bigger point is that, especially when you have banks that have been through severe stress, if they build their equity capital buffers into the funding structure the benefits of that greater resilience from shareholder capital flow in good part to providers of debt finance because they are not so close to being on the hook. They very much flow to the public finances too because the taxpayer is more remote from the hook. Therefore, an uncured too-big-to-fail problem represents in effect a very large implicit subsidy to the banks and the more equity capital they build, that too-big-to-fail problem diminishes, and that subsidy goes away.

Therefore, it is the combination of these taxes and subsidy points which create this large wedge between the private and public interests. However, for the public interest the arguments are very, very powerful to have much greater equity capital buffers than we have. The question is, 'How far do you go?'

III. From the Academic Economists

On this there is, in many ways, a remarkable difference of view between two groups of people who are focusing on exactly the same problem. If you take academic economists – I am one and whatever views you have about academic economists are up to you – the point I am making is that there is a near-consensus that the appropriate levels of capital, taking into account cost-benefit analysis which I will come onto a bit more later, should be a multiple of where we are now. A good representation of the academic consensus is a letter to the *Financial Times* five or six years ago by a galaxy of the leading financial economists in the world. They, commenting on the very disappointing Basel baseline for the global capital standards, said that if at least 15% of banks' total assets were funded by equity, the societal benefits would be substantial and the social costs would be minimal if any.

There you are seeing the mainstream, independent economists would go four times higher than we are currently. Anat would double that again. I am directionally with Anat, but I would not go as far as her. That is an entirely moot point, though, because we are talking about an incremental move from quite a low base. David Miles at Imperial, who was on the Monetary Policy Committee, did a very serious study of all this and he thought that you should not let leverage get more than 12 times; in terms of risk-weighted assets you want at least 20% in terms of equity. In his recent book, Mervyn King said that equity capital at 10% of total assets would be a good start, so he would not let leverage go above tenfold.

Where the international community is settling, it is allowing leverage of 30-ish, depending on the size – bigger banks, not quite so much – but in the region of 30. This is the reform. I was once talking about this in a university setting and the students nodded off; I do not think that any of you have yet. When I said, '30 times' they said, 'Good lord. No wonder we had a crisis'. I said, 'No, no, no – that is where we are trying to get to. That is the solution. Where we came from was even worse'.

IV. From the policy community

There you have the academic and independent economists. They go way higher. Where is the policy community? The Basel baseline for common equity capital in terms of risk-weighted assets is 7% and for globally systemically important banks there are add-ons which would you take you up to 9.5%, 7% plus 2.5% is the biggest add-on. A bank like HSBC, which is of great global systemic importance, would have that add-on.

Typical risk weights vary across the banks, but a typical risk weight would be a number like 0.4. The Bank of England talks about 37%, or three-eighths. You can do the maths and you can see that this translates to leverage, as I have mentioned; something like 3%, i.e. you can have exposures 33 times your equity capital.

V. Recommendations from the ICB

In the work for the ICB, which was five years ago, we had a sense that we were in the crossfire. All of us on the Commission thought that the global standard had been pitched by some margin too low, but we were very conscious that if you put UK capital requirements massively above global requirements then you could trigger all sorts of geographic moves and other unintended consequences that would be an own goal in terms of financial stability.

We were conscious that we could not go beyond, in our view, the very disappointing global baseline by too great an extent. We said that the 7% for the Basel baseline should be 10% for all of the sizeable UK banks. That would have applied to the retail arms of the largest six or so retail banks; you take the 7% up to 10%. That was our recommendation on equity capital. We also made recommendations about bail-in debt. It does not work as surely as equity capital at absorbing boxes, but that it is a very important part of all of that too.

Although we are best known for the ring-fencing bit of the policy package recommendation, for us the loss-absorbency side of things was no less important. That was where we pitched. It was a judgment. If we had had blue skies and had not had to worry about geographic arbitrage or the transition and how to get from where you were in 2011 to where you wanted to be in 2019, all of this would have gone very substantially higher. However, we had to face the fact that the question on our exam paper was: 'What should the UK do given what the world is doing?' It was not the question, and Anat Admati focuses more on this one: 'What should the world be doing?'

