Centre for Policy Studies

Pointmaker

BOOST BANK COMPETITION

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SUMMARY

- A fundamental requirement of competitive markets is the possibility of 'free entry' for new players and 'free exit' for those that fail.
- The regulatory framework for financial services has left competition authorities in a junior role. This has helped to create a banking sector dominated by banks that are too big to fail.
- This has also led to high barriers to entry for new players and complacency about the need for greater banking competition.
- Competition has been too weak in the banking industry for some time. The top five banks have a market share of 80% or more. This stifles competition. Market concentration grew rapidly in the years leading up to 2008.
- The new Financial Conduct Authority (FCA) should be given a specific competition objective to:
  - seek ways to remove barriers to entry (promote new competition);
  - take steps to permit the orderly exit of failed institutions (break up institutions that are 'too big to fail');
  - ensure products and services offered are themselves subject to competition.
- To fulfil this aim, the FCA should establish a Financial Competition Commission (FCC) that would carry out investigations of individual firms or of product areas. It would make recommendations to the Bank of England to promote competition between banks. The Bank of England would have the authority to enforce such recommendations.
- This could result in a profound cultural change in the financial services industry. Over time the focus on competition would:
  - improve customer service
  - restore free market principles; and,
  - may even reduce the risk of bank failure and the need for the implicit taxpayer guarantee.

INTRODUCTION

"In general, if any branch of trade, or any division of labour, be advantageous to the public, the freer and more general the competition, it will always be the more so."

Adam Smith, *The Wealth of Nations*, 1776

A fundamental requirement for competitive markets is the possibility of 'free entry' for new players and 'free exit' for those that fail. Yet, in the banking sector, these principles have been lost.

Some claim that the financial crisis was a failure of free markets and capitalism. But in truth, one of the causes of the crisis was that competition in the banking sector has been extremely weak for many years. The top five banks have a market share of 80% or more. This stifles competition. This must be reversed so that new banks can compete freely and that existing banks are 'free' to fail. (Other causes of the crisis include the failure of monetary, economic and regulatory polices which allowed and even encouraged bad banking practices; and issues such as International Financial Reporting Standards which exaggerated profits and capital in boom years. These issues are outside the scope of this paper).

Many believe that the next financial catastrophe is only a crisis of confidence away. The Governor of the Bank of England has voiced his concern about the continued volatility of the banking sector – indicating that imbalances in the financial system are beginning to grow again. At the same time, some in the banking community have failed to accept responsibility for excessive risk-taking and the irresponsible behaviour that led to the crisis. There is still a lack of acceptance of what their actions have meant for ordinary people, accompanied by a refusal to be held accountable and a failure to restructure the industry in order to avoid another financial meltdown.

Yet bankers have no incentive to reform their behaviour while they know that they cannot lose, and that the taxpayer will have to bail them out if they fail.

Some steps have been taken to address these problems. The publication in February 2011 of the Treasury's Command paper set out detailed proposals for national and international regulation of financial services. This should be welcomed, as should the HMT's acceptance of the Treasury Select Committee's recommendation for a competition objective within the industry. However, regulation must look beyond product competition and protection of the consumer. It must include competition between banks. And that can be achieved by focusing on the structure of the banks themselves.

THE VALUE OF THE UK FINANCIAL SECTOR

The banking industry in the UK has provided an important part of total tax revenues over the last 10 years. The tables and charts opposite show how, at its peak in 2007-08, the financial sector generated 11% of total payroll receipts and 22% of total corporation tax receipts.

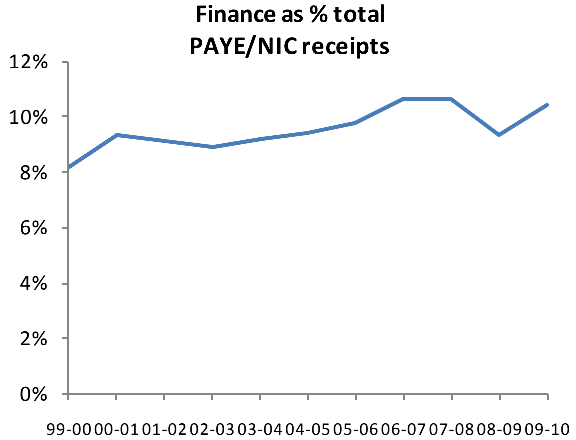
A PricewaterhouseCoopers report for the City of London Corporation in 2009 put the total tax contribution of the financial services sector at £61 billion in 2008-09 (12% of total tax revenue), including income tax paid by employees and so on. The 2010-11 bank payroll tax raised £3.5 billion; while, following the 2011 Budget, the bank levy is expected to raise more than £2.5 billion a year from 2011-12.

