



# Bank Reform:

Getting the policy right

By Tim Ambler and Miles Saltiel

## A banking reform to save us from policy disaster

The Independent Banking Commission's plans to 'ring fence' the banks' high-street operations from their 'casino' investment businesses, and so prevent future failures, are built on sand. They misunderstand the causes of the 2008 crisis, are too bureaucratic, hinder competition and will damage the UK economy unnecessarily.<sup>1</sup> They take a Little Britain approach to an international problem and completely ignore the EU plans for financial regulation.

We need different cures for our banking problems, says a new report from the Adam Smith Institute – greater competition in banking, a fresh look at bank boardrooms, greater penalties for failure, and a new form of 'Trust Banks'.<sup>2</sup>

## The proposals

The Commission, chaired by Sir John Vickers, was set up in June 2010 to advise how to improve the stability of UK banks. The government hoped it would find ways to strengthen the banks, and so prevent the need for future taxpayer-funded bailouts.

The ICB came up with two major recommendations:

**Ring fencing.** The first was ring fencing: the banks would have to separate their day-to-day retail banking operations from their investment banking businesses. With retail banks restricted to supposedly safe assets, they would be less likely to need bailouts from the government – which would not need to be drawn into protecting the investment banks and their more savvy customers.

This Briefing Paper is based on the new Adam Smith Institute report, *Bank Regulation: Can we trust the Vickers Report?* by Tim Ambler and Miles Saltiel.

It argues that the Vickers Commission has misdiagnosed the causes of the financial crisis and that its prescriptions will damage UK banks and the UK economy and prolong the downturn. It recommends instead the creation of market-led Trust Banks, simpler regulation and better supervision.

The full version of the report is available at [www.adamsmith.org/files/bank-reform.pdf](http://www.adamsmith.org/files/bank-reform.pdf)

1 See the Independent Commission on Banking, *Final Report and Recommendations* <http://bankingcommission.independent.gov.uk/>  
 2 For the full case, see Adam Smith Institute, *Bank Regulation: Can we trust the Vickers Report* [INSERT WEB LINK TO ASI REPORT HERE]  
 3 The authors are grateful to Eric Anstee, Mark Austen, Professor Tim Congdon, Lord (Howard) Flight, Richard Jeffrey, Professor Patrick Minford, Jon Moulton, Stephen Priddy, John Redwood MP, Lord (James) Sassoon, Tony Shearer and Stuart Wheeler for their comments. Each has commented in a personal capacity only, and Lord Sassoon has commented only in relation to his 2009 report.

**Capital ratios.** The second proposal is that banks should raise their capital ratios – the equity they have to back up their operations – to levels beyond those being considered by the European Union or the international ‘Basel III’ regulations.

The Chancellor, George Osborne, immediately accepted the ICB report and promised to implement it – though not immediately. But the report and its recommendations are seriously flawed. That breathing space should be used for a fundamental public debate on the future structure of the banking sector – one of the largest employers and earners in the UK economy.

## Misdiagnosis

Focusing on bank structure, the ICB ignores the causes of the financial crisis – inadequate supervision by confused regulators, loose monetary policies and poor decisions by bankers.

It was not Britain’s investment banks but its ‘retail’ banks and building societies that got into trouble. They provided mortgages to home owners who could not keep up their payments, bought US investments they did not understand, made large and risky take-overs, and borrowed too much from other banks.

