Guarantees & the Need for Separating Investment Banks

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(The views presented here are my own & do not reflect those of the OECD or any of its member governments.)

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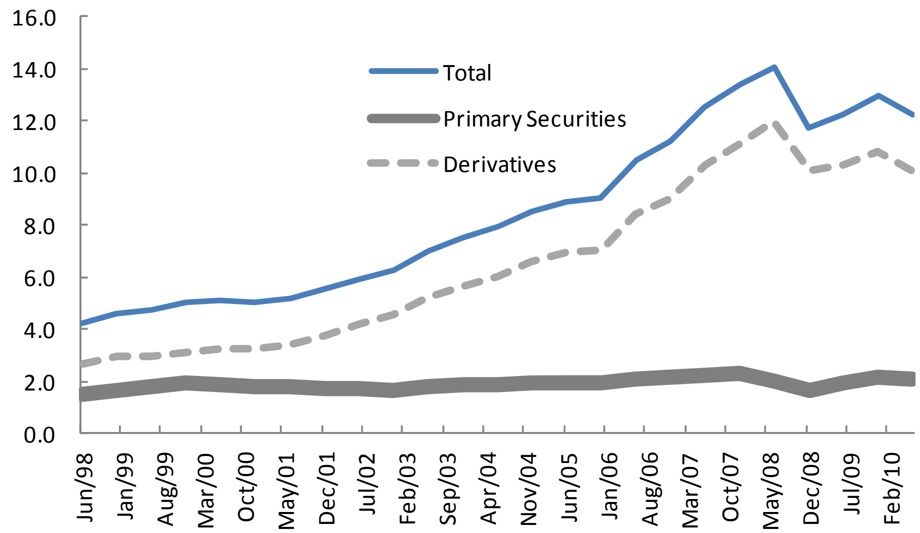
Figure 1: Primary Assets v Derivatives



Source: BIS, Datastream, World Federation of Stock Exchanges, OECD

Figure 2: Firewall NOHC Structure

ALTERNATIVE CONGLOMERATE STRUCTURES

PARENT	(A) TBTF[a]		(B) TBTF & levg.restr.[b]		(C) NOHC (siloed cap.)	
Capital market activity	**Equity** 100		**Equity** 100		**Equity** 100	
SUBSIDIARIES	**Comm. Bank**	**Invest. Bank**	**Comm. Bank**	**Invest. Bank**	**Comm. Bank**	**Invest. Bank**
Equity investment parent, USD bn	30	70	70	30	70	30
Debt, USD bn	480	3 500	1 120	780	1 120	570
Balance sheet total, USD bn	510	3 570	1 190	810	1 190	600
Debt/equity ratio	16	50	16	26	16	19
Leverage ratio (assets/equity)	17	51	17	27	17	20
Profit,[c] USD bn	5	36	12	24	12	6
Return on equity, %	17	51	17	81	17	20
max. loss rate, in % assets	2.5	5	2.5	15	2.5	5
max. loss, USD bn	13	178	30	121	30	30
max. loss in % of equity	43	254	43	403	43	100
GROUP						
Balance sheet total, USD bn	4 080		2 000		1 790	
Leverage ratio (assets/equity)	**41** times equity		**20** times equity		**18** times equity	
Unweighted capital ratio (common equity), %	**2.5**		**5.0**		**5.6**	
max. loss in % of equity	191		151		60	
Return on equity, %	**41**		**36**		**18**	

a) A conglomerate "too big to fail" (TBTF), thus with implicit government guarantee; no restrictions on leverage ratio imposed.
b) A conglomerate "too big to fail" (TBTF), thus with implicit government guarantee; but assuming a group leverage restriction of 20 times equity is imposed.
c) Profits are assumed as 1% return on assets (ROA; balance sheet total) for all cases except for the IB in case B where profits are assumed to be 3% ROA activities (due to riskier IB compensating for the reduction in ROE caused by restrictions on leverage).

Source: OECD