The way the Chancellor described our policy package was as providing a solution to the British dilemma, which is his term and not one that we used. The dilemma in his eyes was how can you have the UK, both a hub for tremendously successful global banking activities, and have a safe banking system that is not going to put the exchequer and public finances at risk next time around? The package that we had of ring-fencing with elevated capital requirements deliberately going substantially above and beyond the global baseline for domestic retail banking, aimed to do just that. It was ring-fencing to have retail separated with these elevated capital buffers. That was the package.

VI. Response to the Bank of England's Consultation Paper on the Systemic Risk Buffer

1. Overview

The handout now comes into play. I should say that the six charts on here are simply lifted from paper referred to in the footnote. I realise that putting web-links on a piece of paper is not entirely practical, but maybe there is a way on the website or something if anyone is interested either in the Bank of England consultation paper or the response that I have put in, you will be able to get it that way.

At the end of January the Bank of England put out a consultation paper on the systemic risk buffer and I will say a little bit more about what that is in just a moment. The consultation period ran until 22 April and the Bank said that it hoped to announce its final policy decision by the end of May – this month. I do not know anything about the timetabling on that or whether that remains on track.

The context then is a proposal from the Bank and its Financial Policy Committee for consultation, so it is a consultation period now closed, but before the final policy decision is made.

2. Figure 1: BoE Illustration of 2019 Tier 1 Capital Requirements

The wider context is depicted in figure 1 which is extracted from the Bank's consultation document and a very similar figure appeared in the December supplement to the financial stability report. This shows a stack of different kinds of capital.

This stack is called tier 1 capital and 'tier 1' is a definition of capital that goes wider than common equity capital. On the ICB, we thought about it more in terms of common equity, that it was the simplest, most straightforward and surest loss absorber whereas tier 1 capital also includes equity-ish instruments such as Contingent Convertible Bonds (CoCos) to the extent of 1.5% of risk-weighted assets.

This stack from the Bank is in tier 1 terms, so remember that that is going, in quantity amounts, 10% or 20% wider than the narrower – and to my mind, preferable, but I do not want to make an issue of it – common equity definition.

What are the elements here? At the bottom of figure 1 is the minimum capital requirements that banks must maintain at all times. That can include this 1.5% risk-weighted asset's worth of CoCos. Pillar 2A I will come on to in a little bit more detail later.

There is then the capital conservation buffer that, as you see, is another 2.5% of risk-weighted assets and what happens with that buffer? The broad idea is that it is a buffer, so it does not have to be maintained at all times; if the bank is under stress, its capital level might eat into that and then it is in kind of special measures, but then it has to rebuild the buffer and on we go. It gives a bit of cushioning. If you add that 2.5% to 6% of the minimum part you get 8.5%. 1.5% of the 8.5% is the CoCos etc., leaving the 7% of common equity, and that is the 7% of the Basel baseline.

Above the capital conservation buffer is the countercyclical capital buffer. This is a system-wide requirement for the UK which can be flexed over time. If the policy makers see risk building up they would want to thicken that cushion. If they think that the risks are diminished and the economy might need some more encouragement, they could release that buffer; it can be run down in a downturn.

At the very top is a bit of supervisory discretion bank-specific and you will find that in all of these regimes around the world.

Between the minimum and the capital conservation buffer are the systemic importance buffers, including SRB, which we are now going to talk about. These are the buffers for systemic importance and they must consist of common equity. There is a list of globally systemically important banks which, as I have already mentioned, have to maintain supplementary buffers at the group, global level because of the disproportionate damage to the world economy that their distress or failure would cause.

3. Figure 2: The BoE's Proposed SRB Calibration

The UK bit is exactly the systemic risk buffer that the consultation paper is all about. The regulations say that this systemic risk buffer could be set on the basis of the ring-fence bank's assets at the various percentage levels that you see on the risk-weighted SRB rate on figure 2. It is in one of the buckets that go up, roughly speaking, in half percentage-point notches up to a maximum of 3%. That much is all consistent with what the ICB said and on our proposal we would have had all of the major banks at the top level.

The Bank of England has set up these size thresholds that you see in figure 2 in its proposal. You have a staircase of rates. The way that they have calibrated it, there would in fact be no bank at the top 3% rate; that bucket is left empty and you would see the major banks spread across the other rates.

Thanks to the Treasury Committee who published in mid-April a letter from the Governor, we now know what the average would be of what the Bank of England's proposal is and the average – that we will come to on a later chart – for the major UK ring-fence bank would be 1.3%, so less than half of a maximum of 3% on the Bank's proposal for the domestic systemic risk buffer.

