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UK's banking climate is making the US look attractive

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A rift is opening up between the United States and Europe on the issue of bank capital ratios. For the big US banks, which have successfully deployed their notorious lobbying power to dilute re-regulation after the financial crisis, the new Basel III capital regime now appears a manageable threat.

In contrast, the two systemically important Swiss banks already face capital requirements much tougher than the Basel III minimum, reflecting national concern about the size of their liabilities in relation to gross domestic product. British central bankers and regulators are thinking along similar lines.

The UK battle on capital is intense, with key players threatening to leave the UK if Basel III is implemented too harshly. They argue that having to increase equity would raise their funding costs and that if they are saddled with a lower return on equity it would destroy value for shareholders. Increased equity, they add, would also force banks to cut back socially desirable lending. The bankers' trump card is the claim that if the UK does not operate on a level playing field with other countries, London's competitive position in international finance would be seriously damaged.

These arguments are not uniformly compelling. It is true that a shift in funding from tax privileged debt to tax unprivileged equity is a cost to the banks. Yet, as Anat Admati and others from Stanford University and the Max Planck Institute say in a trenchant recent paper, the return on equity that investors require inevitably declines when more equity is used, so compensating for reduced risk. Moreover, higher equity lowers the banks' return on equity only in good times when the return is high, while raising it in bad times when the return is low. So shareholders enjoy compensatory downside protection.

As for an enforced reduction in lending, this is true if investors are reluctant to put up fresh capital despite the reduction in risk. Yet there are wider social issues at stake.

David Miles of the Bank of England's monetary policy committee has shown that the costs of even very rare banking crises are so great as to outweigh any growth penalty – marginal in his view – resulting from higher equity capital. While Basel III calls for a 7 per cent ratio of equity to risk weighted assets, Mr Miles thinks 16-20 per cent would be a more sensible range.

Lord Turner, head of UK regulator the Financial Services Authority, buys the argument, while acknowledging that the transition to such levels would require careful management. In fact, the banks themselves have signalled to investors that they are in a lower risk and return environment. HSBC has cut its target for return on equity from 15-19 per cent to 12-15 per cent, while Credit Suisse has cut its target from 18 per cent to 15 per cent where it is in line with Barclays.

Yet these remain phenomenally high in a mature industry where, as Andy Haldane of the Bank of England has pointed out, the return on equity between 1920 and 1970 averaged below 10 per cent a year. In reality, the most likely way such targets can be met is by increasing leverage – oh dear – or rent seeking, the economist's euphemism for gouging the customer.

How great is the threat of a great banking evacuation? **Lloyds Banking Group** and **RBS**, under state control, have their feet nailed to British soil.

The interesting question about HSBC and **Standard Chartered** is whether obvious Asian destinations would want them.

HSBC's liabilities are marginally less than UK gross domestic product, which is uncomfortable for the British. How much more uncomfortable for Hong Kong, where they amount to more than 10 times GDP. In the event of a crisis, Hong Kong going cap in hand to Beijing might entail some very nasty *quid pro quo*s.

The same point might apply to Shanghai. Standard Chartered's liabilities, meantime, are more than two times the size of the Singaporean and Hong Kong economies. Potentially quite a cuckoo in the nest.

The obvious destination for Barclays is New York. If it were prepared to risk the costly disruption of removing its head office and other business, it would still have to leave significant investment banking activities in the European timezone, along with much retail and commercial banking activity. Barclays' departure would nonetheless create a furore.

Yet, from a social perspective the loss of business to the UK would be more than offset by the reduction in the cost of the implicit public subsidy the bank currently enjoys and its liabilities, roughly the same size as the UK economy, would become the problem of the Federal Reserve. Not a bad trade off, when you come to think of it.

Thank you and goodbye...

The writer is an FT columnist

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