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Introduction

The report by the Vickers Commission – Sir John Vickers, Clare Spottiswoode, Martin Taylor, Bill Winters and Martin Wolf – that was published on September 12, 2011 is a formidable document. It is clearly intended to give UK banking the biggest shake-up it has had since Big Bang a quarter-century ago. It is also intended (at least, I assume so) to act as a model that other countries, in Europe and elsewhere, might choose to emulate.

What is less clear (at least to me) is whether it is intended to “put the bankers back in their box” – to punish them in some way for what the general public (and the politicians who represent them) see as their culpability for the continuing economic crisis and their allegedly insatiable greed. Either way, it certainly proposes major surgery – an end to ‘universal’ banking, separate capitalisation for a bank’s retail activities, and (if the Commission’s judgement is right) an end to the pernicious doctrine of Too Big To Fail.

Unsurprisingly, the Commission’s recommendations have proved controversial – in the UK and in Europe, though perhaps less so in the US where there is some parallel with the so-called Volcker rule.

But, to the best of my knowledge, no one has yet tried to pull together the full range of industry views on Vickers.

So, here’s our best shot – modelled (with some of the same contributors) on our March 2009 effort, ‘Grumpy Old Bankers: Wisdom from crises past’. Our intention (now, as then) has been to tap into the collective knowledge and experience of practitioners, regulators and commentators from as wide a range of backgrounds as possible – not all old, but most of them grumpy (some, because they don’t think Vickers went far enough, and others because they fear the Commission will kill the golden goose).

There’s a wealth of insights here – on cost, on compatibility with EU law, on the problems of implementation, on the City’s competitive position, on the power of lobbyists, on parallels with utility regulation. And, of course, on the danger of unintended consequences.

My own view, for what it is worth (that, and an Oyster card, will get you on the tube), is that there is an interesting idea at the heart of Vickers that needs drawing out. It is that we face two options for the financial services sector: more and more regulation, or radical structural reform. Not surprisingly, regulators (and politicians) favour more regulation; it is after all what they do. More surprisingly, so do incumbents in the financial services industry – since it is essentially another row of bricks on the wall that keeps competitors out. But wouldn’t it be wonderful if the banking industry could be restructured so that it didn’t need regulation – except (I guess) for fraud and conduct of business? Maybe we have got it wrong. Instead of fretting about how we can pull the (allegedly under-regulated) ‘shadow’ banking system deeper into the regulatory net, maybe we should think about expanding the ‘shadow’ system into conventional banking. After all, who would care (aside from their immediate families) if a couple of mega-rich hedge fund managers woke up broke because they had taken a punt on, say, Greek CDS that had gone sour. So long as it is their money at risk, and not unsuspecting depositors (who could be protected by private insurance if necessary), let the market rule.

Oh well… Whatever, it is worth emphasising Fildes’s Law of the Banking Cycle: namely, that disasters happen when the last person who can remember what happened last time has retired. Given how short most careers in the City are, that cycle can be disconcertingly rapid.

Thanks are due to a lot of people – notably (of course) the authors of the individual pieces. In addition, David Lascelles, Jane Fuller and Andy Davis all did sterling work editing the submissions, and the CSFI’s staff pulled out all the stops to get everything to the printer post-haste. Thanks, too, to Joe Cummings for (as usual) a striking cover – designed (if anyone doesn’t get the joke) to illustrate investment bankers trying to storm the ringfence (manned by the sturdy retail bankers).
Ros Vickers do the trick? So now we have the Vickers Commission Report, can we relax about the banking system? Certainly not. Banks seem to have almost welcomed the report, which surely in itself suggests the proposals are not tough enough!

What's the problem? The ICB's remit was to promote financial stability and increase competition among UK banks. Following the 2008 crisis, it was clear that the banking system had been allowed to grow too freely and had ended up with so much power that it could effectively hold the rest of the economy to ransom. The government felt forced to rescue the banks, rather than let them fail.

Bank lending had mushroomed out of control and investment banking had become so complex and globally interconnected that, following the collapse of Lehman Brothers, the failure of a major financial institution seemed too dangerous to contemplate.

Investment banking arms of universal banks had gambled billions of pounds of depositors' money on future market movements, had dealt in esoteric financial instruments whose risks they did not fully understand, and had parcelled up risky loans and sold them as almost riskless to unsuspecting investors and to each other. Sophisticated risk models turned out to be fatally flawed.

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The City had been run under so-called ‘light-touch’ regulation, which was basically more like ‘hands-off’. Bank managements had endorsed and encouraged all kinds of financial innovation that seemed to bring in great profits. Short-term trading or speculation was rewarded with huge bonuses, lending to borrowers who could never repay was itself considered hugely profitable and investment bankers or salesmen were richly rewarded for selling these loans, regardless of the risk. Retail banks were bound up with these risky investment banking divisions, so if things went wrong on the wholesale side, retail depositors’ money was on the line and the banks did not have sufficient capital to absorb the large-scale losses.

The ICB’s recommendations

Vickers’s verdict is that banks must in future ringfence their retail operations (for individuals and small or medium size companies) from their investment banking side, each having its own independent board with more outside directors, and that they must hold far more capital. This is designed to ensure that, if investment products go wrong, if trading suffers huge losses or if trading or broking divisions misjudge their risks, retail depositors’ money is not in jeopardy. Rather, it should be the investment bank’s capital that is on the line. As Sir Mervyn King has rightly observed, Western banks have acted like casinos, “making bets with other people’s money” while “not understanding the nature of the risks they were taking”. This must not be allowed to happen again.

In order to shore up the strength of the retail side of UK banks, Vickers says the retail banking arms must meet more stringent capital, liquidity and funding rules on a stand-alone basis in future, with equity capital equivalent to at least 10 per cent of risk-weighted assets. This is stricter than Basel III, which requires only 7 per cent. The banks will also need an overall minimum capital buffer of 17-20 per cent.

Will these recommendations do the trick?

The Vickers measures are designed to promote financial stability by ensuring that taxpayers will no longer be ‘on the hook’ to bail out bankers’ bad decisions about investment risk.
This is a commendable goal. But the sad reality is that banks have been given until 2019 to implement these changes, so they hardly offer much comfort for the foreseeable future. It is difficult to understand why the banks are being given so long to change their practices. The Commission appears to have bowed to the banking lobby, which has frightened it into believing that acting quickly could damage economic growth and increase the costs of banking for business or individual customers. Banks have also continually threatened to move offshore if the measures were too harsh.

We should not have to wait till 2019. These changes should happen far sooner. By 2019, it is highly likely that another full-blown banking crisis will have happened and taxpayers could suffer again as they will not have the benefit of better protection.

Until there is more capital and better separation of investment banking from retail deposit-taking, British taxpayers will remain at risk of having to rescue the banking system once more. Consequently, we are still destroying capitalism, because capitalism thrives on risk and reward – the principle that those who take risk and success reap rewards, but also that those who fail suffer the losses. With banking, however, it’s heads they win and tails we lose - so they can gamble as much as they like, enjoy the rewards when it goes right, safe in the knowledge that taxpayers will still pick up the tab when it goes horribly wrong.

Costs and rewards

The ICB’s report estimates that the costs of separating the casino side from the retail side could be £4bn-£7bn a year. It has been pointed out that, coincidentally, the investment bankers at the big five UK banks paid themselves £7bn in bonuses last year – so surely these changes could be implemented quickly and without additional cost to customers – as long as bonuses were scrapped! In fact, the ICB could and should have made recommendations to better align bankers’ pay with reality but it ducked that issue. Rewards of such massive size, paid to those who gamble with other people’s money, have led to poor decisions in the past, and there are signs that they may be repeating past mistakes.

As long as both retail and investment banking take place under one ‘universal bank’, the retail depositors’ money is going to be used to take giant risks. We need a return to ‘Glass-Steagall’-style separation quickly. Again, to quote Sir Mervyn: “Allowing large banks to combine High-Street retail banking and risky investment banking strategies, and then providing an implicit state guarantee…creates a banking system which contains the seeds of its own destruction.”

Criticisms of the proposals

Many have tried to argue that separating retail and investment banking is not the answer – that there is no proof it will work, that it will be difficult to decide which activities stay on which side of the fence. They claim that Lehman had no retail side and Northern Rock was purely a retail bank, and that therefore this is the wrong solution. However, the latest scandal, with UBS losing billions due to one rogue trader, again reinforces the need for urgent action to protect pedestrian banking from high-octane trading. The reality is that the high-risk investment banking operations, sliced and diced sub-prime loans and complex financial derivatives were all part of the problem of the banking implosion, and it is vital to find a way to separate the taxpayer-guaranteed retail banks from the rest. This is particularly vital in the UK because of the size of our banks - which have been allowed to grow far too large. The balance sheets of our top ten banks amount to more than four times our nation's annual GDP. The equivalent figure for the top ten US banks is ‘only’ two-thirds of one year’s GDP.

In fact, I believe the banks are not Too Big To Fail; they are Too Big To Save. Taxpayers cannot really afford to bail them out - and, in fact, doing so last time has caused huge problems which are only just beginning to be recognised. By paying such a high price for the shares of RBS and Lloyds, we are locked into a situation where taxpayers cannot dictate bank policy in the national interest, even though they are largely nationally-owned.

What about the customer interests? We need a different type of bank

Banks are not doing enough to help growth, because they are desperate to deal with their own debts. If banks are so important to growth, why are they failing to lend to small businesses, continually increasing charges and interest rates and riding roughshod over customer interests? Vickers does not really help address these issues. Yes, we need more competition in banking. But the best way to achieve that might be to have a major bank taken into public ownership and run in the social interest, rather than for profit. This bank could then lend to businesses on better terms, offer better and fairer deals to customers and ensure that ordinary depositors’ interests took a higher priority. I fear, however, that there is little chance of this happening. We only have to look at the precedent of National Savings & Investments, which runs an astonishingly efficient retail banking operation,
managing millions of accounts, paying on time and not ripping customers off. It has been forced to withdraw its index-linked offerings because they were proving ‘too popular’ with ordinary investors and providing too much competition for banks and building societies.

Conclusion

So overall, the ICB has made some good recommendations, but it has not gone far enough. It is certainly true that we need more independent directors and customer groups represented on the boards of banks, plus a separation of retail from investment banking. However, the glacial pace of change means that banks can still put our financial stability at risk. The political establishment and economic policymakers are still being held to ransom, and allowing such a long lead time to 2019 may mean changes not happening at all. The report has not dealt with the remuneration structures that produce dangerous incentives to reward risk and ignore customer interests. Taxpayers must hope and pray that things don’t go wrong again. If they do, we know who will pick up the tab.
The ICB has striven mightily for two years and finally produced a mouse, and a malignant one at that. The report boils down to two recommendations:

- ringfence the retail subsidiaries; and
- increase equity requirements along the lines of Basel III but to a greater extent.

The final report makes a range of assertions, notably about competition, which are not supported by logic or evidence. For example: “The recommendations in this report will be positive for UK competitiveness overall by strengthening financial stability.” One could “strengthen financial stability” by raising the equity requirement from 7.5% to 100%, but it would obviously be disastrous for competitiveness.

Reading the report, it becomes clear that the Commission has no real idea of the competitive consequences of its recommendations. In the main report, we are told that the issue will be justified in detail in Annex 3. But when we get to these 46 pages we find that competition is not addressed at all:

“The Commission’s recommendations to improve UK financial stability are far-reaching, and would have important effects throughout the economy. The aim of this annex, which provides more detailed analysis to support aspects of Chapters 2 to 5, is to set out how the recommendations would improve financial stability and the nature of the associated costs. It covers the following aspects in turn:

- the economic importance of banks and the costs of banking crises;
- an examination of the effects of the proposals on:
  - the diversification of banks’ assets;
  - the liquidity and funding of banks;
  - the interconnectedness of the banking system; and
  - the ability of banks to bear losses;
- how, and the extent to which, banks currently benefit from an implicit government guarantee;
- the nature and broad magnitude of costs which could arise (i) for banks affected by the proposals, and (ii) for the economy as a whole; and
- a summary of reasons to expect that the proposals would promote UK financial stability both effectively and efficiently compared with alternative approaches.”

In short the Commission is relying on a non sequitur, which is a fatal flaw throughout the report.

Turning to the first of the recommendations, ringfencing is a pious myth. The News of the World was ringfenced within the Murdoch empire. That did not protect the group, nor its shareholders, from disaster within the subsidiary or at the top levels of the group. As RBS showed, the big disasters began with the group CEO – unsupervised as he was by outside directors, shareholders, the Bank of England or the Financial Services Authority. If the business of any ringfenced sibling goes bad, the parent will have to pick up the bill and the
whole enterprise will be affected. The idea that ringfencing will allow the UK government to withdraw its implicit guarantee for banks too big to fail is part of the same myth. What a government now declares and what it has to do when the time comes are two very different matters.

How will ringfencing apply to foreign-owned banks trading in the UK? The Commission reckons that the UK retail banking market is, for all practical purposes, a matter for UK banks only. That may be the case now, but if UK banks are penalised relative to foreign-owned banks (what the Commission calls the “super-equivalence” objection) that may not remain the case. Other EEA banks are free to trade in the UK High Street, and that includes Iceland. Plus, it would be difficult to refuse banking licences to reputable banks owned outside the EEA as that would inspire retaliatory action by their governments and London would be the net loser.

Turning to the Commission’s second recommendation, Basel III has the powerful advantage of being a global set of rules: the proverbial level playing field. The Commission happens to think Basel III does not go far enough:

“2.20 As to the cost of equity capital and effects on growth, the Commission’s conclusion from various cost-benefit analyses is that there is a powerful case for the global minimum equity requirement being a good deal higher than 10% of RWAs, and for it to be accompanied by a minimum leverage ratio well above 3%. Much of the higher cost of equity to private parties relates to tax effects, which is a private, not social, cost and in principle could be offset by tax reform. In sum, the Commission believes that the Basel baseline is by some margin too low.”

That is a legitimate point of view that could and should be tested in the court of world opinion. Basel’s proponents will say that it already has been. What is not sensible is to flounce off and say that the UK will hobble its own players in the global market. The Commission claims that the higher standards will actually attract foreign business and be positive for UK banks. Quite apart from the lack of logic or evidence for this assertion, it is torpedoed by the nature of competition. The proposal is to enforce these higher standards against the wishes of the banks themselves. If the banks thought the higher standards would indeed be good for their businesses, they could adopt them whenever they pleased. Clearly, the banks do not agree with them - and outsiders should reckon that banks know their business better than the Commission does.

In short, this report has substance in inverse proportion to its length. Fortunately it is not due to be implemented until 2019, and that should give plenty of time to bury it.
The main feature of the Vickers report that distinguishes it from attempts elsewhere to reform the banking system is its proposed introduction of ringfencing for the retail activities of complex banking groups. Politicians of all parties, and even some more knowledgeable commentators, have been falling over themselves to embrace the report. We are more sceptical.

We believe that ringfencing won’t solve the problem of “too big to fail” because it is based on two premises which we believe to be flawed. If we are right, Vickers won’t help prevent a repeat of the banking collapse of 2008-09.

Premise 1...

That the banking crisis was caused by excessive risk-taking in the banks, especially investment banks. Whilst there was clearly – with the benefit of hindsight – excessive risk-taking, you can’t say that this caused the banking crisis without explaining why banks suddenly started taking excessive risks. They did so, we would argue, precisely because they did not think the risks to be excessive. They considered them to be sensible and well-judged. For the most part, the banks taking these decisions did so within corporate governance structures which complied fully with industry practice. Institutional shareholders put pressure on management to deliver growth – not just in profits, but also in revenues and market share. Regulators and rating agencies were comfortable with the risks being taken. Why? In answering that question, perhaps we will come clearer to understanding of what caused the crisis and what needs to be done to ensure it doesn’t happen again.

Fifteen years of uninterrupted growth, with low inflation and cheap borrowing, created the illusion that politicians and central bankers had somehow found a way to break the cycle. There would be “no more boom and bust”. An intellectual climate had been created in which debt levels – personal, corporate or sovereign – were discounted as a risk, asset bubbles viewed as genuine wealth creation and default or business failure regarded as remote contingencies most likely to be associated with fraud or catastrophic management failure. As the economy overheated, politicians were happy to take credit for the apparent economic miracle which their “wise policies” seemed to be producing.

In truth, they and the officials that they appointed (regulators, central bankers and others) bear a heavy responsibility for what happened. Instead of stoking up bullish sentiment with complacent remarks on how well the economy was growing and how much better off the population was getting, politicians entrusted with power should have used it more maturely and responsibly.

In particular, they should have paid heed to the warning signals which were flashing – particularly debt levels and the property bubble. How different things might have been if politicians had been more interested in governing responsibly and less fixated on satisfying personal ambition. No wonder they were so keen to fix responsibility for the whole debacle on the bankers!

How is all that relevant to Vickers? Simply this – four major UK banking collapses between 2007 and 2009 (Northern Rock, Bradford & Bingley, Alliance & Leicester and HBOS) took place within the ringfence. They were not caused by a rogue trader or by the proliferation of opaque, complex products in the business mix. They were caused by a persistent, institutionalised misreading of risk, which permeated everywhere in the intellectual climate described above. If our politicians, central bankers and regulators are
as complacent in future as they were in the years leading up to 2007-08, there is nothing in Vickers to prevent the same thing happening again. What is needed is the practical judgement to spot problems as they develop and the political will to act to cool down overheating markets, even if that is electorally unpopular. As we saw, that proved too much to ask in 2007-08.

Premise 2…

That governments can allow investment banking businesses to fail. This is a highly dubious premise which Vickers takes as given without attempting to justify it. In fact, the weight of evidence is against this idea. Lehman had no retail business, yet its collapse proved disastrous for the global banking system. Admittedly, many of its counterparties were banks with a retail component, but the fact remains that the interconnectedness within the financial system of investment banks and their products is profound and complicated, and goes well beyond counterparty relations with other investment banks outside the ringfence. Investment banks have connections to the underwriters of credit insurance for their products. Those insurance underwriters often have a systemic status within the financial system, and are often also underwriting products sold to the retail market. Investment banks’ connections extend also to industrial corporations of various kinds through the derivatives and cash flow management products they use to mitigate risk. The last financial crisis demonstrated that interconnectedness is complex and unpredictable – the accountants are still trying to quantify and unwind the trades entered into by Lehman three years after it collapsed! Once contagion starts to spread it is very difficult to stop.

We believe that the consequences of allowing an investment bank to fail can never really be understood by a government or regulator until the event happens and the full ramifications unfold. It would be a reckless act by a government to allow this to happen without understanding fully the impact of the collapse.

If you want any further demonstration that ringfencing is irrelevant, and that banking crises are grounded in the actions of governments, central bankers and regulators, look at the current threat to the banking system – sovereign debt. A ringfenced bank’s balance sheet would be as likely (perhaps even more likely) to be full of Greek and other dubious government bonds as the most aggressive investment bank. And why? Since central bankers and regulators treated these bonds as fungible with bonds issued by serious countries and given the lack of return available elsewhere, it made some sort of sense for banks to invest heavily in Greek and other such bonds even as their yields rose. Thus was the global system presented with its current existential threat.

How robust would a ringfence be in separating retail and investment banking anyway? The ringfence is an artificial division between the retail and investment banks which relies on procedures, definitions and controls to ensure that products and activities remain on the intended side of the divide. We can be sure that armies of highly intelligent investment bankers will be hard at work devising products and transactions which cross over the ringfence – because it is by crossing over the ringfence that banks will maximise their return on capital. Ultimately, Vickers intends that the integrity of the ringfence will be policed by non-executive directors and regulators. In the last crisis, both demonstrated their limitations comprehensively.

Let us draw to a conclusion on the ringfence. It is doubtful that it will make a material difference to the security of the banking system in a crisis. Even taken together with the other measures being put in place by the Basel Committee, the EU and the UK, it is not obvious that the financial system will prove robust when subjected to extreme stress.

Capital

Vickers follows the approach of other regulatory authorities in calling for banks to hold more capital – specifically, that UK ringfenced banks be required to have an equity-to-risk-weighted assets ratio of at least 10 per cent. We have two criticisms to make of this proposal.

First, it is prescriptive, “one-size-fits-all” - and therefore bears no relation to the actual risks being taken by any one bank. We would argue that some banks need more than 10 per cent (where Vickers agrees), but that some banks need less capital – and that not all risk-weighted assets actually bear the risk allocated to them by regulators, as the sovereign debt crisis is showing. Second, the size of the losses incurred by UK banks in a crisis – or likely to be incurred once banks finally recognise them – will probably be so great that no sensible capital base would have been capable of absorbing them.

So Vickers seems to be missing the point on capital. If his proposals are implemented they will raise costs to banks, reduce lending in the economy and raise barriers to entry for new banks - while perhaps not solving the problem! Vickers does have some positive ideas on the subject of capital, though. We think it makes great sense to introduce overall “leverage” limits, and that the proposal to make quasi-equity or subordinated debt more truly risk-bearing through “bail-ins” is useful.
Competition

Let us turn now to another area touched on by Vickers – competition.

It is clear from the language of the report that, for Vickers, competition means mainly the creation of a fifth, sixth or seventh major national bank to challenge the big four, created probably by the acquisition of branches from one or more of the majors. He does touch on the need to reduce the barriers to entry for new smaller banks, but we would argue that his is a limited view of competition.

One of the consequences of the financial crisis is that the major banks have withdrawn from a large number of specialised and niche lending markets as part of their general policy of retrenchment. They have also taken a step back from the unsecured lending market and, in some cases, from the mortgage market as well. The effect on consumers and on small businesses has not shown up as a readily identifiable component of the general business gloom, but there can be little doubt that the withdrawal of lending capacity from these markets is having a negative effect on the overall economy.

It is our contention that a competition policy which encouraged and facilitated the growth of more small banks could be hugely beneficial both to the economy and to the health and stability of the banking system. Although these small banks would compete in a limited way with the majors in certain products, sectors or geographical area, they would have the vital function of providing lending in specific niches where the major banks have reduced their exposure. If conditions were created which permitted such small banks to flourish, the result would be both a major enhancement of competition within the sector and improved access to lending for businesses and consumers, through the introduction of players who represent no systemic risk.

There is no shortage of entrepreneurs ready to create such small banks. The market opportunity which exists at the moment is widely understood. However, the barriers to entry are very high. These barriers are represented by regulation which seeks to impose rules devised for large, complex, multinational banks to all banks, irrespective of size or complexity. This “one size fits all” approach to regulation saddles prospective new entrants with unnecessarily onerous capital requirements and high ongoing costs relating to compliance and governance, and leads to interminable delays in securing licences, launching products and hiring staff.

It is a pity that Vickers missed the opportunity to emphasise more the role of small banks in a healthy and stable financial system. The measures needed to remove the regulatory barriers are easy to implement. What is required is not less regulation, but rather regulation which is more tailored to the particular risks being taken. “Sensitive” regulation would be based around an understanding of the business model, and would take account of management’s record and experience, the ownership structure of the business, and the Board’s overall attitude to risk.

Avoiding “Too Big to Fail”

We accept that ‘Too Big to Fail’ is a problem. But Vickers’s approach is not a solution. So, what might work?

The best solution, in an ideal world, would be to break the big banks up into many smaller players of manageable size. With many smaller banks, the demise of any one would have no systemic impact on the financial system, and a wide choice would become available to bank customers. In other business sectors, the benefits of this approach have long been understood. We think of the breakup of the Rockefeller’s Standard Oil in the United States into the “Seven Sisters”, and of the Bell Corporation into numerous “Baby Bells”. In banking, however, the trend has been in the opposite direction, partly because of weak competition policy (allowing, for example, the disastrous takeover of HBOS by Lloyds), partly as a result of globalisation, and partly as a result of the collapse of some competitors during the banking crisis (e.g. Northern Rock, Alliance & Leicester and Bradford & Bingley). Realistically, we have to acknowledge that breaking up the big banks is politically unacceptable. It would certainly precipitate the flight of some banking head offices and a large chunk of international banking business abroad, and destroy the eminence of London as a global financial centre.

If we cannot de-risk the system by downsizing the banking juggernauts, we have to consider ways in which we can most effectively influence the behaviour of banking executives to make them more responsible. We would suggest that the way to do this is not to hedge executives about with ineffective corporate governance structures, but rather to align their interests more directly and more tightly to the long-term health and success of the banks they lead. What we are suggesting is that they should be put into the position of proprietors – in a partnership sense – of the businesses...
that they manage, to reverse the separation between ownership and management which we believe encourages irresponsible, short-termist behaviour.

Suppose we encouraged – even required – the senior executives of banks (including key officeholders like the Chairman) to purchase amounts of equity substantial in personal terms in the banks which they run. These shareholdings would be financed by loans from the banks on commercial terms. This arrangement would focus the mind of management wonderfully on not just the share price performance but also the security of the banks of which they have charge, since a banking failure would have the effect of putting the directors at risk of personal bankruptcy. This approach is completely against the grain of Vickers and all other attempts to regulate the banking sector, which emphasise the role of independent non-executive directors and take the separation of ownership from management as a given. We believe the opposite approach stands a better chance of working: placing reliance not on myriad controls, but rather on aligning the personal interests of the executives with the objective of financial stability. Their minds could be concentrated even further by introducing a criminal offence of creating a banking failure through irresponsible management of a bank, adding the risk of prison to that of bankruptcy as a sanction.
The UK banking industry and the regulatory environment in which it operates have come a long way in the past few years as they have sought to adapt in the wake of the financial crisis. Further change to the regulatory institutional framework in the UK is imminent. Within the current decade, assuming the UK government’s “in principle” support translates into a formal commitment to action, we will be part of a generational transformation of UK banking ushered in by the reforms proposed by Sir John Vickers and his fellow commissioners.

The proposals in the ICB’s final report represent a significant departure from the existing approach to regulation and supervision of banks in the UK. At the same time, the report rejects the most radical reform options that were under consideration – and rightly so, given their potentially negative impact on the flow of credit to the economy. This is most plainly illustrated by the conclusion that ringfencing of retail banking is preferable to its full separation from investment banking. The ICB’s report recognises the challenge of securing greater financial stability, while simultaneously safeguarding the UK’s position as a global financial centre – what the chancellor has dubbed the “British dilemma”.

In deciding how to respond to the ICB’s report, I would urge the government to take account of the long-term consequences for the UK’s position as a global financial centre. This brings numerous benefits not just to the City of London but to the wider economy. It is a position that has been hard-won over generations, but could very easily be lost. Divergence from internationally agreed regulatory approaches, as the report proposes in a number of key areas, poses risks to the UK’s position.

If, on the other hand, there is a genuine conviction among politicians and officials that the reform package is the right one, and not just a political sop, then I would like to see the government advocate its merits to our international partners in the European Union and at the G20.

Most notable among the ICB’s proposals is, of course, the retail ringfence. It will allow universal banks to continue to enjoy many of the advantages and synergies that their business model and structure currently afford them, while reducing the potential impact of more volatile investment banking activities in times of difficulty. Clearly, the banks most affected are likely to be those with a significant investment banking operation; but the ringfence will have an impact on all major UK banks conducting retail business. This is why we, as an industry, should now devote our energies to ensuring that it is implemented in the best way for the UK as a whole.

In this context, there are a number of key design features: it should be clear which activities must be, or can be, inside or outside the ringfence, and that clarity must be amenable to effective auditing and supervision by the regulatory authorities; and, most important, the ringfence should be drawn widely such that key credit supply is allowed inside it. In the event of another systemic crisis, this will ensure the continuity of vital economic functions within the ringfenced banks, such as lending to individuals and UK businesses of all sizes, thereby minimising the impact on the wider UK economy. Under the Commission’s latest proposals, ringfenced retail banks would be permitted to lend to individuals and (non-financial) companies of all sizes; this is a positive development from the ICB’s interim report.