Moreover, there are complicated issues about how the global buffer links with the domestic buffer. The way it turns out on the Bank of England's proposal is that a lot of the global buffer capital could be used for domestic purposes; so the Bank of England's proposal entails remarkably little extra capital. It is going to make the banks extremely happy if this does become policy, I am sure. There is remarkably little extra capital relative to the global requirement. Unlike the ICB, where we thought the global requirement was way too low and you have to go well above, what you see from this Bank of England proposal is system-wide net of the global buffers; it would add just 0.3% to capital requirements. That is system-wide. For the affected banks it would be larger and more like 0.5%.

4. Figure 3: The ICB's Illustrative SRB Calibration

Figure 3 is the ICB calibration which there is not time to go in to, but all of the banks that you see in the illustrative classification of banks by size section of figure 3 would be, on our proposal, at this 3% rate.

In a sense, who cares what the ICB said, apart from me? It is only a benchmark or reference point. The really important issue is of what the right policy is from now on, whatever the ICB may have said.

However, what we set out has come into play in the public debate. I did an *FT* op-ed in mid-February and went on the Today programme on a quiet news day, so I got a prominent slot. The Bank reacted quite forcefully in various ways, in the *FT* and various speeches, to what I had said. The Bank's lead point was that they were recommending more capital than what the ICB had done, which is a point I want to dispose of fairly quickly, but given the Bank's response, I want to do it.

5. Figure 4: ICB Illustration of Capital Buffers for a Ring-Fenced Bank with a 3% SRB

Figure 4 is an illustration from the ICB report. This was for a hypothetical bank which would only be at the 1% level on the Bank of England proposal. For us it would have had a ring-fence buffer – that was our jargon for what is now called the systemic risk buffer – up at 3%, and you see the various estimates there. In that little example we happened to do it for a scenario where the counter-cyclical buffer was at 2.5%. It is currently at 0% but it is going to be at 0.5% within a year from now.

6. Figure 5: The BoE's 'Apples to Apples' Comparison: Estimated Average Common Equity Requirements for Major UK Ring-Fenced Banks (RWAs as Currently Measured)

Figure 5 is what the Bank of England has called its 'apples to apples' comparison between its proposal and the ICB's. This is an excerpt from the key table in the Governor's message to the Treasury Committee. The other bits of the table deal with loss-absorbing debt and global group-level buffers. This is the point at issue, which is the equity capital from the UK ring-fence

banks. The left-hand column is the Bank of England proposal; the right-hand column is the Bank of England's attribution to the ICB.

What is wrong with this is that the Bank has attributed a dash in the ICB column to both the Pillar 2A and the Countercyclical buffer, and has then added things up as though those dashes are zero, and has said, 'Hey presto, the Bank of England is recommending more than the ICB' despite the fact that for the systemic buffer you will see that the Bank is 1.3 compared to the ICB's 3.0.

This is just a mistaken comparison. For a start, the countercyclical capital buffer: no way in the world would the ICB think that the normal setting of that should be zero. We explicitly talked of it as something to run down in the downturn, so clearly we were talking about a countercyclical capital buffer in positive territory, and a reasonable person would have put the same 1.0 or something like that in our column. It just is not a legitimate difference between the Bank's proposal and the ICB's.

Pillar 2A is extra capital that the supervisors put in place to deal with risks to banks that are not, or not fully, captured under minimum requirements. ICB would have been all in favour of that, not against that; so again I just do not see any logic in attributing a zero to the ICB on that front. Moreover, and the Bank of England is quite clear about this: the current reform of risk weights, which failed so abysmally in the crisis, continues and as those risk weights are improved the Bank of England has said that it will reallocate this Pillar 2A capital into the other elements. As the risk weights go up the other numbers will all diminish and it will spread the Pillar 2A capital across the others.

It would be uncharitable not to attribute an equivalent amount of such capital to the ICB column, and anyway you would have to when those risk weight improvements happened. Therefore, this is just not right in comparison at all. The ICB's proposal is well ahead of the Bank of England. However, as I said, in a sense: so what? That is a historical footnote rather than the live policy question.

7. Figure 6: Differences between BoE and BCBS Estimates of Optimal Capital Requirements

I will conclude by giving some reasons as to why the Bank should rethink its proposal and go higher. I am going to do this by reference to the last figure at the bottom of page 2.

