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Bank of England – **IFRS - intervention required**

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We should go further unbundling banks

By Andrew Haldane

Structural reforms to banks are high on the agenda, with the Liikanen Group's call for European banks to separate retail from trading activities. For some, such calls are a cause for concern. Yet for investors, the concern should be that they do not go far enough.

Back in 2000, financial markets valued global banks at two or three times the book value of their equity – saying, in effect, that an investor who had placed $1 with a bank had doubled, perhaps trebled his stake. It should have been no surprise that investors flooded in, resulting in a threefold rise in global banks' balance sheets in less than a decade, in what was perhaps the largest bank bubble in financial history.

When that bubble popped in 2007, so too did market valuations. Today, most global banks are valued at a discount – many at a small fraction – of their equity book value. Today, an investor who had placed $1 with a bank would on average have seen that return as little as 50 cents. Once a value-creation machine, banks have become a value-destruction machine; in response, bank investors are seeking shelter and bank balance sheets have begun a crash diet.

So what has gone wrong, and what can be done? Lowly bank valuations are in part a legacy of the past and in part a prophecy about the future.

The legacy is the **overhang of overvalued bank assets**. There are several reasons for this. One is forbearance on past loans, which appears to be both large and latent. Quite how large and latent is unclear. Near-zero global interest rates, actually and prospectively, have encouraged forbearance by lowering the costs of prevarication. **Global accounting rules have also contributed to an overvaluation of legacy assets, as they prevent banks adequately provisioning for future loan losses. International efforts to rectify this are at risk of stalling**.

There is a strong case for regulators stepping in to lessen the uncertainties over valuations. **That might mean calculating prudent valuations across banks' balance sheets**, as the Bank of England's Financial Policy Committee recently suggested with respect to UK banks.

These prudent valuations would help in removing residual uncertainty about banks' legacy portfolios. They could thereby spur private investors to return to banks, when they might otherwise be fearful of paying for yesterday's mistakes. That would boost bank valuations and support bank lending.
The prophecy investors are making is a despondent one over the future franchise value of banks. There is no single cause of this franchise erosion. Recent mis-selling scandals have not helped. But a key concern appears to be so-called business model risk. It is not difficult to see why.

Many large universal banks are a complex portfolio of franchises. It is very difficult to value any individual component of that portfolio in the current environment. And it is almost impossible to value the portfolio as a whole. For example, in the current environment are investment banking revenues a hedge or a headache?

At present, investors are pricing for a migraine. Market prices suggest the banking whole may be worth less – in some cases much less – than the sum of its parts. There are market-implied diseconomies of scale and scope. The problem for investors appears to be not so much too-big-to-fail as too-complex-to-price.

This was last the case in the depths of the Depression. Then, mirroring recent experience, US bank price-to-book ratios fell from above two to well below one between 1928 and 1933. This set the stage for the Glass-Steagall Act, a market-induced but regulatory-enforced unbundling of the banking portfolio.

Today, the Volcker proposals in the US, the Vickers proposals in the UK and the Liikanen proposals in Europe envisage a similar unbundling of banking portfolios. Despite the alarm some have expressed, if implemented faithfully and simply such structural solutions ought to help solve the too-complex-to-price problem, to say nothing of too-big-to-fail. Alongside efforts to strengthen macro and micro-prudential regulation, these initiatives would help mobilise bank funding and lending, just when it is most needed for the economy.

The writer is the Bank of England's executive director for financial stability