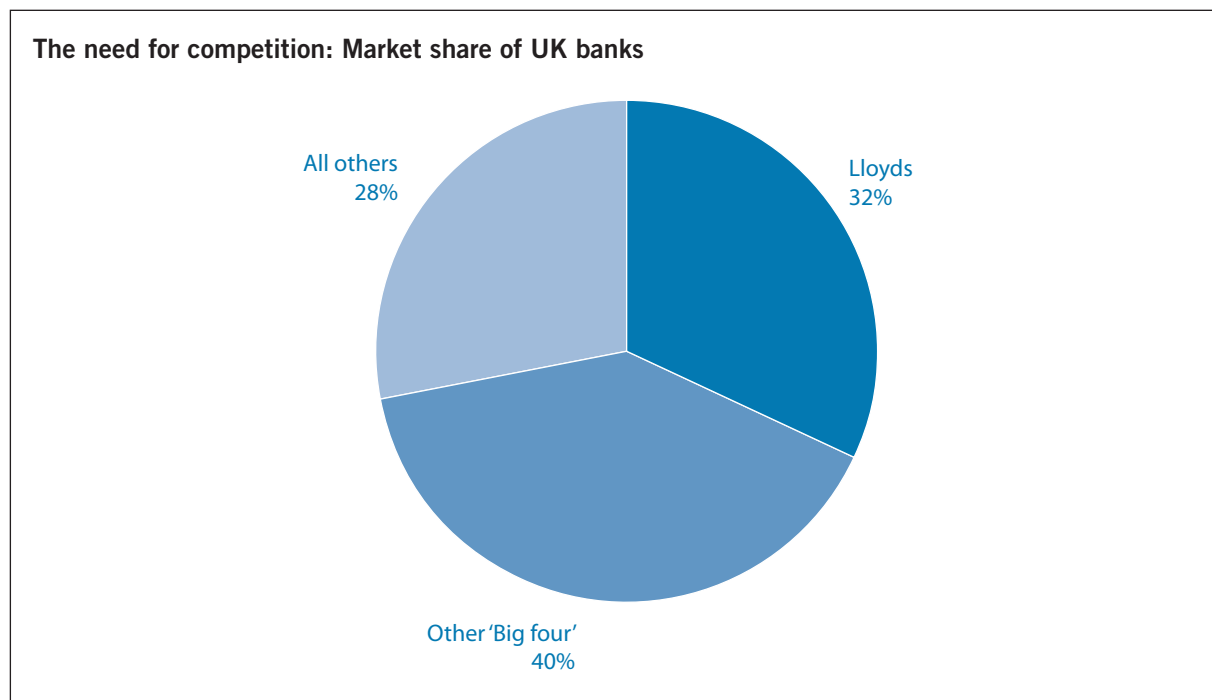
The financial crisis was not caused by any lack of financial regulation. The banks were already the most heavily regulated of UK industries.<sup>4</sup> Regulation gave the illusion of security, though the ‘Tripartite’ regulators (Treasury, Bank of England and Financial Services Authority) were divided and confused, allowing bankers to make over-optimistic business decisions on the back of a decade and a half of a huge government-led expansion of money and credit.

**‘The ICB ignores the causes of the financial crisis – inadequate supervision by confused regulators, loose monetary policies and poor decisions by bankers.’**

## Omissions

The ICB says nothing about the macroeconomic policy mistakes that contributed to the crisis, which were arguably beyond its remit. But nor did it say thing about improving corporate governance and decision-making within the banks,<sup>5</sup> nor how to improve the supervision of the regulators – both well within its scope.

Nor did it consider the option of using insurance to protect customers’ deposits in the event of a bank’s failure. Perhaps it thought that banks might be *more* likely to take risks if they know insurers will pick up the pieces. But it



4 Professor Tim Congdon told us: “Banking regulation has become a disaster, and is a major threat to the market economy and free society.”

5 As Lord Flight told us, two major banks – HSBC and Standard Chartered – survived the crash without needing bailouts. The ICB should have asked what was right with their management, and how to replicate it elsewhere.

seems happy to live with government guarantees to bank customers, which have precisely the same ‘moral hazard’ effect.

Nor does the ICB consider the role that greater competition might have in restraining bankers, ending the oligopoly of ‘too big to fail’ banks, and so making bank failures less likely and less problematic. (The ‘big four’ banks hold 72% of personal current accounts – a situation that is clearly in need of an investigation by the Office of Fair Trading or the Competition Commission.)

Instead of considering these ideas, the ICB focuses only on its own proposals of ring-fencing and higher bank capital requirements.