The Bank of England is absolutely explicit that it has lowered its estimate of the appropriate equity capital for banks. It is very clear about that and has given a number of reasons as to why it has done so. One is that we now have resolution arrangements coming along which we did not have in 2008/09, which is a legal regime that is not bankruptcy where you can have an orderly reorganisation of a bank that has become a going concern. You may want to sell off elements, do a bridge-bank for other bits, and so on. We have this new regime and associated with it we have this bail-in debt which, in theory at least, is debt that converts into equity or can be written down so that the bond holders do absorb loss, unlike what largely happened last time.

The Bank of England points to better supervision, giving itself a good mark for that. It also points to structural reform and to the countercyclical capital buffer which it says can be flexed to meet build-ups of risk and the rest of it, so you do not need to have so much capital running in the system the whole time.

All of those reasons were known at ICB time five years ago – they were all in the pipeline, so there is no news there. However, the Bank's proposal is pinning its lower estimate on those things and I want to show you, just in terms of this chart, the quantitative importance.

The Bank accompanies its proposal with a Bank staff working paper which has an economic model in it. One of the good things about economic models is not that they just spit out an answer. Rather, they are disciplined quantitative mini-machines for seeing relationships between assumptions and outcomes. On the assumptions that the Bank of England is going with, the central estimate of how much tier 1 capital you should have is the right-hand slab; it is a range of 10-14% with 12% as the midpoint. Even the ICB proposal would not be over the top of that range.

The left-hand column comes from a study of the Basel Committee on Banking Supervision six years ago, which was in the high-teens, more like David Miles. You then have various adjustments; some up, some down. I want focus on the two downs.

The first and biggest one derives from the fact that the Bank's analysis assumes average risk conditions. That is a very strange assumption for the question at hand. An analogy that I have used, which I do not want to stretch too far, but it conveys the point: suppose you had asked me to say whether the nation's flood defences were adequate, I went away, came back and said that I had done my modelling and they were just about right, you then question what I had assumed about the weather, and I said, 'Average is what I had assumed'. That would not be very sensible in that context. In this one too, average risk conditions is not the right assumption. It is a different assumption from what the Basel people make. It is equivalent to assuming that you are fantastic at doing countercyclical capital buffer policy, you are clairvoyant and extremely agile, but the world just does not work like that. We are in the very earliest days of that policy. It has not been tried and tested anywhere. Therefore, that is a very strange assumption.

The second is the Bank placing great faith on how well these resolution regimes will work. They are good regimes but I would not want to bet heavily on them. Even in the relatively calm conditions of the past few years – there is a Portuguese case of Novo Banco which is being litigated in the courts all over the place – a number of people say, 'Yes, but that is before the ECB has taken command; don't worry, it will all be fine'. However, yesterday we had the chief economist of the ECB speaking publically and saying that these regimes work very well on paper, but they are not tried and tested. Therefore, one has to put the question mark over that.

Even in terms of the Bank's own model and apparatus, that does not support the Bank's proposal. It argues, even on their own analytical framework, for a substantially higher systemic buffer.

My hope – and I do not know how hopeful to be – and the right policy would be for the Bank to use the full policy room it has, go to the 3% across all of the major Banks and then the nation's economy would be in a better place. Thank you.

Questions and Answers

Lord McFall

We have 25 minutes for questions. Is there anybody from the Bank of England here that wants to contribute? No?

Question 1

Sir John, thank you very much for this very clear exposition and the paper, which is extremely useful. I have two or three comments to make. One is if we look at what the international regulators are all now saying about the appropriate level of capital requirements, all the regulators – not just the Bank of England – are saying that we are more or less at the right amount of capital. They are saying that because in terms of the remaining part of the Basel III package, the objective is not to significantly increase the average overall capital requirement and that is an objective which is held by all the Basel regulators. Again, it is a difference between what the regulators and economists think.

I also want to take you back to your own ICB report where you talked about the total amount of loss-absorbent capital. Your work then showed that 16% of risk-weighted assets in total loss-absorbent capital would have covered all of the cumulative losses between 2007 and 2010, apart from Anglo-Irish. You also said in that report that 17-20% of risk-weighted assets, in terms of total loss-absorbent capital, would be sufficient, the difference between those two numbers being according to whether the Bank had an effective resolution regime.

