The banking sector needs more competition, not more regulation [1]

Written by **Dr Eamonn Butler** [2] | Thursday 19 May 2011

Hector Sants of the FSA, the UK financial regulator, has warned banks that future dividend and bonus payments will be scrutinised for their potential impact on risk [3]. Actually, it is the FSA that is the biggest risk factor in UK. Frankly, the body is not fit for purpose. It's rule-driven tick-box approach missed everything that was going wrong in the finance sector in 2007, and it is no more useful today. What's needed is real reform of the banking sector, and the introduction of a lot more competition, which is by far the best regulator and the best friend of customers ? not more rules and inept rulemakers.

This might actually happen. The Independent Commission on Banking [4] reckons in its interim report that the promotion of competition should be a core function of banking regulation. In other words, we should have a proper economic regulator, which looks at the structure of the industry and tries to make it as competitive as possible. Much of our trouble is that the huge expense of the tick-box regulation means that banks have had to grow big in order to afford it, and competition has largely disappeared.

It is interesting that scores of US banks fail every year. That is manageable, because they are all small. In the UK, by contrast, there is an implicit guarantee (and, up to the first £85,000 of your savings, an explicit guarantee), that the government will bail the banks out. That's not healthy for any business. You can run a pretty shoddy firm if you know that the taxpayers will pick up your debts.

Another idea of the Commission is to separate out retail banking, so if people really do want to make sure their money is safe, they can find somewhere to go. That makes sense too. If we had proper competition, it would already have happened. But like any insurance, government guarantees encourage risk-taking, with its associated high profits.

The question is how you achieve such restructuring. We certainly don't want Vince Cable in hobnail boots forcibly breaking up the banks as he sees fit. We can let the market do it. Making the stringency of banks' reserve requirements proportional to their size would favour the creation of smaller banks and would properly reflect the greater systemic risk which is generated by the bigger ones.

In Brazil, retail and investment banking licences are quite separate, and if you stray from one line of business to the other you get put in jail ? which seems to work pretty well. But again, I think we can use the market rather than this top-down approach. Simply requiring banks to offer demonstrably safe deposit accounts ? or even making them tell customers just how risky their accounts were ? would achieve the retail-investment separation quite naturally.

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