Some commentators have attacked the ringfence concept, saying that it cannot guarantee that there will never be bank failures. On its own, no of course not. But it can provide stronger protection to ensure that the taxpayer is not on the hook in the event of any future bank failure. The ICB, rightly, has not rested its reform proposals solely on this concept. Reform needs a holistic package of measures: stronger liquidity, higher levels of loss-absorbing capital (where the

Sir Win Bischoff is chairman of Lloyds Banking Group, a position he took on in September 2009. Prior to that, he was chairman and CEO of Citigroup and, before that, chairman of Schroders. He began his education in Germany and continued in South Africa, while his career as a banker began in earnest when he went to New York with Chase Manhattan in 1962.
UK banks have already taken significant steps) and effective micro- and macro-prudential supervision. In combination, these complementary and mutually reinforcing measures will create a much stronger and more stable banking structure. For the markets and for the wider economy, the right approach to reform is early clarity of intent, considered work on detailed application and then a realistic period for implementation. This gives the markets certainty of what will come, leads to well-drafted legislation and allows for the necessary transition.

Rushing legislation on the ringfence proposals would be unwise. The ICB’s recommendation that they be implemented by 2019 provides a much-needed transition period, which will help minimise any potential impact on economic growth by allowing banks time to restructure their businesses and resolve unanswered questions, such as issues around shared services and customers. At the same time, the markets will expect compliance, or a firm route to compliance, to be in place well before 2019. The government is undertaking a further round of consultation before the end of 2011, but detailed consideration of the impact of the proposals and ongoing consultation with the banking industry will be needed throughout the transition period.

Getting the implementation timetable right is equally applicable to the ICB’s other proposals.

Though increasing the capacity to absorb losses is necessary to enhance the resilience of the financial system, it will inevitably have implications for the banks’ ability to lend and support economic growth. Flexibility is needed in the timetable, in the event that economic conditions were to worsen dramatically. And, of course, the reform package will need to be considered in the context of the wider regulatory reform agenda, most notably CRD IV, which could restrict the UK regulatory authorities’ room for manoeuvre on capital. The ICB’s proposals on “bail-in” debt will also need further detailed consideration to understand fully how the market will react and the implications for existing unsecured debt (in addition of course to new debt), a key source of bank funding.

It would be remiss of me to write about the ICB’s proposals without mentioning the other key aspect of the Commission’s work, namely competition in UK retail banking – especially since the recommendations are directly applicable to the banking group that I chair.

The final report focuses on the opportunity to create an effective new challenger in the market, through the divestment of Lloyds Banking Group assets under the state aid agreement with the European Commission, the so-called “Project Verde”. We are confident that Verde has been structured to be an effective and vigorous competitor on day one and has the capacity to expand its market share significantly by the time the OFT reviews the market in 2015. Combined with measures to improve the customer experience of current account switching and the transparency and comparability of retail products, I believe these proposals will further enhance the UK’s credentials as having a competitive and thriving retail banking market. Again, the ICB’s recommendation that the OFT reviews competition in the personal current account market in 2015 is a sensible timeline, since it will come two years after the implementation of the switching and transparency measures, as well as the emergence of the new challenger bank following the Verde divestment.

With the completion of the ICB’s formal work, the ball is now firmly in the government’s court. Vickers has laid out an intellectually elegant (and credible) reform roadmap for the government to implement, but there is still much work to do. The scale and complexity of the task warrants a dedicated bill that can be given the parliamentary scrutiny it deserves and be considered separately from the proposed changes to the regulatory institutional architecture. One of the key measures by which many will measure the success of the next stage is whether a course can be steered that achieves greater financial stability without jeopardising the UK’s leading global position.

Whatever your views on the ICB’s conclusions, we should congratulate Sir John Vickers, his fellow commissioners and his secretariat on what is a comprehensive final report. The Commission has had to navigate a highly complex set of issues, and has managed to do so in a relatively short period of time with intense scrutiny from the banking community, politicians, the media and the general public. That, by itself, is no mean achievement; we must hope the detailed implementation of the recommendations will follow a similar path.
The Vickers Commission is not the last word on banking structure in this country, but I reckon it represents about the best that could reasonably be hoped for at this juncture. The Commission’s recommendations have been constrained by two factors: the need to preserve the competitive position of London and the need to avoid inhibiting economic recovery. In both cases, it is right to be constrained.

The case for change is overwhelming. The financial crisis of 2007-09 almost brought us to complete catastrophe. The fundamental reason was the combination of excessive and dodgy lending and weak capital holdings. Equity capital was much too low and, given the way things were structured, debt capital was not capable of bearing losses. The result was that governments were presented with a terrible choice: either risk economic implosion if the banks were allowed to fail, or use huge amounts of taxpayers’ money to prop them up.

This was the result of decades of expansion in banking. In this system, individual banks and individual bankers were hardly restrained from excessive risk-taking. Meanwhile, the banks’ shareholders, the institutional fund managers, who could reasonably be expected to exert pressure to contain the risks that banks were running, in practice exercised no restraint at all. Indeed, many egged the banks on to increase leverage.

One obvious response to this situation is to impose a separation in banking activities between retail (or commercial) banking and investment banking, along the lines of Glass-Steagall.

This the Vickers Commission has drawn back from; instead, its proposal of separation within the same institutions looks like a half-way house. The defence is that the same prize of greater robustness of the vital retail function in the event of failure can be secured by internal separation but at a lower cost to the banks and the economy.

Maybe. But there are some offsetting costs and dangers. Most importantly, for retail banking to give a decent service to its customers, the culture has to change. But how can such a change be secured if the two sorts of banks sit within the same institution? On recent form it would seem likely that the buccaneering risk-taking style of the investment bank would dominate the institution overall, and potentially infect what should be the much more staid activity of the ringfenced retail bank.

Critics have argued that the Vickers separation would not have prevented the financial crisis of 2008 which was, after all, triggered by the failure of an investment bank, Lehman Brothers. They are right. But the objective of the proposed reform is not to try to stop such failures from happening - but rather to stop them from having such catastrophic effects, financial, economic and fiscal.

The real reason that Vickers opted for internal division rather than complete separation, I suspect, was probably the first of the constraints I mentioned above, namely fear of what this might have done to UK banks and consequently to the position of London. The Commission was walking a tightrope. Many of the bleatings of the banking industry were just special pleading of the most blatant kind, often scarcely recognising the strength of the argument that, after the financial crisis, banking structure simply had to change. And the threat of the departure of UK banking groups was almost certainly played up by them.

Nevertheless, in the wrong circumstances, some banks might have decided to leave. This would have been a blow to the UK economy (at least in the short run) as well as to the tax base, and it would not have achieved anything in terms of greater

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stability. Such banks would have continued to have substantial UK operations, which might continue to be put it in peril by whatever else these banks were up to outside the UK.

This is the sense in which it is extremely difficult for a medium-sized country with a big banking sector to set the pace globally. If there is ever to be a more radical separation of banking activities then it will surely have to be agreed internationally. And that would be devilishly difficult to achieve.

The other key recommendation of Vickers, namely on capital ratios, has been heavily influenced by the second of my two constraints. There is an acute tension between the objective of trying to make the system more robust and trying to boost economic recovery. The need to split and reorganise their activities will be enough of a worry and a distraction for banks, which could cause them to be extra cautious in their lending policy. But if much higher capital ratios were implemented soon then the damage could be much greater.

The Vickers solution is to advocate higher capital ratios, but to leave the full implementation of them until 2019. In principle, I think this is the right approach. Nevertheless, banks are bound not to leave everything until the last minute. Accordingly, their existing tendency to be overly cautious in lending might be strengthened so as to build up the capital ratios in the next few years.

Indeed, in today’s difficult circumstances there is a good macroeconomic case for banks being allowed to operate with lower capital ratios in order for them to be encouraged to lend more. The chancellor may have to consider putting back the implementation of higher ratios still further.

I continue to believe that we are heading for another financial crisis, centred on sovereign debt. If this does indeed happen, it would not be surprising if the chancellor chose to put both the increased capital holdings and the structural separation on ice. In these circumstances, what he should be prepared to do is what both the last Labour government and the current coalition government shied away from, namely outright nationalisation of the banks, accompanied by mandatory instructions to them to lend.

Where Vickers falls down most is something for which the Commission cannot be blamed because it wasn’t given the remit, that is to say what happens in the investment banks outside the ringfence. If it wasn’t clear before, during the crisis it became crystal clear that the financial sector has become a monster at the heart of the economy, absorbing too many resources in activity, much of which is essentially worthless, or as Lord Turner put it, socially useless. In essence, too much of the financial sector is engaged in redistributive activity which robs Peter to pay Paul, with a substantial chunk taken by Peregrine (and Chateau Petrus) along the way.

The cure for this will have to be deep-seated and radical: penalties for short term financial activity either in the form of a Tobin tax or unfavourable tax treatment for assets that are held for short periods, restraints on mergers and acquisitions and increased obligations on investing institutions to fulfil their responsibilities.

At the retail end, I have long thought that some of the Big Bang reforms of 1986 were a mistake and should be reversed. In particular, it is wrong to have those people who speak to and give advice to clients in the same house as those who make markets and take positions. And there are a host of other changes to structure and behaviour which could result in a reduction in the cost of retail financial activities and an improvement in the service to clients.

Pay is at the centre of these issues, but it is not as bankers would have you believe. Concern about pay is not simply about envy. It is about efficiency and a basic sense of fairness without which support for the capitalist system will be undermined. Anyone who knows the financial markets and financial institutions knows that although they employ many people of real talent who deserve substantial rewards, in recent years the scale of those rewards has become ridiculous, some would say obscene. Equally, lower down the scale, there are thousands of not very able people earning large multiples of what they would be earning in more productive activities elsewhere in the economy.

Only when financial professionals earn something similar to what lawyers, doctors or accountants earn will we know that this sector is properly structured and competitive. What’s more, if ever we reach that state, I reckon that the financial sector, although smaller, will both deliver a better service to its customers and be more robust and secure.

We cannot blame Vickers that he did not look at these issues; he wasn’t asked to. But we can blame the chancellor if he continues to turn a blind eye to the blatant excesses of the wider financial system – as he probably will.
Clive Briault

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Warnings of flawed assumptions in the Commission’s report – and of potential unintended consequences

Reading the ICB’s final recommendations reminded me of my days as a student, trying to follow lectures on mathematical economics. The proof of the optimality of perfect competition in just four equations was certainly elegant, but what assumptions did this rely on, and how relevant was the result to the real world?

I discuss three concerns here:

• the absence of any consideration of risks to financial stability arising from outside the financial sector;

• the ICB’s focus on retail banking; and

• the potential unintended consequences of the ICB’s recommendations.

Exogenous risks

Clearly, the ICB was constrained to some extent by its terms of reference. But my first concern relates to its narrow focus on regulation. The risk here¹ is that an over-reliance on regulatory reforms will lead to excessive regulation, in an attempt to offset the impact of sources of financial instability from outside the financial sector. This in turn could have adverse consequences for the effectiveness and efficiency of the financial sector.

¹ As discussed in my paper on “Fixing Regulation”, published by the CSFI in October 2009.

There is certainly a need to tighten the regulation of financial institutions, and there is important thinking to be done on the structure of financial institutions and on competition within the financial sector. In retrospect, we can see that many banks – and some other financial institutions - entered the crisis with much lower levels of capital, in terms of both quality and quantity, than they should have held against the risks in their activities. Moreover, their funding and liquidity, corporate governance, risk management and remuneration policies were inadequate. Meanwhile, we can also see that regulation had imposed inadequate capital and liquidity standards; had relied too heavily on the supposed quality of banks’ risk management; and had also relied too heavily on the theoretical advantages of financial innovation and the trading of liquid instruments.

However, we should not lose sight of the roles played by other factors in contributing to the current financial crisis and – most important – we should not ignore these factors when formulating recommendations to enhance financial stability. Loose monetary policy in the first half of the 2000s fuelled the growth of indebtedness and of property and other asset prices. Fiscal and other public policies, such as the drive towards “property-owning democracy”, encouraged home ownership and mortgage borrowing. Tax systems favoured debt rather than equity finance (as indeed the ICB mentions in passing). Global trade and other imbalances prompted a “search for yield” at a time when long-term government bond yields were unusually low. And the impact of all these factors on the pricing of risk and in private sector borrowing was reinforced by the over-optimistic and herd-like behaviour of borrowers and investors, an over-reliance on markets being efficient and self-correcting, and the generally free-market approach of successive governments in many countries since the 1970s.

The ICB’s recommendations perpetuate the notion that the causes of the financial crisis lay wholly within the financial sector - and that the solutions should therefore be imposed solely on the financial sector. But in the absence of progress on the macroeconomic framework, too much of the
burden of maintaining financial stability will fall on regulatory requirements - with these regulatory requirements having to offset weaknesses in the macroeconomic framework.

Even within the spectrum of regulatory reform initiatives, it is not always clear why the ICB’s recommendations hardly touch upon areas such as corporate governance, remuneration, risk management, liquidity, asset quality, the amount of capital that should be held against trading book activities, bank levies and financial transaction taxes, and macro-prudential oversight. The ICB is clear that more needs to be done on organisational and legal entity structure, on loss-absorbency and on competition. But it is not clear whether the ICB believes that too little, too much, or just the right amount is being done on all the other areas of the regulatory reform agenda.

Focus on retail banking

My second concern relates to the ICB’s emphasis on retail banking. For the ICB, the critical banking functions whose continuity needs to be preserved are the taking of retail deposits, the supply of credit to households and small businesses, and payment services for these customers. The retail activities of banks are therefore seen as the main sources or contagion channels of financial instability. Hence, the attraction of a ringfenced retail bank.

This may be contrasted with the Guidance Pack on recovery and resolution plans issued by the Financial Services Authority in August 2011, which lists 25 potentially critical economic functions, ranging well beyond retail functions to the intermediation of credit and capital, and to risk management products and services that facilitate risk pooling and protect agents against adverse events. This list, the inherent complexity and interconnectedness of investment banks, and the historical experience of the adverse impact on financial stability from their failure (as with Lehman Brothers) all suggest that the authorities may still choose to intervene if an investment bank runs into difficulties. The ICB is making a heroic assumption here in relying on resolution plans as a means of enabling investment banks to go into liquidation or to be “resolved” by the authorities without implications for financial stability, even if higher capital requirements and the introduction of “bail-in” debt limit the cost of such intervention that falls on taxpayers.

Indeed, if – as the ICB assumes – resolution plans and greater loss absorbency were sufficient to mitigate the worst effects of the failure of an investment bank on financial stability and the public purse, then the question arises as to the added value of the ringfencing of retail banks. Why not just rely here on a combination of current resolution plan initiatives, enhanced loss-absorbency, and the added protection of the guarantee scheme for retail deposits? The problem, I suspect, is that the ICB is in fact far from convinced about the resolvability of investment banks, but (with the exception of the recommendation on bail-in debt, which is broadly in line with the high-level thinking of the Financial Stability Board and the European Commission) has chosen not to enter the debate on how this could be improved.

Unintended consequences

My final concern relates to unintended consequences. Although the ICB is largely silent on what it believes might happen to the existing businesses of major UK banking groups, the underlying assumption appears to be that much of this business - and especially the retail business - will continue largely unchanged, albeit redistributed across a different legal entity and operational structure. And if investment banking activities are scaled back in response to higher costs of funding, then that is assumed to be fine, irrespective of whether this contraction is in “socially useful” or “socially useless” activities (to use Adair Turner’s categorisation).

An alternative possibility is that all the various regulatory and other reforms of the financial system - not just the relatively narrow set recommended by the ICB - will have a significant impact on the cost of banking services, including retail banking and the risk management services of investment banks. Fewer of these services will be provided, at a higher price, and possibly by a smaller number of providers as some banks decide to withdraw from specific markets or scale back their activities. Greater safety and greater resolvability come at a price, including a higher price for the retail and small business customers of banks. In addition, banks may seek to reshape their product offerings and cost bases in an attempt to protect their rates of return - which may just be a polite way of describing a move into a less competitive, more expensive and lower quality of service environment for bank customers.

Can we be reasonably sure that the cumulative impact of regulatory and other reforms, including the ICB’s recommendations, is not taking us beyond the “tipping point” where the costs of greater safety and financial stability outweigh the benefits?

Another unintended consequence is that banks may make surprising use of the flexibility provided under the ICB’s recommendations on what can be included on the asset side of a ringfenced retail bank. The ICB’s recommendations
only mandate that overdraft lending to individuals and small businesses has to be on the balance sheet of a ringfenced retail bank. One might naturally assume that banks would then choose to add mortgages and other personal lending, and lending to small businesses, to match the profile of a retail bank’s depositors. However, as the ICB concedes, the liabilities of a retail bank can also be used to fund much riskier lending, such as for commercial property development. And banks may choose to make use of this flexibility, for example because mortgages and credit card lending can be used to back securitised or collateralised funding for other parts of a banking group. So even ringfenced banks may not be inherently “safe”, and there remains the possibility that guaranteed retail deposits will be used to fund risky non-retail lending.

What should government do?

On the basis of the concerns expressed above, I would like to see:

- An explicit recognition of the potential contributors to financial instability from outside the financial sector, and a much clearer explanation of how these will be addressed. I look forward to seeing proposals to reduce or remove fiscal incentives to issue debt rather than equity; moves to reduce or remove fiscal and public policy incentives to encourage home ownership; and a less defensive attitude of central banks to the use of monetary policy to “lean against the wind”. The changes under way to the UK regulatory architecture will not achieve this, not least because both the analysis and the toolkit of the new Financial Policy Committee will focus only on risks arising from within the financial sector.

- Deeper analysis of whether we really need “more of everything” in the regulatory space, and a recognition that regulation has limits and cannot solve all our problems. The ringfencing of retail banks has its attractions, as the ICB report outlines, but how much added value does it bring over and above the reform initiatives already under way in areas such as resolution planning, the use of bail-in debt, higher capital requirements, and larger and more rapid payouts to retail depositors in the event of a bank failure?

- A cost-benefit analysis of the full combined set of regulatory, tax and other reforms that have either already been introduced or are on their way. It is all too easy to justify each individual initiative by comparing it against the costs of a financial crisis, but this is less obvious when considering the totality of measures. Yes, we need reform, but we also need to know the point at which the costs of greater safety and stability begin to outweigh the benefits.
I have never been at all expert, nor even particularly interested, in the area of economics normally known as “banking and finance”. Why then am I taking part in this collective response to the Vickers Commission’s report? It is partly as a protest. In 1780, as George III was losing the American War of Independence, John Dunning proposed a House of Commons motion saying: “The influence of the Crown has increased, is increasing, and ought to be diminished.” Despite all the resources of royal patronage, the motion was passed by a vote of 233 to 215. Substitute “banks” for Crown, and this is exactly what I think today.

In a much milder way, this article is a protest against the final report of the ICB. Not so much against its actual proposals as the way in which it has been written and presented. An officially-commissioned report of such length should surely say something about the purposes of banks and how they go wrong. And if that is too contentious, it could at least say something about the history of the subject and of banking crises in earlier epochs. To the best of my knowledge it does not, although who knows what someone may discover in the nooks and crannies of so large a document? But the initial impression is that it is written by technicians for technicians; and it plunges into the minutiae of bank regulation without any discussion of principles. It is symptomatic that the list of acronyms and the glossary are separated by several hundred pages.

Banks began in ancient Greece with tables at which money-changers bought and sold currencies. These were the people whom Jesus drove out of the temple “with their sheep and oxen…and overthrew the tables”. Some will think it a pity that they were ever readmitted. Since currencies were then metallic and expected to have intrinsic value, the bankers’ art consisted mainly in judging the fineness or degree of debasement of the coins presented to them. But it did not take long before citizens brought their money to these dealers, or the goldsmiths who succeeded them, for safekeeping. Wagnerians will recall that a goldsmith was by far the richest of the Meistersingers.

Before long, two further steps were taken. First, realising that not all depositors were likely to demand their money back at the same time, they started making loans on their own account. Second, they went further and began to lend multiples of the sums originally deposited with them. Most fundamental suggestions for banking have attempted to reverse one or both of these fatal steps. Vickers’s proposals to ringfence retail banks may be regarded as a tentative step in this direction.

Reports such as this are frequently compared to generals fighting the last war. This is perhaps unavoidable, since we do not know where or when the next war will be. In any case, one of the most interesting parts of the Vickers report is the table purporting to show how its recommendations would have prevented the crises of the last few years. It is much more doubtful whether, even if they had been adopted throughout the world, they would have prevented the eurozone sovereign debt crisis now raging.

Nevertheless, thinking about Vickers has inspired me to propose one way in which banks could aid UK economic recovery. My suggestion is an amalgamation of two ideas.

The first comes from Adam Posen, the independent radical on the Bank of England’s Monetary Policy Committee. Like many others, Posen argues for more quantitative easing, that is Bank of England purchases of securities to expand the money supply. Incredibly for an economy struggling, not very successfully, to emerge from the deepest recession since the war, nominal money supply has been allowed to stagnate since September 2010, and the real money supply (ie allowing for inflation) by about 5 per cent. Those who prefer to look at bank lending will find the figures even more depressing. Posen calls for a public bank to lend to small enterprises along the lines of the US Small Business Administration and the German Kreditanstalt fur Wiederaufbau.

Sir Samuel Brittan

Wants to see a new public lending bank, based on the state-owned banks

Samuel Brittan has been a columnist on the Financial Times since 1966 and before that was economics editor of the Observer. In 1993, he was knighted for “services to economic journalism”. His books include Against the Flow (2005) and Capitalism with a Human Face (1995).
My second source is a proposal for the future of the three UK banks in which the state has acquired a large stake: namely, Northern Rock in which the state holding is 100 per cent, Royal Bank of Scotland in which it is 83 per cent and Lloyds Banking Group (including HBOS) in which its holdings are 41 per cent. The total for RBS and Lloyds was originally valued at about £65bn, but is now worth less in line with market movements. The official policy is to privatise these holdings when the time is ripe. Stephen Williams, an accountant and Liberal Democrat MP, has proposed instead to replace conventional privatisation with an offer to all UK citizens on highly concessionary terms.

This is tempting. I have long been in favour of wider citizen ownership of capital assets. The main thing that is wrong with private capital is not the “contradictions” that Karl Marx claimed to have discovered. It is that too few people have it. Indeed, I once proposed “A People’s Stake in North Sea Oil”, and in Alaska there is a scheme by which state receipts from oil revenues are distributed to all adult citizens, although the right to these dividends is not transferable in the capital market. Nevertheless, I am afraid that this is not the right course for UK state bank holdings, at least at present.

Why not instead use the state-owned banks as the nucleus of Mr Posen’s proposed state lending bank for small (and indeed medium-sized) enterprises?

Lawyers can always think up objections to anything. But in principle this could start next week. We would need a Treasury directive to these banks to replace profit maximisation with a requirement to promote economic recovery. In practice, this would mean that they would lend for projects that would be just below the threshold of viability in normal banking terms. To the conventional mind, this should surely be more appealing than burying bank notes in holes in the ground for private enterprise to extract or dropping these notes by helicopter. Anything extra lent by these banks would add to demand in the economy, and if there is any value in the structures they help to finance, they should add to its supply potential as well. Above all, being bank loans, they would not add to that horror of horrors, the UK budget deficit. If any EU officials are disposed to argue the point, the mess they are making in their own backyard should soon silence them.

One problem with the specific projects that appeal to politicians in times of recession is that they are on far too small a scale to do the job. No one could say this of the proposal to use state bank holdings as vehicles for economic reconstruction. If anything they are too large. By far the largest of the state bank holdings is in RBS. This bank could be split into two halves. One half could form the nucleus of the proposed state bank for lending to small companies. The other half could be fattened up for eventual privatisation. How far such a split would correspond to the division between retail and investment banking proposed by the Vickers Commission I leave for others to determine.

The biggest argument on the other side is that once the government got into the business of lending to the private sector on any scale, it would have difficulty extricating itself. After all, the IRI state holding company was started by Mussolini as an anti-depression gesture but was still flourishing many decades after World War II. It might help to put sunset provisions into the constitution of the proposed state banks. In any case, in the present conjuncture, the cost of not having them far exceeds the cost of having them.

These and other reforms might not be necessary in a world with an adult attitude to budget deficits. But in the world as it is, it is surely far better than doing nothing or leaving everything to the Bank of England. Banks exist to serve the public and not vice versa. My proposal should not be turned down just because some bankers might not like it.
Eamonn Butler

Argues that Vickers is the wrong answer to the wrong (or even a non-) problem

Vickers is the wrong solution to a non-problem. It was not risky ‘casino banking’ that got us into this mess, and ringfencing retail from investment banking will not save us from future crises – indeed, ringfencing will make future failures all the more certain. And Vickers does not address the deficiencies in international capital regulation that promote systemic risk and again make crises more likely.

The aims of ringfencing

Human beings are not blessed with perfect foresight. It is an inevitable part of life that people miscalculate and that things go wrong. Competitive markets are very effective at punishing mistakes; but when things do go wrong, the usual response of government agencies is to reach for more regulation - not for more competition and more market forces. The ICB has done exactly the same. But again, our problems do not stem from a shortage of regulation. We have had plenty of regulation in the past 15 years. The trouble is that much of it has been ill-conceived, process-driven, or even (like the Basel regulations) counter-productive in a crisis. And our regulators have proved incompetent at enforcing the regulations already in place. The Financial Services Authority, for example, ignored warnings from the Bank of England and remained focused on trivial processes when the urgent problem was systemic risk. And the ‘tripartite’ division of responsibility meant that, when crisis struck, nobody took responsibility.

Ringfencing is intended to save high-street customers from the risky operations of the investment arms of their banks. For the government, that separation is vital, because the state guarantees the bank deposits of those customers up to £85,000 – and if push came to shove, it would probably be prevailed upon to do more. It wants to de-couple customers, and itself, from investment banking risk.

The wrong target

But it was not the high-risk investment banks that failed. Sure, there was Lehman Brothers, but that was a US bank, for which US regulatory failure must take the blame, and a UK ringfencing policy (such as Vickers proposes) would have had absolutely no effect on it. No: the UK banks that failed were the supposedly safe names – Northern Rock, Bradford & Bingley, Dunfermline, HBOS and RBS.

The first three – four if you include the Halifax part of HBOS – were old building societies that simply could not cut it in the modern banking world. Northern Rock failed because it overexposed itself to the interbank market, right under the noses of the FSA. Bradford & Bingley overexposed itself to high-risk mortgages. Dunfermline, which remained a mutual, took on high-risk commercial property deals and overpaid for self-certified retail loans. Ringfencing would have done nothing to stop any of these institutions getting into trouble.

Nor would ringfencing have saved RBS. Its problems stemmed not from risky investment banking, but from its remarkably aggressive policies on funding, lending, remuneration and acquisitions. In the boom times, fuelled by a decade of cheap credit and monetary expansion, that all seemed to make perfect sense.

With money so cheap and plentiful, people throughout the banking sector found that almost every deal succeeded. So they did more deals, rewarded their deal-makers for volume rather than quality, and made acquisitions without worrying...
too deeply about the cost. For that, we should blame a decade of expansionary policies, over-spending and over-borrowing by the US and UK governments, rather than the bankers, who were responding perfectly sensibly to the boom. And in the case of RBS specifically, we might blame the outside directors, shareholders and regulators who seemingly failed to understand the underlying realities and to keep the bank’s over-aggressive chief executive in check. But ringfencing would not have prevented the problems that got RBS into trouble.

**Ineffective and counterproductive**

Can ringfencing actually achieve the segregation that the ICB believes is possible?

Chinese walls are notoriously leaky. To be effective, the separation would have to be complete, with the retail and investment banks having genuinely separate owners. Any difficulties in an investment banking operation would depress the stock price of its parent company, which would in turn cause difficulty for any ringfenced retail business that it owned, because its ability to recapitalise the Tier One capital of its retail bank would be reduced. The News of the World might have been a small, ringfenced part of Rupert Murdoch’s media empire, but that did not leave him or his shareholders insulated when problems were exposed. Nor does it isolate other ringfenced subsidiaries from the impact on the group as a whole.