What we now have is a proposal called total loss-absorbent capital which you will obviously know about and hopefully many of the people in the room will know about, which is imposing capital requirements which may well add up to the mid-20s or a higher percent – 25-28% because it sits on top of the part that you were talking about.

My question to you is: why did you think that 17-20% of risk-weighted assets was adequate in terms of total loss-absorbent capital during the ICB study; and why do you now think that the amount of loss-absorbent capital which banks will hold being significantly higher than that is no longer adequate?

Question 2

I am neither an economist, nor a banker, but I have the unfortunate task of handling little bits of regulation that go through on this. Three things come out to me from that experience and your speech. First is the dependence on risk-weighted assets. That seems to be to be an internal – I might get sued for saying contrary – but negotiated by the banks who game-play to absolutely minimise it. My understanding is that they have a high dependence on property assets being seen as extremely low risk; both of which seem to be dangerous assumptions.

Secondly, do you find – and once again I have had to go through it – the reform and resolution regime is in the least bit credible? In a major crisis it is going to happen over 48 hours; it is going to require a bunch of experts from the Bank of England to manipulate banks over a weekend with no previous experience. You only have to read accounts of the last banking crisis to find that

somehow they will produce a painless answer. I do not see how it is going to happen and any confidence in that area would be very dangerous.

Lord McFall

David, as Chairman of the Future of Banking Commission that led to this…

David Davis MP

The only point that I was going to make around this was really that I just do not trust the risk-weighted assets denominator. They have got it wrong so many times, the banks themselves do not understand the risks, and they have an interest in rigging it. Do you really think that the denominator is the right one?

Sir John Vickers

Let me take the risk-weighted asset point first. Clearly, they failed spectacularly and that is why one definitely needs a leverage cap on unweighted assets in addition. Where the international community is headed on risk-weighted assets is that it is less bad than it was. It not just the gaming risk; it is even more worrying if bankers honestly believe that it is very low risk. That is as worrying as when they are playing the system.

You are quite right about property being incredibly important in terms of lots of banking activities, not just mortgage lending, but so much lending to SMEs is ultimately collateralised insofar as it is on property assets. Property prices can obviously move about very sharply. To lose 5% or 10% on your asset side is not that difficult. It is not impossible to imagine. Remember too that these capital numbers are accounting numbers. The equity capital is the difference between the value of the assets and what you have to pay back on all of the other liabilities. There is all sorts of scope for measurement error there as well.

In a sense, most notorious of all is the zero risk-weight on eurozone debt, but you can see why there is not much impetus to reform that because if you change that and continental European banks – some of which have much more government debt on their asset side than do UK banks – reduce holdings, relevant governments do not want the big sell-off of those debt-instruments. That is still uncured and it is extraordinary.

I do take those points. I see them as, if anything, reinforcing the line that I am taking. I spoke in terms of risk-weighted assets because that is the way that it is primarily done, although with the leverage backstop.

Resolution: those regimes have a decent chance of working, but it is absolutely nowhere near a sure thing. Your example of the weekend where they have to sort out several gigantic British banks, that is quite extraordinarily difficult. With this Novo Banco case I am sure that there will be people in the room that know a lot more about it than I do. This is a Portuguese bank, Espirito Santo, that went into a resolution arrangement and there has been litigation on all sorts of things about what the authority and government did. There was even a dispute about which court it was: is it the Strand because it is a contract under English law or is it Portuguese? That is a relatively simple bank in a relatively simple setting, whereas your weekend of systemic crisis is something else altogether.

That leads on to this TLAC point. TLAC, by the way, is a doubly awful phrase. The 'T' stands for 'total loss-absorbing capacity', which suggests that only something under that description is loss-absorbent and the rest is totally guaranteed by the state, which is a mistake. The other problem with it is that it suggests that this bail-in debt is all going to work, despite the points that we have just been discussing.

On the ICB you are quite right about the 17-20%, but that was not us saying that that was sufficient. We were saying that this global baseline is way too low; what is the best recommendation we can make for the UK in this global world with very mobile capital, including within the EU? That was part of our answer to that.

Now, I am very pleased that the international community has, for the big banks, gone beyond that. That is very welcome. If I thought that it was going to work perfectly and it was just as good as equity, then I would not be standing here; but I do not. The common equity, never mind the CoCos – a lot of people think that the CoCos are not going to work and they are in tier 1 – the common equity is the only sure and certain loss absorber.

