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Briefing Paper

Project Merlin in context

Through UKFI (UK Financial Institutions Ltd), the government now owns over 40% of the shares in Lloyds Banking Group, the largest British retail bank, and over 80% of RBS, another large British retail bank. UKFI is mandated to gain the best possible price from the sale of these and other (e.g. Northern Rock) bank shares. The government has set up an Independent Commission on Banking (ICB) to provide recommendations, by September 2011, on the restructuring of British banking to achieve enhanced competition and greater financial stability.

Major restructuring would however reduce the value of the banking franchise enjoyed by the big banks. This derives from the 'economic rents' (monopoly profit) they enjoyed under the implicit social contract between the big banks and the government, which has broken down during the financial crisis. Hence the government must choose between maximising the value of share sales in the short to medium term, whilst public revenue is badly needed and protecting taxpayers against future abuse and increasing competition to benefit of consumers.

The social contract was a 'Faustian bargain' that underpinned the big banks' monopoly profits in return for responsible behaviour towards banking risks assuring financial stability. The UK government became too reliant on the revenue from taxing the monopoly profits of the banks and 'The City' became a financial oligarchy that in the end broke the trust underlying the contract. As monopoly profits decline following any major restructuring, other sources of tax revenue from banks can however be sought (e.g. VAT, or a transactions tax). Big banks should also pay special taxes to compensate the taxpayer for the insurance it provides them. Higher regulatory 'taxes' (Basel III capital adequacy proposals, and utility regulation of retail banks) may also reduce bank profitability and their ability to lend to small and medium sized enterprises (SMEs) and households, though the likely extent of this is hotly debated.

The UK government wants big British banks to lend more to SMEs and to reduce bonus payments as a result of public (taxpayer) anger towards them. The banks fear ‘excessive’ regulatory and financial taxes. The ‘Project Merlin’ deal between the banks and the government , concluded in February 2011, essentially involves the banks offering to restrain bonuses and increases SME lending (temporarily) in return for lighter regulatory and financial taxation going forward. The government should have said no to the deal, since such a deal is bad for taxpayers and consumers in the longer run.

In this game of Poker, some big banks have threatened to leave London, but they cannot take their retail branches with them! The ICB’s proposal to ring-fence retail banking in separately capitalised subsidiaries seems very sensible; for the competitiveness of The City in genuinely international banking and wider financial markets can then be separately addressed.

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