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# The bank trilemma

From Basel III to the Independent Commission on Banking (ICB) and the Financial Transaction Tax (FTT), proposed new regulations will have a far-reaching impact on the way banks do business. Journalist Brian Thompson hears Clifford Chance partners discuss how banks face a trilemma as their capital requirements, asset book composition and funding sources are affected by regulatory pressures.

With a nexus of regulations facing the banking sector it is tempting to focus solely on the individual details of each new proposal, recommendation or initiative. "But it's also vital to look at the impact as a whole and see what this will mean to banks," explains Simon Gleeson, partner in Clifford Chance's Financial Markets practice in London. "To try and do this we are pulling together thoughts from different parts of the Clifford Chance practice – with particular expertise in bank capital, funding and tax – to give a collective view of the challenges banks face."

Simon believes that the first point to grasp is that when we talk about regulatory drivers, what we are really talking about is capital requirements. Of course, banks have always worked within a framework governing capital, but the difference now is that not only are the capital requirements higher and more multi-layered, the banks' ability to meet them will change on a day by day basis according to a number of factors. "Previously banks had to worry about capital. Now they will have to worry about capital, leverage, short-term liquidity and long-term liquidity and, depending on the shape of the bank, all of those are potentially a binding constraint at a transaction by transaction level," Simon Gleeson explains.

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## Asset composition

Having identified that a lack of liquidity lay at the core of banking's problems during the financial crisis, regulators have

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understandably focused on this as key to preventing the same thing happening again. As a result, banks will now be required to hold more liquid assets, namely cash and government debt. One problem this gives banks is that, with a far greater holding of low-risk, low-return liquid assets, the only way to maintain target returns is to increase high-risk assets. The inevitable loser in this scenario would be middle-risk assets, which is where most corporate lending resides (hardly the original intention of the regulator). "The overall impact is that, even if a bank's asset book stays roughly the same size, regulatory pressures will force it to make significant changes to its composition," adds Simon.

This leads to what he describes as 'the banking trilemma': "Firstly, banks need more capital. Secondly, they need to change asset book composition. Thirdly, they need to think very hard about their funding costs because, with equity markets as they are, their major source of capital is going be internally generated profits." This, he believes, will make profitability an even more vital concern for banks.

## Capital requirements

Simon Sinclair, partner in Clifford Chance's Capital Markets group, describes how each element of the traditional capital requirement formula is being impacted by regulatory change. "Not only has the required ratio been changed but what constitutes capital is being revised and risk weighting has increased. So it's simultaneously affecting every part of the formula." Simon Sinclair computes that, as a result of regulatory pressure, a Basel II 8% T1 + T2 capital ratio effectively becomes 11% under Basel III metrics. Add in the other elements of capital composition and this could reach 15.5%. Add in the ICB recommendations and include bail-in bonds, extra capital requirements for large ring-fenced banks and G-SIBs, and this could rise to 17% – or even 20%.

The introduction of loss-absorbent debt presents banks with a number of challenges. One is the relative unattractiveness of this type of instrument to investors. The second is uncertainty over the loss absorbency triggers, the point at which the debt would 'write-down' or convert into equity. Under the current draft CRD IV, the Additional Tier One capital trigger is set at 5.125%. But loss absorbent instruments will also potentially be subject to bail-in and non-viability triggers. The ICB report has suggested that the point of non-viability will be reached when equity capital ratios have fallen to 4.5%. There are other challenges for banks with the current proposals around non-viability, particularly how and when this requirement will be implemented. First raised in a press release in January 2011, with implementation proposed for 2013, the trail now seems to have gone cold. This lack of certainty over non-viability is compounding problems for banks who may be seeking to issue lower capital in what is already a very uncertain environment.