If you look at the rest of the economy, you do not have an engineering firm with 33 times leverage. We probably do not have one with 10 or 5 times leverage. We are in a situation where it is only the banks which, in a sense, are the most important institutions to stay standing which have the most fragile funding structure. It is a very strange way to run the economy. If I say you have bankers here and academic economists there, neither might look very enticing from your point of view. I would say just use common sense: is this a sensible way to run a market economy? It is not.

I would say that if you cut through all of the economics you will get to the right answer purely on a common sense basis. There is this systemic risk buffer question where we are talking about adding an additional 20-30%. It is quite important, but in the wider scheme of things it would still be allowing leverage in the 20s which clearly, if that is erring, it is erring on the side of too little.

Another point is: where is the cost of this? Where does the cost come from? It is, from society's point of view, almost free insurance and it is insurance against an event which if it happened again in the near term could be politically and economically cataclysmic.

Question 3

I would like to just challenge you very slightly on that last point. The banks compete for equity funding with others for credentials. David Miles has this theory that if the banks get less risky they can have equity almost free, but that is not how it works in the real market. There is Bank of England work that demonstrates that.

If you increase capital requirements for the banks, you increase the total costs of the bank. All costs imposed on banks are, by definition, paid by bank customers. Therefore, by increasing bank equity requirements you are to some extent increasing the cost of credit to the economy as a whole. Therefore, there is an argument that what you are doing here is forfending economic damage in the future by taking it today.

Question 4

I have a couple of points. You mentioned at the beginning that you tried to minimise the probability of [inaudible]. A problem with the Basel regulations compared to Solvency II is they do not have a level of confidence. You have lots of numbers but no probability.

In this Bank of England paper, to my surprise, they derived the numbers you have in your table which looks at probability of distress compared to capital ratio. Even more surprising – first you had to wake up your student who fell asleep – they say that the probability will fall at 8.5%; 6% plus 2.5% would be 4.2%. The only thing with that 4.2% in a hundred years, there is a very high probability. As you would know from looking at this, to get to a 1% probability fall, which might still be high, requires a 6% systemic risk buffer.

On the other hand, although it is not mentioned in Mark Carney's letter, the PRA issued a really good paper last year, like the stress-test from the year before, on assessing capital as it was under Pillar 2. The PRA buffer in that, they indicated that their approach would be to take the systemic capital conservation buffer and systemic risk buffer together, and principal stress-test and decide whether that was enough, or whether to add on a PRA buffer. That does seem to be a very sensible joined-up approach, although these numbers are not properly disclosed that the stress-testing could incorporate the sort of situation we are talking about, and the PRA buffer might an overlay on whatever numbers are determined.

Question 5I am part of a crowdfunding association and a peer-to-peer platform. My question is around competition implications of subsidy and particularly around the amount of lending, and productive lending, that goes on in the economy. Are we faced with a paradox of safety whereby the big banks can hold up ultimately the deposit-holders as like these sacrificial kittens, meaning we have to bail them out? Maybe we might think that they are taking quite big risks on the other side of the balance sheet which probably should not be joined together in quite such a way as they are.

Ultimately, although we are talking about capital ratios, that is going back to alchemy and saying, 'We are safe. Here are a series of numbers you do not understand. You can keep your deposits liquid with us'. Perhaps we should be looking at some of the emergency measures that we still have around liquidity, particularly around the [inaudible] level that we have over deposits, to say to people, 'Should you be seeking this much liquidity from banks in your cash savings, and should you be looking to invest money and diversify your risk as individuals?'

Yes, there is a bigger institutional thing here, but surely we should be encouraging individuals to take some risk in to the real economy and not pretend that their stuff that is in banks is somehow being protected ultimately by the Government, so you still have that protection [inaudible] there.

Sir John Vickers

The questions were on lots of different points. On Simon Gleeson and the cost to banks of equity: there are several points to be made. In our hearings at ICB a couple of times there was the delightful moment when banks were saying, 'You have to give our shareholders 15-20% return on equity otherwise they will never put equity in our bank.' Martin Wolf would say, 'Good lord, what is the risk-free rate nowadays? Is it 1% or something like that? If you need a spread in the high teens, you must be running a hell of a risky bank'.