**Ring fencing**

The ring-fencing idea came originally from the Bank of England’s Kevin James in 2007. He argued that regulators cannot keep up with innovations in banking, so regulation should focus on ‘narrow banks’ that would have to invest and borrow safely, while other banks would be given more freedom. *Financial Times* writer Martin Wolf took up this idea in 2008, calling bank groups ‘a utility attached to a casino’ and arguing that ‘utility’ customers should be protected from ‘casino’ trading in volatile markets. In 2010 another *FT* columnist, John Kay, proposed another kind of ‘narrow banking’, where banks would be prevented from using depositors’ cash in capital markets.

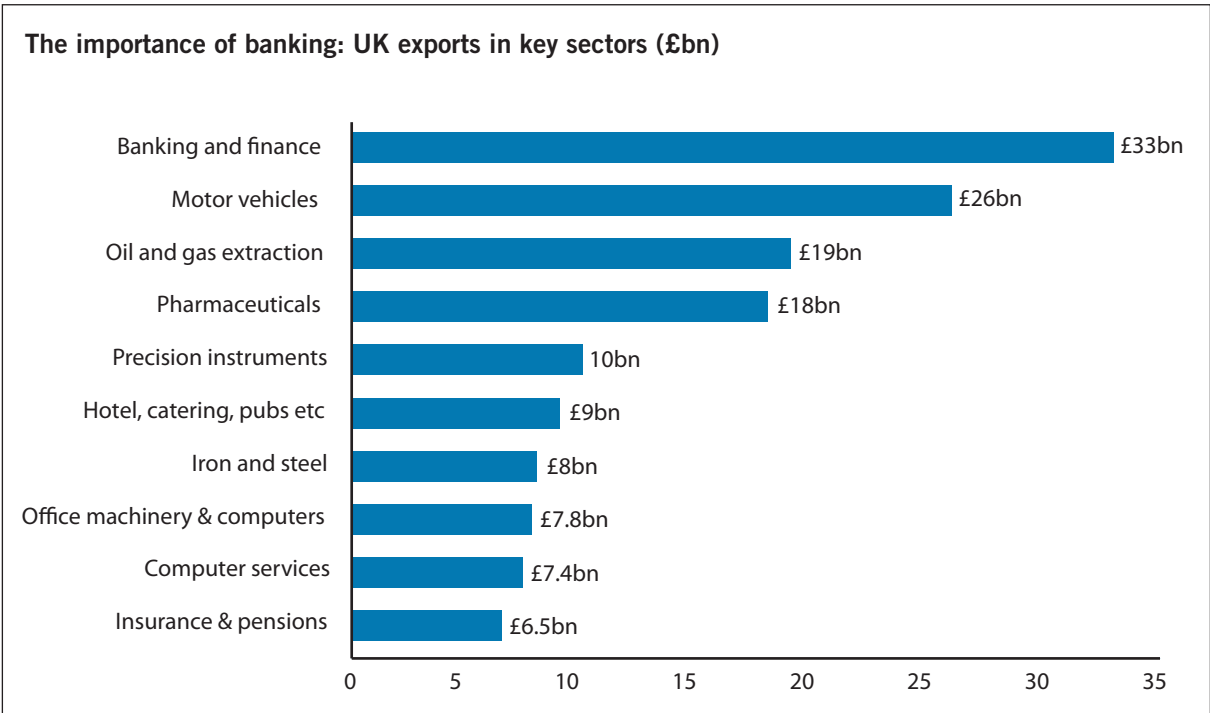
There is merit in the idea of narrow banking, but the version of it proposed by the ICB in 2011 is so narrow, prescriptive and bureaucratic that it cannot possibly work. For example, the ICB sees the 20007-8 failure of the interbank market – where banks became too nervous to lend to each other – as a major cause of the credit crunch. But their proposal – to keep ring-fenced banks out of the interbank market altogether – is over the top, probably infeasible, and likely to increase banks’ running costs and reduce competition. Where banks have temporary liquidity problems but are otherwise trading profitably, the Bank of England is supposed to help. Instead it stood back pleading, wrongly, that Brussels did not allow it to.

