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

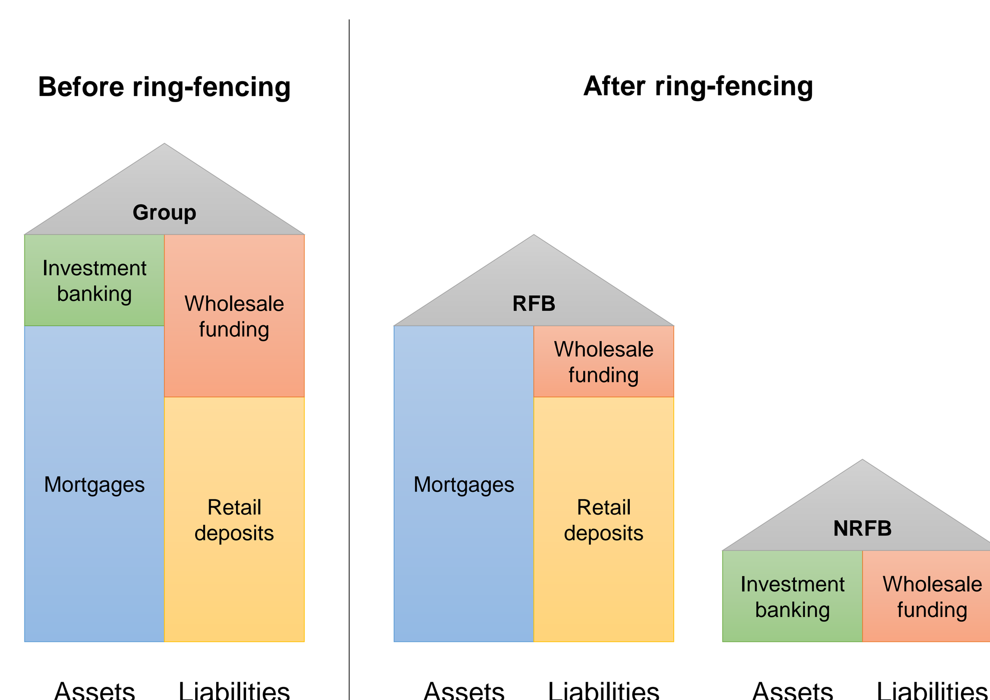
We test this idea using recent **UK ring-fencing regulation**.

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 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)
ΔRetail 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