# Separating Retail and Investment Banking: Evidence from the UK

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*The views expressed here are those of the authors and do not necessarily reflect the views of the Bank of England or any of its committees.*

## 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 undewriting (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

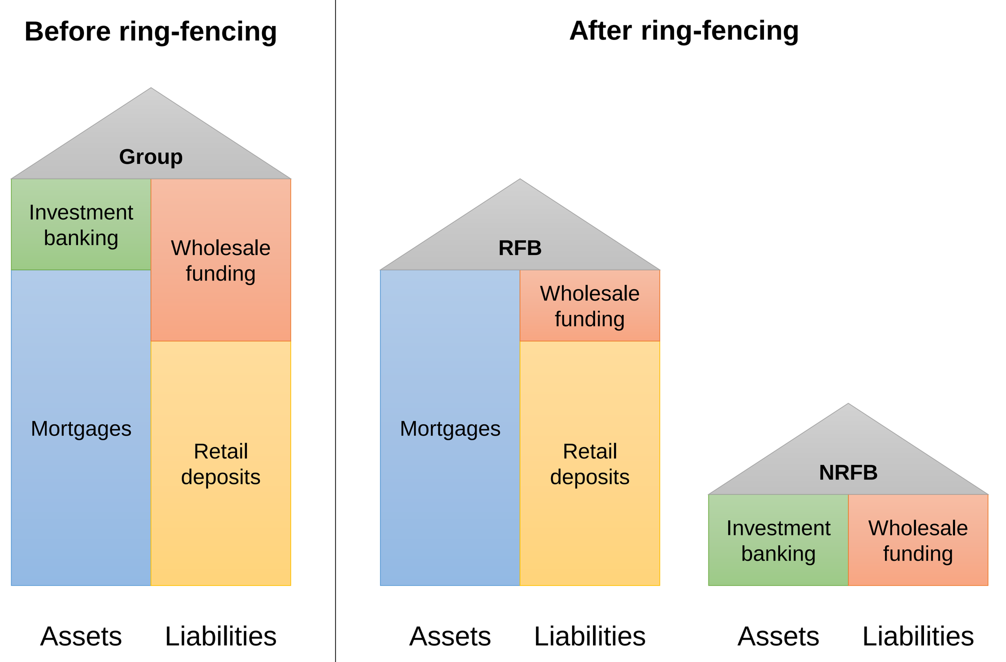
We test this idea using recent **UK ring-fencing regulation**.

**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 the 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
  - Household preferences for liquidity (Stein 2012)
  - Deposit insurance (Stein 1998; Hanson et al 2015)
  - Market power (Drechsler, Savov 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**:

$$\text{Loan}_{i,l,t} = \beta\,(\Delta\text{Retail funding}_i \times \%(\text{Post})_{l,t}) + \text{Controls}_{i,l,t} + \epsilon_{i,l,t}$$

where

- $\text{Loan}_{i,l,t}$ is price or volume of loan $l$ originated by bank $i$ at time $t$
- $\Delta\text{Retail funding}_i$ = change in retail funding ratio as a result of ring-fencing
  - Between-bank variation
- $\%(\text{Post})_{l,t}$ = share of loan maturity that falls after implementation
  - Within-bank variation
  - Captures idea that ring-fencing should have larger effect on loans that remain on balance sheet for longer after funding structure changes
- Controls include **bank-time fixed effects** (among others)

## Results: Direct effects

**Domestic retail mortgage market (RFB):**

- Affected banks reduce the interest rates on mortgages

| Dependent variable: | Interest rate spread$_{i,l,t}$ | | | |
|---|---|---|---|---|
| | (1) | (2) | (3) | (4) |
| $\Delta$Retail funding$_i$ × %(Post)$_{l,t}$ | -0.461*** | -1.011*** | -0.859*** | -0.817*** |
| | (0.157) | (0.163) | (0.136) | (0.137) |
| Loan-level controls | No | No | Yes | Yes |
| Bank-level controls | No | Yes | Yes | Yes |
| Bank-month fixed effects | Yes | Yes | Yes | Yes |
| Maturity-LTV-month fixed effects | Yes | Yes | Yes | Yes |
| Bank-maturity-LTV fixed effects | Yes | Yes | Yes | Yes |
| Location-month fixed effects | No | No | No | Yes |
| Observations | 4,570,771 | 4,528,616 | 4,518,056 | 4,324,803 |
| $R^2$ | 0.824 | 0.820 | 0.846 | 0.867 |

- This leads to increased mortgage market shares
- Effect is no larger for higher-risk mortgages

**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)**

## Results: Indirect effects

- 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)

## Policy implications

- Structural separation reduces cost of credit for consumers
  - This is *not* concentrated in high-risk segment, limiting financial stability concerns
- Expansion of consumer credit mirrored by reduction in credit supply to large corporates
  - But this is mainly focused on *foreign* borrowers
- Ambiguous longer-term impact on retail credit market
  - Increased market power for larger banks
  - Increased risk-taking by smaller banks