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Briefing Paper

Revisiting Vickers

In response to the 'Vickers Report'[1] in September 2011, the big UK banks reportedly lobbied the government intensively to secure a watering down of its 'ring fencing' recommendation. Others felt that the ring fencing of retail banking within 'universal banks', which combine it with investment or 'casino' banking, was insufficient to protect taxpayers from future bank 'bail-outs' and that full separation of retail banking from investment banking was required, akin to the 1933 US Glass-Steagall Act (GSA).

In the light of the recent clutch of bank miss-selling scandals, and particularly the miss-selling of financial derivatives (swaps), normally associated with investment banking, to small and medium sized enterprises, the debate about ring fencing has been re-kindled. Is ring fencing, as currently proposed in the Financial Services Bill, the right solution, or do we need stronger legislation akin to the GSA?

Functional separation of commercial banking from merchant banking and various stock market related activities was organised through professional associations until the 'Big Bang' reforms of the City in 1986. Subsequently, the separate capital market and merchant banking businesses were amalgamated into modern investment banks, and the 'high street' banks became large universal banks by adding investment banking to traditional commercial banking. Lloyds TSB was an exception until its ill fated merger in 2008 with HBOS, the

[1] The Independent Commission on Banking Report and Recommendations
http://www.birmingham.ac.uk/Documents/college-social-sciences/social-policy/CHASM/independent-commission-on-banking-report.pdf

troubled universal bank. A number of these big banks, including ‘Lloyds’, also developed insurance businesses in the hope of ‘cross-selling’ insurance products with car and home loans.

The big UK banks have become too big to be allowed to fail. Mergers such as those of Lloyds with HBOS, and mergers other EU countries, have made the problem worse by creating financial conglomerates that are seemingly too complex to manage effectively.

Does this mean that separation of modern investment banking and commercial, or narrower retail, banking is a good idea?

The Global Financial Crisis of 2007-9 had its origins in US retail and commercial banking. Like many other banking crises, it resulted from excessive lending to property developers and house buyers. The modern investment banks added fuel to the fire by seeking fee earning securitisation and financial derivative business. Given their incentivised pay structures, it seems likely they would have done so whether universal banking existed or not.

The potential advantages of universal banking lie in cost reducing economies of scale and scope. Numerous studies have attempted to measure these. They find that medium sized banks can fully exploit them and there are significant managerial and operational diseconomies of scale and scope. Big banks appear to have become too big and too complex to be managed effectively.

Taxpayers should be protected from having to bail out failing banks and yet there are probably enough legitimate economies of scale and scope to justify universal banking, but not mammoth banking conglomerates. Governments are working on new banking regulations aimed at protecting taxpayers, but big bank lobbyists are also trying to water these down. If the governments have the will, many economists are confident there is a way; without the need for a GSA. Reducing the oversized banks through further branch sales to new competitors might be a better idea.

Consumers of increasingly complex retail financial products and services should be protected from miss-selling abuses and, to deal with financial exclusion, a 'universal service obligation' should require banks and insurers to make essential financial products and services available to all. Retail banking is fundamentally a utility and should be regulated as such[2]. If, as a result, universal banks find they cannot offer their shareholders sufficient return from their retail banking businesses; they can *voluntarily* separate them from their investment banking businesses and divest them. It should be noted, however, that a good reason for combining commercial and investment banking is to benefit from diversification of risks over the business cycle. Appropriately regulated, and managed, universal banking should increase financial stability and help protect taxpayers from further abuse!

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[2] Why the 'Free' Banking scam should be stopped http://www.birmingham.ac.uk/Documents/college-social-sciences/social-policy/CHASM/briefing-papers/2012/briefing-paper-free-banking-may12.pdf