GOVERNING 'TOO BIG TO FAIL' BANKS

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Abstract

This paper considers possible and proposed responses to the "To Big (complex, interconnected, important) To Fail (TBTF) Problem". It argues that the corporate governance of large shareholder-owned deposit taking banks is particularly problematic because of the implicit insurance their shareholders and bondholders enjoy, at the taxpayers expense. This creates issues of moral hazard and also competitive inequality, because TBTF banks can raise funds more cheaply than non-TBTF banks. The US pre-funded deposit insurance scheme with risk-related premia does a pretty good job managing the moral hazard issues relating to non-TBTF banks. A parallel mechanism involving a special resolution regime for TBTF banks and the equivalent of deposit insurance with risk-related premia needs to be put in place. Whether the scheme should be pre-funded or operated on a *ex post* 'polluter pays' basis, and the associated tax regime for TBTF banks needs further consideration. Bondholders should not enjoy the current level of protection and 'Co-Co' bonds may be part of the solution. Consumer Protection is a good idea and deposit taking banks should be regulated as other 'utilities' are in the UK. The corporate governance problem would be simpler if all retail deposit taking banks were mutuals!

Keywords: banks, shareholders, risks, corporate governance

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1. Introduction

The 2007-9 Global Financial Crisis (GFC) revealed significant inadequacies in the corporate governance and the regulation and supervision of banks. Large, complex or interconnected banks, with the notable exception of Lehman Brothers in October 2008, were bailed out and/or merged with other banks because of the systemic risks they posed. They were judged too important or interconnected to be allowed to fail, or 'too big to fail' (TBTF) for short. The Financial Stability Board introduced the term SIFI (Systemically Important Financial Institution)in 2010, but we will stick with TBTF as it has resonance!

Many banks, including large ones (e.g. Merrill Lynch, an investment bank, and Washington Mutual (WaMu, a mortgage lender) were merged with others (Bank America in these cases) to form even bigger banks, despite a regulatory rule that no bank in the US should have more a 10% market share. Concentration in banking in the US and elsewhere has thus increased. Bank bondholders (including providers of 'Tier 2' and some 'Tier 1' capital – see www.bis.org) have generally been protected (except in cases such as Lehman's and WaMu) and, post Lehman, bank bond issuance has been guaranteed by governments in the EU and the US, and more widely.

Meanwhile, the Federal Deposit Insurance Corporation (FDIC) in the US has been able to allow numerous non TBTF banks to fail under its bank resolution arrangements; with the protected deposits transferred to other banks promptly. In addition, the US deposit insurance (Deposit Insurance) cover was raised from USD 100k to 250k to reassure depositors. Deposit Insurance was effectively extended by the 'Fed' (the Federal Reserve System, the US central banking system) to money market mutual funds after a couple of large ones 'broke the buck' when the value of their assets fell below those of their liabilities. Specialist investment banks merged with deposit taking banks to gain access to the Fed's 'lender of last resort' and other liquidity facilities; which were dramatically expanded using the Troubled Assets Relief Programme (TARP) and other special asset purchase and loan schemes e.g. the Troubled Assets Loan Fund (TALF). This further increased the complexity of investment banks and marked an even greater departure from the 1933 Glass-Steagall Act, which had required a separation of investment banking, from (deposit taking) commercial banking.

The European Central Bank (ECB) concentrated primarily on providing liquidity at short and medium term maturities, but did buy 'Covered Bonds' which underpinned German and Danish mortgage markets. They are secured not only by the receivables on the underlying mortgages, but the mortgages themselves and other issuing bank assets. The Bank of England (BoE) provided short term liquidity, and engaged in 'quantitative easing' (buying new issues of government bonds), but unlike the Fed, did not engage extensively in 'credit easing' (buying asset backed securities, including mortgage backed securities, from the US 'Government Sponsored Enterprises' (GSEs), 'Fannie Mae' and 'Freddie Mac'.

2. Structural Reform to Make Banks Safe

One possible solution to the TBTF problem might be to break up big and complex banks as part of a wide ranging structural reform. One of the most fundamental and longstanding proposals is to prevent banks from using retail deposits to make loans-see Kay (2009) on 'Narrow Banking' and Katlikoff (2010) on 'Limited Purpose Banking'. Both see deposit taking 'banks' operating a range of mutual funds. The safest of which effectively have 100% liquid reserves, or 'narrow banking' as originally conceived by Henry Simons, Irving Fisher and Milton Friedman *inter alia* (Katlikoff, 2010). This would dramatically reduce leveraging and lending, but a less dramatic, narrower banking, solution could be sought.

