Published on *Adam Smith Institute* (http://www.adamsmith.org)

Vickers report fails the competition test [1]

Written by **Tim Ambler** [2] | Tuesday 13 September 2011

The Independent Banking Commission has striven mightily for two years and finally produced a mouse, and a malignant one at that. The report boils down to two recommendations: ring-fencing the retail subsidiaries and increasing equity requirements along the lines of Basel III but to a greater extent.

The final report makes a whole range of assertions, notably about competition, which are not supported by logic or evidence. For example: ?The recommendations in this report will be positive for UK competitiveness overall by strengthening financial stability.? (p.15). One could strengthen financial stability by raising the equity requirement from 7.5% to 100% but it would obviously be disastrous for competitiveness.

Reading the report, it becomes clear that the Commission has no real idea of the competitive consequences of their recommendations, if implemented. In the main report we are told that the issue will be justified in detail in Annex 3 but when we get to these 46 pages we find that competition is not addressed at all:

> ?The Commission?s recommendations to improve UK financial stability are far-reaching, and would have important effects throughout the economy. The aim of this annex, which provides more detailed analysis to support aspects of Chapters 2 to 5, is to set out how the recommendations would improve financial stability and the nature of the associated costs. It covers the following aspects in turn:
>
> ? the economic importance of banks1 and the costs of banking crises;
>
> ? an examination of the effects of the proposals on:
>
> ? the diversification of banks? assets;
>
> ? the liquidity and funding of banks;
>
> ? the interconnectedness of the banking system; and
>
> ? the ability of banks to bear losses;
>
> ? how, and the extent to which, banks currently benefit from an implicit government guarantee;
>
> ? the nature and broad magnitude of costs which could arise (i) for banks affected by the proposals, and (ii) for the economy as a whole; and

? a summary of reasons to expect that the proposals would promote UK financial stability both effectively and efficiently compared with alternative approaches.? (p.269)

In short the Commission is relying on a non sequitur, which is a fatal flaw throughout the report.

Turning to the first of the recommendations, ring-fencing is a pious myth. The News of the World was ring-fenced within the Murdoch empire. That does not protect the group, nor its shareholders, from disaster within the subsidiary or at the top levels of the group. As RBS showed, the big disasters began with the group CEO, unsupervised as he was by outside directors, shareholders, Bank of England or the Financial Services Authority. If the business of either ring-fenced sibling goes bad, the parent will have to pick up the bill and the whole enterprise affected. The idea that ring-fencing will allow the UK government to withdraw its implicit guarantee for banks too big to fail is part of the same myth. What a government now declares and what it has to do when the time comes are two different matters.

How will ring-fencing apply to foreign owned banks trading in the UK? The Commission reckons that the UK retail banking market is, for all practical purposes, a matter for UK banks only. That may be the case now but if UK banks are penalised relative to foreign-owned banks (what the Commission calls the ?super equivalence? objection) that may not remain the case. Other EEA banks are free to trade in the High Street and that includes Iceland. It would be difficult to refuse banking licences to reputable banks owned outside the EEA as that would inspire retaliatory action by their governments and London would be the net loser.

Turning to the Commission?s second recommendation, Basel III has the powerful advantage of being a global set of rules: the proverbial level playing field. The Commission happens to this Basel III does not go far enough, e.g.:

> ?2.20 As to the cost of equity capital and effects on growth, the Commission?s conclusion from various cost-benefit analyses is that there is a powerful case for the global minimum equity requirement being a good deal higher than 10% of RWAs, and for it to be accompanied by a minimum leverage ratio well above 3%. Much of the higher cost of equity to private parties relates to tax effects, which is a private, not social, cost and in principle could be offset by tax reform. In sum, the Commission believes that the Basel baseline is by some margin too low.? (p.28)

That is a valid point of view that could and should be tested in the court of world opinion. The Basel proponents will say that it already has been. What is not sensible is to flounce off and say that the UK will hobble its own players in the global market. The Commission claims, but see above, that the higher standards will actually attract foreign business and be positive for UK banks. Quite apart from their lack of logic or evidence for this assertion, it is torpedoed by the nature of competition. The proposal is to enforce these higher standards against the wishes of the banks themselves. If the banks thought the higher standards would indeed be good for their businesses, they could adopt them whenever they pleased. Clearly the banks do not agree with them and outsiders should reckon that banks know their business better than this Commission does.

In short, this report has substance in inverse proportion to its length (363 pages). Fortunately it is not due to be implemented until 2019 and that should give plenty of time to bury it.

Source URL: http://www.adamsmith.org/blog/regulation-and-industry/vickers-report-fails-the-competition-test

Links:

[1] http://www.adamsmith.org/blog/regulation-and-industry/vickers-report-fails-the-competition-test
[2] http://www.adamsmith.org/taxonomy/term/5859
[3] http://disqus.com/?ref_noscript
[4] http://disqus.com