**‘The ICB’s ring fencing proposal is so narrow, prescriptive and bureaucratic that it cannot possibly work.’**

On the other hand, the ICB argues that ring-fenced banks could well be part of larger groupings that include investment banks. But if the investment banking arm of such a group failed, it seems likely that its ring-fenced subsidiary would face reputational damage that could bring it down too. We propose instead that there should be completely separate branding.

**Capital requirements**

The ICB’s other main proposal – raising the proportion of equity (versus borrowings) and of ‘safe’ assets that banks



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must hold – is equally flawed. In the first place, it is not always clear how safe or risky an asset is. Mortgages, for example, might be thought ‘as safe as houses’ – but many building societies and retail banks got into serious difficulties when things turned down and many householders could no longer meet their mortgage repayments.

Nevertheless, the ICB proposes to raise banks’ capital requirements to levels beyond those proposed by the EU and the Basel Committee. If this policy is so sound, the ICB should be recommending it as an international standard. Instead it seems content to impose the cost and burden of such regulation solely on the UK banking industry, which is vital to the UK economy. Banking is a global market and should have just one set of global regulations, such as Basel.

This additional requirement on UK banks to strengthen their reserves will mean that the banks have less money available to lend to UK businesses and will charge higher prices. Small and medium-sized enterprises – which are important job-creators but which rely heavily on bank loans and overdrafts – will be particularly hard hit. The result will be that the UK economy’s stagnation will drag on, and unemployment will persist – putting the government in an uncomfortable position when it faces the next election. All for no good reason.

The ICB’s prescriptive capital rules will do more harm than good, blocking more flexible approaches towards helping banks in temporary difficulties. As well as reducing what banks have available to lend to businesses, it will raise UK banks’ costs, raising barriers to entry and reducing competition.<sup>6</sup>

### **‘The ICB’s capital proposals will hit business and unemployment – a problem for the government when the next election comes.’**

Another consequence of the ICB wishing higher costs on UK banks is that business, jobs and the banks themselves will transfer to other countries.<sup>7</sup> The ICB does not consider what would happen if high-street banks kept their UK branches moved their headquarters to Dublin (say).

Indeed, it gives virtually no attention to the regulation of European Economic Area banks with UK branches – like the Icelandic banks that proved a major part of the 2008 crisis.

### **Better approaches**

We need to focus on getting growth back into the UK economy as a whole, not on new banking regulations that will stifle it. Instead of worrying about future bailouts, we should be improving bank management and supervision.

In terms of management, the incentives are lopsided. Success is highly rewarded, but failures are costless due to taxpayer bailouts. We propose instead severe penalties on directors who lead their banks into failure.

### **‘Competition is the best regulator.’**

In terms of regulation, the rules must be clear and properly enforced. Too many, or too complex rules are worse than useless. Regulators must understand the market – as the Financial Services Authority did not – focus on the essentials, and be prepared to act robustly.

There is merit in focusing regulation on ‘narrow banks’ that cater for high-street customers and scaling back the regulation of investment banking. Retail banks should be run and capitalised separately from investment banks, but we should use market principles rather than prescriptive regulation to achieve this.

Instead we should allow the banks to become (or create) new market-led Trust Banks that would so solid that customers’ deposits could be guaranteed – and so solid that such guarantees would be unlikely to be called upon. There should be no government guarantees for other banks. And vigorous competition policy should mean that no bank is too big to fail.

Trust banks status would be attractive to smaller banks, such as supermarket banks and Virgin Money, and also to new market entrants – so bringing true competition to the banking High Street. Competition is the best regulator.

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<sup>6</sup> Professor Patrick Minford was critical of the Report and told us ‘By raising costs it has also set back entry and so competition.’

<sup>7</sup> John Redwood told us that unilateral UK action like this is ‘economically irresponsible’.