Other structural solutions include the 'Volcker Rule' (discussed below), an updated 'Glass-Steagall Act' (discussed below) separating retail or commercial banking from investment banking, and simply breaking up big banks so that they do not have market shares in excess of, say, 10% (by loan or other assets, or deposits). The aim would be to eliminate TBTF banks and increase competition, thus simplifying the regulation problem, but would such reform reduce banking cost efficiency?

Andrew Haldane has argued in speeches (www.bankofengland.co.uk) that the accumulated evidence on economies of scale and scope suggests that they are not sufficiently substantial to justify large and complex banks. A counter argument is that 'universal banks', which combine commercial and investment banking, are more diversified and better able to weather business fluctuations.

The Glass-Steagall Act was passed in 1933 following a review of the causes of the financial crisis that generated the Great Depression. It was repealed in 1999 by the Gramm-Leach-Bliley Financial Services Modernisation Act, and since then US banks have taken the opportunity to diversify their businesses. In the UK, diversification followed the 'Big Bang' financial reforms in 1986. As lessons were drawn from the GFC, the question arose of whether investment and commercial banking should again be separated, or whether some other structural reform was appropriate? One such proposal was the 'Volcker Rule' which was proposed by G.30 Report (2009) following the deliberations of a working group chaired by Paul Volcker, a former Chairman of the Federal Reserve System, the US central banking system. It recommended that deposit insured banks, and possibly also specialist investment banks, should cease 'proprietary trading' on their own accounts in order to eliminate conflicts of interest with purchasers of securities they design and sell. It effectively aimed to separate 'banking' from hedge fund and private equity fund activity.

'Prop trading' did not cause the crisis, but the interaction between banks (deposit taking and investment), hedge and private equity and money market mutual funds did create a 'shadow banking system' that borrowed short to lend long and both participated in the increased leveraging and added to the demand for bank funding and collateralised debt obligations (CDOs) that lay at the heart of crisis (Tett, 2009). The shadow banking system contracted dramatically following the failure of Lehman Brothers. Further, in April 2010, a US regulator, the Securities and Exchange Commission (SEC), alleged that Goldman Sachs' dealings with John Paulson's hedge fund involved a conflict of interest with the purchases of the CDOs issued. This demonstrated that hedge funds were not mere 'innocent bystanders' after all, and that the 'prop desks' of investment banks were essentially internal hedge and private equity funds. As a result, conflicts of interest abounded (Augar 2006, 2009). Further, hedge funds were significant holders of (CDOs) in the run up to the GFC, but unwound their positions ahead of it.

Hedge and private equity fund activity grew rapidly in the run-up to the GFC and then contracted sharply, especially in 2008, but assets under management in April 2010 were only 2% below their October 2007 peak, having reached their post crisis nadir in early 2009. It seemed prudent to regulate them more tightly; for the nature of crises may be similar, but the causes commonly differ (Reinhart and Rogoff, 2009). The EU agreed to tighten regulations on such 'alternative investment funds' in May 2010 and the US has also been considering tougher regulation involving more disclosure. The US has already tightened the regulation of money market mutual funds, a crucial supplier of funds to the 'shadow banking system'. They had got into difficulties by investing increasingly in riskier assets in an attempt to raise returns and attract investors.

3. Post GFC Progress with Regulatory and Structural Reform in the UK and the US

The US passed the 'Dodd-Franks' Wall Street Reform and Consumer Protection Act in July 2010. It contains a weakened version of the Volcker Rule and introduced a consumer protection agency, which is to be a semi-autonomous division of the Federal Reserve System, whose responsibility for the safety and soundness of the banking system is to be enhanced. Many of the regulatory details were to be decided by the various US regulatory agencies, which were not fundamentally rationalised. No fundamental restructuring of the banking industry beyond the Volcker Rule was required and so there was no return to the Glass-Steagall Act separation of investment and commercial banking. Large bonuses, particularly in investment banking, re-appeared on Wall Street in

2009 as the banks quickly repaid government stakes in them in order to escape the attention of the government appointed regulator of banking remuneration.