There is also the question of why banks should even wish to qualify for ringfencing. Arguably, they may enjoy lower rates for deposit insurance. But the generally unattractive nature of retail banking business would have a much greater effect in the opposite direction by raising the cost of capital. This, of course, would have to be reflected in higher charges to customers, specifically the individual and small-company customers whom ringfencing is supposed to protect. Perhaps UK banks will be given no option but to ringfence – and of course the government, as a major shareholder in several, can push through the policy even so. But this would burden UK banks with costs and administration that their international competitors escape: hardly a way to expand the UK’s advantage in the financial services sector.

Contrary to what is claimed for it, ringfencing makes the chances of bank failure higher, not lower. Indeed, it makes failures a near-certainty. The whole point of ringfencing is to add to public confidence in the government’s £85,000 explicit guarantee to depositors – and indeed the implicit guarantee that it would go further if another crisis erupted. The idea is to make it less likely that these guarantees would be called on, and therefore to make people more confident that the government would be able to save everyone in a crisis. But the more confident that banks are about the government’s determination and ability to bail out them and their depositors, the more riskily they will operate. In search of the highest margins, they will make risky decisions on loans, mortgages and deposit rates, confident that the government will save them from disaster. True, the ICB proposes capital rules that are intended to prevent the banks from stepping too near the brink. But that will not prevent them from operating as close to this new barrier as they can. And if they breach that barrier, they are still bust under the ICB’s rules. Even if they were not actually tumbling over a cliff, they would still be unable to pay their depositors and would have to be restructured. We will see more bank runs like Northern Rock, not fewer.

**Missing the real problems**

One can make many marginal criticisms of the ICB’s report. Why, for example, should ringfenced retail banks be excluded from intercontinental operations, yet free to involve themselves in EEA countries like Greece and Iceland? Would foreign banks operating in the UK have to be ringfenced, or is it just our own businesses that we are hobbling? How damaging is that burden to the UK, given the importance of its banking sector and the increasing competition from abroad? And are the ICB’s funding proposals simply unrealistic?

But the most telling criticism is that Vickers does not properly address the things that are really wrong in UK and international regulation, and in the banking sector itself, which make systemic failures more likely. The lack of competition in the sector, for example, is particularly damaging. Partly because of the growth of regulation itself, firms have had to expand in order to carry the huge compliance costs; and other regulatory rules have also encouraged this. (Gordon Brown’s pressuring of Lloyds to take over HBOS was another, astonishing, move that increased concentration and reduced competition still further.)

The result is that almost every bank has grown too big to fail – a huge systemic risk that we have released on ourselves by undermining free markets and creating a banking oligopoly. One way to correct this would be to have more onerous capital requirements on larger banks, which might discourage gigantism; but this is a second-best solution. A better solution is to promote a positive competition policy, and reduce the burdens on small banks in particular to encourage new providers to emerge and existing providers to break themselves into smaller units that pose less systemic risk.
And while we are at it, we need to make bank regulation not more complex and burdensome, but lighter, simpler and driven by clear principles. We need in particular to make banking intelligible to customers, and to make banks’ practices transparent to them. Most customers do not realise that their deposits are a loan to the bank – they presume the bank keeps the money somewhere secure so that it can oblige them when they want to draw it out again. Simply making customers aware of the risks they run with any particular account in any particular bank would do far more to avoid disasters than ringfencing ever could. Competition and well-informed customers are by far the best regulators.
C S F I

Sir Ian Byatt

Looks at how ringfencing worked in the privatised water industry and draws some parallels

Ian Byatt spent two years in the Treasury (from 1962 to 1964) on secondment from academic life. After spells in the Department of Education & Science, the Ministry of Housing & Local Government and the Department of the Environment, he returned to the Treasury in 1972, becoming Head of the Public Sector Economic Unit & subsequently Deputy Chief Economic Adviser. He left the Treasury in 1989 to set up Ofwat. In 2005 he became first Chairman of the Water Industry Commission for Scotland, leaving the post last June. He is now Chairman of Trustees of the David Hume Institute in Edinburgh.

Vickers has set out powerful arguments for separating the retail and investment activities of universal banks. Ringfencing the retail activities may well the best way to proceed – but we have to be sure that the right ringfence is constructed, adapted and, where necessary, repaired when holes appear. It also needs to be properly and sufficiently policed. An ineffective ringfence could be the worst of all worlds, involving costs without providing adequate defences.

This is not a simple task. As John Kay has argued in the Financial Times, this is a matter of enforcement as well as of accounting. There are always incentives to get round or penetrate the fence and bankers are nothing if not innovative. Protecting customers is not easy; Martin Vander Weyer wrote in The Spectator (September 24): “If I were a Swiss citizen with a UBS deposit account, I’d be yodelling for a ringfence as high as an Alp.”

For a utility regulator, the Vickers proposals imply looking at retail banks and their payments systems as forms of utilities with universal service obligations, to be kept separate from more speculative financial activities. There are possible lessons from utility regulation and I will set out what I learned in from my experience at Ofwat in regulating ringfenced licensed water companies.

When the water authorities were privatised in 1989, a company structure was devised that put licensed subsidiaries within a PLC that was able to undertake other activities. This was a crucial part of the privatisation settlement, needed to ensure the co-operation of management. It also had the useful corollary that regulated companies could be bought and sold, and so made subject to capital market competition.

It was clear from the outset that the wider activities of the PLCs could be more risky than the core function of providing water and sewerage services. Customers had to be properly insulated from these risks, in particular by ensuring that these activities could not involve any recourse to the regulated companies; in other words, losses in the unregulated companies could not be visited on the water customers. The initial licences contained provisions to this effect.

Events quickly showed the wisdom of this. The water PLCs were not slow to get into loss-making businesses, especially in the highly competitive and politically dangerous world water market. Both Thames and North West Water (subsequently United Utilities) lost a lot of money in Asia. And there was also a natural desire to expand into waste management. An easy privatisation settlement gave them the resources for these activities.

The big test came when Enron wanted to venture into a $300bn-plus world water market. It decided to acquire expertise in the provision of water services, proposing to buy Wessex Water. My job was to ensure that the ultimate owner of a regulated water company was a fit and proper person to control a company with public health responsibilities, and to continue to protect customers from external financial risks. I had seen the risks taken by Thames and North West - although at the time I did not know about the unruly behaviour that brought Enron to its knees. We made a strengthening of the ringfencing clauses in the Wessex licence a condition of the purchase.

It worked. When Enron crashed, its bonds turning to junk, Wessex Water bonds retained their investment grade status. The licensed company could be – and was – sold to a new owner. There were no losses to the customers of Wessex, and its investment programme continued to be financed. When other companies merged or were purchased, we always took...
the opportunity to do any necessary updating of the relevant licence conditions in the light of experience gained.

But there was more to this than accounting. The ringfence protected water customers in the event of failure, but there were other regulatory tools and controls available. As the regulator, I knew the Wessex management and what I could expect from them. In the event of poor behaviour, companies could, on Ofwat’s recommendation, lose their licence to operate.

For its own reasons, the City was on the “right” side. Apart from those engaged in a particular deal, City managers are generally cautious about diversification; it might bring profits, but it certainly brings risks. It was also helpful to the regulator that fund managers, and their analysts, were keeping their eyes on management – because regulators had the powers to take action that could have a serious effect on the finances of a regulated company.

Action could be formal or informal. Water companies were particularly susceptible because they needed to raise money to finance their investment programmes. Access to auditors can help, but their loyalty tends to be towards the audited company. It is possible, however, for a regulator to use experts with a duty of care, as we used the “reporters” in Ofwat, to undertake special investigations into how the ringfence is working.

Ringfencing may strengthen competition in retail banking by increasing capital market competition. It would be unfortunate, however, if the Vickers reforms were to inhibit entry. This need not be so; indeed there are ways in which entry would be encouraged. Ringfencing would involve attributing some share of profits to retail banks. The approaches used by utility regulators to the cost of capital could be useful; it would be good public policy to avoid large swings in profitability, while avoiding cross-subsidy. This would provide a more transparent presentation of the profitability of retail banking, helping to provide useful information for potential entrants.

It may also be necessary to strengthen the power of the customer to switch from one bank to another. Utility regulators have considerable experience of defining necessary and sufficient standards of service in energy, telecoms, water, airports and rail; their techniques could usefully be extended to banking.

Perhaps retail banks should operate under a licence – where the essence of the licence is the nature of the universal service obligation: proper operation of a payments system, rules to facilitate switching of accounts and adequate protection for depositors. A licence would provide the regulator with a powerful tool, by its ability to provide a continuous incentive on management and shareholders lest they risk the whole business. Experience, for example in the case of Yorkshire Water, shows this to be a powerful incentive.

Ringfencing has been used in the water industry in Scotland. The retail operations of Scottish Water were put into a ringfenced retail subsidiary to increase scope for competition in the supply of retail water services. This has been to the considerable benefit of a large number of business and public service customers.

It would be misleading, however, not to draw attention to a potential gap in any ringfencing arrangements - the payment of dividends to the parent company. When I was at Ofwat, I did not want to seek control of dividends; previous experience with the statutory water companies, established in the 19th century, did not provide good examples of efficiency. But I became increasingly concerned about the scale of the dividends from the regulated water companies to their parents. This owed more to the distribution of the capital gains from increased gearing and reductions in interest rates, than to operational efficiency. The regulator must keep an eagle eye on this – exactly what action might be necessary would depend on circumstances.

So I conclude that separation between retail and investment banking is possible – and can be made to work. But it requires much more than accounting arrangements. Conventional Chinese walls will not do the job; regulation and attention to both incentives and corporate governance are crucial. Perhaps we should ask the Bank of England to consult on how it would undertake this work.

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1 The remaining companies were switched to price control in 1989.
2 I was minded to write back “excessive” dividends into the regulatory balance sheets.
At a point in history when every country, government, business and person in the world is being forced to consider the meaning and worth of the money they have access to, it is perhaps natural to wonder how, and why, ‘money’ came into existence in the first place; why once upon a time, trade and barter became insufficient for our needs.

As civilisations evolved, food supplies became more certain and basic needs became less immediate and more predictable; times began when you might have something to sell or barter, but not necessarily anything you needed to buy or trade for at that moment. Money allowed you to delay this process of exchange, to extract the benefit of your bartered asset at a time that suited you. It also allowed you to accumulate the value of your assets, because unlike most food, money wasn’t perishable. Put simply – money bought you time.

In an increasingly complex and sophisticated financial world, the fundamental nature of ‘money’ still remains a question of timing. The basic premise of banking, in its simplest form, is to borrow short and lend long; to take money that is immediately accessible and utilise it quickly to make more money, while at the same time lending money over longer periods of time. This model was why traditionally banks needed to have more savers than borrowers. The core reason for the financial crisis is that complex financial engineering led some to believe the age-old model could be set aside, and the basic premise was forgotten.

Instead of relying on the original banking model, organisations started borrowing from each other and from wholesale money markets – creating ways of sharing out debt, of passing it round and repackaging it. By the time Lehman Brothers went to the wall, vast amounts of debt were circulating through sophisticated collateralised debt obligations. In the UK, the situation was little different; the problem with Northern Rock, for example, was too great a reliance on wholesale funding.

Now, because of this, Vickers is recommending radical reform of the operations of Britain’s biggest banks. In essence it provides a rationale and method for removing retail banks from risk by ringfencing mainly personal and small business banking from investment banking. Currently, proprietary trading by banks often uses client funds (not just banks’ own funds) in the trading casino. If banks are forced to separate their retail banking business, it is argued, that will essentially remove the gambling element from personal banking - removing ordinary customers (and governments) from the risk of loss, by separating them from the casino.

While the motivation is understandable, there have been concerns raised that this new approach will have unintended consequences. In the largest sense, UK banks are worried that it could make them too constrained competitively versus other world-class finance centres such as Hong Kong or New York. Others have argued that asset bubbles are inevitable, and that they are more likely to cause retail banks issues due to mortgage failures and defaults.

Ultimately however, there has been acceptance that a change in the status quo is inevitable - and, more recently, Bob Diamond, Barclays chief executive, has welcomed the ICB report.

Despite this, I believe that there are further unintended consequences that need to be thought through, and that these come down to the fundamental nature of money that I discussed earlier.

Because money is linked to time, not all money is equal. Of course, we are all aware of this basic concept in the currency markets, where, as well as being linked to time, money is also linked to the fortunes of its country of origin. But money can also be defined in other ways, for example:
- Hot Money – this is wholesale money, traded from institution to institution, not needed for a day, or a week. It moves quickly, is put on overnight positions, is linked to short timescales and can be volatile in terms of supply and demand. You don’t want to be holding it for long, otherwise it becomes...

- Dead Money – which is money that you are holding without return. Pure cash, Neanderthal, primal money that replaced trade and barter centuries ago, and that has gone cold because it cannot be linked to any time period. You can spend it or put it under the bed, but not much else.

Finally, to quote Goldilocks, you have money that isn’t too hot, or too cold, but is just right...

- Sticky Money – this is money from private individual savings and capital accumulated from real businesses and pension funds. It is linked to stable, calculable, longer terms: to time that is useful, and less risky.

Sticky money is what the UK wants and needs at the moment. Sticky money is low risk, ‘real’ money that encourages responsible lending to private individuals and small businesses, and therefore stimulates the economy. It is the most valuable type of money right now. It also happens to be something of which Jersey has an abundance, because of its traditional banking practices and conservative risk profile. Currently, the equivalent of £1 in every £20 of ‘sticky’ or ‘safe’ money in the UK banking system originates from Jersey. This is significant evidence of the benefit that Jersey can provide to the UK; but it is also a reason for concern in light of Vickers’s recommendations, which don’t currently consider the role of the Crown Dependencies. In their existing form, the FSA liquidity rules announced prior to the IBC review would mean that money from institutions in Jersey would be considered, or labeled, wholesale, despite the fact that the underlying sources are ‘sticky’. And this would mean that money from Jersey would be prevented from being used in retail banking, where ‘sticky money’ is most needed.

In a worst case scenario, a large and valuable source of low-risk funding will unwittingly be prevented from feeding through the UK banking system into the economy, simply because new regulations will be based on incorrect categorisation and inaccurate labels. In a best case scenario, if this labeling and its impact are better understood, Jersey and the rest of the Crown Dependencies could become a valuable line of support for UK individuals and businesses, providing the right sort of money, at the right time.
The banks seem to have heaved a sigh of relief about the final report of the Vickers Commission, in large part because, although the ringfencing proposal will go ahead, it will leave them much flexibility about what activities they put inside the fence. The bankers’ sense of relief might, though, prove premature. For the final report is also quietly tougher on the banks in other ways, notably on increasing competition. In fact, although on the face of it the report is a disappointment for critics of the banking system, its recommendations pave the way for steady, albeit slow, progress towards the necessary outcome of more and smaller banks that can be allowed to go bust in times of trouble. This is probably all that was politically feasible at present, given the continuing – and inexplicable – reluctance of Britain’s politicians to reform the industry that caused the most serious economic crisis we have experienced for nearly a century.

The fundamental long-term problem the ICB needed to address was the “Too Big To Fail” phenomenon. Not only does “Too Big To Fail” cost the taxpayer too much in times of crisis, it also encourages excess risk-taking by the banks and, through a massive implicit government guarantee for incumbent banks, is bad for competition.

There are two ways to tackle this. One is to make it possible for regulators to allow banks to fail by creating greater clarity about their activities, and the ringfence will do this. Casino banking outside the fence will have no implicit taxpayer guarantee. Activities inside it will probably retain the implicit guarantee, but will be highly restricted and regulated.

The other path is to make the banks smaller. Since the 1980s, there has been a substantial increase in market power – and political power – in both retail and wholesale banking. The UK competition authorities have been nibbling at the problem for years, the latest ruling being the Competition Commission’s finding on the scandalous mis-selling of payment protection insurance. This was such a large-scale abuse of customers, who would never be able to claim on the insurance product they were being sold, that the banks taking part acted as though they had entire departments devoted to customer exploitation.

At the same time, the absence of competition has meant that while the banks have had every opportunity to take advantage of customers through excessive charges and fees and inappropriate products, there has been none of the dynamic innovation that would have occurred in a competitive market. Thus while people from Singapore to Kenya can use a range of new payments technologies, British banks have been slow to bring these innovations to their customers - and when they do so they manage to put the (hidden) fees up, rather than bringing them down.

However, essential as it is to restore competition to UK banking, the Vickers report probably went as far as it realistically could at the moment. It stuck to its interim recommendation that Lloyds Banking Group should make a bigger divestiture than it has agreed with the European Commission – and, what’s more, spelled out that the new divested bank can only pose a genuine competitive challenge if it inherits enough deposit accounts. This is vital, because it is the iceberg of inert, low-cost deposits that incumbent banks use to price their ‘best-buy’ products aggressively and hence keep out potential new entrants to the market.

The report also includes some useful recommendations on bank account switching, which are to be in place within two years. The banks will no doubt overstate the practical difficulties, but the Competition Commission’s experience over the years is persuasive.

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that when changes of this kind have to be made, as if by magic they prove perfectly practicable. The example of mobile phone number portability imposed on the operators by Ofcom shows that bank account switching can be made straightforward, however cautiously customers will want to test it.

The final, key lever offered by the report is its recommendation that if competition in the market has not improved within the next few years, there should be a full market investigation by the competition authorities. Ideally, given the likely timescale for all the reforms to be put in place, politicians (of all parties) will set a deadline for an assessment by the OFT of whether enough progress has been made, say, four years from now. Just in case the political will proves weak, or the banks’ lobbying too strong, consumer groups should be preparing the ground for making a wide-ranging competition complaint to trigger a market inquiry.

Of course, the banks’ lobbying of the government will already be well under way, aiming to water down some of the specifics. Lloyds can be depended on to oppose the larger divestiture recommended by Vickers, and we can only hope the government follows the considered expert advice it has received, as opposed to the special pleading of rich men who want the industry organised in their own interest.

However, given the fragility of the eurozone, such that, as in 2008, we see banks with so little mutual trust that they are reluctant to lend to each other, there is a danger that the Vickers Commission will soon be overtaken by events. If the Great Financial Crisis is indeed entering a new phase, many people will be wondering why the Commission was so cautious - and, in particular, why the government has remained so deferential to the banks.
C S F I

Hugo Dixon

Argues that ringfencing is all very well, but “living wills” provide the most effective protection against systemic crises

The Vickers report does not solve the “Too Big To Fail” problem. Ringfencing retail banks, as the IBC proposes, may help at the margin. But proper resolution plans are a more important way of safely winding down big lenders. Vickers’s focus on ringfencing could even be harmful if it diverts attention from drawing up such so-called living wills.

Ever since the 2008 financial crisis, it has been apparent that the world needs to be able to pack delinquent banks off to the knacker’s yard in a way that does not cause chaos for the rest of the financial system. During the crisis, the only big institution to go bust was Lehman Brothers – and it did so in such an explosive fashion that politicians rescued virtually every other weak institution. Shareholders were sometimes diluted, but almost all senior bondholders were made whole – and taxpayers got a raw deal.

Banking needs a system of orderly default – in much the same way the eurozone does for insolvent countries. Otherwise, banks will face inadequate market discipline to manage their risks and there will be more and bigger bailouts in the future. Vickers tries to solve this problem in two ways. First, all unsecured creditors (with the exception of depositors) would be bailed in if a bank became insolvent. To ensure there was an adequate cushion, equity plus “bail-in” debt would have to be at least 17-20 percent of risk-weighted assets. Second, banks’ retail operations would be ringfenced with their own capital and board of directors. The idea is that this would make it easier for the authorities to close down a bust investment bank because doing so would not put the retail bank at risk. If bondholders know that they could face haircuts in default, they will apply more discipline to wayward banks. A higher cost of funding will also squeeze out activities that do not have adequate returns to cover their risks. Other countries should adopt a similar approach. There is a strong case for an internationally agreed minimum level of bail-in bonds, just as there is for equity.

The second part of the plan - ringfencing - is more questionable. The notion that a retail bank is a utility while an investment bank is a casino is just not true. During the crisis, there was excessive risk-taking right across the spectrum. Northern Rock and Washington Mutual were pure retail banks; Lehman and Bear Stearns were pure investment banks; RBS and Citigroup were universal banks.

The lesson of the crisis is that the world needs a way of dismantling any banking institution if it gets into trouble. Ringfencing might help a bit but, on its own, it is clearly not enough. It is fanciful to imagine that – even if their retail divisions had been ringfenced – RBS’s or Citigroup’s investment banking arms could have been allowed to collapse without causing havoc. Even if investment banks shrink (something that is already happening as a result of increased funding costs and tighter regulation), politicians would probably still conclude they were Too Big To Fail.

This is where resolution plans enter the picture. The idea is that supervisors would agree plans with each bank, setting out how they could be safely wound down in a crisis. Doing this is extremely hard, especially with large cross-border banks. But, over the past three years, much thought has gone into defining what needs to be done. In particular, the Financial Stability Board, the body set up by the G20 to coordinate cross-border financial regulation, produced an excellent consultation paper on the topic in July. It is due to be submitted to the G20 leaders summit in Cannes in November.

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1 A version of this piece previously appeared on Reuters Breakingviews.
Five main things are required for such living wills to work:

• Countries need to have regimes that allow regulators to seize banks and then either wind them down, recapitalise them by converting debt into equity, or sell them off.

• The resolution regimes in different countries need to be able to work with one another; and regulators have to be able to share confidential information across borders.

• Supervisors and their banks need to draw up resolution plans and then review them at a senior level at least once a year.

• Such plans need to be assessed to see if they can actually do the job. When big cross-border banks are involved, the home regulator should share its assessment with regulators in other jurisdictions who should also judge whether they are adequately robust.

• If the plans aren’t good enough, regulators should have the power to force banks to impose necessary remedies. These could include structural reforms, such as ringfencing (as Vickers has recommended) or even spinning off businesses (which would go further than Vickers’s proposals).

A proper international regime along these lines would be a practical yet radical way to solve the “too big to fail” problem. Accomplishing it, though, will be a massive job. Mere approval by the G20 won’t be enough. Deadlines will have to be set. Knotty questions - such as whether at least executive summaries of the plans should be made public - will need to be resolved. (They should.) Governments will have to follow through with legislative and regulatory changes, probably in the teeth of tenacious lobbying by the industry. Even countries that have such resolution schemes, such as the UK, will need to modify them.

Although the Vickers report supported living wills, it only discussed them tangentially. So far, there has been little public debate on the topic; ringfencing has grabbed the headlines. The risk is that British politicians will conclude that the Commission’s proposals alone solve the Too Big To Fail problem, even though they don’t. Given the UK’s importance in international finance, the focus on ringfencing could also divert attention from the more important global push to make living wills work. If so, Vickers could even end up doing more harm than good.
People are jolly cross about the banks. And they are right to be. Three years ago, the financial crisis precipitated a global bail-out of banks, fully revealing how the preceding years’ carnival of greed had led to pervasive and extravagant blunders, frequently verging on fraud (and in some cases actually fraudulent). Alongside this bail-out, interest rates in most major currencies were reduced virtually to nil, both as a general monetary stimulus and to permit banks to be recapitalised by wide interest rate spreads and a steep yield curve. With hefty fiscal stimulus in parallel, financial markets recovered sharply (for a while). Bankers had stripped out huge bonuses up to 2007 on what turned out to be false profit statements, denuding their banks of needed reserves in the process. Over the past 24 months, they have renewed their bonus-paying habit on the back of strong revenue recoveries arising from cheap money – while ordinary savers get little or no interest and the economic recovery remains feeble.

No wonder we have the Vickers Commission, with its proposal to curb banks’ more extravagant types of activity – or at least to wall them off. But the justification for any new measures needs to answer certain questions:

- What went wrong? The default assumption that it was all caused by bad banker behaviour is incorrect.
- In what way are existing regulations most inadequate?
- Would the proposed changes have prevented the crisis or made it much less severe?

- Will the proposals involve collateral damage that can or should be avoided?
- Are the proposals likely to prevent future crises?

An unduly easy monetary policy almost invariably expresses itself in credit excesses. And the lenders are mostly banks. But if bankers take all the blame for a crisis arising from a vertiginous expansion of debt, then no monetary policy can be too easy. The oddity of the run-up to the 2007-08 crisis is that monetary policy was clearly too easy in provoking debt that would certainly exceed the capacity of income to justify it – yet it was just about right in relation to normal criteria, for example the US Federal Reserve’s mandate to aim for stable prices and low unemployment. In the six good years of the last cycle, from end-2001 to end-2007, the US real growth rate was 2.75%, well below the long-run average of 3-3.25%, which covers recessions as well as growth periods in the cycle. Inflation was less than 3%, little over 2% excluding food and energy. Although a housing bubble was evidently blowing up, a stricter monetary policy would have been highly controversial, possibly leading the Fed to be over-ruled by Congress. British policy was obviously less material to the emergence of the banking crisis than American, but was also balanced, though permitting slight overheating by 2007.

Why did it require such a massive run-up of debt ratios to provoke such modest growth?

The answer is that the underlying cause of the crisis (we are not talking about blame here) was the Eurasian savings glut. The long-standing excess of private savings over investment in Japan was compounded by:

- the mercantilist policies of the Asian Tigers, traumatised by their treatment in the Asian crisis.
- the repression of growth and incomes in Germany and other countries of north-central Europe, reinforcing demographic effects, as in Japan; and finally, in 2005-07, a massive build-up of net exports from China.
The argument is virtually incontrovertible: the huge expansion of financial activity and debt saw the real cost of money go down, at least until 2006, by which time the die was cast. This can only mean that supply was driving up demand – not the reverse. This theory was first proposed by me in 2004, (then independently) by Mr Bernanke in 2005, and is accepted widely, including by Martin Wolf, who was a member of the Vickers Commission.

Supporting the ease of US and other countries’ policies was a lax Zeitgeist. If the US regulations then in place had been properly enforced, most of the disgraceful “Ninja” loans (“No income, no job or assets” – not to mention no documentation!) would have been prevented. While British households had (and have) debt at a higher ratio to disposable income than their US counterparts in 2007-08, those debts did not contribute to the need for the massive bail-outs that the Vickers proposals are designed to avoid in future. So the proposal to separate out the British conventional banking activities of banks would not address the source of the 2008-09 problems –unless it is thought that the exposure of the likes of RBS and HBOS to catastrophic losses in the US, Ireland etc could and would have been ignored - in other words, that they would have been allowed to go bust, with the domestic ringfenced conventional banking activities left standing and as fully capitalised as before.

This seems unlikely. The debacle that ensued when Lehman was let go led within less than a week to the rescue of AIG – admittedly not by the British, but certainly to the benefit of the British. The reason was that the cat’s cradle of global interlocking derivative contracts meant that even the bankruptcy of a relatively minor investment bank such as Lehman threatened a “domino effect” through the entire global banking system. The British played their part in the rescue that this made necessary – and one suspects that if the same happened again, they would again. So the benefit of the new ringfence would be confined to ensuring non-depositor lenders to banks bore the full extent of such losses as their capital covered before the government had to chip in. But this could be achieved – and probably will be achieved – by appropriate capital ratios.

Meanwhile, the problem for now – and for at least the next 10 years – is highly unlikely to be wildly extravagant risk-taking by bankers. It is, rather, the refusal of the savings-glut countries to accept any responsibility for what went wrong, and the consequent dependence of the world recovery on unacceptable government deficits in the deficit countries. This is, and has always been, an economic and political crisis. Excessive government debt has indeed provoked a new banking crisis – but it is not, this time, the bankers’ fault. Even in Ireland, Spain and Portugal, where future potential banking crises arise from excessive private sector debt, that debt is in any case legacy debt from the years up to 2007, and would be less of a burden if the world recovery had been – or, dare one hope, is in future – led by consumer demand in savings-glut countries.