Similar importance is observed in employment. The Financial Services Sector employed over one million workers in March 2010 (3.5% of the total UK workforce). The industry is a great asset for the UK, one that must be developed and protected.

UK PAYE and NIC net receipts 1999-2010

£ billion

	Financial sector	Total net receipts	Finance as % total
1999-00	12.3	150.3	8%
2000-01	15.5	165.8	9%
2001-02	15.6	171.2	9%
2002-03	15.5	174.1	9%
2003-04	17.1	186.4	9%
2004-05	18.9	201.0	9%
2005-06	21.2	216.0	10%
2006-07	24.5	230.6	11%
2007-08	26.3	247.7	11%
2008-09	22.9	244.7	9%
2009-10	24.5	234.8	10%

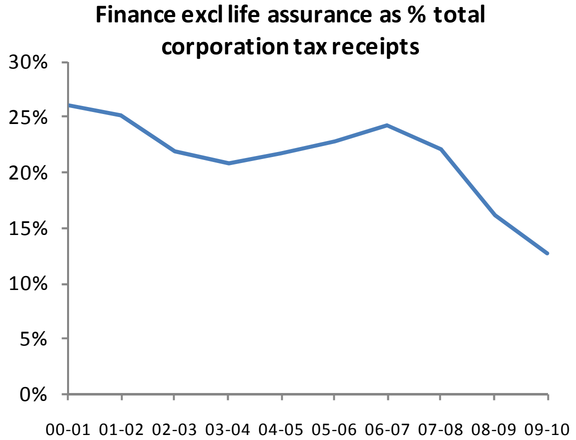


Source: HC Deb 23 Nov 2010 c283-4W and HMRC

UK corporation tax net receipts 2000-2010

£ billion

	Financial excl. life assurance	Total net receipts	Finance as % total
2000-01	8.4	32.4	26%
2001-02	8.1	32.0	25%
2002-03	6.4	29.3	22%
2003-04	5.8	28.1	21%
2004-05	7.3	33.6	22%
2005-06	9.5	41.8	23%
2006-07	10.7	44.3	24%
2007-08	10.3	46.4	22%
2008-09	7.0	43.1	16%
2009-10	4.6	35.7	13%



Source: HMRC Corporate Tax Statistics table 11.1

Yet it must be recognised that this undeniably valuable industry wiped out an as yet unquantifiable amount of taxpayers' money during 2008-09. Even today, the banks still arguably receive significant subsidies: in December 2010 the Bank of England's *Financial Stability Report* identified an implicit subsidy of £100 billion for those banks considered too big to fail. That subsidy is the saving in cost of funds from the implied taxpayer guarantee. In other words, without the implied support of the taxpayer, bank credit ratings – and hence their cost of funds – would be £100 billion higher.

Without a change in the culture of banking, it is not hard to see why some people think that driving the industry overseas is a good idea.

DURING THE CRISIS

The failure to anticipate the crisis cost the economy dearly. Taxpayer bailouts, the special liquidity scheme, the emergency asset purchase facility (quantitative easing), the asset protection scheme and a lowering of interest rates to 0.5% were all designed to save the banks and the UK economy from collapse. The table below from the National Audit Office (NAO) indicates that the support of the banks, in gross terms, came to nearly £1 trillion in 2009; and over £500 billion in 2010 (equivalent to around £60,000 a household in total).

The potential net loss to the taxpayer is hard to establish, and will not be known until taxpayer support is unwound and the banks re-privatised.

Changes in scale of support December 2009 - December 2010

	as at December (£bns)	
	2009	2010
Guarantee and indemnities	280	131
Asset protection scheme	200	115
Credit guarantee scheme	250	110
Loans to Financial Services Compensation Scheme, Bradford & Bingley and others	37	35
Cost of shares		
RBS	46	46
Contingent RBS share purchases	8	8
Lloyds	21	21
Total scale of support	842	466
Other support to wholly-owned banks		
Loans to Northern Rock	16	22
Guarantees to Northern Rock	24	16
Capital and contingent capital in Northern Rock and Northern Rock Asset Managment		3
Guarantees to Bradford & Bingley	10	6
Unused committments		
Contingent capital for other firms	13	
Asset backed securities scheme	50	
Total	955	512

Source: NAO fig 1, HC676 2010-11

WHAT HAS BEEN DONE TO AVOID FUTURE CRISES?