In contrast, the UK's Financial Services Authority (FSA), the regulator of investment and commercial banks and the wider financial sector, has issued a bank remuneration code designed to curb the incentivisation of risk taking through bonuses that are essentially guaranteed regardless of performance. In August 2010, it began to consult and revisions to the code which are required by the EU's updated Capital Requirements Directive and the UK's Financial Services Act (2010). In addition, Her Majesty's (HM) Treasury (the UK Finance Ministry) began consulting in July 2010 on a restructuring of UK financial regulation (CM7874, 2010). It is proposed that (the Bank of England), the central bank, takes over the prudential regulation of banks, alongside enhanced responsibility for the stability of the financial system, from the FSA. A new Consumer Protection and Markets Authority (CPMA) would be created to take over from the FSA the regulation of markets and consumer protection; and a separate body had already been established in 2010, the Consumer Financial Education Board (CFEB), to take over the FSAs role in raising consumer financial capability.

Thus, both the UK and the US aim to enhance the protection of retail consumers of financial services and products and to give a greater role to the central bank in regard to promoting financial stability. The lender of last resort has an incentive to protect the taxpayer against abuse of the liquidity insurance it provides and so it is appropriate for the central bank (and any deposit insurance fund) to be involved in prudential regulation and supervision.

There remains a case, however, for separating retail consumer product and service regulation from 'microprudential' regulation, given that the payments systems and perhaps other retail financial services are essentially a public utility and TBTF banks control a large share of the market. This is particularly the case in the UK, the more so after the GFC, but less so in the US so long as the '10% rule' relating to bank deposit concentration is enforced there and the Federal Reserve system remains at the hub of the US payments systems. In the run up to the GFC and the 'Fed' and the FSA seemed to find it difficult to juggle their prudential supervision and consumer protection roles and both were criticised: the Fed for paying too little attention to its consumer protection role; and the FSA for paying too much attention to consumer protection at the expense of its prudential supervision roles.

It seems possible that more substantial structural reform will emerge in the UK from the deliberations of the 'Independent Commission on Banking' (ICB) set up by the new 'Coalition' government in June 2010 and due to report in September 2011. It is to be chaired by Sir John Vickers, former head of the Office of Fair Trading, the UK competition (anti-trust) authority that currently also has responsibility for regulating consumer credit under the Consumer Credit Act (2006). Given the significantly more highly concentrated nature of UK banking (than the US), and the substantial increase in concentration that followed the mergers induced by the response to the GFC in the UK, this is welcome; although it stops short of a full Competition Commission review of the banking industry such as the one that was being contemplated in Australia in late 2010.

Early announcements by the ICB and it members suggested that it was likely to recommend a substantial restructuring of the British banking system on competition/anti-trust grounds alone, including requiring the reversal of the Lloyds TSB-HBOS merger brokered by the previous government to the chagrin of the competition authorities. There have been fewer clues about its views on separating investment from retail banking or the Volcker Rule.

A number of the big banks in which the government does not hold major shareholdings, unlike the Lloyds Banking Group and RBS, have all but threatened to re-locate their head offices abroad if the government acts on recommendations leading to a major restructuring. It is, however to be noted that Standard Chartered has no UK retail branch network to speak of and HSBC already does the majority of its business in Asia. Barclay's could, however, demerge or sell off its UK retail banking operation and move its investment banking operation (famously incorporating the rescued part of Lehman Brothers in New York) to New York. For these banks, relocating their head quarters away from London probably already makes strategic sense, but the government will be loathe to loose the tax revenues they generate.

Meanwhile, UKFI (UK Financial Institutions) was committed by the previous government to maximise the value of the bank shareholdings it sells in order to compensate taxpayers for the costs of recuing the banks. If Lloyds and RBS were substantially restructured, their 'franchise value', and thus their sale price, would fall. The government thus faces a conflict of interest. It can maximise the value of the shares it sells by ignoring recommendations to significantly restructure, to the short term benefit of taxpayers, or it can restructure to reduce the probability of future 'bail outs' and to increase competition in retail banking to the benefit of consumers of all banking products and services, not just depositors.

There was pressure from the heads of the London Stock Exchange and the Financial Reporting Council (FRC), which overseas auditing and the corporate governance codes in the UK, to split the Consumer Products and Markets Authority, which is being formed as a 'rump' FSA, into a (capital) markets authority (along the lines of the Securities and Exchange Commission (SEC) in the US and a consumer (financial) products and services. The reasoning behind it was to bring all the capital market regulation together and to create an institution to give the UK 'voice' under the new EU regulatory framework, but the government rejected their proposal.