Sadly, it is also true that in some future boom and bubble, if the Zeitgeist is again as absurdly laisser-faire as in the run-up to 2007, new regulations, however well conceived, will be ignored just as before – and will therefore do little good. Fortunately, while the Vickers proposals may not do much good, they will probably do little harm, despite predictable squawking from bankers – and if the capital of the new ring-fenced banks is required to be kept in the relevant subsidiaries, they may even lead to some increase in corporation tax revenue. Bank-haters will be gratified to know that a world needing debt deleveraging clearly requires less lending activity, and therefore fewer bankers – of the investment as well as the commercial variety. In any case, the economic system will take its revenge on activities that became so overblown in importance.
I am old and grumpy enough to remember the days before banks had regulators. Hardly credible, surely? However did we get along without them?

Quite well, in fact – for something like a century, when the external shocks included two World Wars and a Great Depression. Banks teetered, were propped up or tidied away, but the structure somehow held together. Then a rash of pseudo-banks sprang up and threatened to infect the real ones, and though the epidemic was contained, the shock persisted. All agreed that there ought to be a law. We got one.

The Banking Act of 1979 set out for the first time, by statute, to regulate the banks and to protect their customers. Since then, two more Banking Acts, so far, have followed, and of course two Financial Services Acts to go with them. And a regiment of banking regulators in Canary Wharf with financial stability parked at the opposite end of the Docklands Light Railway. The sequel to all this has been a banking crisis of the first magnitude, and the treatment prescribed involves new laws and more regulation. Sir John Vickers’s ICB has now recommended surgery.

Before the lawmakers reach for the saw and the scalpél, they could usefully ask what may have been at fault with the treatment so far. They should look at the textbook case of the Bank of Cocaine and Colombia, where the regulators failed to use their statutory powers for fear of being challenged in the courts and defeated. The ultimate lawsuit lasted for a decade – so, in fact, they had something to worry about.

The moral speaks for itself. In a system of rules which are established by statute, the chancers will always be tempted to push those rules to the limit – and then, if challenged, to reach for their lawyers. The regulators, for their part, may feel that their duty is done when every rule has been observed and every box ticked. All this is guaranteed to ensure that when things go wrong, they go badly wrong.

No wonder that some of the specialists now want to reinforce the treatment by introducing what they call intrusive supervision. That may sound like a desperate resort to rank with heroic invasion, but it does at least recognise, late in the day, that alternative medicine may yet have something to offer. It gives credence to the old-fashioned idea that supervision can achieve what regulation cannot.

Regulation could not stop Northern Rock or HBOS from piling on loans against bricks-and-mortar assets, or teach them that mortgages are not the same as ready money. Nothing in Vickers’s recommendations would have saved them from the consequences. A supervisor might have learned (perhaps the hard way) the lessons of earlier cycles. He would have noticed that neither of these banks was run by a qualified banker.

Noticing is his first duty. What Bagehot said of the private banker may be said of the supervisor, and for the same reasons: his is a watchful but not a laborious occupation. He has to watch the markets and to listen to them, without always taking them at their face value. Alan Greenspan blandly maintained that a central banker could not be expected to recognise a bubble, but a supervisor may need to.

Banks are, of course, fertile in finding new ways of losing money, or failing to identify the old ones in disguise. They believed Walter Wriston of Citicorp when he told them that countries didn’t go bust – and some of them believed...
this same story when, with the invention of Europe’s single currency, it worked its way round again. They believed the rating agencies, stocked up with paper, and found themselves lending on inaccessible security somewhere in sub-prime America. How is the supervisor to stop them? The question was first posed by Swift: how is it to be supposed that men will take advice, when they will not so much as take warning?

The supervisor’s ultimate sanction is credit. His disapproval must be seen as a threat to any bank’s standing, and thus to its lifeline. Conversely, his approval is worth having, most of all in hard times. Some of his sanctions impose themselves. A slipshod back office can represent a false economy, as Barings found out, and as UBS may have needed to learn.

No doubt, his task was easier in the days when the City was a place of clubs and cartels, and when the Bank of England’s most powerful deterrent was supposed to be the raising of the Governor’s eyebrows. There are lessons, all the same, to be learned from that far-distant era. Nothing in our subsequent experience of laws and regulation suggests that what we now need is more of them.
It is clear that the FSA continues to take the issue of living wills very seriously. Its recent pronouncement (on August 9) that around 250 UK deposit-takers will have to prepare these documents, when previous edicts have applied only to the very largest UK banks, is evidence enough of that.

Make no mistake: preparing living wills is a potentially huge and expensive exercise (for a firm and for the regulator). To ensure that the associated expenditure of time and energy isn’t wasted, there are a number of painful lessons that need to be borne in mind when preparing these documents.

To set the context: one useful result from the crisis of 2008 was that some of the old taboos were broken. I am thinking particularly of the understandable (but unhelpful) reluctance of bank managements to talk seriously about the problems that would bring the bank down. Typically then, every stress test dreamed up showed the bank concerned coming through leaner and wiser. Managements find it very difficult to accept that external circumstances can bring them down; but, post-2008, it is obvious that this can happen – and regulators generally have been much tougher in wanting to talk about and plan for such a set of events.

Another useful result of the problems in 2008 (though it should hardly have been news) is that they provided a vivid reminder that the structure of a group can facilitate or make much more difficult the resolution of life-threatening problems at group level. This is not just the result of often incredibly complex corporate structures that have been set up over the years for tax or other purposes. Nor is it solely the result of the centralisation of treasury functions that has happened around the world, as groups have sought to use their capital and trading expertise to the best advantage. In fact, specialisation has occurred throughout the bank - and has gone, in many cases, to the point that, once you look from the other side of the teller’s window, it is immediately clear that complexity rules in almost every aspect of the bank’s day-to-day operations.

In addition, the sheer geographical reach of a large banking group can create an additional layer of complexity that would hinder any attempts to resolve a significant problem. IT (including key payment systems), data storage, back office support and many other services are now provided by other parts of the group or by third parties under contract. In many cases, these services are provided from countries thousands of miles away. The result can easily be that, if its parent had failed overnight in some global disaster, a local subsidiary would probably not be able to get deposit or balance sheet data on its local screens the next day. So – even though it might well have the capital and liquidity to continue its local business – it would be unable to continue to function in the absence of special intervention by the authorities (in both host and home country).

So, what can living-will exercises usefully achieve in this complex world?

For the home regulator, they can:

- Facilitate a real discussion about the options open to a bank to mitigate the liquidity or capital pressures on it at a reasonably early stage. (Whether or not those options are ever activated will probably depend on the severity and the speed with which the problems appear, but in some cases at least they will be relevant.)

- Identify issues within the group – either because of structure or mindset – where there will be real
problems in the event of certain kinds of external pressure. (At the very least, the regulator can take these into account – plan to work around or mitigate these problems or, if necessary and cost-effective, work with the bank over time to reduce or eliminate the problem).

For the home authorities more generally, livings wills can and should help decisions before the heat of a crisis (not in the middle of one) about what to try to save and what to let go, in the interests of the hapless taxpayer who last time round stood behind the rescues.

None of this might appeal much to the bank concerned, which has to pay for much of the work on living wills and for whose management this represents a significant additional duty. Some host country regulators may also look askance at the process, though some home country regulators are talking to and involving the key host regulators which – if done well – will reduce the risk of a fragmented and divisive response in the event of a crisis. A positive outcome along these lines would be good news for any bank involved.

What bank managements have to accept, however, is that this work will proceed with their co-operation or not. At least, if they are fully engaged from the outset, that will maximise the chance that decisions taken by the authorities are taken in the light of a clear explanation from the bank as to what it thinks is at stake. The home authorities are the only ultimate source of liquidity and capital if the markets once again seize up. It can help no one if their decisions at such times are not well informed. It is in banks’ strong self-interest that they are. The regulators, for their part, need to accept the importance of working together to avoid excessive costs to the banks (and thus to the final customers) and to ensure that their requirements remain realistic.
At one level, given that the government has already welcomed the Vickers report, an obvious response is to say: “Close the debate and get on with implementing it.” One of the things the banking industry most needs, as Bob Diamond said in his initial reaction to the report, is clarity as to future structural requirements and the related capital requirements, as well as a clear timetable for implementing them. It is time to draw the line under the banking reform debate.

It is important, though, to understand what the proposals represent, and what their limitations are. They are not designed to prevent future crises, and indeed will not do so. The ringfencing proposals will make it much easier to resolve a failing retail bank, and will provide reasonable protection against an investment banking disaster bringing down a retail bank in the same group. They are a logical extension of the international proposals for rescue and recovery plans. As such, they will not prevent the next crisis, but they will make it a little easier to manage - and potentially therefore, less costly to the taxpayer.

The proposals focus heavily on capital and on “bail-in” debt. This comes at a cost for UK banks - and one that they will inevitably seek to pass on. The Commission hopes these costs will be split with shareholders. But given current retail bank returns on equity, there is little margin for shareholders to absorb much more and still regard bank equity as an attractive investment. After all, increasing capital requirements requires investors to buy the shares. Two key questions, therefore, need to be answered before the recommendations can be adopted:

- Will the increased costs have a detrimental effect on credit supply?
- Will the proposals make UK banks less competitive internationally?

The Commission has tried to answer these questions. On the question of credit supply it makes an economic case that the long-term benefits outweigh the costs, although it doesn’t articulate the marginal benefits of the increase in capital over the Basel III requirements. It does, though, sensibly recommend a long transition period to allow the economy to absorb the costs without a shock. The Commission has been criticised for this by some, but it is vital given the parlous state of the economy today – and in particular the potential threat from the eurozone sovereign debt crisis. The Commission has not modelled the impact on the economy of banks passing on higher charges or indeed shrinking credit supply to preserve capital. But it has recognised these are risks that only a gradual transition can mitigate. In practice, implementing the ringfence will be so complex as to require the sort of timeframe envisaged by the Commission anyway, irrespective of the economic arguments.

On the second question, the Commission is less convincing. There is also the nagging thought that, if the ringfence is such a good idea, why is no other country considering it?

The Commission rightly makes the point that retail banking is still largely national, and has carefully avoided imposing additional equity requirements outside the ringfence. However, it then contradicts this by imposing a sharply increased capacity to absorb losses on UK-headquartered, global systemically important banks via the “bail-in” debt proposals. EU banks furthermore have the right to branch into the UK, and these branches will not be subject to the ringfence – thus, potentially making the UK a place where they have a significant competitive advantage. It is also possible that a UK bank might restructure itself by moving its UK retail banking into a subsidiary based in another EU country. In its report, the Commission dismisses both scenarios as highly unlikely, but gives the impression that it

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**John Hitchins**  
Says the time for talking is over. Now we need to implement Vickers – but he worries about the lack of a level playing field

John Hitchins joined PwC in 1976 and became a partner in 1988. He has specialised in bank auditing and advisory services throughout his career and his audit clients have included both leading UK banks and the London operations of major international banks. He has also carried out a wide variety of advisory work for banks and has led a number of investigations for banking regulators. He served as PwC’s banking industry leader from 2001 until 2010.
CSFI

didn’t spend a lot of time considering them. The operational complexities of creating the ringfence may mean that a more radical restructure will not be out of the question for an individual bank. Attracting more competition into the UK may meet the Commission’s other objective, but this should not be because of an unfair playing field. The interaction of these proposals with EU law is, therefore, something that needs a more detailed study as the Government decides what to do next. Overall, the Commission seems to have focussed on making sure the proposals are not detrimental to the City, but in doing so it has given foreign-owned banks a potential advantage.

“Bail-in” debt is a key plank of the proposals. The Commission argues that it will address the issue of how debt-holders can be made to participate in a resolution, and that it will also provide a market mechanism which will act to police the amount of risk an individual bank is taking.

The first of these reasons is clear, but the second is very much an act of faith. Equity holders had no impact in the run-up to the crisis on policing the amount of risk banks took; in fact, many criticised banks who took less risk for losing market share. Debt holders will not have the same concerns over growth and so may do a better job, but it would be unwise to put too much faith in this too early. The scale of “bail-in” debt envisaged by the Commission may also be a big stretch; further work is needed to see if sufficient investor demand will exist. It may simply not be possible to finance on this scale. Further, as mentioned earlier, requiring UK-based global systemically important banks to hold the same overall loss-absorbing capacity as the large banks inside the ringfence also potentially puts them at a disadvantage to international competitors and seems inconsistent with the Commission’s decision not to impose super-equivalent equity requirements outside the ringfence.

Despite its 350-plus pages, the Commission’s report is actually a statement of recommended principles, and it contains no details on how it should be implemented. The structure of having certain activities as “must be ins” and certain as “must be outs”, with a large number in the middle to be left to individual choice, will prove to be a strength of the proposals. Many practical difficulties will be encountered in trying to get real banking operations to fit within the new structure, and guiding principles will make these easier to solve than detailed rules. For the same reason, the primary legislation needs to be kept to a high level, with rule-making through statutory instruments or the FSA’s permission regime. Banking products evolve all the time, and it is essential that the detailed rules are capable of being changed quickly as new situations emerge.

It also needs to be recognised that the proposals carry their own risk. There are short-term operational risks as banks deal with the considerable complexities of restructuring while trying to manage the day-to-day risks of their business. There is also a real risk that the higher costs will result in banks taking much more risk within the ringfence in order to restore their levels of return – not to the levels seen pre-crisis, but simply to regain a sensible margin over the cost of capital. There will also be quite substantial operational risks for the FSA/PRA as a result of the significant challenge of working out the details at a time when the organisation is going through considerable internal upheaval. The proposals are thus not a panacea, and high-calibre supervisors will be needed just as much as at present.

On competition, the second of the Commission’s tasks, there is much less substance in the report. While there are some sensible suggestions (such as the redirection service for switching current accounts), it is unlikely that the proposals will have a significant effect on the nature of competition in retail banking.

In conclusion, the Vickers report should be seen as one part of a jigsaw of banking market reform, rather than a solution in its own right. Taken alongside the new liquidity regime and other aspects of Basel III, the introduction of the special resolution regime and more robust funding of the Financial Services Compensation Scheme, it will help create a world that is easier for regulators to deal with in future. Bank crises will still occur, and great care needs to be taken in translating the proposals into detailed regulation to avoid unintended consequences. Modification is likely to be needed, particularly around the “bail-in” proposals, but a workable structure has been articulated. The government should move on to designing the implementation.
The Vickers Commission's recommendations are aimed at controlling the risks said to be inherent in universal banking. The idea is to make banking safer, and the report goes to great lengths to combine this with preserving as much of the universal bank model as possible. The Commission's analysis is deep, well-informed and impressive. So it deserves the closest attention.

Given the mess the financial sector is in, the ferocious, continuous and almost unanimous attack on bankers is not surprising. All bankers are unpopular; but investment bankers have become the prime scapegoat.

It is not their fault that the eurozone is in trouble; this is the direct result of blunders in the construction and management of the eurosystem. But the wider troubles of the financial system are blamed on the concept of universal banking.

A well-run universal bank can, however, be perfectly safe. It provides services which customers demand. The model has worked for years quite satisfactorily on the Continent (catastrophes in Switzerland excepted), and in the years which led to the abolition of Glass-Steagall it was obvious that universal banking services were badly needed by corporate customers. US banks went to great lengths to circumvent the prohibitions, without causing harm.

Nowadays, with data processing, securities can be distributed to investors by banks with full information and in a transparent and open way; and the process can be policed by regulators. So the practices which some banks engaged in to circumvent Glass-Steagall could not operate today.

Therefore it is worth analysing briefly what went wrong, so as to identify whether the defects which allowed this disaster can be remedied without such drastic surgery as is recommended by Vickers.

It is a sorry story. It started with the housing boom in the US, which became a bubble. This was caused not by a bankers' ramp, but by Federal Reserve monetary policy and US government social policy, making mortgages readily available, often to doubtful borrowers, and much too cheap. This led directly to banks lending heavily to this sector, too heavily in fact, and, naturally, they started seeking ways to reduce the risk they had unwisely taken on. This gave birth to the process of securitising mortgages, bundling them up and selling them to investors as collateralised debt obligations. In turn, the search for ways to increase the quality of the securities being sold, in order to make them better investments and hence easier to sell, led to the slicing of CDOs into layers of declining quality, so that the top slice could gain triple A ratings from the rating agencies. This slicing up of mortgage debt was highly attractive to purchasers, including banks, because the top quality AAA tranches attracted very low capital requirements under the Basel rules.

In fact, of course, as is now obvious, even the top slice was often not high quality at all, because of the difficulties of enforcement when borrowers started defaulting in droves. The result was a mess of monumental proportions. But it was not just the bankers who made it so. They may be primary culprits; but also to blame were the regulators who governed levels of capital requirements, the rating agencies which misjudged the difficulties of enforcement and the quality of CDO security, the accounting profession which failed to see the flaws, and the US central bank which failed to see the gigantic bubble, something which invariably leads to dangerous banking.

Of course some universal banks did engage in dangerous and bad, not just unwise, banking. Moreover, over these
years of easy money, investment banks developed the habit of trading securities unconnected to customer needs. This ‘proprietary trading’ is something a well-run bank should never do, for it obviously involves taking on unnecessary risk. It was this activity, which extended far beyond securities related to collateralised mortgage debt, which has attracted the pejorative label ‘casino banking’. Prudent management avoids such trading and the Volcker rule will eventually prohibit it everywhere. Trading to hedge risks taken on to satisfy customer needs is, however, something quite different.

In trying to work out how to prevent it all from happening again, one has to confront a difficult fundamental point. It is up to government to ensure that the financial system, vital to any economy, does not break down. This is particularly important in the UK, where the financial sector is very large in proportion to the economy as a whole. This leads to the ‘Too Big To Fail’ proposition. It goes much further than making liquidity available to a solvent bank, something which a central bank always has to be ready to do. The ‘Too Big To Fail’ principle applies even where a systemically important bank becomes insolvent. To this has to be added the political imperative of ensuring that (small) retail depositors do not suffer when a bank fails, a consideration which makes a substantial problem even bigger. The UK government felt obliged to rescue Northern Rock and HBOS even though they were not systemically important. The resulting burden on the taxpayer, who has to underwrite this risk of saving failing banks, must certainly be minimised. Everyone can agree with that.

Hence the quest to make banking safe. The trouble is that there is never going to be a perfect answer to this, because even the simplest form of banking, pure retail for example, involves risk. Deposits have to be lent out to earn a return to make the business viable, and some loans will inevitably go wrong. This is where the skill of bank management comes in; for a prudent manager knows how to assess risk, and on the whole, makes enough surplus to take care of what should be only an occasional loss.

The trouble comes when you replace prudence based on sound commercial judgment, backed by the self-interest of sensible owners, with regulation. As this happens, bank managers, particularly when they are employees rather than proprietors (as they almost all are today), take the regulations rather than prudent commercial judgement as the touchstone. Quality goes down and risk goes up.

Herein lies a difficult dilemma. There is no chance of big banks reverting to being managed by their proprietors. So, against the ‘Too Big To Fail’ background, some other way needs to be found of eliminating, or at least suppressing, moral hazard and encouraging and incentivising prudence.

Vickers makes a serious attempt to do this. Each part of the banking group, to be divided by a ringfence into ‘retail and commercial’ on the one hand and investment banking on the other, can fail – and if it does, a resolution procedure comes into play, designed to insulate the taxpayer from loss and the financial system from damage by contagious loss of confidence. This risk of failure goes some considerable way to answer the moral hazard issue. For it makes managers aware that they can lose their jobs and reputations. Moreover, the requirement for ‘bail-in’, or loss absorbing, capital should in theory go much further in order to create a commercial reward for prudence. For a bank known to be well run will have to pay less for this capital. Whether this is a sufficient incentive to induce constant prudence is, however, questionable.

The Vickers recommendations have disadvantages. They call for substantial increases in capital, something which is expensive and which will inevitably dampen the flow of finance to the economy. Apart from the cost of extra capital, the ringfenced structure will be complex and expensive to run. It will increase the operating costs of banks and reduce the return on capital invested in banks. It may be difficult for banks to attract the extra capital required on reasonable terms. A consequence of making banks hold more capital is that bank intermediation becomes more expensive, and this in turn means that quasi-banking operations will develop outside the regulated banking sector, which could itself carry dangers.

The new regulations and capital requirements may also make London less attractive than it is now, if other financial centres do not follow the Vickers lead. The chances of Frankfurt and Paris winning banking business may improve. This could be a serious drawback, bearing in mind the employment and tax revenue which the UK derives from the financial sector. On the other hand, if the ringfencing and resolution ideas, with all their innumerable complexities, are adopted and made to work smoothly, London may be seen as still the best and safest place to do business. Universal banking services, however, are bound to suffer, as cost and inefficiencies take their toll.

There should be a more direct and economically effective way of making banking appropriately safe.

The regulations could stipulate that if a bank gets into trouble - by which is meant if it has to go to the Bank of England for help - and the Bank of England judges that the trouble is more than a temporary liquidity shortage, the Bank can impose a resolution procedure under which the board of the bank in question and its management is immediately replaced.
(as per Vickers), but in addition that all creditors, including depositors, would lose 10 per cent of their money. They would only recover this in so far as there was a surplus on winding up or disposal. This risk of loss would make depositors more careful where they put their money. Banks with a reputation for prudence would then need to pay less for their deposits than riskier operations. Their profit margin would improve. Rating agencies and commentators would inform the public which banks were considered safe. Well-managed banks, having to pay less for their deposits, would thus have a strong incentive to continue with safe and prudently-run operations. It would be a step back towards something much more like management by proprietors. People who own banks do not make bets with customers’ money – or, indeed, their own capital. Hired managers would begin to behave in the same way.

However, to achieve this requires politicians to step back from the all-embracing implied guarantee of insured retail deposits. I would add an extra dimension to the supervision of banks. The regulator should implant personnel in banks, on a continuous basis, so that the regulator can know all the time what is going on and can assess what risks each bank is undertaking. Equally, if that happened, the bank would know the regulator was looking over its shoulder - something which nearly always improves behaviour. This procedure is already in place in some jurisdictions.

The Vickers Commission also addresses the quite different issue of competition and how to attract more of it so as to increase efficiency and reduce costs to the customer. I do not deal with that part of the report here except to observe that, while it is in principle good to attract more competition, new competitors, searching for enough business to make early returns, do not always remember that the customer and the obligations to the customer always come first. New banks do sometimes involve increased operational risk.
John Kay

Worries about the long-term influence of lobbyists on implementation of the Vickers reforms

If you think, as many people still do, that the core activity of banks is gathering savings to oil the wheels of industry, then you are sadly out of date. Large businesses, overall, generate internally more than enough cash to cover their investment needs. Small and medium size businesses badly need access to bank finance. They have been woefully short of it since the credit crunch. But the amounts they need are very small relative to the current scale of financial activity.

The assets – and liabilities – of British banks exceed £6 trillion, four times the country’s national income. Lending to UK businesses – to manufacturers and retailers, construction companies and road hauliers, accountants and farmers – accounts for about £200bn of that, around 3 per cent of the total.

Banks contribute to the real economy in other ways. They make consumer loans. They finance property development and investment. They lend more than £1 trillion in residential mortgages. But most of the assets and liabilities of UK banks, which make up the £6 trillion total, represent financial institutions trading with each other. What purpose such trading serves, and why taking in each other’s washing seems to generate so much profit for the businesses that engage in it, is an intriguing question – for another time.

From the 1980s onwards, banks expanded their balance sheets to a size that dwarfed their core activities of deposit-taking and lending for productive investment. Initially, this explosion of intra-market activity had little impact on the core business of banking, because trade between financial institutions was assumed to be conducted in liquid markets, and was more or less free of credit risk.

In 2007-08, we discovered that the assumptions of assured liquidity and security were false. Governments – Britain in the lead – were forced to bail out the banking system as a whole to avert a credible threat that its collapse would bring the global economy to a halt. The capital and liquidity which the British government provided to keep the banking system afloat was more – far more – than was needed to finance the whole of bank lending to non-financial businesses.

Even though politicians were motivated by the needs of the real economy, the priority of the banks which had built these balance sheets was to resume business as usual. But the conglomerate banking structure that had emerged by 2007 can be viable only with far greater capital than banks traditionally held – or are likely to be able to raise. Investors will not subscribe new equity for banks on anything like the scale required, and banks claim that equity capital is very costly to them. This is not surprising since the experience of the past decade has been that shareholders in banks lost most of their money, while the individuals who ran these banks became very rich. The outcome is that companies in the real economy – those factories, shops and service businesses – find that capital to support their activities is scarce, and the banks that service them have been enabled to raise lending margins sharply in order to increase their own capital through retained earnings.

Only if traditional retail banking is ringfenced can taxpayer guarantees be limited to personal and business depositors, and government funding of the banking system be directed to the needs of the businesses that create jobs and growth. That is the irrefutable case for the Vickers Commission’s recommendations. We need to get back to banking as usual: not banking as it was in 2007, but banking focussed on the needs of depositors for a safe haven for their cash and on the

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Worries about the long-term influence of lobbyists on implementation of the Vickers reforms

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needs of business for the funding of productive investment. The justification offered by the ICB for preferring ringfencing to complete separation are feeble – that shareholders face less risk as a result of diversification by banks and that customers of retail banks will be better served if their banks can offer them derivative products as principal rather than as agent. Still, most of the benefits of separation can be achieved through ringfencing.

The principal argument the banks have raised against ringfencing is that the cost of capital to investment banking would be higher if retail deposits and the associated taxpayer guarantee could not be used as collateral for its borrowings. That argument is correct – but more compelling to investment bankers than to depositors or taxpayers. The jobs and growth the bankers claim will be in jeopardy are their own. Still, the departure of Mr Grübel from UBS as a result of activities far outside the scope of his direct knowledge suggests that the present structure may, in the long run, also be inimical to secure employment in the financial services sector.

The revelations of large losses at the Swiss bank could not have been better timed to reinforce the case for ringfencing retail banking. Mr Adoboli’s unsuccessful activities apparently involved implementation of arbitrage strategies to replicate the liabilities of synthetic ETFs. Whatever the profitability of these transactions, they should not be underwritten by UBS depositors or Swiss taxpayers.

Effective ringfencing depends on effective implementation of its detail. The exposure of retail banks to other financial institutions must be severely constrained; derivative transactions must be limited to those necessary for everyday banking. Retail banks can no longer be allowed to present their treasury operations as profit centres (which have shown a distressing tendency to become loss centres). The boards of retail banks must be sufficiently independent to support a culture very different from the one in which Mr Adoboli operated.

The proposals of the Commission would allow up to eight years for implementation. This is too long. Not just for the obvious reason that eight years is a long time to wait. A graver concern is that reform phased in over an extended period will never be effectively implemented at all.

The ICB has finished its work, and will now be dissolved. As evidence and argument have been developed, informed public opinion has become more and more supportive of its proposals. The members and staff of the Commission will now turn to other activities, and commentary will focus on other issues. But lobbyists never go away. Public opinion, well briefed and properly marshalled, is a decisive force in public policy. But since there are many issues in public debate, attention to any one is necessarily transient. The attention of vested interests to their own particular concerns, however, is permanent.

On the same day that the banking report was published, the European Union’s Council of Ministers approved a proposal to extend the term of copyright in sound recordings from 50 to 70 years. The cost of such an extension to the public far exceeds any benefit.

The proposal had been beaten off several times by a small group of disinterested people – mainly academics. But they are under-resourced, and have other things to do. The lobbyists, in contrast, are over-resourced and have nothing else to do. Wherever the proposal is rejected, its advocates revive it in another forum at another time. Eventually they get their way. The lobbyists never go away.