It is a bit of a cheap shot, but it is a good way of conveying the essence of the David Miles proposition that you are referring to. When you have more equity, then that is less leverage, so the

risk faced – not just by the equity holders, but by the debt holders too – does diminish. In fact, the Bank of England's analysis has made some allowance for that. If that was the only adjustment to be made it would be at – it looks something like 22% on its own analysis.

A lot of the reason why equities is relatively costly to banks is because the more you have in the banks, the more risk is being shifted from the taxpayer to the banks themselves and that goes to your point. That is a desirable thing because otherwise we are in this scenario where we are betting the economy on 'Nothing bad happens'. It is a fingers-crossed approach to running the market economy, which is just unwise. It is also anti-competitive because it favours some banks over others. We had the CMA yesterday and indeed competition issues were part of the ICB remit. We thought that the biggest competition issue would be an uncured too-big-to-fail problem because that so favours the systemically important over the others. I have not gone into it today but the Bank of England in its response to my intervention was citing some competition arguments to deter big banks from getting too big by having this empty top bucket. That is entirely the wrong way round; in fact, I made a submission to the CMA which is on their website, explaining why these tiered thresholds could really be quite anti-competitive.

A final point on this is the cost of equity. If your big aim was to keep lending capacity as big as possible in the banks, then there is no way that you would be allowing the rates of dividend pay-out which are currently going on. I quote in the paper a recent speech and paper by Hyun Shin, at the BIS in Basel, on this point. He has done this empirical work where the more equity capital they have, far from constraining lending, more equity capital is more lending capacity and it increases lending. A lot of people you see arguing that, 'You do not want these ratios to be too high because lending capacity is tremendously important; oh, and can we have a big dividend pay-out?' It is terribly difficult to argue both things straight-facedly at once.

Those are some points I would make to Simon's point.

Now, the probabilities of the crisis – is that the appendix in the staff paper that you are quoting from?

Question 6

It is the appendix to the Bank of England paper and it had a chart which they say is based on empirical evidence, but it is not clear where it came from, out of the sky?

Sir John Vickers

The paper by Martin Brooke and others – the staff paper – they have a table showing different assumptions and it is, 'What is the probability is of a crisis per century or annum', or whatever. The cost of another crisis; this one was bad enough. If we had another one in the near-term, depending on its magnitude, it could easily be worse because the public finances have had to deal with the last one, so they are much less able to cope with the next one.

Also, in some broad political sense, if you had the banking system fall over twice in quick succession – I am not talking about just the UK, but more generally – it is just not a risk that should be taken with the market economy. That uncertainty and that insurance point would point me to having more.

You mentioned stress-tests and the PRA. I am a fan of the PRA and of Andrew Bailey and Sam Woods, who was the Secretary to the ICB; they are tremendous individuals. However, to say, 'Don't worry; the prudential regulators will sort it out'; that does not work, no matter how excellent they are as individuals because they can be under huge pressure of circumstances, political pressure and the rest of it, and that is why you want to set out the stall and say, 'This is how the system works.' That is why I see these baseline buffers as very important.

I am all in favour of stress-testing as another bit of the policy diagnostic and so on, but there is only so much that stress-tests can do and they rest on all sorts of assumptions too. There are many criticisms, for example Kevin Dowd is very interesting on the whole subject of stress-testing.

Moreover, there is the Donald Rumsfeld point about the unknown unknowns. I can only put in my stress-test things that I have thought of and it could well be that the next severe crisis is something that nobody thought of until it came out of the blue. That is not going to be in the stress-test because people just did not think of it.

I hope that has been responsive to most points in that clutch.

Question 7

To what extent do permissible incentive structures inside the banks themselves play a role in the structure of the funding kit? At the end of the day if I get rewarded for the internal equity, but I get cheap debt-funding because of the backstop, I am incentivised to run a low equity ratio. To what extent is that really a problem and what should be done about it?

Question 8

You are saying that the risk to debt holders has decreased because of the equity buffer, but the language in the parliaments makes it a lot riskier. Have you looked at the contagion risk between a bank falling over and asset managers holding it?

Also on that point, you seem quite disheartened by tier 1 and the triggers within that when someone will actually kick in for equity gates. Why is that?