There is, however, also a strong case for having a separate retail consumer financial services and products regulatory and supervisory authority. The payments systems are clearly infrastructural, as the Cruickshank Report (2000) argued, and so there is a strong case for assuring access to it, especially as bill paying becomes cheaper using automated payments, such as Direct Debits in the UK. Further, information asymmetry and low levels of financial capability make it important that retail financial institution 'treat customers fairly', as the FSA is currently required to assure they do. It is not at all clear that the regulation and supervision of London' truly international banking and capital markets should be combined with regulation of retail banking and insurance and investments. A public utility regulator of retail financial seems to recommend itself ('BancInCo'?). In the UK it would naturally also take over the supervision of the Consumer credit Act from the Office of fair Trading, which is likely to disappear in its current form following a review of UK comeption/anti-trust authorities< It would also naturally take on the role of raising financial literacy from the Consumer Finance Education Board, which was established to take over that role from the FSA in the first half of 2010.

4. The Corporate Governance of Shareholder-owned, Deposit Taking Banks

Mutual ownership has a long tradition in banking, and it is a good model for delivering retail banking to households and small and medium sized enterprises (SMEs) and assuring widespread access to finance (BSA, 2009). Local or state government and post-office banks also play a significant role in many countries, such as Germany (Mullineux and Terberger, 2006). Shareholder-owned deposit taking banks require special treatment because shareholders (increasingly including management) have interests that differ from those of depositors. The desire to maximise 'shareholder value' potentially leads to short-termism and risk seeking behaviour. Bank depositors in contrast are risk averse, for otherwise they would have instead bought bank shares (Mullineux 2006).

The GFC made clear that, to prevent 'bank runs', Deposit Insurance needs to be comprehensive and access to deposits maintained. This implies that, as in the US, DI should be pre-funded (with risk-related premiums) as a means of 'taxing' risk taking (Merton, 1977). If it is not pre-funded, there is no *ex ante* tax, only the threat of post crisis levies. But how large should the Deposit Insurance funds be? The existing funds, even in the US, are clearly not big enough to protect depositors of TBTF banks; who have instead been revealed to enjoy insurance from taxpayers well above that provided to smaller banks through Deposit Insurance schemes. Further, contributions cease when few banks are failing and so the disincentive to risk taking declines. Risk-related capital adequacy requirements and provisioning against bad and doubtful debts are also notoriously 'procyclical'. Hence, just as a 'buffer stock' of capital needs to be built up by banks in booms, so too does a buffer stock of Deposit Insurance funds.

How then can the TBTF banks be made to pay for the implicit taxpayer funded insurance they enjoy? Free implicit insurance gives TBTF banks the competitive advantage of cheaper funding as a result of higher credit ratings. It also creates a major moral hazard problem; leading banks into higher risk strategies because they expect to be bailed out if bad outcomes result. This has been made abundantly clear by the bail outs during the GFC and made worse, along with the anti-trust issues, by the resulting increase in concentration in banking. Hence, the TBTF problem has been worsened by the GFC and responses to it.

An improvement in the corporate governance of banks requires assigning special roles to independent directors, and possibly also auditors of banks, and greater institutional shareholder 'engagement' (Walker, 2009). The bank board should also take responsibility for internal risk management.

The appropriate division of labour between non-executive directors and instiutional shareholders unclear and so is whether they can deliver remuneration restraint in banking. In the UK, the revised (in 2010) Corporate Governance Code and the new 'Stewardship Code' (see Financial Reporting Council (FRC) http://www.frc.org.uk) attempt to resolve such issues in the case of banks and other companies. In addition, the FSA has laid down rules aimed at preventing remuneration packages from encouraging short term risk seeking. The best that can be hoped for is that 'claw backs' of bonuses are introduced, more incentive compatible remuneration packages are developed and introduced, and internal risk controls are improved.