## Funding

Emma Matebalavu, partner in Clifford Chance's Capital Markets group, believes these new capital requirements will have a major impact on both banks' funding and their ability to lend to the wider economy. "With the sovereign crisis stifling the unsecured debt capital markets [banks' traditional source of funding], we have seen record covered bond issuance. Indeed, for the first time ever [in Europe], these have exceeded the amount of residential mortgage-backed securities in issuance," says Emma. Although banks are willing to lend to each other they are increasingly doing this through collateralised structures such as asset swaps or repo transactions. We are also seeing bank facilities being extended, with simple security granted over financial assets whether pursuant to assignments, mortgages or under the financial collateral directive.

Implementation of ICB recommendations may exacerbate this trend yet further. Through the introduction of depositor preference for ring-fenced retail banks, unsecured debt will rank below retail and SME depositors. This could increase the costs of unsecured funding and potentially discourage non-insured depositors, such as corporate depositors, from holding their cash with the ring-

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fenced bank. This is likely to either result in the movement of assets which cannot be funded solely through retail deposits, or retail assets shrinking to match the retail deposits available to fund them (which is not in line with government policies of encouraging the provision of finance to individuals and businesses). Given the restrictions in terms of the assets which the ring-fenced bank can hold, it may make it significantly more difficult for it to comply with new liquidity requirements. And as for the commercial or investment bank, this will now need to fund itself without access to retail deposits, increasing its need to access secured funding sources.

## Tax issues

The changing nature of capital composition, and in particular the loss-absorbency features, throw up a number of major tax questions. As Dan Neidle, partner in Clifford Chance's Tax practice, explains, "The tax code in the UK and most other countries is designed to deal with straightforward debt instruments. Anything that departs from being a straightforward debt instrument is looked at suspiciously. Take bail-in bonds, which might turn into equity if a regulator presses the trigger. Would the tax code in the UK and elsewhere therefore characterise it as equity, so that the interest becomes non-deductible? And if the trigger was pulled, would the noteholder get a write-down to reflect their economic loss?" These are just some of the issues that will need to be resolved and until this happens, structuring this kind of instrument will remain challenging. Dan takes the example of potential write-downs for bail-in bondholders. "What about the bank's tax position? Could it be taxed on the resulting accounting profit from the write-down? If so, it would be a pretty perverse result – a measure intended to protect a bank's solvency would instead trigger taxes that render the bank insolvent," adds Dan.

The Financial Transaction Tax (FTT), recently proposed by the European Commission, would certainly increase banks' cost of capital. But its effects go much wider than that. The headline rates – one basis point on derivatives; ten basis points on financial instruments – are only the start of the story. By making all parties in a transaction, whether intermediaries or instigators, liable to the charge, the full impact of the FTT will go well beyond the headline rates. Indeed, by Dan's calculation a relatively straightforward equity purchase by a pension fund could incur a total FTT of 0.9%, making the prospect of the abolition of stamp duty a less-than-fair exchange. But Dan Neidle believes it is not just about revenue. "In fact if you read the small print in the Commission's impact assessment it's easy to believe the FTT may cost more in lost GDP and consequential declines in tax revenues than it would raise. For some of the FTT's proponents this is besides the point – a key objective for them is killing off elements of the financial sector for good, regardless of the economic cost for banks or national exchequers."

Dan added that, although many expect the UK to veto the FTT, and Germany (at least) to enact a more limited version of the tax, we would be wrong to think this would give the City a competitive advantage. The nature of the tax, and its wide jurisdictional scope, is such that even such a limited FTT would nonetheless have a profound effect on the City, and indeed financial markets worldwide.

The headline impact is that the FTT threatens to reduce bank profits at a time when these are vital to funding; penalise intermediaries, which will reduce liquidity; and increase the cost of raising capital. Which brings us neatly back to the banks' trilemma: with all three fundamentals of their business model being impacted, albeit in different degrees, by each regulatory measure, the cumulative effect will have a deep impact on the ways banks do business. As well as making it difficult for banks to remain active in certain areas of their operations that the regulators appear to disapprove of, there is a real danger that it may also make it more difficult for banks to do things that regulators want them to do.

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