Nor in British banking. An earlier independent review of the banking industry – commissioned a decade ago – concluded that the operation of the payments system restricted competition in banking (the Vickers Commission identified the same problem, although it proposed to solve it in a different way). The recommendation of the Cruickshank report, which the government also accepted, was that a payments regulator be established to limit prices and encourage access.

Then the lobbying began. The eventual outcome was the establishment, seven years later, of the Payments Council: not an independent regulator, but a membership organisation controlled by the banks, which appoint 11 of the 15 directors. A recent report of Parliament’s all-party Treasury Committee concluded that “consumers are entitled to be suspicious of the motives of such a body” and went on to observe that “the Payments Council is an industry-dominated body with no effective public accountability”. Only the interest groups could disagree.

The Vickers Report raises issues even more fundamental than the Cruickshank Report. Its recommendations must not suffer the same fate.
Anyone who thinks the ICB’s recommendations are not radical has clearly not read the report properly or fully thought it through. Its recommendations will involve very considerable changes, in addition to the many that are already being made as a result of the 2008 crisis. It has become fashionable to portray the banking industry as not having changed, and this is particularly prevalent among those who have an axe to grind or idea they want to promote.

The fact is that massive changes have been made since 2008 and, not surprisingly, the UK is leading most – if not all – countries in implementing the spirit of what was decided at the G20 meeting in London in 2009.

These changes include:

- huge increases in capital requirements for UK banks;
- the implementation of a liquidity regime;
- reduction in leverage;
- much more protection for depositors;
- a total overhaul of corporate governance;
- the regulation of remuneration; and
- the creation of recovery and resolution plans (sometimes called ‘living wills’).

Not only does this mean that banks and the system as a whole are now much more stable, but also that if a bank – no matter what its size - gets into difficulties in future it can be allowed to fail with depositors protected, the supply of finance maintained and without the taxpayer getting involved. The fact that none of these changes sounds very sexy does not diminish their effect.

The discussion on banking remains very emotional, which is understandable given the very dramatic nature of the global financial crisis. Politicians took particular (and different) views on the causes and the solutions - and, in part, the ICB was a response both to these political differences and to the imperative to be seen to “do something”.

As far as next steps are concerned, policymakers should bear in mind that:

- most banks survived the crisis without needing a bail out from the taxpayer;
- when the failures happened, they did so regardless of the size or type of bank – in other words regardless of whether the bank undertook only a few activities or was a so-called universal bank, carrying out both wholesale operations and high street banking;
- the big majority of banks failures either in the UK or elsewhere resulted from inappropriate retail and commercial lending, and not the wholesale/investment banking side of things; and
- failures took place in many countries regardless of the regulatory structure of that country.

The main recommendations of the ICB are the introduction of the ringfence, and capital increases over and above internationally-agreed levels. It is essential that policy makers look at the impacts and the consequences of these main proposals.
The introduction of a ringfence between retail banking and investment banking brings with it a requirement for a separate legal entity for retail banking activities. The ringfenced bank will need to meet regulatory requirements for capital, liquidity, funding and large exposures on a standalone basis, and must have an arm’s length relationship with the wider group. The ICB allows for some flexibility for banks to choose how much of their corporate banking business they put inside the ringfence, but not for banks to allow funding to pass through it.

The retail ringfence therefore comes at a cost of increased organisational complexity, loss of benefits of diversification and arguably may well work against financial stability as it will reinforce the pro-cyclical nature of retail and small business lending. It cuts across the measures already in hand to address the problems, specifically the changes I mentioned above. So, we now have several proposals, all directed at the same end result and tripping over each other.

What about customers? From their perspective it remains to be seen whether the ICB is right in its belief that a ringfenced bank will still be able to make available a full range of financial services. Clearly, as only some services can be undertaken within the retail ringfence and all activities need to be undertaken at arm’s length between the retail ringfence and the rest of the bank, this will mean that a customer requiring services from both sides is going to have to go through a number of agreements. The agency arrangements to allow this to take place are both complicated and pricey.

There are two potential reactions to the ICB proposal from other countries. The first is that they could decide to follow suit, with the result that there will be trapped capital and pools of liquidity across a number of jurisdictions. In good times, this will reduce lending capacity; in bad times it could reduce the ability of banking groups to respond to financial difficulty. The second option is that other countries do not follow suit and that banking services are passported into the UK in “branch form” – so offering better priced finance than can be offered in the UK by a ringfenced bank.

This is not just a bank view – the ICB accepts there are costs involved and that ringfenced banks may have to offset part of the increase in costs associated with this restructuring by charging high prices to borrowers. It has said that if this is of concern, customers should simply be able to go elsewhere for their finance. These two statements are evidently dismissive of the potential competitive effect on the retail ringfenced banking groups and the potential consequences for their customers, whether retail or corporate. As a country, and as the borrowers and the lenders in this country, we may want to accept these consequences of the ringfence, but at least let’s discuss it now and be open and honest about the fact that it is going to cost us more to go down this route.

On the recommendation to introduce capital increases over and above internationally agreed levels, the ICB requires all UK-headquartered banks and all ringfenced banks to put in place both the current Basel III leverage ratio of 3 per cent and then to increase it to a little over 4 per cent for larger banks. On top of this is a new class of “bail-in bonds”, and other capital requirements are proposed, taking the total up to at least 17 per cent of risk-weighted assets. The ICB may well have good stability reasons for proposing this, but has anyone asked the investors? There is evidently an urgent need for this views from a wide range of investors.

So where do we go from here? First, much better analysis of the ICB’s proposals needs to be undertaken. There is some quantification within them, placing the direct cost of the proposals on investors, banks and customers at £4bn-£7bn. Sadly, there is little analysis of the impact on the real economy of the additional capital requirements. This is a vital part of the equation and must be addressed urgently.

Next, it needs to be fully appreciated that the organisational, legal and administrative task in bringing about the ringfence will be substantial – and equally substantial will be how to tailor it with the other requirements on the industry. What it is going to mean for customers and investors must be fully assessed too. It is too easy to dismiss the views of those who call for careful, clear analytics and who caution that big picture high-level ideas are not necessarily the right answer.

Some have said that 2019 – the implementation date for the additional capital proposals – is too far away. But the real question is whether eight years is long enough, recognising that banks need time to build up their capital if further demands upon them are to be met by means other than selling off more assets and/or restricting lending.

The stakes in terms of getting these recommendations right are clearly very high, not only for the UK banking industry but also for the UK economy. The world will be watching this experiment very carefully indeed. The biggest task therefore has to be to work through the potential consequences of the recommendations carefully, clearly and honestly. We must be brave enough to disregard things that have been
addressed by other means, and to act on the analysis and not on assumptions.

It is easy to cheer the ICB, but before this happens we all have to be fully confident about a few things. First, that what we are doing is protecting against a future financial crisis and not just simply reacting to recent events. Second, that what we are doing is beneficial for economic recovery and does not have the unintended consequence of slowing it down even further. Third, that the package of actions is ultimately implemented in a way that we do not come to regret in future decades.

In the midst of all this, let’s not forget that the real issue for today, tomorrow, next week, next month and next year is not regulation but economic recovery, growth and jobs.
Michael Mainelli

Urges the City to take the lead – write its own ‘London Directive’ on financial services regulation

Michael Mainelli is executive chairman of Z/Yen, a London-based consultancy which (among other things) publishes the Global Financial Centres Index. He is also emeritus professor of Commerce at Gresham College. He is a graduate of Harvard, Trinity College, Dublin and the LSE, plays the bagpipes and sails one of the last racing barges on the Thames. His latest book (with Ian Harris) is The Price of Fish.

A couple of years ago, I went on tour with my family – you can go on tour with your family? – and in honour of our father, the emblazoned motto on shirts and towels was “prickly don’t mean ornery”. Well, actually it mostly does, which gets you all riled up again. If there is any depth to the tour motto it is that bad temper alone won’t achieve much; you need to be stubborn as well.

We are four years into a series of financial crises -dramatically marked by Bear Stearns and liquidity shocks in 2007, followed by Lehman and RBS failures, Irish and Icelandic collapses, and eurozone earthquakes. Yet there have been no financial reform markers to match the scale of problems. I can be prickly. In 2009, Bob Giffords and I wrote a CSFI booklet - “The Road to Long Finance: A Systems View of the Credit Scrunch” - in which we argued that people should recognise that leverage and regulation lead to more risk rather than less, and that banking competition should be at the centre of debate. I wanted reform, some reform, any reform at all. At the 2011 CISI Annual Conference, the Institute’s chairman, Alan Yarrow, said we are living in a “cloud of risk aversion and mediocrity”. When we look back on the first four years of responses to the financial crises, I think we’d all agree it’s been a cloud of risk commissions and mediocrity. Scarily (and something I contrasted publicly to uproarious objection in 2008) the financial crisis of 1929 didn’t result in genuine reform starting till 1933, four years later.

I still support the ICB’s recommendations; any reform in a storm. But the outlook for genuine reform is bleak. The ICB shines a chink of light through the wall of the status quo. Reform might be possible. And we’ll certainly have a lot of time to think and discuss what kind of reform we might want. The Long Finance initiative continues to ask, “when would we know our financial system is working?” We return time and again to two big themes - a need to link economics with communities and the nature of money. We discuss reforms ranging from reinventing money to utility banking to confidence accounting to pensions indemnity assurance.

All commissions contend with the battle between the ‘right’ answer and the status quo. The ICB is no exception. In my opinion, the status quo has won the battle in three ways. First, and most often raised, it isn’t yet reform, and certainly not urgent reform. Odd that implementation is five to eight years away from crises only four years behind us. Second, the ICB shied away from virtually all reform risk, encouraging hundreds of new banks or mutuals again, portable account competition, utility banking, zero leverage banking. No risk, no reward. Third, the status quo has a few years yet to find ways to entrench the current state of affairs. Rather conveniently for the UK status quo, the press shouts “sovereign debt” or euro crisis, not “yet another banking crisis” - letting off additional pressure for genuine bank reform.

Sadly though, I think London may be the big loser. Our firm runs the Global Financial Centres Index and we have tens of thousands of opinions on 100 centres. More and more people opine that financial sector regulation in London is really regulation from Brussels - but that the corridor from London to Brussels is blocked, by Londoners. Surely we can’t fail to have noticed the scale of financial crises surrounding banks? As the leaders in European(and global) finance, can’t we just say sorry? Whenever Brussels suggests reform, we say “no”. Our trade associations and our leaders just say “no”. Yes, Brussels has had daft ideas on offshore centres or hedge funds; but, as leaders, we should teach and lead them - not just say “no”.
When other European industries have a crisis, they don’t just “get engaged earlier with Brussels” (a London mantra for the past few decades); they initiate and lead. The Germans would write their own EU directive after a manufacturing crisis, the French their own after an agricultural crisis. A London Directive would have each of the various financial services - banks, auditors, rating agencies, exchanges, clearing houses, and even insurers - propose one genuine EU reform they would support to make financial services better or more robust. Banks on separation, competition or leverage; auditors on indemnification; rating agencies on Basel; exchanges on high frequency trading; clearing houses on OTC.

I’d like the leaders of London - led by the City of London or the Mayor or any of the expensively-funded promotional or trade bodies – to get financial services firms round a table to draw up a London Directive. Just developing that would be a “mea culpa”; admitting you need reform is the first step. Something, anything to show we can lead. Yes I’m stubborn, and proud of it.
The recommendations of the Vickers Commission represent a significant strategic challenge for both government and the banking industry, and they will have far-reaching implications for the whole of the financial services sector – not just in the UK, but throughout Europe and arguably further afield. The reverberations in both second-order effects and unintended consequences will have a long half-life. Regulators the world over will be scouring the report for clues about how to improve financial stability, facilitate bank resolution, and reduce the strategic risks of bank balance sheets to national economies.

However, beneath the umbrella of this strategic debate, the Commission’s recommendations will also have immediate and broad-ranging implications for the structures, operations, cost bases and value chains of the banks. There is still much detailed work to be done, which will probably have a fundamental impact on the future shape of banking.

In summary, the Commission’s key recommendations are:

- A robust, yet flexible ringfence should be put in place between UK retail banking operations and investment banking activities.

- UK retail banks should have equity capital of at least 10 per cent of their risk-weighted assets, with a consequent reduction in permitted levels of leverage.

- Large UK banking groups should have primary loss-absorbing capacity of at least 17-20 per cent, which includes unsecured bank debt and contingent convertible bonds that could be triggered to absorb losses.

- Banks will be able to decide whether or not to include big corporate deposits and loans in the ringfence.

- Greater transparency and competition within the banking sector.

- Seamless redirection of individual and small business corporate bank accounts within seven days.

- Annual interest foregone disclosures should be issued to customers.

The Commission’s recommendations will fundamentally alter the business models of UK banks. By recommending that the ringfenced bank be a legally, operationally and economically stand-alone entity, the restructuring exercise is likely to make the existing costs of providing products and services across different entities and geographies more visible. The tougher retail bank and group-level capital requirements will drive a review of the viability of existing services and models. The flexibility in the activities to be included means that what is carved in or out of the ringfence will now be a much more strategic decision. It effectively creates a “bank within a bank” and will require each organization to consider the needs of its particular client and geographical location – creating new value chains and competitive differentiators, new product and service packages, and associated channel and pricing structures.

The ringfenced bank could include all payment services, together with many other corporate banking services for clients regardless of size. The positioning of payment services and its impact on corporate relationships will be important. As cost structures become more visible and as the Financial Conduct Authority demands greater transparency across the industry, the “free” banking model may also come under pressure.
Only once the organisation is clear about where future profits are likely to come from – and where margins will be made – should the new operating model be designed.

A key determinant for banks, in relation to the composition of their ringfenced entity, will be the current relative size of retail and small business liabilities (ie deposits), compared to assets for the same customer groups. There will be significant accounting and tax implications as well as governance, process, people, technology and data issues to be resolved — all at a time when the banks are already undertaking significant work to reduce costs and improve efficiencies. This is why strategic thought needs to be given now to the future business model, so that the portfolio of programmers across each group can be realigned to the future vision of each company. The banks will be pushed to think through the resolvability issues within the next year as part of their resolution planning. The FSA and other key stakeholders (e.g., the Bank of England and investor community) will want to see the future structures as soon as possible, as well as gain an understanding of the route map to achieving the changes, together with the associated costs and risks. The migration and transfer of assets and liabilities is an extremely complex process affected by a variety of factors such as funding, tax and Part VII transfers (ie of business assets and liabilities from one legal entity to another). The legislation (due in 2015) ideally will find ways to streamline the process and remove some of the obstacles that currently exist.

There are a number of issues that must be resolved:

- Most Financial Services Compensation Scheme-insured deposits, more than 95 per cent, will be housed within the ringfenced entity, but there is flexibility on where lending to large companies sits.

- The ringfenced bank must have its own governance engagements, and must ensure that internal service-level agreements with the rest of the group are similar to those for third parties.

- In designing the future legal entity and associated operating model, both compliance with Vickers and overall resolvability should be factored into the solution.

- The new capital requirements will create extra funding costs for the non-ringfenced entity, and will be a critical factor for decisions on where group headquarters should be located.

- The provision of key services to the ringfenced bank (shared infrastructure, for example) may reside within a separate entity. However, it is likely that any such entity will itself require protected working capital to support the provision of services during a financial crisis or resolution event.

- Existing group-wide service contracts and associated transfer pricing are likely to be affected. It will be necessary to balance liquidity, funding and tax against the financial stability objectives of simplicity and separability.

- Some firms may need to consider the implications for existing European branch networks in light of the changes to their UK structure, and many may be affected by a revised external ratings assessment.

Our work to date in these areas suggests that the optimum approach is a well-considered, top-down design of the future business model, together with some bottom-up simplification of less significant legal structures.

The principle that prohibited services would include “any service which results in an exposure to a non-ringfenced bank or a non-bank financial organisation, except those associated with the provision of payments services where the regulator has deemed this appropriate” will have important implications for the rest of the financial services sector. Non-bank organisations within financial services will also need to reflect the principles outlined within the report.

It is already evident that UK banks and others are commencing a fundamental review of their business strategies, their operational models, and the impact that their actions (and those of competitors) will have on the shape of the future marketplace. Should the UK implement the Commission’s recommendations in full, it will be one of the boldest regulatory steps taken in Europe, and is likely to be closely studied – and possibly emulated by other national regulators.
Ian Plenderleith

Argues that it is hard to see a less bad way of reining in moral hazard

Ian Plenderleith worked at the Bank of England from 1965 to 2002, where he was executive director responsible for market operations and a member of the Monetary Policy Committee. From 2002 to 2005, he was deputy governor of the South African Reserve Bank and a member of its Monetary Policy Committee. Since his retirement in 2006, he has become Chairman of BH Macro, a listed investment fund in the Brevan Howard hedge fund group. He also holds directorships at BMCE Bank International, Europe Arab Bank in London and Sanlam in South Africa.

Extreme crises typically require governments to take extreme measures – rightly so. But extreme measures can produce unwanted side-effects. The financial crisis of 2007-08 required governments to provide large-scale support for commercial banks – rightly so. But one of the many unwanted side-effects has been the demonstration in fact that in extremis governments have no option but to support banks, in order to protect depositors and limit damage to the wider economy. Moral hazard was made manifest, in spades.

As the storm passes, a way has to be found to rein back moral hazard. It is plainly intolerable, in a market economy, to have banks regarded as “Too Big To Fail”, able to undercut competitors and earn profits for their shareholders on the basis of an implicit underwriting of their business provided free of charge by taxpayers. As the Commission’s report puts it, crisply and correctly: “The risks associated with banking have to lie somewhere, and it should not be with taxpayers.”

Devising ways to cure this market distortion is the main task tackled by Vickers. The report is thorough, unflinching and relentlessly coherent in its analysis; it is also far-reaching, but ultimately moderate and pragmatic, in its conclusions. However reluctant one may be to accept the need for structural upheaval on the scale it proposes, it is hard to see any less bad way to address the problem of banks that are Too Big To Fail.

In principle, there is a spectrum of possible ways to address the problem.

At one extreme, one could contemplate a world in which moral hazard was an accepted, if only implicit, feature of the system. Within a perimeter of regulation, designed to limit excessive risk-taking and provide basic consumer protection, banks would be free to compete and innovate in whatever areas of business they wished, inventing new products and services and experimenting with idiosyncratic business models. It would be recognised that from time to time banks would fail and that, if the systemic shocks from such failures were severe enough, public funds might be needed to re-stabilise the system. The cost to taxpayers of such support, required perhaps every 20 years, could be regarded as the price to be paid for having an innovative and competitive banking system, with the benefits that ought to bring to the growth capacity of the wider economy. If the periodic cost to the taxpayer was regarded as unfair, banks could be charged an annual tax, as an insurance premium for the implicit underwriting they enjoyed by public funds.

It is doubtful that this extreme laissez-faire approach could win any degree of public acceptance in the present mood of hostile dissatisfaction with the financial services industry. But even if it were feasible in terms of public opinion, the Vickers report demolishes the case by demonstrating the huge cost of a financial crisis: Its analysis suggests that systemic crises, occurring even only at extended intervals, could cost the equivalent of 3 per cent of national output every year (which is more than the annual growth capacity of the UK economy as a whole).

At the other extreme, critics have argued for a complete separation of retail banking from wholesale and investment banking – a “narrow banking” regime more extreme even than Glass-Steagall. As the Vickers report demonstrates, the idea of the UK unilaterally taking this extreme approach, in a world in which there is free movement of financial flows, is highly implausible – and the costs to the UK’s financial services industry would be very high.
So what the Vickers Commission appears to have produced is a middle road that avoids many of the unnecessary costs of complete separation, but does not flinch from the minimum reform needed to give us a chance of reining back moral hazard. The upheaval will be immense and sizeable costs will undoubtedly be incurred. But it is hard to see a less bad way of achieving the necessary end.

There are, of course, all sorts of ways in which the Vickers proposals could fail to work, or could themselves generate unwanted side-effects:

- For the UK on its own to implement such fundamental structural changes could seriously damage the competitiveness of UK financial services, though the Commission rightly argues that the end-state may give the UK competitive advantages.

- The costs could be larger than the Commission estimates – both the costs of change and the steady-state costs of providing banking services in the new ringfenced world. Ringfenced banks may find that the cost of providing banking services from within the ringfence makes some areas of customer service uneconomic – though part of this cost will be the withdrawal of the implicit taxpayer subsidy, which may be a cost to the banks and their customers and shareholders, but not to the economy as a whole.

- More fundamentally, it is hard to assess whether it really will be possible to allow the investment banking arm of a banking group to collapse, even in an orderly wind-down, without affecting confidence in the group’s ringfenced retail subsidiary.

- At a practical level, it may be hard for regulators to prevent ringfenced banks’ so-called ancillary services, for example permitted operations in the wholesale markets designed to manage a bank’s customer-related exposures, from creeping into market-related customer services that are not permitted within the ringfence.

But issues like these serve only to illustrate that there is no simple antidote to moral hazard. It was necessary and right in the crisis to allow that Pandora’s box to spring open, but that does not make it any easier to force it closed again now. The medicine offered by the Vickers Commission may be bitter to the taste, but the alternatives all look worse – and the consequences of not taking any medicine would be intolerable.
I had the honour of being quoted in the late David Atterton’s collection of memorable sayings for suggesting that “the clearing banks are the last smokestack industry in the UK”. That was in 1996. The clearers have hung on in there pretty well for the past 15 years, thanks mainly to excess profits from their “investment banking” activities subsidising their insipid commercial banking business.

This protected them from adjusting to a new world and enabled them to avoid dealing with their four fundamental problems, namely:

- an unnecessary and costly bricks and mortar network in an increasingly online world;
- legacy systems, made worse by acquisitions, which have rendered them incapable of modernising;
- legacy problems in their loan portfolios, which were exacerbated in 2007-08 by the banking crisis and which (courtesy of accounting practices) may not have been fully accounted for; and
- an over-reliance on “bought money” from the inter-bank market.

All this happened against a background of weaker boards caving in to management’s desire for compensation against the interests of shareholders. Meanwhile, regulators lost sight of the need for capital security and for prudence to be exercised by boards and management (partly, to be fair, because the people who did understand this, at the Bank of England, had been replaced by a non-market participant at the FSA). Ironically, this was all done by a chancellor who called himself “prudent”, probably the biggest political con trick in our lifetime. The accountants gaily signed the accounts, and not a single regulator got fired.

So, what effect will the Vickers proposals have? Three main things are likely to happen.

First, banks and their new boards (headhunters are an unexpected winner) will prepare for the implementation of “a UK-style Glass-Steagall Act”, which will cause a substantial change to their investment banking operations. While continuing to lobby against it, the view will rapidly emerge that “we should never have gone there in the first place”. Therefore, they will not bother with ringfencing (and its myriad complications) but will instead sell their investment banking operations. I believe that this is what the ICB really wants, and it is clearly what the Bank of England, the new regulator, wants.

Most important, it is what shareholders will come to want as they realise that they will again be able to hold a slightly dull dividend-paying utility stock. We all need income today. This will be rather uncomfortable for the investment bankers, who will find themselves progressively less well paid as the clearers will not be blackmailed into keeping them. They will probably find it difficult to find finance for MBOs of “their” businesses. This is all very good news for large corporations, which might even see fees go down – or might pluck up courage to demand lower fees. Note the rapid growth of investment banking boutiques and hedge funds. These are non-systemic businesses that are highly competitive, and so will drive fees and commissions down.

Second, the effect on smaller companies is less clear as the banks have lost touch with them since they abolished long-serving branch managers, who knew their town well – both personally and corporately. SME and mid-market lending (financed by sticky retail deposits) was the engine of clearing banks’ profitability. Their foray into investment banking to service their large corporate clients, which started in the...
mid-1980s and which was fuelled by Big Bang, has long since played out as international capital markets became commoditised and big companies got used to “sleeping around for a few basis points”.

My hunch is that the banks will rapidly try to regain the small and mid-cap market. Their first task will be to win back the trust of smaller enterprises, many of which have long since lost confidence in the clearers’ inconsistent policies. There are signs of new banks springing up, which will not have the legacy problems alluded to above. Ironically, regulation, as currently practised, will come to the aid of the clearers as it raises the barriers to entry: ask anyone trying to get a new banking licence.

The third effect of the Vickers report could be a decline in London’s role as a global financial centre. There is an element of this that would, in the long run, be a good thing – if (but this is a huge “if”) the UK can rebalance its economy. It needs to create (and maintain) leadership in other areas, such as the development and application of technology, renewable energy, military peacekeeping, education, science, the law and the cultural industries (London’s second largest sector). And, dare I suggest it, manufacturing - where it already has some pre-eminence. It is worth noting that these sectors create jobs at all levels. Such a laudable long-term policy objective probably does not need Vickers to hasten the decline of London financially. The capital will always enjoy the time-zone advantage presently shared by minor competitors such as Paris and Frankfurt.

The smokestack element of a declining industry, threatened by technology and padded by excess profits in investment banking and weak board leadership, was probably irreversible anyway. What the country needs are new banks, like Metro, Tesco, NBNK and the others waiting in the wings. That is the competition that would shake up the clearers. What the regulators need to understand is that these new banks will be too small to be systemic and thus do not need to be regulated in the same way as the (as yet unbundled) clearers.

The Vickers Commission has made a far-sighted start, and it is further sighted than many commentators and practitioners realise.
C S F I

Vicky Pryce

Worries about the deteriorating macro-economic environment – a very different background than envisaged when the Commission was launched

Vicky Pryce has worked as a senior managing director in FTI’s economic consulting practice, based in the London office, since September 2010. Before this, she was director-general, economics, and chief economic adviser at the Department for Business, Innovation and Skills from 2002 to 2010, and joint head of the UK government Economic Service from 2007 to 2010. Vicky is also a member of Vince Cable’s Business Advisory Group.

The secret of good comedy is timing. Perhaps the same can be said for serious attempts to change the financial system, or indeed any major part of our political economy.

When the master plan for the Vickers review was being drawn up, the timing seemed impeccable: set up the Commission while memories of the financial crisis were still recent and raw, but give it long enough to do a decent job. Its recommendations would be released during 2011, a year of recovery with growth expected to be at or near 3 per cent. It would have a good, strong, balanced set of individuals on the Commission – I remember names bouncing backwards and forwards between the Department for Business and the Treasury when I was working for Vince Cable’s ministry after the May 2010 elections. And, of course, it would have the right terms of reference, again the subject of negotiation between the two departments. Moreover, its recommendations would be implemented during the subsequent economic recovery phase, taking advantage of relatively benign conditions to push through potentially difficult structural change. There was a lot of impatience to get things moving, and to proceed at pace.

It hasn’t quite turned out as planned. The global economy has taken a turn for the worse. Concerns about a sovereign debt crisis in the eurozone have damaged confidence across Europe – and been felt more widely, with even the Obama Administration taking an interest in how eurozone leaders respond. Growth forecasts for 2011 and 2012 are being downgraded. The IMF is now suggesting that UK growth in 2011 might be just 1.1 per cent, with the possibility of less than 2 per cent growth in 2012. There is the prospect of unemployment beginning to rise again.

The result is that uncertainty and nervousness still haunt the global financial system. Some French and German banks are uncomfortably exposed to Greek debt, should there be a chaotic, forced default. This creates the risk of unforeseen, knock-on consequences elsewhere. And it raises an even more difficult question: if a small economy like Greece can trigger this level of anxiety among markets, central bankers and policy makers, what would the risk of default in Spain or Italy do?

So Vickers’s recommendations arrive at a point where policymakers see something of a dilemma. The possibility of another financial crisis reminds them of the need to strengthen the resilience of the banking system and to reduce systemic risk – issues Vickers was asked to address. But the current economic environment will also make them very sensitive to the possibility that proposed reforms will damage competitiveness and reduce UK growth.