The interests of retail depositors and other consumers of banking products and services also need to be protected. The high pre crisis profitability of TBTF banks, and the quick return to bumper fees from underwriting and banking profits in investment banking after the crisis, along with widening interest rate spreads between lending and borrowing rates in retail and commercial banking, point to serious anti-trust issues. A far reaching competition authority review in the UK, and the rest of the EU and the US, is thus required. Recall, however, that the US has a rule preventing individual banks taking more than

10% of US deposits, and note that the much more concentrated Australian and Canadian systems had a 'good crisis' (as indeed did Texas in the US!). Were they better regulated or structurally organised, or just lucky? Both of the countries benefited from the global commodity boom in the last decade, it should be noted, but both have also undertaken substantial banking sector reforms in the last decade or so.

One possible solution to the corporate governance problem is to legislate to give banks a legal 'fiduciary duty' to depositors on a par with, or ahead of, that to shareholders (and other creditors), as proposed by Macy and O'Hara (2006). Another is to reduce or eliminate the limited liability of bank shareholders. Alternatively, all deposit taking banks could become mutuals and be regulated accordingly; thereby resolving the conflict between shareholder and depositor interests and reducing the risk exposure of taxpayers. Such a solution to the fundamental corporate governance problem of shareholder owned banks, however, seems even more unlikely than the fundamental restructuring of banking systems required to eliminate other conflicts of interest, and so we turn to the regulation of TBTF banks. Mutual banks (credit unions, savings and loans, building societies and co-operative banks etc) have often got into trouble following deregulation allowing them to diversify away form retail banking. This is particularly evident in the UK following demutualisation (Northern Rock), but also some of the banks that remained mutual got in to trouble following an expansion , of often wholesale funded, 'buy to let' and commercial mortgage lending (Bradford and Bingley). The 'Savings and Loans' banking crisis in the US following the 1980s financial liberalisation is another example. Credit unions and other mutual savings banks that 'stick to their knitting' have few problems beyond the occasional fraud perpetrated by employees, although they are perhaps overexposed to a fall in housing prices due to lack of diversification.

5. Regulating TBTF Banks

The approach of the US Federal Deposit Insurance Corporation (FDIC) to regulating non TBTF banks based, on funded Deposit Insurance with risk-related premiums paid by banks and a prompt resolution regime for failing banks, works well. It allows numerous weak banks be closed without inconveniencing depositors; thereby containing the moral hazard problem and eliminating bank runs. In contrast, not only depositors, but also the bondholders of TBTF banks (*pace* Lehman) were protected during the GFC; and so were the shareholders of bailed out banks to a considerable extent.

Can a similar, funded Deposit Insurance scheme, with risk related premiums as in the US, be established for TBTF banks alongside a special resolution regime involving 'living wills', and is there a need for a European level deposit insurance fund and/or a European level bank resolution fund? The aim should be to devise a system where big banks can be allowed to fail and bondholders and shareholders are not underwritten by taxpayers. This would enhance the incentive of bondholders and shareholders to monitor bank management. It requires banks to have a pre-agreed plan (a 'living will') determining how they would be broken into parts, with perhaps some parts saved or sold and other parts closed, when a crisis occurs. For many banks, the 'living wills' would have to be agreed with regulators in more than one country, making international co-operation essential, particularly in Europe.

The advantage of a funded deposit *insurance* scheme with risk related premia is that funds are available to restructure failing TBTF banks, risk taking is taxed, and the banks as a group need hold less in-house insurance (i.e. capital and liquid reserves). But, what would the fund be used for between crises and can TBTF banks really be successfully re-structured during crises? An alternative, or additional, option is to rely on enhanced capital and liquidity requirements for TBTF banks such as the July 2010 revised 'Basel III' proposals (www.bis.org). But how much capital and liquidity is required to assure systemic stability without dramatically curbing lending (IFF, 2010)?

The Eurozone crisis that erupted in April 2010 highlights another problem. European banks holding bonds issued by Greece, in particular, but also Spain (downgraded in late May) and Portugal clearly risk losses on their bond holdings. The consequences of this crisis are potentially much larger, however. Should any government including the USA be regarded as risk free? If not, the bonds that they issue should not have zero risk weightings under the proposed Basel III capital adequacy requirements? Instead, capital must be held against them. Further short term papers issued by governments that are required to be held as part of liquidity ratios are not riskless either. Hence banks may need to hold more of the liquid reserves in cash, rather than Treasury Bills. The increased capital and cash reserve holding will further reduce the banks' lending capacity, which has already been curbed dramatically by the collapse of securitisation and the need to rely less on wholesale funding.