Lord McFall

John, can I add one of my own? You spoke about zero-weighting of solvent bonds. I have been on the Committee in the House of Lords on EMU and the development of EMU. We have the Banking Union and other projects like the five presidents' report; but it seems that the zero-weighting of the bonds is the elephant in the room which nobody is talking about. I wondered what the implications of that are for EMU and whatever else.

Sir John Vickers

I am not going to talk about Brexit.

Internal incentives are very much a part of this. In the ICB work we did not get into that question, nor did we get into the cultural questions and the standards issue that the Parliamentary Commission went on to look at in a big way. It was partly that we wanted to have a

defined remit and we had 15 months. I remember at the beginning a friend of mine said, 'Who is going to finish first, you or Chilcott?', so we won that one. I also kept the lawyers out.

On the fact that the question of internal incentives is important to this, all I suggest is that not enough has been done about the external regulation. Internal incentives in hedge funds are not, to my taste, especially palatable, but they do not raise the same sort of public policy issue because the taxpayer is not on the hook for what goes on there. Even on the question of equity levels generally, John Cochrane, who is a Chicago economist, had a nice definition of what is enough capital. He said that, 'It is enough that we do not have to talk about it anymore.'

The fact that there is a question is itself indicative of something. We do not say about engineering firms, 'We need to have a minimum equity capital requirement' because the market system, imperfect though it is, it works there and you get on-put the discipline, governance, and all the rest. With banking, partly because of the deposit structure and the guarantee to the retail deposits, you just do not get and that is why you have this huge public policy issue where there is not even a question for other types of firm. There is in insurance, but in most of the rest of the economy it is just not an issue at all; but your point is very well taken.

On tier 1, I hope I did not sound too disappointed about that. I personally like to think in terms of common equity. Even though it is an accounting number it is conceptually easier and more straightforward than with this quite significant 20% additional – relative to it – slab of these other instruments. These things ought to convert into equity if needs beand as you said they will probably do so; usually the triggers are so-called 'high triggers'. Therefore the contractual clauses are such that that equity will be built before you are into the capital conservation buffers and the like.

However, they are not completely problem-free. It is with the contagion point that you mentioned. It was very interesting in the new year when you had some quite sharp movements, not so much in the British banks, but continental European banks, share prices, and these instruments were moving about quite a bit. There was a market realisation of, 'Uh-oh, these triggers might actually be triggered one day not so far over the horizon' and you saw a market re-pricing for that risk.

You could imagine dynamics where triggers are triggering other triggers and so on where you could in principle get something cascading of an unpleasant kind. Pure old equity it is not contagion-free, but the risks are a level or two lower.

On your point about the risk upon holders, there are two separate issues. As resolution regimes become more credible, and they are never going to be 100% credible because of this nasty weekend point, but if they become more credible then the market will price it with its risks, and that is good. That is not a bad thing. That is a good thing. That is a move towards proper pricing of risk.

The point more generally about equity is, let us say, instead of paying out big dividends for a couple of years a bank pays out half that dividend rate, it will have more equity. That means that the circumstances where the bond holders made loss are more remote because there is a big equity cushion. That is good for the bondholders. Therefore, there are different forces acting up and down on bond values.

The eurozone zero risk-weighting: that is a bigger problem in continental Europe than it is for the UK banks. In some countries in particular you have this embrace between the banks and the state where you have a lot of government debt on the bank balance sheets, so it is very important for funding the state. It is also zero risk-weighting so no extra capital has to be in the funding structure on account of those debt holdings.

Partly the fact that this problem is unsolved says something about the politics of the situation. It is not that mysterious when you see the mutual aversion to solving this problem. It is pretty strong on both sides and that is partly why I do not take comfort from your earlier comment about the global regulatory community saying, 'We have done enough.' Your choice of words was exactly right. You said that they were focused on not increasing capital. I was astonished to see that in a speech by the Governor. He said, 'Our focus is not increasing capital', as though it is an aim not to do it. It is extraordinary.

However, that is where the international community is and that is really disappointing; but we will see. It is good that the debate carries on. Thank you again very much for fostering it.

Lord Sharkey

I would like to say thank you to Sir John Vickers for speaking with his usual clarity and force. I was particularly struck by the conversations about reformed risk weights and the operation of resolution regimes. I was also taken by the notion Sir John advanced that common sense is a proper guide to the answer, even if I am notsure, what traction common sense has in banking or political communities. Sir John, thank you very much.

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