Fundamental regulatory change is taking place in the UK, the EU and through the Basel Committee.

Treasury reforms

The Treasury has set out detailed reforms with the focus on three institutional changes:

1. A new Financial Policy Committee (FPC) within the Bank of England with responsibility for 'macro-prudential' regulation, or regulation of stability and resilience of the financial system as a whole.

2. A Prudential Regulation Authority (PRA) to take on the 'micro-prudential' regulation of financial institutions that manage significant risks on their balance sheets. This will be an operationally independent subsidiary of the Bank of England.

3. A Financial Conduct Authority (FCA) which will have responsibility for conduct issues across financial services. This is a new specialist regulator, taking on much of the FSA's role of managing orderly markets as well as having an additional objective of promoting competition.

These institutional changes, while a valuable contribution to addressing the fundamental failings of the previous administration's 'tripartite' approach to financial regulation and financial stability, do not go far enough.

The Coalition has also appointed Sir John Vickers to lead an Independent Commission on Banking (ICB) to examine the structure of banking, together with issues of choice and competition. This is due to report by September 2011, with an interim report due in April.

EU reforms

In the EU, the old 'co-ordinating' regulatory bodies are being replaced by a two tier system – a European Systemic Risk Board and three European supervisory authorities consisting of a European Banking Authority (EBA), a European Securities and Markets Authority (ESMA) and the Committee of European Insurance and Occupational Pensions Supervisors (EIOPA). The Banking Authority will sit in London, the Securities Authority in Paris and the Insurance and Pensions Authority in Frankfurt.

Basel reforms

The G10 Basel Committee has put forward new proposals (Basel III) that require lenders to increase their tier one capital ratios to 7% from around 3% prior to the crisis. The new capital rules are proposed to be implemented in stages between 1 January 2013 and 1 January 2019 and are endorsed by the G20 countries.

WILL THESE CHANGES FACILITATE FREE ENTRY AND FREE EXIT?

These are all important initiatives to establish a framework that will be better able to avoid a future crisis. Increased capital requirements will improve the loss absorption ability of financial institutions. Counter cyclical capital requirements will also help prevent a future repeat of 2008.

However, none of these solve the issue of free entry and free exit. Indeed, the Basel requirements will make it more expensive for new entrants to raise capital. In addition, the moral hazard resulting from the implicit tax payer guarantee for banks should they fail, leaves regulators with no incentive to encourage new entrants or to rethink their own risk policies.

In 1995, Barings collapsed as a result of propping up Nick Leeson's rogue trading in the Far East (as I was running Barclays' Investment Banks team at the time, I witnessed the problems caused by Barings collapse at first hand). Barings' London treasury pumped money into Singapore to the point where the entire bank failed. Had Barings operated under a proper subsidiarisation model, failure might have been avoided. However, what is interesting in today's context is that Barings' failure did not result in systematic contagion.

A major reason why a run on the banks was avoided is because the Bank of England was in sole charge as banking supervisor and lender of last resort. Governor Eddie George knew the buck stopped with him and acted immediately to reassure all those banks with significant exposure to Barings so that when it failed, there was little ensuing panic.

Returning responsibility for the integrity of the banking system to the Bank of England will enable it to spot and pre-empt future crises better. However, it does not in itself solve the specific challenge of ensuring free entry and free exit.

One size fits all is not the answer

The ICB is apparently considering the reintroduction of a form of Glass Steagall and/or imposing a subsidiarisation structure on global banks. Such a proposal would be dangerous: the separation of retail and investment banking would be hard to enforce with today's sophisticated products. It would be impossible to police and would risk being seen as an 'anti-free enterprise' proposal that would inevitably be challenged over time. Subsidiarisation may work for some – Banco Santander already operates under such a model, but global investment banks might find such a structure unworkable and extremely costly.

And it is important to remember the banking crisis was not about proprietary trading versus retail banking. Lehman – whose failure was the trigger to the crisis in 2008 – was not even a deposit taker. No reasonable capital requirement would have saved it. No split between proprietary trading and deposit taking would have saved it. No cap on bonuses would have saved it.

Conversely, Northern Rock was not an investment bank and nor, on its own, was it too big to fail – it just had a lousy business model. No regulation to separate retail and investment banking would have saved it. So separation of activities and/or a subsidiarisation model of banking would not solve the issue of free entry and free exit.

THE SCALE OF THE CHALLENGE TO ENSURE FREE ENTRY AND FREE EXIT

Last year, Metro Bank was the first company to be granted a full service high street banking licence in the last hundred years and that was after a wait of 18 months whist investigations were carried out by the FSA.