The Basel Committee is also working on the aforementioned 'procyclicality issue', the tendency of risk-related capital adequacy requirements and provisions against losses to rise in slumps and fall in booms, by proposing that capital and liquidity ratios vary over 'the cycle' (which cycle?) and provisioning is forward looking, or 'dynamic'. Spain was praised for its dynamic provisioning regime, but has now recognised that it was not tough enough on its public sector savings banks, which had been allowed to develop excessive exposure to property and construction markets. Further, prevailing accounting standards are creating an obstacle to widespread adoption of forward looking provisioning due to concerns that the banks will simply use 'provisioning' to 'smooth' reported profits.

A pre-funded Deposit Insurance arrangement for TBTF banks seems unlikely to be agreed by all G.20 countries, making it difficult for some to go alone because it would put domestic banks at a competitive disadvantage. A 'Second Best' solution is to require banks, like polluters, to pay for cleaning up the mess they create. US President Obama's proposed a special levy on banks for 'as long as it takes' to recoup the costs of the crisis induced by the banks aims, but had to abandon it to get the Dodd-Frank Act through Congress. It aimed to make the 'polluters' pay and could potentially have reduced moral hazard, because future miscreants would also expect penalties *ex post.* Alternative special taxes on TBTF banks have been proposed by the International Monetary Fund (IMF) and are being proposed in various countries, but an international agreement on a common approach seems unlikely and thus the taxes will be kept relatively low for fear of undermining the competitiveness of domestic banking champions. If, however, capital requirements and special taxes were high enough on TBTF banks, then banks might perhaps *choose* to downsize and to separate off, or sell, activities with higher capital requirements and thereby to downscale and simplify their structures. The UK 'Coalition' government's budget in June 2010 introduced a levy on large banks to force them to contribute to the recovery from the crisis they helped to cause. A levy is to be introduced in January 2011 as part of parallel action by France and Germany

A post bailout 'windfall tax' on banks, was levied in early 2010 in the UK and France, seemed justified (and popular!) because banks were operating with reduced competition and benefiting from bumper fees from underwriting and broking increased government (and corporate) bond issuance to fund the bank bail-outs and curb the 'Great Recession' in 2009. The focusing of the windfall taxes on investment banking was probably also correct, but populism dictated that employee bonuses, rather than bank profits, were taxed in the UK.

6. What else should be done?

There is growing evidence of misreporting, as well as fraud. Misreporting of loan losses at Northern Rock was prosecuted by the Financial Services Authority (FSA) in July 2010, and the use of a Repo 105 accounting loophole by Lehman Brothers was identified in April 2010 by the Valukas (US Court Examiner) Report. Both pointed to continuing shortcomings in auditing. Such problems were supposed to have been resolved, post 'Enron', by the 2002 Sarbanes-Oxley Act in the US and Financial Reporting Council (FRC) oversight of auditors in the UK. Auditing of banks was recognised in the 1989 UK Banking Act as being special because of the risk of sparking a bank run/failure if a bank's accounts are 'qualified'.

The financial innovations (CDOs etc) at the heart of the crisis were clearly complex and often traded 'over the counter' i.e. outside organised markets ('exchanges'). In 2009, the G.20 agreed to require much more exchange trading of derivatives in order to reduce 'counterparty' risk exposures. The investment banks, which stood to lose a lot of fees, lobbied hard against the proposal and were supported by captains of US industry, who feared that the use of exchange traded derivatives would tie up their liquidity because of 'margin requirements'. The 2010 US Dodd-Franks Act contained compromise requirements and the EU was working to match them in 2010.

Financial innovation itself should probably be regulated: at the retail level by the consumer protection regulator; and at the wholesale and market level by a capital markets regulator. As with pharmaceutical drugs, new financial innovation should be 'trialled' before widespread use; although the innovators will oppose this as they will fear loss of 'first mover' advantage since financial innovations are hard to patent because they tend to benefit from rapid widespread adoption, leading to the formation of new markets.

'Short-termism' remains an issue. Lord Turner (the FSA Chairman) has questioned the usefulness of much of the financial market trading (FSA, 2009), as did Tobin (1984). 'Tobin', trading or 'turnover' taxes have been considered on a number of occasions (e.g. in France), but will only work if applied uniformly in all major financial centres, and what would the funds be used for? - a 'Robin Hood tax' to fund the World Bank, or aid to achieve the 'Millennium Goals', or just to boost government revenue? In June 2010, the German government announced that it would unilaterally introduce a financial 'turnover tax', having already introduced restrictions on the 'short selling' of equities.