The Vickers report thus gets caught up in the more general debate about the UK’s macroeconomic policy stance – and, in particular, the arguments for and against a short-term relaxation of fiscal policy.

The general argument is for another place. However, fiscal stimulus will only have the desired effect on consumption and investment if the banks keep lending, especially to businesses. Anticipated requirements on the banks to hold more capital potentially threaten the pipeline of new credit at a sensitive time. The counter-argument, of course, is that the unexpected fragility of the global economy means the threat of further financial turbulence remains - and thus strengthens the hands of those seeking to reform the system in ways that reduce this risk or increase the ability of the system to mitigate it.

Another aspect of the timing debate is around how and when the UK seeks to strengthen its regulatory regime compared...
to other major and emerging economies. There are constant reminders (as stress tests and so on unfold) that the banks brought us the crisis, and that the lack of proper regulation, excessively low capital requirements and under-taxation of financial services meant our sector was arguably too big. And that something needs to be done to allow for a rebalancing of the economy. The rebound (for a while) after 2008 of profits, salaries and bonuses in the City (and associated sectors) smacks of economic rents all over the place.

But will there be a meaningful reduction in systemic risk to the UK in the absence of change to the global system? And if the UK goes it alone, will it damage the competitiveness of the UK financial services industry? Will more tightly-regulated UK banks lose out to those in Paris, Milan, Frankfurt, Dubai, Shanghai or Singapore?

The Commission’s report acknowledges the risks here. Some wholesale and investment banking activity might be tempted to locate elsewhere because of restrictions on operations in the UK. But it is argued that these risks are outweighed by the additional benefits arising to the UK from a more stable, transparent and resilient regime. Investors – and financial services firms in their wake – will want to locate in the UK because of the regulatory regime.

There is also another argument. By taking a lead, the UK sets down regulatory standards for other countries to emulate, in the process strengthening the position of those [UK-based] firms already operating to, and comfortable with, the tighter regulatory regime. I heard this argument many times when I worked in government – most often to justify why the UK should adopt tougher environmental or safety standards in advance of its competitors. It was (so I was told) why the Danes had cornered the market in manufacturing wind turbines. But I must confess to being a sceptic: there is little robust evidence of the benefits of setting tighter standards.

The ICB report acknowledges the changed economic circumstances, and the consequent rise in stress in bank funding markets. While reaffirming the need to proceed with banking reform, Vickers accepts the need to tread carefully and suggests that the implementation phase could extent to 2019. That will be important, of course. But if there are concerns about UK reform arriving in advance of that elsewhere, then the scale and timetable of the proposals for increasing competition in the retail banking sector raise opposite concerns. They arguably do not go far enough, and the pace may be too leisurely. No further disposals are proposed beyond the existing sale of the 670 branches of Lloyds TSB. This is despite concerns that a divestment of this size is insufficient to create a “strong and effective” challenger bank. A reference to the Competition Commission is mooted, but only if certain conditions are not achieved by 2015, and even then the text is hardly definitive: “A market investigation reference should be actively considered …”

No doubt, this recommendation is meant to provide the banks with an incentive to go along with the report’s recommendations and provide a better deal for customers. But if the Vickers Commission has now decided against more ambitious structural change, what are the odds that the Competition Commission would reach a different decision in five or six years’ time? Perhaps, indeed, there is tacit recognition of the difficulties for new firms being able to enter the market when capital and other requirements are increasing and when access to payment systems may be hard and expensive to achieve.

So, the timing of the report’s arrival and its recommendations raise a range of issues. In the current economic environment, how much of a priority is reform of the banking sector? We might not yet be out of the woods in terms of further financial sector turbulence – but will implementation of the report’s recommendations happen in time to prevent that? Will UK reform that is more stringent than – or in advance of – that elsewhere damage the UK’s financial services industry? Or will the enhanced stability act as a magnet? And will the leisurely and uncertain timetable for further structural reform mean the possibility of meaningful restructuring is lost forever – or is an emphasis on switching costs in the short term the right way to proceed?

One piece of timing may have worked in the banks’ favour. This year’s party conference season suggests that the big energy companies might have replaced the banks in the public and politicians’ minds as Corporate Public Enemy No 1. But this may prove only a temporary respite.
The financial crisis that began in 2007 and picked up speed and force in 2008 was, by common consent, the first truly global financial collapse – global in both the geographical extent of the crisis and in the range of market and institutional connections through which the crisis spread. So is it worthwhile adopting radical measures that apply only to British banks while most other countries are still grappling with existing problems, and when there is as yet no agreed framework for a solution to match the global scope of the problems that have been exposed?

Moreover, it is by no means clear that the crisis is over. New fissures and faults in the financial system cannot be ruled out. The surfacing of the sovereign debt issue some two years after the first problems appeared suggests that our understanding of the connections within the global financial system may still be incomplete. Other examples may be lurking unseen and undiscovered. Why propose changes affecting British banks which may be shown to be premature?

By setting 2019 as a deadline for implementation of its main recommendations, the ICB has shown a commendable sense of what is practicable. But it makes it virtually certain that developments in financial markets and international financial regulations, as well as in market participants’ behaviour, will have overtaken its recommendations before then – or at least raised questions about their suitability.

On the question of timing – interesting, innovative and impressively thorough as it may be – is the report therefore premature? I do not think so. As it says, doing nothing is not an option. Domestically, confidence in Britain’s banks has been severely damaged and is in serious need of reinforcement. Whatever you might think about their behaviour in the past, the banks do need to plan ahead and take time to decide how they should equip themselves to respond to the needs of their customers when the economy recovers. And not all countries are waiting for a global solution. The Dodd-Frank Act, for instance, shows a determination to tackle the weaknesses of the US system, despite paralysis in other areas of policy, with benefits already for its financial system. Getting on with it has practical as well as therapeutic value.

If the case for producing the report now is clear, do its recommendations meet the terms of reference satisfactorily?

The objectives – a more stable and competitive UK banking system – are hardly open to challenge. Achieving greater stability through more strongly capitalised banks, separated broadly into retail-commercial and investment banks, seems a balanced response to a complicated question. But striking a balance implies contesting arguments at best, and a design weakness at worst.

Banking and financial crises will never be abolished; their frequency or amplitude may be reduced, but that should be the limit of our ambitions. The tendency to excesses of irrational optimism and pessimism is part of human DNA and is manifested too obviously and too often in our financial dealings. Greater transparency as the answer is also a snare and delusion. In terms of market information, there has never been more to guide the actions of lenders, borrowers and investors. The problem, as several episodes illustrate, is that it is not always the right kind of information. Only a much greater knowledge of individual and group behaviour is likely to yield answers to the question of exactly why market equilibrium for more than a limited time seems unattainable. This is recognised implicitly in the ICB’s report, which speaks in terms of reducing instability, not removing it.
How successful is the ringfence likely to be in insulating the UK retail banking system from the contagion that is assumed to be a greater risk in the investment banking markets?

The report recognises that there are tricky issues regarding definitions and boundaries which challenge the plausibility of maintaining the ringfence between the two classes of bank, especially when the flexibility in choosing its structure rests with the bank itself. Some of this derives from the attempt to avoid placing UK banking groups at an international competitive disadvantage; but not all of it. It is doubtful that complete separation of retail-commercial and investment banks – whatever that means – would prove to be watertight in practice. Driven by technology, it broke down in the past and must be likely to break down in future. This seems to be one of Donald Rumsfeld's known unknowns.

Furthermore, how the proposed separation would affect certain markets, and with what implications, is not clear. One of the defining features of the past 20 years is the fusion of banking and capital markets; securitisation being perhaps the most evident example. Could the commercial bank in a group originate asset-backed securities which could be marketed and traded by its investment banking sister? As well as its own capital and board of directors, would the commercial bank be allowed to share the name? If so, aren't those the kinds of connection that could spread contagion throughout the group if things went wrong in one part? Would the retail bank be prohibited from funding itself and placing excess funds in the domestic and foreign currency interbank markets? More generally, attempts to reduce the connectedness of the financial system, and therefore its capacity for transmitting shocks, may be possible – but in one country?

The case for strengthening the loss-absorbing capacity of banks on both sides of the ringfence is incontestable; and the proposed levels on the face of it seem about right in terms of the balance between safety and cost. But that cannot be much more than a guess so long as the accounting treatment of bank assets, a fundamental issue in the current crisis, remains in dispute. When there is no effective, functioning market in a financial product, the greater weakness in any mark-to-market method of valuing assets is the uncertainty created, rather than the actual losses registered. It was this that sank Lehman Brothers and necessitated the intervention of the central monetary authorities.

This is not solely a problem for investment banks and capital markets. I can still see the firms of auditors in my office in 1991 and 1992, asking whether I could give them any guidance on how they should value banks’ property portfolios in the absence of any functioning commercial property market. (For the record, I could not and did not.) If banks from many countries had been required to mark their exposures to Latin American countries to the non-existent market in 1982, the first truly global financial crisis would probably have occurred then, and not some 25 years later. Both Bear Stearns and Lehman Brothers raised very substantial amounts of equity in the months before they met their respective fates. The point here is that in the wrong conditions, when assets are of no determinable value, it can be virtually impossible to state with any confidence, in terms of capital, how much is enough. It is a pity that the ICB could not express a view on this fundamental issue for financial stability.

The strengthening of secondary capital proposed is also welcome. This is partial vindication for the German representatives on the original Basel Committee, who were very resistant to any deviation from the highest quality capital in the first Capital Accord (Basel I). Of course an effective market in instruments such as Cocos has not yet been established, and their cost and marketability is unknown; but the ICB sees them as a potentially useful add-on in particular circumstances, not as a primary buffer against loss. International supervisors knew well that most second-tier capital would be useful only in a liquidation; what they did not appreciate was that there could be circumstances in which liquidation of a bank might create a systemic issue, not one confined to individual banks.

There is a degree of uncertainty in the ICB report about the transferability of capital between the investment bank and the commercial bank in a group. It appears that this can take place in one direction only, from the former to the latter in case of difficulty. If such a transfer were publicly known to have taken place, this could destabilise the whole group; better to keep capital within the separated banks. This would, of course, be costly, but it would address another potential source of contagion.

In the negotiations preceding Basel I, the US representatives argued (somewhat half-heartedly) for a leverage cap as an additional requirement. This was not agreed by the other countries taking part, including the UK, and was not pursued. I thought then, and still think, that a risk-weighted capital adequacy requirement was a superior form of gearing restraint, providing the elements of the gearing ratio are right. But as a backstop or flashing light, a leverage cap could add some prudential value.

It is in the report's section dealing with the links between competition and financial stability that the most debatable arguments arise. If I have understood the report's logic correctly,
if you get the framework of regulation right – eliminate lax regulation, remove the “Too Big To Fail” subsidy, and introduce more effective competition in banking – then the perceived conflict between competition and instability will disappear. In fact, healthy competition would contribute to stability. In other words, imprudent risk-taking by banks which leads to systemic problems is ultimately attributable to indulgent supervisors and to bankers who, unconsciously or knowingly, act as if they can pass their mistakes on to the taxpayer.

If only it were so simple. Without knowing all the data for all the UK banks at the time of the collapse, I am fairly sure that most, if not all, of them were at or above their required regulatory capital and liquidity ratios. However, not all failed – and there is no evidence to suggest that those that survived had much higher levels of capital or liquidity than those that had to turn to the government in order to continue in business. The largest banks have long opted to hold capital and liquidity well above the regulatory minimums, partly to ensure a high rating from the agencies, and partly to demonstrate their strength to customers and counterparties, actual and prospective.

This is not to argue that the regulatory regime is not crucial to financial stability, but it has to be appropriate to the situation and part of an environment that supports prudent banking. The regulatory system in the 1990s did not keep up with developments in financial markets and in financial instruments nearly well enough to enable supervisors to rely on their existing tools to know what was going on in their banks. So their ratios were misleading about their vulnerability.

The other crucial elements are monetary policy and corporate governance.

When monetary conditions are such as to create sizeable asset bubbles and negative real rates of interest, borrowers and lenders both have irresistible incentives to convince themselves that the only way is up. That some banks – among them several large enough to be Too Big To Fail – weathered the perfect storm, while engaged in the same activities as those that foundered, surely points to the quality of their boards and their corporate governance generally. Banking is about behaviour as much (if not more) than it is about numbers and models. One sentence in the report that resonated with me was this: “The financial stability of banks depends primarily on the regulatory framework in which they operate and how well they are run.” If the report of the ICB stimulates further work into the direction and management of banks, it will have added importantly to the understanding of why some banks and banking systems seem prone to failure, while others survive.

The proposals for increasing competition in the UK retail banking sector seem reasonable enough. Whether they will succeed in serving customers better, if implemented, remains to be seen. There has been a variety of new entrants in recent years from the retail consumer and electronic sectors, without any noticeable reduction in the number of complaints so far. Perhaps it takes time; or perhaps people are never satisfied. Relaxing the barriers to entry has a fine liberal tone to it – but not, I trust, at the expense of lower prudential standards in the early years. The rule of thumb adopted by the Bank of England – that newcomers should play mostly with their own capital rather than depositors’ funds, at least for the first couple of years – still appears to be right.

Conclusion

The financial crisis caught the world’s central bankers, supervisors and regulators unawares, most obviously in respect of the profound change in the capacity of the financial system to transmit risk across countries, markets and institutions. The report of the ICB attempts to introduce firebreaks in the UK banking system that will reduce the likelihood of a repetition. It also makes specific suggestions for strengthening the traditional prudential tools, which seem sound. The split between retail-commercial banks and investment banks is clever, but it probably understates the difficulties of enforcing and maintaining that split. It also leaves unanswered the question of whether the split can work in one country, particularly one in which the banking system is such an important part of the global system.

However, the alternative of a complete separation is even less persuasive and likely to be much more costly. Improvements – or at least advances – in technology would also risk jumping any barrier designed to insulate the two organisations from one another. The deadline for full implementation of the ICB’s recommendations gives ample time to adjust for unforeseen developments. So it is probably the best that could be done, given its remit.
It seems to me that separating capital markets activities from more traditional banking, as suggested by the Vickers Commission, makes sense. There are a number of reasons in favour and little against the proposal.

Separation ensures that the capital and the deposit insurance related to traditional banking is not used for market activities. It also protects traditional banking, which is central to much economic activity, from market disruptions – but not, of course, from the credit problems of traditional lending. More important, the separation is a natural one from the perspective of management culture.

There is little that favors integration. Most fundamentally, the returns on capital – if we ignore occasional crises – from market activities are much higher than the returns in traditional banking (particularly in Europe). So, managements like the impact of the higher returns on the integrated institution. And they will have a fiduciary obligation to their shareholders to defend that position.

From a societal point of view, both businesses are important and need to exist. But there is no societal benefit from integrating them.

In my experience, traditional lending to rated companies (i.e., to those that have market access) is not profitable. Intermediating the capital markets on their behalf, and providing them with advice, is. Only one or two institutions that have important global businesses with rated companies would gain any economies of scale from their calling officers by integrating capital markets activity and banking. These few cases would not add up to a societal benefit.

How much of the superior returns in market activities relate to leveraging a bank’s capital and funding costs is not clear, but it is not likely to be zero – and there is no reason for the public to provide this subsidy. If one were to look at P/Es, the value that markets place on earnings, the significance of this differential return for capital market activities diminishes.

While I favor separation, we should not be under the illusion that this removes risk from the business. Banks have a long history of getting into trouble, or even going bankrupt, owing to bad credit decisions (hence, the advent of deposit insurance). The recent “meltdown” in Wall Street, which clearly came from market excesses, was singular. Market losses occur, but it is rare to have contagion of this scope. Compartmentalizing the business is likely to produce more focused customer sensitive activities, but risks will remain.
The final report of the ICB contains an interesting statement about competition. The Commission says that one of its basic principles is “promoting effective competition in the provision of banking services in the UK”.

However, the original terms of reference say something rather different – that the Commission’s report will deal with “promoting competition in both retail and investment banking”.

The second part of the final report contains three chapters on competition. There, we discover the Commission saying that it has assessed “structural conditions for competition in UK retail banking”. The report then proceeds, only a few lines later, to discuss problems of competition and choice in retail banking, plunging deep into the thickets of current account switching and how the new Financial Conduct Authority will operate. Chapter seven sustains the emphasis on retail: “The Commission focuses on those markets in which competition is working least effectively, namely the personal current account and SME banking markets.”

As one advances through the report, even a casual reader notices that much of the text and many of the footnotes are devoted to a painstaking analysis and refutation, almost line by line, of an important submission by the unfortunate Lloyds Banking Group!

So a reader can be pardoned for feeling puzzled by the Commission’s unexplained reluctance to follow its original terms of reference, in particular the explicit direction to consider the wholesale and investment banking sectors as well as retail banking. Paragraph 7.6, at last, gives an explanation (of a kind) for this omission in the bald statement that: “The Commission did not include... investigation of competition in wholesale and investment banking markets because the interim report provisionally concluded that there is limited scope for action by the UK authorities, due to the global nature of some of these markets and the absence of strong representations from customers... [it] invited further evidence but received very little... accordingly the Commission has not investigated further.”

This terse and formalistic explanation calls for questioning and debate as public examination of the ICB’s recommendations gets underway, and as the Commission shuts up shop. Questions demanding answers include:

- Why did ICB do no discernible research of its own into competition in the wholesale, investment banking and capital markets sectors?
- Do the conditions in these important sectors resemble those of a classic “perfect market”? Did the Commission really need evidence and representations from the lay world outside in order to learn that there might be serious imperfections in those sectors that call for thorough examination – as its terms of reference requested?
- Why are firms in the wholesale sectors so prominent in the “Too Big To Fail” category?

These wholesale sectors certainly exhibit many of the characteristics of imperfect competition – which, as a former investment banker and director general of

Sir Adam Ridley worked as an economist and economic adviser in government and opposition from 1965 to 1985, including spells in the Department of Economic Affairs, the Treasury and the Central Policy Review Staff from 1965 to 1974. He was economic adviser to the leader of the Conservative Party, assistant director and director of the Conservative Research Department, 1974 to 1979, and then special adviser to Sir Geoffrey Howe and Nigel Lawson (1974 to 1984) and to Lord Gowrie (1985). He was an executive director of Hambros Bank from 1985 to 1997, served in senior roles at Lloyd’s and was director general of the London Investment Banking Association 2000-06. He is currently chairman of Equitas Trustees.
London Investment Banking Association, I believe are not essentially the responsibility of those involved, but are rather the natural consequence of the dynamics of the relevant markets. Thus:

- The numbers of firms active in such markets has been falling for a long time almost everywhere in the developed world, and major new entrants are rare.

- The size of such firms has long been on a rising trend when measured in real terms. So, probably, has their share of many of their relevant markets.

- Profit margins are very high, while incomes and bonuses are very generous.

- Indivisibilities and scale effects are important in many of their main markets (though there are some where smaller firms can and do flourish, such as corporate finance advice, private equity and fund management).

- Barriers to entry – not just capital adequacy and regulatory requirements – are high and growing.

Perhaps most important of all is the sustained process of merger and takeover in most wholesale, investment banking and capital market sectors. Thus in the UK, 20 of the 60-odd members of LiBA in 1997 had disappeared by 2008 – and there were almost no new entrants in the London market during that period, save for smaller and highly specialised boutiques. In the aftermath of the crisis the (inevitably global) marketplace saw a spate of mega-mergers as the businesses of Bear Stearns, Lehman Brothers, Merrill Lynch and others were swallowed up by large competitors.

Given all this, any realistic observer would surmise that while the number of “Too Big To fail” firms in developed markets has fallen since the crisis, their market shares and collective weights have increased, perhaps markedly so. In future the policy responses to the crisis and its aftermath may slow down these processes and, in time, introduce various mitigations. But the processes which lead to this result surely merit thorough analysis and discussion - rather than casual dismissal in one short paragraph in the middle of a 358-page report.

**Reducing the likelihood and impact of failure**

Concern about the absence of relevant research or diagnosis is all the more appropriate when the proposed palliation also raises serious questions.

Bankers have a tendency to look down on insurance, but sometimes they could learn important lessons from some of its basic principles. This is one of those times. The capital adequacy debate being conducted by Basel and the European Union has offered an irresistibly tempting bandwagon on to which the ICB has jumped. While everybody recognises that a number of wholesale, investment banking and capital markets firms have been shown to be undercapitalised when faced with the challenges of the recent crisis, and that some need more capital, few people have bothered to ask whether all of them should raise their “loss-absorbency” substantially, particularly to the sort of levels the ICB proposes.

The recent crisis and the stress-tests it has spawned have concentrated on ensuring that _all_ firms have, without exception, not just more capital but the capacity to withstand very extreme events. Most, perhaps nearly all, such events should be classified as long-tail, low-frequency, high-impact phenomena. Is it rational and optimal for every firm to hold enough loss-absorbing capital and other resources to meet such extreme and rare claims with reasonable confidence?

In everyday life, nobody in his right mind would follow such an approach. To protect our households or our businesses against the costs of permanent injury or extreme ill health, our houses burning down, or the need to compensate third parties for damage or injury, we do not build up gigantic reserves sufficient to meet the full losses such extreme events might inflict on us; we _insure_. So why do we completely disregard the compelling principles we follow day to day when we set out to contain analogous risks in our most systemically important institutions?

“Shome mishtake, shurely?”

Yes, indeed. As readers will be aware, the guarantee and compensation funds introduced long ago by stock exchanges and clearing houses show how serious risks and the consequences of major failures can be very largely controlled, and their costs absorbed, while the business carries on. It is striking that no major exchange or post-trade institution has failed in recent years.

In the world of insurance, there is also the interesting example of the Lloyd’s insurance market. Lloyd’s has long operated a system of annual levies on market participants which finances a “Central Fund” whose purpose is to compensate those insured who have an unpaid claim, and to support the marketplace more generally in a crisis. This risk mitigation mechanism has kept the market going for several hundred
years without any call on the taxpayer for external help, even in the most severe crises.

Thus, it has removed the need for the authorities to intervene to save an institution which probably would be (and certainly should be) deemed “Too Big To Fail” – while reducing rather than increasing the loss absorbency of individual Lloyd’s businesses.

If a marketplace which trades in some of the biggest and most challenging risks the world faces can survive for centuries on this basis, why should others not do likewise?
It has been the old story of the law of unintended consequences. Efforts over the past decade and more to boost the fading growth rate of the British economy (the same applies across much of Europe, and the US too) have led to financial crisis.

But it is vital to get the analysis of the causation right and to avoid a scapegoat culture. The current political dogma is that the crisis which began in 2007 was the fault of irresponsible bankers who now need to be disciplined. There is no question that many of the bankers have plenty to answer for, as they cheekily continue to collect their bonuses. But we should not accept the Labour Party's retro-spin, which is that until 2007 the British economy was growing perfectly well and government debt was falling, at least as a ratio to GDP, until suddenly a "global financial crisis" emerged from nowhere – as though Northern Rock and Lehman Brothers arrived from outer space.

In fact it was loose money and "lite" regulation, introduced in the pursuit of growth (and successfully so, it appeared, for a few years), which more fundamentally triggered the banking blow-up. Keynes criticised the ineffectiveness of monetary policy in weak economic circumstances as being like "pushing on a string"; but although he knew all about financial speculation, and indeed practised it personally, he did not have to reckon with the vast global casino that is modern banking. By the early 21st century, monetary policies were not weakly pushing on a string but were blowing, successfully but very dangerously, into a bubble.

Now, in 2011, politicians and central bankers are again panicking as growth stalls. We have been promised near-zero interest rates for two years, together with the likelihood of further instalments of quantitative easing. It is all too likely, indeed inevitable, that monetary excess will again spill over into financial bubbles, bonanzas and busts.

Bankers sense correctly that they are once again going to be presented with tremendous opportunities to reap short-term profits. There might have been some credibility to this monetary madness if draconian controls had been imposed on the banks three years ago and were being reinforced now. But instead, after a painstaking analysis, the ICB has proved reluctant to inflict too much damage on the City of London and has opted for a "safety in 2019" compromise. I wonder whether the bankers are being set up to become scapegoats again, when the real crisis comes. They would do well to worry about it because the next time some of them will go to jail, even in the UK.

The British position is particularly vulnerable because of the presence in the City of so many global banks. Such banks can threaten to walk away to some more convenient regulatory haven in a way that domestically-oriented retail or mortgage banks cannot pretend to be possible.

The international banks, after all, had the Labour government under Tony Blair and Gordon Brown (not forgetting Ed Balls, then "City Minister" and now Shadow Chancellor) dangling on the end of a piece of rope and boasting of its "lite" touch on regulation, as the dangerous derivatives markets expanded exponentially and many of the banks doubled themselves up in unreported "shadow" versions.

Meanwhile, the Labour administration eagerly promoted the pumping-up of the British economy on the basis of an avalanche of lending on property and, in parallel, a credit-fuelled consumer spending binge. That debt mountain has started to contract, with difficult consequences for the economy in the medium term. Now the coalition government is trying to create another credit-based expansion – fortunately on a more modest scale and with some improvements to the regulations.

Politicians are under enormous pressure to "do something", slightly less so at present in the UK than across the Atlantic.
where President Obama faces a difficult election in just a year’s time. In theory, governments should boost public spending; but to do so on a substantial scale would trigger collapses in currencies and government bonds. So they resort to near-zero interest rates and QE, with the Americans adding yield curve manipulation, or “twisting” – ignoring the destructive consequences of such monetary distortion lurking a year or two away.

Certainly, if governments are to pursue reckless monetary policies they must first clamp down on the banks. The ICB approach – like St Augustine, prudent but not just yet – will simply not be enough. After all, in the past couple of years we have seen many banks continuing to make big profits – and individual bankers taking bonuses on a scale which is deeply embarrassing to governments and regulators, especially in the UK.

There needs to be an honest focus on the fundamental reasons for this crisis. Europe and the US have lost competitiveness on a shocking scale over the past 15 years or so. For many years, loose money permitted growth to be maintained, at the cost of occasional bubbles in equities, commercial property and housing. But now the machines of money and debt have reached their limits: we have come face to face with the real problem – a North Atlantic crisis consequent on the inability of the developed countries to compete strongly in the global goods markets at Western income levels.

Out of this growth problem has developed a financial crisis. First, banks began to collapse in 2007 as the bubbles inevitably began to burst. Second, economic stagnation (or worse) is creating a sovereign debt crisis. Third, finally exposed for all to see, is the structural inadequacy of the eurozone, which always represented a fragile and temporary victory of the whims of politics over the laws of financial economics.

There are three ways in which this mess can be unravelled. They are not solutions in the sense of neat turnarounds which might allow incumbent governments to win their next elections. They are more like costly outcomes which have highly unpleasant consequences. But they would pave the way for stability and balance in the future.

These Three Horsemen of the Economic Apocalypse will soon ride into action. There is inflation, a method by which debt burdens can be eroded in so-called “soft default”; there is actual hard default, when accumulated borrowings become unpayable, which used to be a South American curiosity but is now stalking Europe; and there is a trade war, which will not preserve current living standards in the developed world but should at least protect jobs.

Unfortunately, these are all taboo subjects: such policies and outcomes happen but can never be discussed in advance, with the pros and cons, and alternatives, subjected to a democratic debate. The mere acknowledgment of such possibilities will trigger pre-emptive responses in the financial markets, certainly where devaluation and default are involved. The denials, therefore, continue until the last moment on a Sunday night when a decision has to be made ahead of the opening of the markets on the Monday morning.

Instead of launching real policies, governments prefer to resort to shadowy monetary stratagems, from QE to yield curve “twisting”. But meantime the IMF has warned, in its Global Financial Stability Report in September, that “risks are elevated and time is running out”.

Never mind. When the going gets tough, governments appoint commissions. The Vickers Commission attempted, it said in its final report, “to reconcile the UK’s position as an international financial centre with stable banking in the UK”. This was a clear hint that the banks still have the British government under their control.

