Briefing Paper

The public duties and social responsibilities of British banks

An implicit social compact between the big British banks and the government under which the banks enjoyed control of the payments systems, and the resulting profits, in return for assuring access to them, broke down in the 1980s. Since then the big British banks have sought to maximise 'shareholder value' by increasing their return on equity. This involved reducing costs, by closing less profitable branches, and thus reducing access, and increasing risk taking. Since the mid 1990s, the banks have substantially increased their dependency on wholesale, relative to retail deposits, and dramatically reduced their liquid asset holdings; increasing their 'leverage', and risk exposure, as revealed by the Global Financial Crisis (GFC). The UK government's response to the crisis following the Northern Rock debacle was to 'bail out' the most troubled big banks, provide even the less troubled big banks with unprecedented support through new facilities created at the Bank of England, and to encourage mergers of weaker banks with stronger ones; increasing concentration in the banking industry and thus potentially reducing competition in banking. The need for the bail out demonstrated a breaking of the trust in the big banks that underpinned that government's willingness to underwrite their ability to create bank money through lending, and make substantial profits from doing so, by providing 'lender of last resort' liquidity insurance to them through the Bank of England. This underwriting of their liquidity by the government was undertaken on the understanding that banks would manage their risks responsibly. The banks clearly broke the trust the government and the taxpaying public put in them as guardians of the deposit based payments and bank credit systems. An Independent Commission on Banking (ICB) was established by the government to recommend, by September 2011, a restructuring of the British banking system in order to enhance competition and reduce the risk of another systemic banking crisis. As a result of the 'bail-outs', the big banks have been revealed to enjoy insurance by UK taxpayers above and beyond what they are paying for. They should pay for that insurance by making a 'Financial Stability Contribution', as recommended by the International Monetary Fund (IMF). This is what the Bank Levy introduced in the government's last 'Budget' aims to achieve. The big banks might also be expected to acknowledge their duty to the taxpaying public by signing a new social contract. Instead, the big banks negotiated a deal ('Project Merlin') with the government, trading lower, and slightly more transparent, bonuses and a promise of higher SME lending in the short term, for lighter regulation and lower bank levies in the future. Within days of the agreement in February 2011, the government urged the Financial Services Authority (FSA) to reduce its proposed stringent new bank liquid reserve holding requirements in order to assure a 'level playing field' internationally. The big banks must also be hoping that the government will ignore recommendations from the ICB that they feel might reduce their 'shareholder value' and international competitiveness.

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