In April 2010, the IMF reported to the G.20 on its deliberations on special financial taxes. It favoured a new tax related to the size of a bank's liabilities (net of insured deposits and more narrowly defined Tier 1 capital) to pay for future 'clean ups', and an additional levy on profits above 'normal' (how defined?) and on 'high'(how defined?) pay, in preference to a trading, or turnover ('Tobin') tax. Revised proposals were submitted to the G.20 in June 2010 (IMF, 2010). Widespread international agreement on tax levels etc would be required. Canada and Japan immediately came out against the April proposals, and Australia and others were less than enthusiastic about them.

Canada prefers requiring banks to issue 'Conditional Convertible' ('CoCo') bonds (pioneered by Lloyds Banking Group in late 2009) and the Swiss National Bank has required its two major banks (Credit Suisse and UBS) to hold capital well in excess of the minimum levels recommended by the Basel Committee of banking Supervisors under its current ('Basel III') recommendations, making up the difference by issuing CoCos; which are bonds that convert to ordinary shares at some trigger point. Further, the Basel Committee was concerned that attempts to agree on special bank taxes will be a distraction, leading to a delay in agreement on Basel III.

If banks were required to hold an agreed proportion of their liabilities as CoCos, then the bondholders would have an incentive to monitor banks' risk taking. This relates to a long standing proposal of the 'Shadow Basel Committee' (http://www.ceps.eu/content/european-shadow-financial-regulatory-committee-esfrc) that banks should be required to issue more bonds in order to subject themselves to monitoring by bondholders acting as informed debt holders. The 'CoCo' proposal would increase the cost of bank funding, further reducing their capability to lend, or raise the cost of borrowing. The Institute of International Finance (IIF) issued its estimates of the substantial reduction in economic growth that would be caused by the sizeable (in their estimation) reductions in bank lending that would result (IIF 2010). Stephen G. Ceccheti (Head of the Monetary and Economics Department at the Bank for International Settlements) alleged that the IIF estimates were much exaggerated (www.bis.org). Would one or both of the levies proposed by the IMF be used to build up a DI fund for TBTF banks, as Sweden is doing with its bank levy, or will cash strapped governments find other uses for the revenue raised? Further, should the tax levels be the same in well established financial centres, such as London and New York, as in emerging capital markets?

More fundamentally, should interest and other payments on debt continue to be tax deductable? If banks could not deduct the interest they pay for debt financing, then they would probably issue more equity. Bank lending might fall dramatically and SMEs would also borrow less, as they too would lose the tax deductibility of interest. There would be a shift to more venture capital based financing and wider adoption of Islamic 'profit and loss sharing' principles. US households would also lose tax deductibility of interest on home (and other?) loans, making 'over borrowing' less likely in the future. A significantly smaller banking and financial system may however be just what is needed.

The TBTF banks, and indeed banking and financial systems, may in fact simply be 'too big to save' by the host country, as the crisis in Ireland demonstrated in late 2010. The cost of stopping the GFC generating a second Great Depression has resulted in heavily indebted governments, so much so that a second round of bank rescues in Europe as a result of their exposure to risky government bonds, rather than the subprime mortgages this time, would be crippling; leading to years of significantly higher taxes, and slower growth. There are seemingly limits to Keynesianism and the 'welfare state'. The debt of the financial system in the eurozone was estimated to be 250% GDP on the eve of the crisis in 2007. That of the governments was estimated to be 67%. Can governments and taxpayers afford the risk of having to bail out such a massive financial sector?

7. Conclusions

Hitherto, UK and US banks have 'got out of jail' virtually free. The US banks seem to have been spared far reaching structural reform beyond a partial application of the Volcker Rule and a requirement that there should be substantially more issuance of exchange traded, as opposed to bespoke, 'over the counter', derivatives; as part of the 2010 Dodd-Franks Act.

