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Bring competition back to banking [1]

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The Parliamentary Commission on Banking Standards, headed by Andrew Tyrie, wants to electrify the proposed ring fence between retail and investment banking. Regulators should be able to force a complete split of retail and investment banking operations if a bank tries to resist the ring-fencing rules, it says.

We need smaller banks and more competition in banking, yes. But this proposal is a bad idea.

In the first place, the Vickers Commission ring-fencing proposals are the answer to the wrong question. The idea is to separate the 'risky' investment banking (or as the Business Secretary Vince Cable calls it, 'casino banking') from the supposedly less risky retail element (the 'Captain Mainwairing' business). However, it was not the investment banks that crashed back in 2007-08. As our report by Miles Saltiel explains [3], it was the mortgage banks and former building societies like Northern Rock that came to grief. Ring-fencing could actually increase risk. And it will certainly raise costs for retail bank customers, as their banks will not be able to pass on the savings from the savvy management of pooled funds by their investment arms.

Second, regulators are the last people you want telling the banks how to run their businesses. if they were empowered forcibly to split up banks, they would undoubtedly make a hog's ear of it. They would, in the process, damage UK banking and drive yet more banking business out of the UK. If you want to break up the banks, use the market: simply have more onerous capital ratios on the larger banks. That reflects the fact that the larger a bank is, the more damage its failure would do: small bank failures are manageable. It is the huge cost of regulation that has actually caused the elephantiasis of our banks: with smaller banks we would have more competition and we would need less regulation.

Third, the proposal is typical of politicians' belief that they can manage markets. In fact they are hopeless at it. A decade ago they were telling us how well they were managing the banking sector, and the Financial Services Authority had more than two thousand people on the job. They failed, miserably. Politicians and regulators don't know what is happening in markets. They wouldn't know whether a bank was getting round the ring-fencing rules or not. And they certainly wouldn't know what to do about it.

Fourth, our banking system is broken, but the politicians and regulators have done nothing to expose its problems. Nor would this proposal. The banks are still loaded with toxic obligations, but nobody outside the banks themselves knows how much. Banking depends on trust, but how can you trust them, if you don't know how many skeletons are in their cupboards?

A better solution would be to make the banks fess up and reveal their toxic 'assets'. Then put those assets into an isolation ward and let the healthy parts of their business get on with life. Then encourage more

competition in banking by making market entry easier, reducing the regulations on smaller banks and raising the capital (and ? see our forthcoming report by Robert Miller on this ? their cash requirements). In other words, return banking to the real world of market competition. Job done.

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