In effect, the Vickers report has come to the conclusion that little can be done in the short to medium term to force the banks to toe the line. True, some partly effective measures will be brought in soon, and more by 2019. Other agencies are rumbling: the new Financial Policy Committee has urged banks to restrict “discretionary distributions” such as bonuses and dividends, although it still has not worked out the policy tools that are required, let alone been granted the power to use them.

There are likely to be several more crises before 2019. Pumping out money is bound to destabilise the system unless severe limits are imposed. So, if the British government is determined to destroy monetary self-discipline in the pursuit of economic growth at all costs, then it will have to accept responsibility for the consequences. A country that wishes to host a large proportion of the global banking system must tailor its monetary policies appropriately, downgrading its domestic priorities.

At some point, we will have to go back to the basics of the argument. Banking is supposed to be a service industry, aiding wealth creation in the wider economy. It should never be permitted to become a leading sector in itself, creaming off wealth from elsewhere.
There are signs that the rest of the EU is more determined to get a grip on the financiers. Of course, this anti-banking bias can be portrayed – and in the UK almost always is – as reflecting simple envy at the power and wealth of the City. But the old chestnut of a tax on financial transactions has just been raised by Jose Manuel Barroso, President of the European Commission, and it may take only one more major financial crash – an appearance, it might be said, by the Fourth Horseman - for the idea to gain powerful support across most of the EU.

As for the UK, for several decades there has been an undercurrent of concern about successive governments’ tolerance of (and indeed, enthusiasm for) the City’s disproportionate appetite for the nation’s talent. The export of the country’s manufacturing base to China and elsewhere, and its replacement by a swollen financial sector, may have brought short-term benefits but it has not generated long-term security.

Vickers was once the name of a great UK engineering group, but the bankers are winning again – for the time being.
Gene Rotberg

**Worries that retail banks might be tempted to take on even more risk to goose returns – unless they get a special deal to ensure their profitability**

The report of the Vickers Commission has two basic goals: first, to shift the burden of loss to shareholders and creditors rather than depositors in retail banks; second, to strengthen the financial capacity of retail banks and at the same time reduce their risk-taking activities in order to maintain their viability and capacity to serve as intermediaries between depositors/creditors and borrowers. These are commendable goals.

The approach to achieving them is:

- to require more capital (10 per cent) for “retail” banks;
- to require more debt;
- to assure priority of depositors over creditors;
- to prohibit lending by “retail” banks to finance investment banking activities (proprietary trading, flash trading, program trading, derivatives, leveraged buyouts etc);
- to prohibit retail banks from engaging in such activities; and
- to require a distinct legal, financial and governance structure for retail banks (apparently with separate shareholders from the parent investment bank) – a so-called “ringfence” from their investment banking arms.

**Impact on retail banks**

I fear the proposals will work – too well. Yes, the retail banks will be much safer; but my concern is that they will be unable to attract capital or creditors given that they will be restricted to engaging in what have become “commodity” businesses and products with narrow spreads and heavy competition. Potential capital providers, particularly if they represent 10% of the retail banks’ liabilities, will be reluctant to invest where there is minimal upside and substantial downside. Indeed, in the United States, that is precisely the reason why Glass-Steagall was emasculated – the retail banks could not compete for capital with investment banks that had a wide variety of products and activities at their disposal.

I am therefore concerned that the retail banks, constrained as they would be, might take even more risks in their lending activities in order to increase profitability and attract capital – a highly unsatisfactory development. They certainly have shown that penchant in the very recent past. Witness their lack of prudence in the residential and commercial property markets. Or, they could simply wind down and therefore no longer be able to meet their capital and debt requirements on one hand and serve as viable financial intermediaries on the other. Moreover, I doubt that their investment banking siblings would find the opportunity of “cross-selling” products to the retail depositor base a sufficient reason to invest capital.

But there are some “solutions”. Retail banks might be given the (sole?) capacity to execute agency orders in the stock markets or to serve as investment managers – both relatively low-risk and profitable activities. And/or they might be required to distribute a high percentage of their earnings to shareholders – say 80 per cent, combined with a reduced tax rate for the recipients. There will certainly be more efficiency gains through IT that will help lower the high fixed costs of the retail banks, but I doubt it will be enough to assure profitability without carving out for them some areas that offer decent profits with minimal risk.

**Impact on the investment banks**

They are in trouble. Their main proprietary activities – trading in all its traditional and arcane forms (derivatives, underwriting,
leveraged buy-outs etc) – will have to be financed either by shareholder capital or debt from sources other than deposit-taking institutions. That is probably the most far-reaching recommendation of the Commission – and I believe a good one. It will substantially constrain those activities that have doubtful public purpose or utility and that are fraught with risk. It was always dangerous to have a system where depositors in banks, which were government (taxpayer) insured, finance the most risky products and activities of investment banks. Essentially, we privatised the asset side of their balance sheets and nationalized the liability side – a dangerous and unwise policy. The Commission’s proposal will return the investment banks to their situation before they went public – having to rely on their own capital. Yes, they will still be able to borrow (and leverage their proprietary activities), but not from banks. That will considerably reduce risk-taking for their more esoteric and proprietary products. And, frankly, I think that is a salutary development. Yes, investment banks provide valuable services. But, given the scandals – Merrill Lynch, Salomon Brothers, Enron, Barings, Orange County, LTCM, Société Generale, Daiwa, Sumitomo, UBS, etc – I believe they cannot meet the burden of proof to justify why their proprietary activities should be financed by taxpayer-guaranteed deposits.

Investment banks will argue that their proprietary activities are the cement that holds the market together; they are the providers of liquidity, liquidity, liquidity – the argument heard each time regulators seek to constrain or regulate their activities.

While there is not space here to argue the point fully, it is relevant to note that liquidity, even assuming that proprietary trading increases it, is a mixed blessing. The quicker one can liquidate an obligation, the less attention to prudence in assuming the risk in the first place. Moreover, there is no evidence that markets now are less volatile than decades ago when volume was a fraction of today. No, flash traders are surely not “market makers” providing liquidity in opposition to a prevailing trend. And, given the tremendous growth of venture capital funds and private equity, where investments are typically held for five to ten years, involving hundreds of billions of dollars (or euros), we should give pause in arguing that the “market” demands immediate liquidity. But whatever the arguments for the advantage of proprietary trading, computer trading, leverage, derivatives, flash trading, the use of complex algorithms for trading – call it what you will – the issue is not whether, on balance, these products and activities do more harm than good to our society but whether, given their history, they should be financed by and their risks borne by government-insured deposits, or by the private sector. To me, the answer is clear. The Commission has it right. And lest we forget, it was not too long ago that all investment banking and proprietary trading was done by essentially private partnerships, with no public capital.

**The issue of sovereign debt**

Notwithstanding everything above, there is little doubt that the “retail” banks – on their own and without the help of investment banks – have managed on many occasions to screw up big time, the latest example being sovereign debt. Their imprudent lending to developing countries in the 1970s and 1980s has been repeated in the past 10 years by lending to eurozone countries. The regulators and the rating agencies missed it. And unlike the complexity of derivatives (about which the regulators have still only a passing, trivial expertise), this was simple stuff that had (and still has) the potential to do great damage to the global financial system. And, given continuing government deficits, the potential for damage by contagion is great.

I propose a modest “solution”. Retail banks – those with government-insured deposits - should not be permitted to lend or hold the bonds of any government other than their own. If governments cannot finance their deficits domestically and must borrow “abroad”, they have the capacity to borrow from central banks, sovereign wealth funds, the IMF, the World Bank, other international financial institutions, pension funds (government and private), a huge array of institutional funds, managed funds, hedge funds, investment banks all over the world etc. That’s enough. “Retail” banks outside their country need not and should not be one of the lenders of last resort of sovereign debt.

Yes, as you can tell, I have always been and still am a “grumpy old man.”
C S F I

Jamie Stevenson

Believes we should look to Spitzer’s ‘Global Resolution’ to see how banks run rings round regulations

Jamie Stevenson worked for 20 years in equity research as a building sector analyst, ending up as head of research at Dresdner Kleinwort. He collected all the various tee-shirts on the way (No 1 rankings etc) and, like Groucho Marx, remained doubtful about joining a club which would have him as a member. Hence today’s cynicism about Vickers’s belief in the power of ringfencing to control the animal spirits of investment bankers. He now spends half his time lecturing at the University of Exeter Business School and the other half mixing boardroom commitments with those of a grandfather.

Vickers has been nobbled; just as Eliot Spitzer was nobbled a decade ago. Then, Spitzer had his legal claws deep into the flesh of Wall Street’s finest. He had them bang to rights with their fingers in the till called “conflicted research”. Then, for some unfathomable reason (perhaps connected to his own political ambitions), Spitzer released his vice-like grip from their throats and settled for fines totaling $1.4bn and agreement from the Wall Street investment banks to keep at arm’s length (or ringfence) their trading, merger and acquisition, and equity research activities. Spitzer presented this “Global Resolution” as a triumph of market reform:

“This agreement will permanently change the way Wall Street operates. Our objective throughout the investigation and negotiations has been to protect the small investor and restore integrity to the marketplace. We are confident that the rules embodied in this agreement will do so.”

(Eliot Spitzer, NY Attorney-General, December 2002)

“This agreement represents the dawn of a new day on Wall Street. Our goal and the goal of this agreement are simple: investors, not investment banking fees, come first.”

(Robert R. Glauber, NASD Chairman and CEO, December 2002)

Quite! Nine years on, these grand claims of Spitzer and his collaborators were exposed and shattered. Back in 2002, armed with his unanswerable legal case, Spitzer had the chance to break up the “bulge bracket” firms and return Wall Street to a single capacity, Glass-Steagall world. Instead, he allowed the investment banks to concoct an array of verbiage and disclaimers around their Chinese Walls and carry on, albeit with altered working patterns, with the same fully integrated (and hence conflicted) business model that had brought about the scandal of conflicted and deliberately misleading research.

Roll on nine years and does not this extract from the executive summary of the final ICB report, sound familiar?

“…the ringfence principles are designed to identify the features of financial services that should determine their treatment and thus provide a guide for the operation of the ringfence when new products arise. These principles are not in a format which would be appropriate for legislation or regulatory rules. But they aim to provide clarity on the Commission’s intentions while recognizing that the development of detailed rules is not part of its remit.” (paragraph 3.6)

The prose is less purple than Spitzer’s, but it has the same sweeping confidence that the proposed reforms will change behaviour and protect the system. This confidence looks shakier when examined under the light of the report’s subsequent Section 3, which claims to detail the specifics of that ringfence.

At best, this is deferring the hard choices until later. Some other body with more grit will have to develop the “detailed
rules” and tackle the banks on how to make ringfencing effective in the absence of legal separation. At worst, it is ceding the case and allowing the banks to write their own rules for the operation of ringfencing. Just as Spitzer fooled himself into believing that tightened Chinese walls and separate boards could alter the behaviour of integrated investment banks, so too the Commission has bought the bankers’ spin that ringfencing, rather than full legal separation, can insulate retail banking from the pressures of wholesale and investment banking. This is humbug. If ultimate control lies with the integrated banks, all the corporate governance box-ticking in the world will not deflect their power to manipulate the behaviour of the retail banking executives.

The giveaway lies in the direct contradiction between the executive summary and the final sentence in the above extract from Section 3. The former states boldly:

“Retail banking activities should have economic independence…the UK retail subsidiary of a wider banking group should meet regulatory requirements for capital, liquidity, funding and large exposures on a standalone basis...relationships with other parts of the group should be no greater than regulators generally allow with third parties, and should be conducted on an arm’s length basis.”

How does a retail bank retain “economic independence” if it is not a legally separate entity? By definition, its majority owner has legal rights of control. And how does it “meet regulatory requirements...on a standalone basis” if the ringfencing principles upon which its claimed “arm’s length” operation is based are “not in a format which would be appropriate for legislation or regulatory rules”? This contradiction over regulatory remit (or the lack of it) between the executive summary and the detail in Section 3 on ringfencing is reminiscent of The Emperor’s New Clothes. It has to be questioned. Unless Vickers can explain specifically how he would insulate the career and bonus-promoting actions of retail executives from the ultimate control of their integrated bank bosses, then his ringfencing proposal will prove as ineffective as Spitzer’s attempt a decade ago to protect the investor from the conflicts of interest within integrated investment banks.
Some change was inevitable. With public opinion behind greater protection of UK retail banking and Vince Cable’s continuing banker-bashing rhetoric, segregation of retail activities from investment banking, with higher capital ratios, was a foregone conclusion. But, recognising the incremental costs that bank customers will bear, is the introduction of this firebreak enough?

Vickers concludes that the Commission’s proposals will “reduce the risks” and “contain the damage”. One half of his remit was to “promote financial stability”. However, to “contain the damage” does not appear, to the average reader, to deal with the root problem. This is particularly so given that none of the collapses to date has been the result of combining investment and retail banking.

Companies invariably get into trouble when they do one of three things:

- choose the wrong strategy;
- make the wrong acquisition, perhaps at the wrong price; and/or
- fail to manage their risks.

Vickers only deals with the problem after it has occurred, rather than seeking to prevent it in the first place.

I was interested to read in the press, after the latest rogue trader episode, that a senior executive at a rival bank to UBS was quoted as saying “you can’t always eliminate these kind (sic) of events, no matter what you do”. After all, UBS only lost 5 per cent of its net worth!

But what about the reputational damage to the bank and to the banking industry as a whole? It only emphasises, at least in the public’s mind, Vince Cable’s much repeated criticism of “casino bankers”. I do wish he would stop and instead support the financial sector, which contributes 12 per cent to gross domestic product and a lot in taxation to the exchequer.

I, like many in financial services, was pleased that Vickers did not recommend a reintroduction of Glass-Steagall in the UK. Indeed, the Commission’s conclusions were generally supported by the media and the industry. More legal constraint would not have been helpful.

It does seem clear, however, that the industry needs to continue to improve its corporate governance and risk management. In this, the regulators and the auditors also have a role to play. “Light touch” regulation, which we all promoted a few years ago, did not work. The assumption was that banks would regulate themselves and that this was in their own self-interest. Financial regulators were not close enough to those they regulated. Like many main board directors of financial institutions, they did not fully understand the business or the risks associated with different types of instruments and trades. I have some sympathy, as some of these activities are highly complex and you need to be a “senior wrangler” to comprehend all the issues.

Regulators need to get closer to the institutions they regulate, and to discuss and challenge strategies and risk management procedures a great deal more. The present form of regulation is often seen as too detailed and nitpicking, with regulatory staff unhelpful and not sufficiently resourced to do their job. Much greater engagement, co-operation and, I suspect, training are required.

Sir John Stuttard

Urges more emphasis on the auditors’ role – particularly in relation to corporate governance

Sir John Stuttard is a former Lord Mayor of the City of London. He spent his entire career with PwC, advising global companies on stock exchange listings, mergers and acquisitions, financial reporting and corporate governance. He worked extensively in Scandinavia and chaired the firm’s operations in China for five years. He was seconded for two years to the UK Cabinet Office advising on privatisation. He is a Fellow of Churchill College Cambridge, lectures frequently on the financial crisis and on corporate governance, and is currently Master of the Chartered Accountants livery company.
Then, an independent review of systems, practices and regulatory returns is always helpful – and this is where the auditor can play a part. I was interested to read the results of a recent survey, conducted by the Chartered Institute of Internal Auditors, of 141 heads of internal audit (albeit of all types of company, not just banks). Some 32 per cent responded that their non-executive directors’ scrutiny of risk management was inadequate. According to the Financial Times, a staggering 28 per cent of boards did not have a formal process to determine how much risk the business should take on. Risks were clearly being given too little attention.

External (or statutory) auditors, with extensive skills and knowledge of the industry and client, are both independent and objective. They can add greatly to the management of risk. In the 19th century, the concept of an independent auditor was invented to ensure that the annual financial report (originally just the balance sheet) showed a true and fair view. Shareholders could thereby be assured of the finances of the company in which they had invested. That role is still required and remains valuable, if not essential. But today, the public needs more than mere assurance that the books balance. It needs greater satisfaction as to the right choice of strategy, the adequacy of corporate governance and the comfort that risks are being properly addressed.

I was disappointed that the Walker review of corporate governance in banking stopped short in this respect. Both internal and external auditors can do more. Even though Vickers did not address this, perhaps the Financial Reporting Council can now take a few more steps forward and seek to introduce further measures to “promote financial stability”, which is what Vickers was asked to do.
Timing seemingly is everything - but and the timing of the Vickers report seems a little late in the day, given the advanced stages of global agreements on the future of banking capital. Over the past few years, since the financial crisis, policymakers, regulators, supervisors and central bankers have been looking at ways to make the global financial system more stable and to ensure that taxpayers never again have to fund our banks.

The main lesson to be learned from 2008 is that financial crises are now global – and therefore our solutions must also now be global.

Bodies like the Basel Committee, the Financial Stability Board and IOSCO have spent the last few years gathering experts together to look at the details of how to achieve the G20 commitments made in Pittsburgh in 2009, as well as how to change existing bank capital rules to better reflect our new risk-averse reality. To a large degree, and after much political horse-trading, these bodies have come to conclusions that should now be implemented as uniformly as possible. Ultimately, the interconnectedness of the world’s financial system means it is only as strong as its weakest member.

However, these international bodies were not just looking to make banks “safe”; they were also looking to strike a balance between stability and the ability to continue to provide capital to finance jobs and growth. The results of all of these expert discussions are now on the table for implementation, including plans for additional capital surcharges on the largest and most interconnected global banks. The Basel Committee has also announced plans to monitor full implementation globally to ensure that the outcomes of the new rules are consistent in all banks and across all jurisdictions. The first draft of the European Union’s legislation to enact Basel III, CRD IV, has already been criticised by some for its apparent divergence from the global agreement. Further deviation by a single member state, namely the UK, would seem ill-timed.

The rules regarding financial services relate to the EU’s single market, which guarantees the free movement of goods, capital and services. Before the crisis, rules governing capital holdings of the banking sector were already legislated for in the form of multiple CRDs. Since the crisis, legislation concerning the EU’s financial services sector often appears in the form of Regulations instead of Directives. This means that they are negotiated at an EU level, and then pass directly into law without the need for individual transposition by the 27 Member States. The concept of a single rule book for EU financial services is one we should support. A level playing field across as many countries as possible is not only good for competition, but also for financial stability and legal certainty for European financial institutions and businesses seeking capital.

The draft proposals for CRD IV were released in July and currently take a “maximum harmonization” approach, meaning that member states will not be able to go beyond what is in the Regulation and impose higher capital requirements on banking institutions.

While there may be many good arguments for the need to impose more than the minimum levels proposed by Basel, given that the EU is a single market it would be much better to put forward arguments for this at an EU level instead of going it alone.

So, where does the ICB report fit into this global and EU picture?

The European Parliament often debates measures it might take unilaterally as an EU bloc, even though they have been rejected on the global stage. This includes the ill thought-out

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Worries that, if the government implements Vickers, it may be in breach of EU single market commitments
Financial Transactions Tax. Yet, no matter how much the UK argues that a European FTT will make the EU uncompetitive and lead to transactions (and financial institutions) simply avoiding the EU or relocating their headquarters, many politicians and citizens claim that the extra stability the EU would gain is worth it. It would be the same problem should the UK attempt to impose higher capital charges unilaterally. The financial sector is mobile, and has no reason to stay in the UK - any more than it had to stay in Sweden in the 1990s.

If the ICB genuinely believes that banks would be safer with an extra 3 per cent capital or that ringfencing retail and commercial banking activities is critical, it should be taking its case to the European Commission, Council and Parliament, and feed into the ongoing European debate. If the arguments are that persuasive, why wouldn’t the EU want all of its banks to come up to the same high standard?

After all, an opportunity exists with regard to the bail-in mechanism and the resolution plans being considered by the EU; they could be made to incorporate a retail bank ringfence. In addition, the Commission is still in the drafting process for a proposal on cross-border crisis management that will cover resolution and recovery plans. The arguments laid out in Vickers, with regard to which activities need to be held in which legal structures to protect depositors, would feed very well into the European debate. However, should the UK follow the ICB’s recommendations independent of what comes out of the European Commission later this year, it would be a major concern.

The UK needs to use the EU legislative programme for financial services to ensure best practice, not just in the UK, but across all 27 member states. Not to do so leaves British banks and companies at a significant competitive disadvantage, as illustrated by recent attempts to introduce a UK-only Retail Distribution Review. Following scandals surrounding the mis-selling of certain financial products to retail investors, the FSA undertook a review of retail distribution. Yet the problems it sought to remedy were not unique to the UK; they were taking place across Europe. However, the RDR cannot be applied to financial advisers from other European countries that currently offer services in the UK – which will still leave consumers open to questionable products and practices.

To add to this unsatisfactory outcome, the Commission (as a result of a similar exercise at EU level) is also drafting new rules on the selling of retail products – known as Packaged Retail Investment Products. These rules will be included in the European Market Infrastructure Regulation – which, as a Regulation, will obviously supersede the RDR. The result is that while British independent financial advisers are currently implementing a costly set of new rules, before long they will have to implement a whole new set of EU rules. Having the debate, and engaging with the EU processes, is critical. The UK should engage now on recovery and resolution plans and on other measures raised in the ICB report. Moving alone will not achieve more stability or better consumer protection.

The ICB discusses the concept of ringfencing retail banks from investment banks, but it does not fully acknowledge that any retail bank or “credit institution” (under the EU definition), from another EU member state, can set up a subsidiary in the UK and offer its services to UK consumers, just as UK banks can operate across the EU. It will not be possible for the UK to impose the ringfence or higher capital requirements on those European banks, as it would be against the EU’s single market concept and would constitute “gold-plating”.

While there are many valid arguments in the ICB’s final report, the UK cannot operate as though it is in a vacuum. Since the first Financial Sector Assessment Programme, the EU single market in financial services has been a growing reality and has produced significant benefits for the UK economy. A recent City of London report, for instance, claims the UK economy as whole grew by 2 per cent as a result of just one piece of legislation, namely the Markets in Financial Instruments Directive.

Some of the EU legislation that has emerged as a result of the crisis is unlikely to be as positive, however. But, as long as the UK remains part of the EU, or even wants to trade with the EU from outside, UK rules need to remain compatible with the rest of the EU – and UK ministers should endeavour to take the lead in EU financial services legislation. As home to the EU’s largest financial centre, the UK should make sure that it is shaping pan-European legislation, instead of turning inwards and focusing only on its domestic market.
Before delving into the detail of a cleverly balanced report, a few overarching comments are necessary.

First, Vickers is at least as much a political response to the banking crisis as it is a regulatory one. We live in a democratic society in which banking occupies a critical role in wealth creation — that of intermediating between those who have money and those who need it. Despite its central role, banking still answers to democracy, not the other way round, and sometimes bankers don’t quite get the importance of this subtle nuance. The report, therefore, reflects the voters’ cry to their elected members: “This must never happen again.”

The second point is that, of course it will happen again, just as night follows day. Banking crises happen about every 30-40 years: 1870, 1908, 1929, 1974 and now 2008. All emerge through different routes but all arise for the same reason: poor control of the money supply leading to bad lending followed by a bubble which then bursts and threatens the banking system. In the aftermath, the taxpayer has a central role — either of providing liquidity or bringing some of the banks under government ownership (or, as in the most recent crisis, both).

So, if the purpose of the report is to prevent a future banking crisis in which the taxpayer will have to bail out the banking system, rather than to alleviate a future crisis or make it less likely, it is doomed to failure and politicians should not sell it as such.

If, however, it is intended to ensure that no one will ever again face queues to withdraw their money from banks, it may well succeed.

The report backs the idea of changing the law such that in a bank insolvency, retail (defined as “insured”) depositors will stand ahead of those in the wholesale market. Were this to happen, any taxpayer guarantee would become a liquidity guarantee, rather than one covering insolvency, since a retail bank’s balance sheet is so constructed that in liquidation it is almost inconceivable that retail depositors would not eventually be covered by the bank’s assets and thus the government repaid. It also has an added advantage: retail depositors have neither the knowledge nor the time to determine the creditworthiness of their bank and so cannot be held responsible if they have money with the bank when it becomes insolvent. Wholesale depositors, including large corporates can. In the case of Northern Rock, there was certainly a view in the City that the bank was becoming over-exposed to the wholesale deposit market and that loan-to-value ratios were very high. Had wholesale ranked below retail depositors, there is at least a chance that the whistle might have been blown earlier and resolution effected more easily. It would also have removed the moral hazard from which professional wholesale depositors benefitted.

Thirdly, as the Commission points out, UK banks’ balance sheets are almost four times the size of the country’s gross domestic product, compared with “only” 100 per cent in the US. This means that the UK government has a duty to be more cautious than the US government — not so much “Too Big To Fail” as “Too Big To Host”!

Finally, the flip side of that coin makes the UK one of the two leading financial markets in the world. Therefore, there is no reason why, in a banking market which continues to be largely domestically regulated, we should not take a lead in prudential regulatory innovation. In part, that is what Vickers has done.
Within the banking sector, there were three causes of the systemic crisis.

First, the banks were hugely undercapitalised for the risks they were taking, and thus vastly over-gearde. At the peak, some banks were 44 times-gearde meaning that only 2 per cent of the bank’s assets needed to go bad for the bank to fail.

Second, banks held insufficient liquidity against markets freezing up.

Finally, there were no general methods or rules for winding down distressed institutions. That said, in the case of Northern Rock there were of course resolution procedures at the Bank of England, which were well tried and tested in the 1970s secondary banking crisis. These appear to have been lost in the ham-fisted reorganisation of supervision dictated by the Labour government’s Banking Act, which left supervision as a shared responsibility of the Treasury, the FSA and the Bank.

The Commission’s main (and most controversial) recommendation concerns the ringfencing of retail and wholesale banking within UK universal banks. This seems to be a neat way of side-stepping complete separation, which would certainly have severe economic consequences, particularly in the extreme form of the Narrow Bank proposed by John Kay.

There are two main advantages of partial separation: first it allows the UK authorities to impose higher capital requirements on the ringfenced entities than those called for under Basel III without impacting the international competitiveness of the non-ringfenced part of the group. At the same time, it also makes resolution of the ringfenced bank less complex. The devil, however, is in the detail, and some of the detail is less than clear. For example, would a ringfenced bank be able to provide forward foreign exchange hedging and run a forward book to allow its customers to hedge their FX exposure? If it were to act as an agent rather than as a principal, costs to small and medium sized enterprises would be considerably higher. Secondly, to what extent would SMEs and retail customers lose the benefit of financial innovation by being customers of a ringfenced bank?

There is no doubt that ringfencing would provide added protection in the case of meltdown. But it is not clear that such protection would be absolute. Banking crises almost always begin with the drying up of liquidity, while the ringfence might mean that deposits would flow initially to ringfenced banks, in the end a disruption such as that which accompanied Lehman’s bankruptcy would cause a total seizure of the banking system - particularly in the interbank market, on which all banks, ringfenced or otherwise, are dependent for short-term funding.

One of the places where the report seems to fall short is in the critical area of liquidity controls. While it does lay down some recommendations on wholesale versus retail deposits for a ringfenced entity (following the rules for building societies), it is largely silent on the maturity profile of deposits within a bank. This may be because it is satisfied with the Basel III proposals. But for banks, illiquidity and insolvency are more interlinked than in normal companies, certainly in terms of the time in which the first can lead to the second. It is surprising that the Commission did not discuss this in more detail. All its focus is on capital, which is important but goes hand in hand with liquidity. No amount of practical buffers can deal with a run on a bank.

There are two other areas where the report seems strangely silent and where Basel III is also light on recommendations. The first is on the capital that the non-ringfenced banks need to hold against their trading book; the second is on shadow banks.