More needs to be done to encourage other new entrants. In particular, banking reform must therefore include two key goals:

1. New, smaller banks must be able to enter the market without barriers to entry;

2. Existing retail banks and/or higher risk investment banks must be able to fail without resulting in the Hobson's choice between a taxpayer bailout and the collapse of the entire system.

Size matters

A major reason why Barings' collapse in 1995 did not spark a run on the banks is that Barings was a relatively small investment bank by today's standards. It was not too big to fail and concentration in the banking industry was far less than it is today. Paradoxically, allowing a relatively small bank such as Barings to fail has led to a reduction in competition as it became clear that small banks did not enjoy government protection. This accentuated the moral hazard of larger banks. This is turn unwittingly gave the larger banks a significant competitive advantage.

In 1995, Barings was, according to *The Banker* (which publishes an annual list of The Top 1000 World Banks), the 545th biggest bank in the world and the 15th biggest in the UK as measured by the favoured Tier 1 Capital measure. Barings' US$432million Tier 1 Capital compared with $17.9 billion for the largest UK bank (HSBC) and $22.6 billion for the then largest bank in the world (Sanwa, Japan).

Barings' failure caused enormous confusion and complication for the financial markets, but its manageable size meant that (while there was short-term panic) there was no serious risk of contagion among other banks. Today there is little scope for new entrants; nor, as market concentration has increased, is there much chance of an orderly exit of failed banks. For over the last 10 years, the banking sector has been consolidating, often with clear benefits for the senior employees and directors, and less clear benefits for shareholders and customers. The table below shows how in 2000, there were 41 banks in the major British high street banking groups and their subsidiaries. By 2010, there were 22, a drop of nearly half.

As concentration has increased, so the scope for new entrants has narrowed and the risks associated with failure have increased. The assets of the major British high street banking groups have increased almost four fold in the last ten years.

Number of UK banks, 2000 to 2010

	Major UK banking groups and their subsidiaries	**All banks authorised to take deposits in the UK**
2000	41	420
2001	42	409
2002	41	385
2003	42	380
2004	35	356
2005	32	346
2006	30	335
2007	28	335
2008	23	338
2009	22	336
2010	22	332

Source: British Bankers' Association, Annual Abstract of Statistics, various years

Notes: The major British high street banking groups used in this analysis are Abbey group, Alliance & Leicester group, Barclays group, Bradford and Bingley plc, HBoS group, HSBC Bank group, Lloyds TSB group, Northern Rock group and Royal Bank of Scotland group. Note that the activities of a number of subsidiaries have been absorbed or fully consolidated with their parent institution; on the other hand, restructuring of other groups has sometimes had the effect of increasing numbers.

THE FUTURE

Better regulation and higher capital ratios could mean that future crises will be less severe. But they cannot stop them.

What is needed is a strong, flexible regulator that will consider the issues of being 'too big to fail', barriers to entry and achieving healthy competition. The mere existence of such a body should lead to a change in the culture of financial services from the current high degree of complacency to one that accepts the need for fair competition and efficiency.

This can be achieved by giving the FCA a ***primary*** competition objective. It can fulfil this objective by establishing a Competition Commission whose role will be to:

- seek ways to remove barriers to entry (or promote new competition);
- take steps to permit the orderly exit of failed institutions;
- ensure products and services offered are themselves subject to competition.

Why have a Financial Competition Commission?

There are already both UK and European competition authorities. They have investigated plenty of proposed corporate actions in the finance industry. For example, the merged banks of Lloyds and HBOS have been required to divest about 600 branches in the UK by the EU Commission.

But these competition authorities are 'reactive' to proposed changes in the structure of banks and, as we have seen over the last decade, have allowed a position of market dominance to arise without taking steps to reduce barriers to new entrants. What is needed is a more active approach where a regulator can identify the changes that are needed on a case by case basis.

It should also be recognised that the role of competition in the banking industry is both uniquely complex and contains many paradoxes. For example, a higher capital requirement for the banks is seen, almost universally, as a good thing. Yet is also deters the emergence of smaller banks – also almost universally seen as a good thing – as it raises the cost of entry significantly. To resolve these and similar tensions, a specialist, independent organisation, acutely aware of the importance of, but not over-sympathetic to, the industry is needed to make appropriate recommendations to the Bank of England.

