

## **The Independent Commission on Banking's Report and Recommendations**

The Independent Commission on Banking (ICB) chaired by Sir John Vickers was established in June 2010 to consider structural and related non-structural reforms to the UK banking sector to promote financial stability and competition and it reported on 12 September 2011 ([www.bankingcompetition.independent.gov.uk](http://www.bankingcompetition.independent.gov.uk)).

The ICB was set up in the wake of the 2007-09 banking crisis. The context is important because there had been concerns about uncompetitive banking conduct, and also mis-selling of products, dating back to the Cruickshank Report in 2000 ([www.competition-commission.org.uk](http://www.competition-commission.org.uk)); which recommended the regulation of the payments systems as a utility and a review of uncompetitive practices relating to the bank charges for small business loans and accounts. The Small and Medium sized enterprise (SME) banking market was overwhelmingly dominated by the big four British banks, which had over 85% of the accounts. The Competition Commission (CC) concluded in 2001 that price controls should be imposed to reduce costs for SMEs. These were removed in the run up to financial crisis because it was felt that the entry of the Spanish bank Santander, through Abbey National, a former mortgage bank, and the Bank of Scotland, following its merger with the Halifax, another former mortgage bank, to form HBOS, had increased competition sufficiently.

In the run up to the crisis, the Bank of England had stopped monitoring small business lending. It had taken on the mandate at the behest of the Treasury during the 'credit

crunch' that followed the early 1990s recession, when there were similar debates about whether the fall in SME lending was due to a lack of supply by the banks, or demand by the SMEs, or a bit of both. The costs of SME borrowing also rose and as now, banks blamed rising funding costs.

These concerns about uncompetitive behaviour had prompted a series of investigations by the UK competition authorities (the CC and the Office of Fair Trading, OFT) and rulings against bank misconduct by the Financial Ombudsman Service (FOS) and the sector's regulator and supervisor since 1997, the Financial Services Authority (FSA). A ruling in 2010 related to the mis-selling of Payments Protection Insurance (PPI) and the banks are now required to pay substantial compensation to customers.

Government actions in 2007-09 to prevent a systemic failure of UK banking resulted in the full and partial nationalisation of two other mortgage banks (Northern Rock and Bradford and Bingley, respectively) and the government injecting substantial capital and taking share holdings in two of the largest banks (over 40% in the Lloyds Banking Group (LBG) and over 80% in the Royal Bank of Scotland (RBS), which owns NatWest). This was following the merger of Lloyds TSB and HBOS, and Santander added the struggling Alliance and Leicester mortgage bank and the savings accounts of the Bradford and Bingley to Abbey National.

Market concentration in the UK banking was thus increased substantially as a result of the measures taken to stem the crisis; with potentially deleterious effects on competition; particularly in the provision of retail banking products and services for households and SMEs. This was despite a warning from the OFT that the Lloyds TSB – HBOS merger would severely distort competition by creating LBG, which has over 30% of UK deposits and a large share of SME banking business.

The contrast with a number of other major European countries is stark. The big 'universal banks' in Germany (Deutsche and Commerzbank) combine retail banking with wider commercial banking services for firms larger than SMEs, and wholesale and investment banking, 'Casino banking', or trading, and merchant banking and asset management etc, but they control less than half of the retail banking market even after Deutsche Bank's recent takeover of Deutsche Postbank. The rest of the German retail banking market is controlled by regional and local savings and co-operative banks and so the concentration of retail banking in just a few banks is much less in Germany. The picture is similar in France and other European countries, including Switzerland.

The size of the major UK banks, at over four times Gross Domestic Product (GDP), is also very large relative to Germany, France, and indeed the US and even Ireland; but smaller than Iceland and Switzerland. The UK taxpayer is thus much more heavily exposed to the costs of bank 'bailouts', than other major European countries and the US; where no bank is allowed to have more than 10% of deposits.

To protect UK taxpayers from a repeat bailout of banks that are 'too big (to be allowed) to fail' (TBTF), because of the consequent damaging economic consequences, structural reform had to be considered. The underwriting of TBTF banks by taxpayers allows them to raise finance more cheaply than smaller, non TBTF, banks and thus distorts competition. It also makes it difficult for new, smaller, banks to enter the market to increase competition.

One option was thus to break up the big banks into units that are not TBTF. Another was splitting retail or 'utility' banking from investment or 'City' banking. The evidence on economies of scale and scope in banking points to medium sized US banks being of optimal size, not mega banks. Universal banks arguably need scale to achieve the full benefits of

diversification and thus to reduce risk, but the benefits of diversification for retail bank customers and taxpayers seemed to be outweighed by the desire of the more risky investment banking operations to fund themselves cheaply and reliably by using retail deposits. There is no need for taxpayers to underwrite City banking as well as utility banking.