On the positive side, the Commission report proposes an amount of capital for ringfenced banks over and above the Basel recommendations (which do indeed seem weak). It also links the capital required to the ratio of banks’ risk-weighted assets to UK GDP, which given the size of the banking sector in relation to GDP must make sense. Many banks have suggested that this will increase the cost of capital and therefore reduce lending to customers – and thus retard economic growth. But to what extent is this really true? Whilst it may reduce the absolute return on bank equity, given the extra margin for safety might it not increase the risk-weighted return and therefore in fact lower the cost of capital? Even if it does increase the cost of capital, there must be an argument for trying to ensure that – while there may be another banking crisis in the next 40 years, if history is any guide – we should try to reduce the likelihood of one occurring in the next decade. That in itself makes the case for better capital buffers.

The second area the Commission investigated was competition in the retail market. However, it is not clear that it identified the real barriers to entry correctly. Nor did it make the case that the deficiencies in banking services for SMEs or retail customers result from a lack of competition, in spite of the current level of market concentration.

It correctly lays down some rules for the divestment of the Lloyds portfolio, ensuring that a new entrant has enough
scale to make a difference in the market place. But beyond that, the real barriers to entry are beyond its remit.

These include, first and foremost, “free” (or rather, perceived as free) current account banking. When this first appeared more than 20 years ago, it was feared by all the clearing banks. But in the end, it created a ringfence in which they could imprison their customers. The critical tie for any retail customer is the Personal Current Account (PCA). If these are to be free for all customers with a credit balance, huge scale is needed to make personal mass market banking profitable. Thus, if the authorities want to make competition in this area keener, they will have to ban “free” PCA banking. At that point, we would have some chance of seeing the new entrants like Tesco becoming successful.

For SMEs, the issue is quite different. Over the years, local relationship management has disappeared and credit decisions have become more remote and more quantitative. Whilst this may work for large corporates, it does not work for SMEs. Knowledge of the business on the ground in Inverness cannot be usurped by credit analysts in Birmingham. If it is, the length of time taken to agree a loan is extended and the likelihood of an accurate appraisal is reduced. Equally, the banks are the only real entity which can provide mentoring – which they always executed through the local branch. The loss of this service has been hugely detrimental both to SMEs and to their repayment record. Organisations such as the Prince’s Trust have demonstrated how repayment history can be greatly improved by good mentoring. The problem is how to make this a profitable business. That, however, is beyond the remit of Vickers.

In truth, the real resolution of the crisis is also outside the control of the Commission - and of the UK government. Its root cause was not just the interconnectivity of banks, nor the bonus culture, nor the asymmetry of information; it was that the crisis involved global banks that were domestically regulated often in economies which were smaller than the banks’ balance sheets.

It could be said that the systemic disaster we saw in 2008 really stems from the abandonment of Bretton Woods in 1971. That is not to say that the world should go back to fixed exchange rates. But after the end of Bretton Woods, financial markets saw the end of fixed commissions in the US in 1975, the abandonment of exchange controls in October 1979 in the UK and Big Bang in London in 1986. These events heralded the first free flow of global capital the world has ever known – and with it huge enrichment across the globe. But the flows of global capital were transmitted by global banks which were locally regulated. The contradiction of global banks and local regulation is a danger that still lurks today. It has to be resolved - and in part it has at least been recognised by Basel in the identification of Global Systemically Important Banks (GSIBs).

In 1944, in the middle of a war, some of the greatest economists of the time (led by Keynes and Harry Dexter White) encamped in The Mount Washington Hotel in New Hampshire and thrashed out a new world monetary order which stood the world in good stead for over 25 years. After it was abandoned in 1971, it was never replaced. It is now time to do so. At its core should be an international institution whose responsibility would be to supervise the GSIBs and to be their lender of last resort. Its members would be the host nations of the GSIBs, who would also capitalise it in proportion to the balance sheets of the GSIBs they host. That is the only way we will overcome regulatory arbitrage and enable financial centres to be safely situated in the most efficient cities, where the host country may be small in relation to the financial institutions it supports. It will also perhaps provide the foundation for cross-border resolution of failed banks, where in the case of Lehman Brothers we were woefully deficient.

With the coming bail-outs by the IMF of European governments, maybe we are not a million miles from that solution.
Policymakers around the world want to prevent taxpayers from having to rescue delinquent banks. That, for example, is the overarching goal of the UK’s Vickers report. If implemented, its proposals should eventually produce a safer and fairer financial system. But in a stagnant economy where credit is scarce, bailout-free banking remains a distant and possibly unattainable goal.

There’s no doubting the urgency of Vickers’s mission. The financial crisis prompted supposedly private financial institutions to throw themselves onto the mercy of the state. Some governments were overwhelmed. Even banks that received no direct support benefited, because the system did not collapse. In other words, the bailouts exposed massive moral hazard in the banking system. If left unchecked, this will eventually produce another severe crisis.

Breaking the unhealthy link between banks and taxpayers is therefore crucial. Vickers’s solution is to stuff lenders with more equity and loss-absorbing debt, and to put their consumer and small-business operations in ringfenced subsidiaries. The latter will make it easier to wind down failing banks. The former may ensure that any losses are borne by shareholders and unsecured creditors, not the public. Put together, the reforms should encourage investors to pay closer attention to banks’ risks, rather than just the rewards.

If such a banking system were designed from scratch, it would be more stable and more equitable than the one we have today. But making the transition to this more desirable state of affairs is tricky. For one, bank bondholders who face a real risk of future losses will demand greater compensation. This will make bank credit more expensive.

According to Fitch, the five-year historical default rate for the world’s banks is 0.8 per cent. But if lenders that were rescued by governments are included, the default rate rises to 8 per cent. That means that ending the “Too Big To Fail” problem will involve incurring real up-front costs in exchange for the immeasurable and possibly distant benefit of avoiding future bailouts.

Higher funding costs will make some banking activities uneconomic. This is not a bad thing. Businesses that are only profitable thanks to an implicit subsidy from taxpayers should probably not exist. Besides, most of them are sub-sectors of investment banking. One of ringfencing’s big advantages is that it exposes these businesses to the true cost of private wholesale funding, clearly separated from government-guaranteed retail deposits.

However, it would be naïve to believe that the Vickers reforms will end financial excess. Even when faced with better incentives, banks and their creditors will at times be guilty of exaggerated optimism. And their mistakes will not just be confined to trading operations that sit outside the ringfence. HBOS and Northern Rock, which were floored by reckless property lending, would both have been entirely inside the ringfence. Given Britain’s dismal track record, another speculative property boom and bust will be hard to avoid.

What will future authorities do in this situation? Will they use their powers to wind down failing lenders, protecting depositors while leaving all unsecured creditors to their fate? Or will they conclude that enforcing moral hazard is not worth the risk of triggering another credit crunch?

This is not a straightforward calculation. The economic costs of Britain’s financial crisis were large: gross domestic product shrank by almost 5 per cent between mid-2008 and mid-2009. If the government had not injected capital into RBS and Lloyds, the contraction would doubtless have been more severe. Despite the public anger, future politicians may conclude that bailing out the banks was a relative bargain. But the success of Vickers’s proposed reforms depends on the authorities convincing investors that next time really will be different.
Future booms seem a distant concern when Britain is still suffering through the hangover from the last party. The sluggish economy has exposed a worrying asymmetry in debates about reforming the financial system: while policymakers have plenty of ideas about how to stop banks from getting carried away in future, they have few suggestions about how to stimulate private sector lending today.

Once again, the government may have to step in. George Osborne, has already announced an as-yet-undefined “credit easing” plan to help small businesses. Others have recommended setting up a state-owned bank that can offer cheap loans, or converting one of the partly nationalised banks into a full-fledged government lender. Countries such as Germany and France have experimented with state-directed lending in the past, with mixed success. The same goes for China, which uses the country’s big state-controlled banks as tools of economic policy.

Britain will not go that far. However, if Vickers’s proposals are implemented in the way that the Commission intends, it’s likely that bank credit will be more expensive and harder to get than before. To the extent that this affects consumers and businesses, the government will be under pressure to intervene.

In its eagerness to protect taxpayers, the Vickers Commission may have had the perverse effect of encouraging the state to play a more explicit role in the banking system. If the government’s role is made clear, this is not necessarily a bad outcome. But it can hardly be what the Commission members were hoping to achieve.
The Vickers report looks very much like a done deal. And if that is really the case, then the important question is not what the government should do with it but what else can be done, either by government or by the banks themselves, to ensure the future stability of the financial sector and its contribution to the nation’s prosperity.

But just because it looks like a done deal, does that mean it really is one? Or is it the sort of well-intentioned, loosely-stitched deal that will gradually be undone over the eight years allowed for its implementation?

In the fortnight before the Commission released its final report on September 12, banks were still lobbying fiercely against the very concept of ringfencing their retail operations, while predicting dire consequences (in terms of the price and availability of credit for businesses) under such a costly, capital-intensive regime.

In Westminster, there were whispers of pressure from the chancellor, George Osborne – anxious to avoid both a diminution of tax flows from a profit-squeezed financial sector and a diminution of City support for his own policies – to water down Vickers’s recommendations, particularly in relation to the deadline for erecting the ringfence. And there were growls from the business secretary, Vince Cable, that he would kick up trouble if the outcome did not swiftly knock sense into the bankers whom he so patently dislikes.

What happened on September 12? Vickers introduced an element of “flexibility” on the core question of which activities should be corralled on which side of the ringfence. And he announced a timetable, running out as far as 2019, which Osborne was able to endorse without a flicker of discomfort — perhaps (those of a suspicious mind might think) because it was precisely the timetable that Downing Street aides had whispered to Vickers might secure smooth passage for his proposals, rather than a sweeping under the carpet. Cable sat beaming on the House of Commons bench beside the chancellor, uttering no word of dissent.

As for the banks, they were suddenly and strangely quiet, unable to put up a spokesperson for most of the news bulletins that day. Even Barclays chief executive Bob Diamond, previously well known for his aversion to regulatory interference and reputedly one of the Commission’s most combative witnesses, had mutated into a pussycat. “A cloud has been lifted”, he said. The report was “a welcome step towards the greater clarity that banks need to be able to operate with confidence”.

The bankers’ change of tone may mean that they immediately spotted sufficient “flexibility” in the final report to allow them to carry on more or less as usual, profits and bonuses preserved. But, for the time being, let us take the reactions from all sides at face value and move on.

Yes, independently-capitalised retail banking operations, limited in their scope of activity and risk, should be less volatile in behavior and less likely to need taxpayer bail-outs than proved to be the case for unreformed universal banks. Vickers’s logic is particularly eloquent in the passage that explains how far the benefit of greater stability will outweigh the modest cost to the economy (0.1-0.2 per cent of gross domestic product) of the more expensive services offered by ringfenced banks. It’s an insurance premium well worth paying, says the Commission - and few practitioners or commentators now seem to disagree with that principle,
or to believe that its implementation will drive established players out of the British High Street, though it might deter new players from trying to get in.

But will the new structure turn High Street banks into “normal” businesses? Here is a question Vickers did not even begin to answer. By normal, I mean businesses such as supermarkets and consumer-goods manufacturers that seek customer loyalty through quality, service and price competition; whose products “do exactly what it says on the tin”; whose performance fluctuates with the broader economic cycle but whose offering to customers remains more or less constant; whose managers and senior executives see themselves as part of a wider community, rather than a breed apart which merits levels of reward superior to those of comparable non-financial occupations. Until that kind of normality is achieved in the financial sector, instability will always threaten.

How to make it happen? I have argued repeatedly in The Spectator and elsewhere that our retail banking industry needs “re-humanising and de-systematising” – to be taken back to a phase sometime in the first half of the 1980s when the major clearing banks ceased to operate an implicit cartel, began to compete avidly for new custom but had not forgotten the lessons of the 1973 crash and had not yet acquired the boom-to-bust habits that have recurred ever since.

It may seem as much of a cliché to argue for bringing back real branch managers in High Street banks as it is to shout “Bring back Matron” during Tory party conference debates on the NHS. But it is a vital issue nevertheless.

Having dispensed with managers who knew their locality, nurtured relationships with valued customers and took responsibility for lending decisions, banks have come to rely instead on remote, systematized mechanisms which drive customers to fury, provoke accusations of mis-selling, and lead the banks themselves to take on too much of any category of business that looks good at the time but turns bad afterwards.

The banks protest that such habits are a thing of the past, and that they are listening to us as they have never before. NatWest, for example, says: “We want to become Britain’s most helpful bank and our Customer Charter is key to achieving that goal.” But the customer experience across the whole sector remains largely the same – as is vividly evidenced by the 10,000 complaints per day received by the FSA in the first half of this year.

And be in no doubt that the bad decision-making (which is the other side of the coin of bad customer service) will continue, ringfence or no ringfence. When the property market eventually hots up again, perhaps towards the end of this decade, you may be sure that retail banks will be up to their necks in irresponsible mortgage lending for which no individual manager will ever be held to account.

Counter-examples are few and far between. The Nationwide building society is one of the few big names to have steered a steady course and retained its customers’ trust. Handelsbanken of Sweden, which now has more than 100 British branches but rarely blows its trumpet, has established a model which allows branch managers to lend to whoever and on whatever terms they choose, and which treats every customer as a human being.

In balance-sheet terms, Handelsbanken has been rated (in a recent Bloomberg survey) one of the strongest banks in the world, and its progress over here, quietly adding one branch at a time, is well worth watching. Another important difference is its remuneration system: staff participate equally in a modest profit-sharing fund, but otherwise there are no bonuses at all. And there are no cash rewards for cross-selling – one of the most corrosive elements of the more typical 21st century retail bank.

But from now on the big bonuses will all be on the other side of the ringfence – where (we’ll be told) the investment-banking risk-takers deserve them because they’re never going to be bailed out by the taxpayer again. But what we’re not told is that on the retail side, in imitation of the investment side, a culture has grown up in which every product offered can carry a little cash kicker for the employee selling it or recommending it - which means advice is rarely objective, though that nuance is never made explicit to the customer. This internal rewards system is now integral to the management structure of banks, which, after many rounds of internal restructuring and with high levels of staff turnover, have destroyed the institutional loyalties and hierarchies that used to make them tick.

Ministers and the Bank of England have made clear that they regard continuing high levels of remuneration in the banking sector as both a political embarrassment and an impediment to sensible reform of the sector. In practice, however, they cannot intervene much more on the pay issue than they already have, although they also cannot just go on repeating the FSA’s mantra that regulators’ concern should be with “resolution not remuneration”, meaning that it does not matter what a bank pays its executives so long as that bank can fail without causing a systemic crisis.

Pressure has to be maintained, not by regulatory edict but from every public pulpit, to persuade banks to bring their pay levels into line with comparable professional sectors. If that is...
not achieved, over a period of time, then behavior will never come into line either.

I don’t want to encourage Vince Cable too much. But, by repeatedly telling bankers they are still paying themselves too much, he is doing the sector a useful service. He would be even more useful if he made a clearer distinction between bonuses and dividends: banks need shareholders more than ever to provide capital that is at risk, and the two forms of “discretionary distribution” (as the Bank of England recently labelled them) should not be bracketed or confused.

In summary, ringfencing will do more good than harm, and having met an unexpected consensus of approval, Vickers’s recommendations should now be implemented as proposed, though we should expect significant blurring of the boundaries before the project is complete in 2019. But just because regulatory reform has gone as far as it feasibly can (and further than many of us expected), let us not imagine that the essential problem of British banking will be solved by strengthening its capital structure. Regulation cannot cure the cultural disease – that remains to be eradicated.
The broad thrust of Vickers has been welcomed by the government, and the current standing of the banking industry (as well as the state of UK politics) means that there is no significant countervailing power pointing in a fundamentally different direction. Genuine discussion and debate is now under way, but only at the margin, and this is likely to be brought to an end by early in the New Year. The chancellor, following discussion with the secretary of state for business, will then need to decide on a firmed up version and Treasury officials will have the less straightforward job of working out what, if any, legislative change will be needed for implementation. It may be that a good deal can be achieved through delegated legislation, and the powers for the rest may already exist within the Financial Services and Markets Act. Failing that, the forthcoming Financial Services Bill may be used.

We therefore know the diagnosis, and the proposed remedy, as well as the timeframe for policy change (to be finished by 2019). What remains unknown is what will happen when government and the Prudential Regulation Authority try to implement the finalised plan for ringfencing domestic UK banking operations.

What is clear is that life within the ringfenced bank will be very challenging for senior management and newly established boards. They will be obliged to hold significantly more capital – 10 per cent tier 1 equity and up to 20 per cent in total including new types of debt capital.

These are onerous requirements, partly because the debt capital products have never been used on this scale; and it is not obvious that there will be demand from investors for them, or that they will work. To be told, as an investor, that the pharmaceutical or hotel business that you have invested in is doing badly and that you now have only 60 cents on the dollar, or that you are the proud owner of new equity, is one thing; to be told that about a bank investment is another. Banking (as we have all witnessed) is materially, if not conceptually, different to other parts of the economy.

There are undoubtedly real risks within the ringfenced bank that justify substantial equity capital against risk-weighted assets and even a leverage ratio. It is also reasonable that there is some ambiguity about large corporate lending, both domestically and internationally; on Vickers’s own account, there could be £1 trillion of assets here. All this aside, the core thrust of Vickers will be to require the UK domestic banking system to have much lower risk assets, backed by more (and higher cost) capital.

From a banker’s point of view, this is challenging. Returns on equity will fall sharply – it has been suggested to 10 per cent rather than 20 per cent. The new autonomous boards will, therefore, find it hard to justify spending on IT systems, marketing and staff development. The group which owns a ringfenced bank will presumably take comfort from its increased safety – but it may not be minded to grow or develop the business.

Life will also be different for retail customers within the ringfenced bank...

Vickers will be implemented from 2013. However, it is not the only show in town. European initiatives on retail packaged products and much else are in train, and in the UK we should finally see the introduction of the Retail Distribution Review.

While the RDR changes are good, they will further drive banks to rethink which customers they really want and what services they can provide. Core savings and structured deposits have escaped heavy conduct regulation, so are cheaper to provide. But banks will be looking for more...
margin on them to offset funding problems in the wholesale markets and to generate a higher return on equity. Financial services focused on the provision of financial advice are good news because they are capital-light on the main balance sheet. However, in an RDR world, the economics of providing retail products on a fee basis don’t obviously stack up.

In this analysis, ordinary retail customers will, therefore, get to deal with a systemically safer bank. But the kind of product offering they get is going to change profoundly as a result of Vickers and other measures. The cost of many products looks set to rise since changes elsewhere make it hard to envisage banking products being provided as a loss leader.

What about the world outside the ringfence?

Much has been said about banking within the ringfence - and about the return to a simpler safer model, devoid of a trading book and with enhanced capital. If this were not enough, Vickers even proposes that “capital could be injected into the UK retail subsidiary by the rest of the group if it needed support”.

But not, of course, the reverse! There is a one-way support valve here, and banking outside the ringfence will therefore have fewer guarantees from the home state supervisor, and less funding. If you add to this the ongoing tensions in wholesale funding markets, the massively enhanced trading book calibration that Basel III requires, as well as the costs of new liquidity requirements, then the situation outside the ringfence starts to look problematic. If you are a business (like Standard Chartered or HSBC) that can raise big retail deposits ex-UK, then you are greatly helped. However, it is hard to escape the view that international banking will have to reposition itself in terms of which risks it takes and how it prices them, particularly in credit and interest rate markets, including derivatives. This structural change need not be a disaster, but we can be sure there will be consequences.

Plus, what will Johnny Foreigner do?

Vickers is very much a British initiative for the British market by a British government. If the British pursue it rigorously, other countries may decide that a version (not necessarily the same) is a good idea. After all, if the British have now decided that domestic subsidiarisation is the answer, maybe there is something in it. This could lead to creation of a different border line between banking structures around the globe. It is plausible to imagine an international finance system which intersects in some places (e.g. simple corporate lending), but not in many others. This could work to weaken the international flow of capital and will certainly produce more volatility in international banking and capital markets.

Vickers is keen to stress that the ringfenced bank can provide its services within the European Union - especially payments services - to all European Economic Area individuals and firms. However, it doesn’t feel a good fit with the UK bank scraping by on its minimum legal obligations under EU treaties. Moreover, deep in the report, Vickers argues that “…. branches with entitlement to conduct activities in the UK under European law are not considered to be ‘granted permission’ for the purposes of these principles.” What does that mean? It reads as if it is a restriction on deposit-taking within the UK. And does it suggest a breach of EU law?

Even if it does not breach EU law, it is hard to avoid the conclusion that UK ring-fenced banks would be at best “semi-detached” from European developments.

In conclusion, the Vickers report is fascinating and superbly argued – and really should help make UK domestic banking less prone to systemic crisis. Along the way, it will protect the UK taxpayer from undue exposure, and make a domestic bank failure easier to handle. But policymakers will need to think hard about the implications – for banks within the ringfence, for their retail customers, and for those financial activities, especially trading activities, outside the fence. For this latter group, the consequences will be as great as for those within the fence.
The UK government should move to implement the Vickers Commission’s report in full, although it falls well short of recommending fundamental solutions to the problems that caused the crisis. But this is no time to bicker with the banking lobby, and the reforms proposed are better than nothing.

In the run-up to the widely leaked report, the banking lobby went through several phases in its defence of the indefensible: mild concern, increasing concern, near-panic and, finally, hysteria. Following publication, we can expect the lobbying to reach fever pitch. Of course, in the real world, one would expect the views of those responsible for the mess prompting the reform to be heavily discounted by those responsible for executing the reform. But politics and the real world have little in common. Since the political class has a lamentable lack of understanding of how finance actually works, it is forced to rely on advice from roughly the same crew that sank the ship in the first place, in determining how the ship should be remodelled.

The indefensible is, of course, the megabank business model, sometimes referred to as the “Too Big To Fail” model – formerly known as the universal bank model popular on the Continent. To be fair to the old universal banks, these were run by proper bankers – whereas, with some exceptions, the new megabanks have been run by corporate cowboys, not to put too fine a point on it.

From the outset, it was clear that Vickers would toy with some form of separation of retail deposit banking from so-called “casino” investment banking. In order to appease the banking lobby, and following other pressures, the recommendations sadly stopped short of a full-scale, Glass-Steagall-style separation. Thus was developed the ringfencing approach. The background to this was the received wisdom that any cure to modern banking ills, and attendant risks to the public, must involve substantial increases in capital deployed in the industry. No one has stopped to consider whether too much capital might be the problem, causing the banks to move into increasingly high risk assets and activities, in order to remunerate a capital base no longer earning satisfactory returns from traditional banking.

The banks’ arguments against ringfencing, and its various permutations, fall into four main categories:

- Cost - first of implementation and then higher funding costs.
- It will not increase lending to business (related to the first concern).
- It will not decrease systemic risk (neither Northern Rock nor Lehman was a megabank).
- It will undermine London’s position as the financial capital of the world.

To evaluate these points, one must review what has happened to banking in the last few decades.

Traditional banking margins have been eroded by massive disintermediation in the corporate area and rising costs in the retail business. The companies that provided the bulk of bank profitability have gained direct access to markets for their banking needs, and now often access these on
better terms than the banks. The banks sought to restore profitability through massive consolidation. However, this largely failed to provide the expected cost benefits, massively destroyed shareholder value through post-merger fair value adjustments, and reduced competition.

But it was the migration of the money centre banks into investment banking and its perceived higher returns, facilitated by Big Bang in London and the end of Glass-Steagall in New York, that set the stage for the carnage that was to follow. Never has there been such an exchange of incompetence between two branches of the same industry. Suddenly, everyone wanted to be Goldman Sachs. Even the simplest appreciation of the relationship between risk and reward was lost in the shuffle. But the biggest casualty from a prudential point of view was the erosion of the basic divide between agency and principal functions. This distinction lies at the heart of financial regulation.

Turning to the arguments, the cost issue is the least documented.

Implementation costs will depend on the timetable. Funding costs today reflect the shift in the business mix of the megabank model. For some time, banks have carried risk assets way in excess of their natural deposit base, depending on the interbank market, securities issuance and derivatives to fund the difference. The interbank market is now semi-paralysed because banks do not trust each other’s accounts, knowing toxic assets are yet to be marked to market. A pure retail bank, enjoying protection for small depositors and unable to engage in proprietary trading and other high-risk activities, would access interbank funding on improved conditions. This is less clear for the ringfenced hybrid.

The reason banks are not lending to small and medium-sized enterprises is that they are focusing on restoring ratios rather than growing assets. They have also lost the confidence to lend, having fewer people trained to do so. A Scandinavian bank has seized an important share of the UK’s SME market by employing a bottom-up credit assessment and approval process, rather than the top-down, mechanistic process adopted by the main High Street banks. Reform will help restore traditional lending practices.

Reform will also decrease systemic risk. The argument about Northern Rock is a red herring. Of course it was a retail bank on the asset side; but it was a fully-fledged investment bank on the liability side, funding its gross over-lending in the capital and derivatives markets, something the Financial Services Authority totally failed to spot. Lehman was only able to get into the mess it was in because of the stupidity of its counterparties, and is hardly an argument against reform.

But the real nonsense is the contention that reforms – in particular any separation of retail from investment banking – unless adopted universally, will hurt the City. It may come as a shock to them, but the world does not beat a path to London for its global financial needs because of the presence of Barclays, HSBC and Lloyds Banking Group (and certainly not RBS). The City is primarily an investment banking centre, and it is its skills base and the liquidity of its markets that count, not how its domestic retail banking market is organised. International corporate and public sector needs are largely served by the investment banking community, which will still be there post-reform.

The other megabanks of the world do not base their retail business in London. In fact, it is the foreign-owned firms that make the City what it is, not the High Street banks. The clearing banks stood by after Big Bang as the merchant banks and stock exchange members were bought up by overseas concerns. When they finally moved, they destroyed the franchises they had overpaid for. (The foreign banks did so as well, an early indication that commercial banks had no business engaging in investment banking.)

Commentators who claim reforms will destroy the UK’s banking industry fail to appreciate that this very important industry is largely a foreign-owned, entrepôt industry based on London’s unique set of attributes, none of which is the slightest bit affected by the Vickers recommendations. The investment banking arms of UK banks left outside the ringfence may lose some competitive edge against non-ringfenced foreign banks, but their market share is too small to have an impact on the City’s global revenues.

Most of the issues above would have been more easily dealt with if the Vickers Commission had not flunked total separation. Shareholders would have retained franchise value through the spin-off of investment banking divisions. A cleaned-up retail sector could revert to traditional banking and concentrate on customer service. Yes, this would be a dull business, like water and sewage treatment, or electricity supply; but those businesses produce very good shareholder returns.

The investment banking sector would have no problem raising capital from non-risk-averse private investors – hedge funds do fine in this respect. London prospered under this scenario (so did Wall Street under Glass-Steagall). Actually, the London clearing banks had little to do with the post-war revival of London as an international centre.
But no reforms can address the underlying problem: a total shift in culture in the financial services industry. Hans Baer, the Swiss private banker, in a slightly mixed metaphor, famously said: “Incest in the banking world will lead to venereal disease in the future.” The biggest disease the commercial bankers caught when they decided to sleep with the investment bankers was the latter’s compensation habits. Bonus pools attached to business units, with awards made regardless of the firm’s overall results, killed what was left of corporate loyalty. Alan Greenspan thought that self-preservation instincts would ensure banks avoided excess. He had failed to appreciate that bankers no longer gave a tinker’s curse for the reputation or long-term integrity of their employer; they were only concerned with the integrity of their bonus pool in the current year.

No amount of reform of regulatory structures will restore the ultimate regulatory tool: shame. Nor will the pre-eminence of reputation over reward be re-established. When malfeasance became a source of celebrity status rather than social exclusion, the main force that kept the City on the straight and narrow was exhausted.

The one absolutely accurate point being made by the banking lobby is that the reforms will reduce profits. One’s heart bleeds.
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