This should be accompanied by Parliamentary scrutiny into the smooth working of the FCA, as well as the PRA and FPC. In particular, the Treasury Select Committee should scrutinise specific major policies adopted by the Bank of England (such as quantitative easing) as well as scrutinizing recommendations made by the Competition Commission. The Chairman of the Treasury Select Committee would report to the entire House with the Committee's findings.

Modus operandi

Giving the FCA a primary competition objective will address the free market imperative of 'free entry' and 'free exit' of market players. The FCA should establish a Financial Competition Commission (FCC) whose role it is to seek to remove barriers to entry and to resolve issues around being 'too big to fail' through:

- ***Tailored Investigations*** on an individual basis. This would have far greater impact and offer broader solutions than the 'one size fits all' alternative currently favoured by many regulators.

- ***Business or Product Share Investigations*** Where a financial institution is not 'too big to fail' but has excessive market share (in for example mortgages or insurance or equity underwriting or gilts trading) then it could be required to reduce its influence in much the same way as, say, British Airports Authority was required to do in reducing its ownership of British airports. This means that the Commission would have the dual role of ensuring freedom of entry/exit and protecting consumers through regulating individual products.

- ***Statutory power:*** The recommendations of the Competition Commission within the FCA would need to be enforceable. Ultimate oversight for compliance with the recommendations should lie with the Bank of England. In an extreme cases of failure to meet such recommendations, the Bank of England would be empowered to 'go nuclear' and demand changes to the terms of the licence for the bank(s) in question.

The mere existence of the FCC within the FCA should force a significant change in culture of the finance industry. Banks and Non-Bank Financial Institutions are likely to try to pre-empt potentially radical FCA rulings by considering internally how to meet competition objectives in the least disruptive way to their business.

The FCC will therefore aim to ensure competition *within* the UK. But it should also seek to minimise making the UK uncompetitive as a place for financial institutions to operate. Over a period of time, the work of the FCC could lead foreign regulators to pursue similar reforms.

CONCLUSION

The Treasury's New Approach to Financial Regulation goes some way to addressing the dangers inherent in the existing banking structure. However, only by giving the FCA a specific competition objective will we create a more competitive and efficient banking structure; thus helping this immensely valuable sector of British business to thrive in a globally competitive market.

IDEAS MATTER

The following proposals, all recently advocated by the Centre for Policy Studies, have recently been adopted by the Coalition:

- **Merging NICS and Income Tax:** in the 2011 Budget, the Government announced that it will consult on a proposal to merge the operation of NICs and Income Tax. The recommendation to merge the two and simplify the UK's complicated personal tax system was outlined by David Martin in *Abolish NICs.*

- **Corporation Tax:** the 2011 Budget reduced the main rate of corporation tax by 2% this year, with commitments for further 1% reductions each year until the end of the Parliament. Michael Forsyth and Corin Taylor emphasised the pressing need for lower corporation tax in *Go For Growth.*

- **Increasing tax allowances to £10,000:** proposals to increase tax allowances to £10,000 – and to lift millions of people out of paying tax – were first made by Maurice Saatchi and Peter Warburton in *Poor People! Stop Paying Tax!* in 2001.

- **Enterprise Investment Scheme:** the Enterprise Investment Scheme was limited to companies with 50 employees or less. From April 2012, this will be extended to firms with up to 250 employees. This Budget change was one of a range of measures made by Charlie Elphicke in *Ten Points for Growth.*

- **Tax simplification:** the Coalition has announced plans for simplifying the tax system, taking up many of the proposals made by Lord Forsyth in his Tax Simplification Committee report, *Tax Matters,* and by David Martin in *Tax Simplification: how and why it must be done* (2007).

- **Abolition of the tripartite regulatory regime:** recommendations to abolish the tripartite regulatory regime and to ensure the Bank of England has the authority needed to ensure overall stability were first put forward by Sir Martin Jacomb in his 2009 CPS report, *Re-empower the Bank of England*.

- **Pension Tax Relief:** Following Michael Johnson's CPS Report *Simplification is the Key*, the Treasury has announced that the annual contribution limit has been reduced from £500, 000 to between £50,000 and £30,000.

- **Public Sector Pensions Reform:** Following Michael Johnson's report, *Don't let this crisis go to waste*, the Public Sector Pensions Commission has published a report advocating an increase in contributions and that in the future pensions should be based on the person's career-average salary.

- **Benefit simplification:** proposals for simplification of the benefit system and proposals in the Welfare Reform Bill to reduce the scope for fraud and error both followed the central recommendation of *Benefit Simplification: why and how it must be done* by David Martin (2009).

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