Regulation
Fallacies and misconceptions

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Belief simple and tough capital requirements best…

- This was promoted by Haldane’s 2012 ‘The dog and the frisbee’
  - Purported to show that the financial crisis of 2008 was related to the 2004 Basel II agreement on models
  - But Basel II internal models for credit did not come into force until 2008 for major banks!!
  - But misconception still embedded in thinking. Eg BCBS ‘High level summary of Basel III reforms’ echoes the same argument as Haldane.
- Now a widespread belief that simple –non risk-based is best

What really lay at the heart of the 2008 crisis?

- In terms of Regulation-
  - The 1998 weakening of Tier1 definition – at least one major bank had only equity equal to 2% of risk-weighted assets in 2008. The rest of Tier1 was debt!
  - No liquidity requirements
  - Inclusion of illiquid RMBS in the market risk requirements which assumed saleable in 10 days
  - Distortions from the simple Basel I requirements which had driven the development of the securitisation market as a capital arbitrage– see BCBS Working Paper 1 1999 *The Impact of the Basel Accord.*

- Misunderstanding and mispricing of risk in the 2 trillion mortgage-backed securities market and related markets eg SIVs.

Now a belief that simple requirements won't distort markets

- Banking is sophisticated, far more so than in 1988 when Basel I came in or even 2004 when Basel II agreed.
- Individual exposures are assessed for return on capital – if capital required is too high relative to risk the bank won't be able to price it to make a return and won't transact
- Eg requirement on income producing real estate in the UK under slotting very high
    - EU bank requirement (where slotting not required) less than half UK banks' requirement
    - Recent data has shown that commercial property lending has moved out of UK banks into PE, insurance companies and overseas banks - Uk banks less than 40%, non Uk 30%, non banks 30%. *Bayes Business School Commercial Real Estate Lending Report*

Driving lending out of banks matters

- Banks are franchise players – insurance companies, PE houses and other non bank players are not.
- If the going gets tough, the non franchise players will exit the market
- Exacerbating cycles
- Without experience of the markets mispricing of risk more likely

Competition in Uk banking

- The Financial Services and Markets Act 2023 gave PRA a competition objective
- But increasingly there seems to be a view that allowing new style banks to grow isn’t important – competition between the existing incumbents is enough
- But the threat from the digital banks led to the clearers investing in digital
- Some market segments not well served by the incumbents
- £150bn of SME deposits held in deposits at zero interest – *Allica Bank Report October 2023*
- And innovation is important

Bank regulation has an important role

- Not to give preferential treatment to challenger banks but to avoid penalising them
- Over conservatism reduces the prospect for growth –capital backers have to see prospect of return on capital employed
- Making the path to the capital treatments used by the clearers (models too slow) makes the gap impossible to bridge