Philip Augar (2006, 2008, 2009) has identified a string of conflicts of interest in investment and universal banks that have emerged in the wake of the UK's 'Big Bang' reforms of stock broking in 1986 (Mullineux, 2007) and the banning of 'fixed commissions' on 'Wall Street' in the US in 1975. To make banks safe and protect consumers of banking products and services, the conflicts of interest should be eliminated, or managed through regulation and supervision. Their elimination would require substantial structural reform that separated broking, market making, underwriting and asset management, and more generally, the 'buy side' from the 'sell side' and the provision of 'advice' to purchasers of financial securities. Proprietary trading would have to be separated from trading on behalf of clients (the 'Volcker Rule') and retail deposits prevented from being used for 'casino banking'; which may additionally require a separation of investment from commercial banking. In other words, there would be a return to a pre-Big Bang model in London and a pre 1975 model in New York, but with the markets better regulated and cartelistic arrangements such as 'fixed commissions' eliminated.

To the extent, however, that economics of scale and scope and diversification can be demonstrated to be beneficial, the universal banking model, combining investment and retail and commercial banking, can be justified, and instead the conflicts of interest would need to be as assiduously monitored for abuse. This would leave the system open to 'gaming' by banks seeking loopholes, 'regulatory capture' by banks of regulators, and disaster myopia (Guttentag and Herring, 1986) on the part of regulators and supervisors, as the time that elapses since the GFC increases.

In the UK, the government, strapped for cash as it is, may be tempted to minimise structural reform in order to maximise the 'franchise value' of banks, and thus the price of the bank shares it holds, prior to selling them. The Independent Commission on Banking (ICB), set up to explore structural reform options, is to be 'independent', drawing on evidence from experts. "Which?", consumer organisation, set up its own independent 'Future of Banking Commission' which reported in June 2010 (Which Report, 2010). It recommended: the establishment of special resolution regimes for banks ('living wills'); enhanced deposit insurance; and structural reform going beyond the Volcker Rule, designed to eliminate the most important conflicts of interest in banking. It supported US and EU proposals to bring the majority of trading in derivatives (and other securities) onto organised exchanges, so that counterparty risks can be monitored and managed. It was generally supportive of developments in the bank prudential regulation, remuneration and corporate governance spheres and suggested some enhancements, especially in the consumer protection sphere. It thus urged the UK's Coalition government initiated ICB to pay particular attention to promoting 'effective competition' in order to eliminate or manage conflicts of interest in banking and to protect consumers.

A dedicated retail banking and insurance public utility regulator may well be required to protect consumers of retail financial sector products and services. The UK banking system has been under almost constant review by the competition authorities and the financial regulators, not just the FSA, but also the Financial Ombudsman Service and the Banking Codes Standards Board, since the Cruickshank Report in 2000 recommended the establishment of a payments system regulator **inter alia.** The government did not act on that recommendation, but concentration in the British banking system has subsequently substantially increased, in part in response to the GFC. It is now time to reconsider the Cruickshank proposals and to go further and establish a separate consumer retail banking (and insurance) product and service regulator (BancInCo?) to assure appropriate access to finance and that all customers are treated fairly, which will mean the end of the cross subsidisation underpinning 'free banking' in the UK. The capital markets should be separately regulated and supervised in the UK, as done in the US by the SEC. It makes no sense to regulate and supervise domestic retail financial services in an organisation that also has responsibility for the major international capital markets in London.

Further, the reduction in the return on equity from retail banking resulting from regulating it as a utility might well encourage TBTF banks to sell their retail operations to potential new entrants, such as large grocery stores.

In addition, the UK government should reconsider its position concerning the creation of a privatised PostBank to increase competition. Short of that, however, the Post Office branches could be used as a retail banking distribution network by potential competitors to the big banks, such as credit unions, small building societies and other mutual banks.

Such a proposal was being considered in late 2010 by the Australian Senate Banking Competition Inquiry along with a proposal to establish a dedicated retail banking public utility regulator, as proposed in this chapter. The Australian 'Twin Peaks' financial regulation model has clearly influenced the current UK government's thinking. At present Australia has two agencies outside the central Bank, APRA (the Australian Prudential Regulation Authority) and ASIC (the Australian Securities and investments Commission), which combines market and consumer product regulation. Messily, there is actually a third peak because the Reserve Bank of Australia regulates access to the payments system, including ATM charges. The US Dodd-Frank 'Consumer Protection and Wall St. Reform Act' establishes the authority of the Federal Reserve System in regulating TBTF banks and the SEC remains separate from the enhanced consumer product regulator, the Consumer Financial Protection Agency (CFPA), which is however to be within the 'Fed', rather than an autonomous regulator outside of it. From a consumer protection perspective and to assure access to finance, this paper argues that an autonomous retail financial 'utility' regulator is required.

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