The big banks naturally lobbied vigorously against the more extreme restructuring proposals and seemed pleased with their efforts when the ICB report recommended the 'ringfencing' of retail banking in separately capitalised subsidiaries, along with higher capital requirements (core equity capital plus bonds that can be converted to equity in crises) than the proposed international standards; though less than those imposed by the Swiss authorities on their two major universal banks. The big bank also gained some flexibility in deciding how much business lending *inter alia*, above and beyond SME lending, to include within the ringfence and a generous amount of time to phase in the required changes.

The implication is that the parts of banks outside the ringfence are no longer underwritten by taxpayers and can be allowed to fail, or financially restructured, if they run into difficulties, without burdening the taxpayer. Further, higher internationally imposed ('Basel III'), capital requirements should make them better able to absorb losses and thus less likely to fail.

In order to increase competition in retail banking, the ICB proposed that LBG sell the 600 or so branches that the European Commission's Competition authority had required it to, in order to compensate for its receipt of 'state aid',<sup>1</sup> to an existing smaller competitor (e.g. the

---

<sup>1</sup> A UK banking subsidy that the rest of the EU did not benefit from and which was thus distortionary with regards to competition at the EU level.

Co-operative Bank). LBG's share of the market will not be reduced as much as the ICB's interim report, which mooted requiring LBG to sell a significant number of additional branches, had suggested. It is however recommended that LBG transfers more customer accounts with the branches.

In parallel, the government is overhauling the regulatory structure, moving 'micro-prudential' regulation of the banks back to the Bank of England, from the FSA, and requiring the Bank to take on an extended role in securing financial stability; alongside its current price stability role and a pro-active 'macro-prudential' role to head off future financial excesses and thus reduce the risk of financial crises. The rest of the current FSA is to be converted into a Financial Conduct Authority with responsibility for overseeing financial conduct in retail banking, 'city banking' and the wider securities markets. These changes are to be contained in the 2011 Financial Services Bill ([www.hm-treasury.gov.uk](http://www.hm-treasury.gov.uk)), but sit oddly alongside the ICBs conclusion that: "domestic retail banking services should be inside the ringfence, global wholesale/investment banking should be outside" and the competition part of the report; which concludes that: "the new Financial Conduct Authority (FCA) should have a clear duty to promote effective competition" in retail banking.

The FCA's brief thus includes regulating 'city banking' conduct. A specialist retail banking (and insurance) utility regulator would be much better focused on retail consumer issues. It could take over, from the OFT, regulation of the consumer credit market and would naturally also take on the consumer education role and promote universal access to financial services, and thus financial inclusion. Future referrals to the UK competition authorities could also be obviated if the utility regulator had sufficient powers to assure that customers are truly 'treated fairly', which the FSA was tasked to do. The City wholesale and

capital markets would then get their own regulator, like the Securities and Exchange Commission (SEC) in the US, and the UK regulatory structure would then be better aligned with that being developed at the EU level.

The big UK banks have warned that substantial structural reforms would undermine the international competitiveness of 'The City', and some have even threatened to move their head offices abroad. It is hard to see why removal of a taxpayer subsidy should undermine a UK industry which believes it has a competitive advantage, especially when competitor big banks in Germany, Switzerland and the US (especially since the July 2010 Dodd-Frank "Wall Street Reform and Consumer Protection Act") enjoy less of a taxpayer subsidy!

The big banks changed their lobbying tactics as the UK economy slowed after the publication of the ICB's interim report in April 2011 and began warning that the proposed ringfencing would slow down the faltering recovery and perhaps cause a 'double-dip' recession by prompting a reduction in SME lending, and making it more expensive. Their lobbying seemingly secured a softening of April proposals in the final report, but will the ringfencing of retail banking adversely affect SME lending? It is hard to see why it should, though enhanced capital requirements might.

Notably, the Federation of Small Business and the Institute of Directors favours ringfencing and the associated measures to increase competition in SME lending. To address the possibility of reduced and more expensive SME lending, the government has the option of enhancing the Enterprise Finance Guarantee scheme ([www.bis.gov.uk](http://www.bis.gov.uk)) that provides government (taxpayer) guarantees against bank losses on SME lending. The Confederation of British Industry, which represents larger companies, was hostile to ringfencing, but bigger

companies have a much broader range of funding options and lending to them can now be kept within the ringfence.

The City must simply compete with New York and other major financial centres on its own merits. Arguably, differential taxes are an issue here, but City investment banks have hitherto found ways of adequately, and many would argue more than adequately, remunerating talented staff! If the UK 's 50% tax rate is really too high, and the treatment of 'non-doms' and the curtailment of tax deductibility of pensions is genuinely too onerous, the UK's 28% Capital Gains Tax provides an alternative option for rewarding financial sector stars, it should be noted. However, bonuses and taxation issues are a separate issue for the government to consider in regards to 'The City's' international competitiveness and the overall fairness of the UK tax system.

Andy Mullineux

Professor of Global Finance

Deputy Director of Centre on Household Assets and Savings Management

December 2011