Separating Retail and Investment Banking: Evidence from the UK

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Summary

Should retail and investment banking be separated?
- Question has been debated at least since 1933 Glass-Steagall Act
- Large regulatory divergences across jurisdictions
- Existing literature has mostly focused on implications of combining corporate lending and underwriting (conflicts of interest, synergies).

We instead focus on a novel deposit funding channel:
- If universal banks must separate retail and investment banking, they cannot use retail deposits to fund investment banking activities
- But wholesale funding is likely to be imperfect substitute for retail deposits
- So this constraint has potential to affect universal banks’ asset allocation decisions

We test this idea using recent UK ring-fencing regulation.

Main results:
- Deposit funding channel causes large universal banks to rebalance away from capital market activities and towards retail lending (mortgages)
- These large banks gain market share in retail credit market at expense of smaller competitors
- The smaller banks respond by increasing riskiness of their lending

Policy

- Ring-fencing requires large banking groups to split into subsidiaries:
  - Retail deposits must be held in Ring-Fenced Bank (RFB)
  - Investment banking must be housed in Non-Ring-Fenced Bank (NRFB)
- Restrictions on intragroup exposures prevent banks from circumventing capital requirements via intragroup contracts
- Legislation passed in 2013; requirements in force from 2019

Theory

- Retail deposits might benefit from liquidity and/or safety premiums relative to wholesale funding
- Households prefer for liquidity (Strem 2012)
- Deposit insurance (Strem 1998; Hanson et al 2015)
- Market power (Drechsler, Savoie and Schnabl 2017)
- Ring-fencing implies retail deposits can only fund RFB (primarily retail lending), and cannot fund NRFB (wholesale and investment banking)
- This redirects benefits of deposit funding towards retail lending...
- ...incentivising rebalancing from capital markets to retail lending

Anecdotal evidence

UK’s 15 biggest mortgage lenders hit by price war

Legislation designed to cut risk in the banking sector has flooded the market with capital!

Financial Times, 2019

LONDON, Sept 29 (Reuters) - Ring-fencing regulation is increasing the cost and cutting the profitability of syndicated lending for UK banks, which is... Reuters, 2017

Data and identification

Loan-level data for two markets:
- Domestic retail mortgages (RFB)
- Global syndicated lending (NRFB)

Sample period is run-up to ring-fencing implementation (2010-2019).

Main loan-level regression specification:

\[
\text{Loan}_{i,t} = \beta \left( \Delta \text{Retail funding}_{i,t} \times \% \{ \text{Post}_{i,t} \} \right) + \text{Controls}_{i,t} + \epsilon_{i,t}
\]

where

\[
\Delta \text{Retail funding}_{i,t} = \frac{\text{Retail funding}_{i,t} - \text{Retail funding}_{i,t-1}}{\text{Retail funding}_{i,t-1}}
\]

Results: Direct effects

Domestic retail mortgage market (RFB):

- Affected banks reduce the interest rates on mortgages

Results: Indirect effects

Global syndicated lending market (NRFB):

- Affected banks reduce provision of syndicated corporate loans
- Effect is larger for loans to foreign borrowers

In sum, results consistent with rebalancing from capital markets (NRFB) to domestic retail lending (RFB)

Policy implications

- Universal banks subject to ring-fencing already held dominant position in domestic mortgage market
- Their increased market shares caused by ring-fencing therefore lead to an increase in mortgage market concentration
- Smaller banks more geographically exposed to the increased competitive pressure increase the risk of their lending, consistent with Keeley (1990)