

**A Botched Opportunity:  
Why the Vickers Report Won't Fix the Financial Sector**

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## Introduction

While Sir John Vickers goes through his promotional round for the final report of his Independent Commission on Banking (ICB), I observe with regret that his report recapitulates the errors of the past. Sir John draws attention to the history, but gets it dead wrong. No surprise that the policy follows suit. George Osborne has done his duty by publicly accepting the report, but fortunately he has given himself eight years to correct its mistakes.

In particular the ICB piles on new levels of *regulation*, when the problem was that former regulations were either poorly conceived, imperfectly enforced or went unheeded. Additionally, the ICB's proposals run the risk of encouraging *moral hazard*, while the report fails to get to grips with the systemic risk inherent in the deficiencies – current and expected – of *international capital regulation*.

My purpose here is not to defend either the banking industry or its present structure. Instead, my intention is to suggest reform that addresses the sector's real problems.

The ICB's report has three central recommendations: in its own order of priority, they are a *retail ring-fence*, *loss absorbance*, and *competition*. I argue that the priority should be reversed, with competition to the fore, loss absorbance revisited and ring-fencing abandoned.

## Unanswered questions

Let us begin with the ICB's own first priority, a *retail ring-fence*. The intent is to ensure the continuity of retail banks' operations (in other words, that they carry on providing essential services even when times are bad), by restricting their activities and locations (Figure 3.6; p54). Excluded activities would be certain types of funding and lending, as well as dealings in securities including derivatives. Excluded locations would be those outside the European Economic Area (EEA).

The proposal leaves a number of important questions unanswered. Most fundamentally, *does ring-fencing address an important problem?* The answer must be that while continuity is undoubtedly crucial, the systemic risk in 2007 and 2008 came from banks which would actually comply with most of the report's ring-fencing criteria.

Next, *why would banks wish to qualify for ring-fencing?* The report offers few incentives, explicitly and properly rejecting a government guarantee (para 2.9, p24 *et seq*; para 3.34, p48), but suggesting that banks might benefit from lower rates for deposit insurance (para A3.104, second bullet point; p303) and unspecified benefits in a resolution regime. In effect, the notion must be that banks already in the business would have no choice but to sequester their operations. Possibly so, but the unattractiveness of the business would raise the cost of capital. This in turn would increase charges to the personal and SME customers whom Vickers purports to defend. The report makes things worse by ruling out the international competition for retail deposits which might cause private persons and SMEs to flock to institutions perceived as secure. To the contrary, *ring-fencing and deposit insurance are more likely to institutionalise moral hazard* and give the wrong message to depositors by relieving them of their prudential responsibilities.

The report presents a *problematic approach to financing ring-fenced banks*. It excludes instruments such as corporate bonds and envisages further controls of funding (table 2.1, p31; para 2b, p235), specifically ruling out reliance on bank bonds and the interbank market which brought down Northern Rock and others. This is odd, as para 3.55, p61, recognises the essential character that interbank transactions play in financing imbalances between assets and liabilities. Contrary to the report's throwaway remark, however, these may be not be "short term" but are often inherent in the business profile faced by one or another bank. In any event, the

report is silent as to where the limits in interbank activity might lie.

Vickers is also silent about the financing of non ring-fenced banking operations, other than implying that they would be unconfined by the restrictions upon ring-fenced banks. But this just won't achieve the segregation of risk the ICB seeks: *difficulties in a non ring-fenced subsidiary would depress the stock price of the parent company and thus the scope to recapitalise the tier-one capital of the ring-fenced bank.* You can't separate these things.

The rationale for *excluding retail banks from intercontinental operations*, while permitting operation within the EEA, is mysterious. *This makes no economic or prudential sense* and is revealed as the consequence of Brussels regulations (n1, p11). This gives rise to the serious follow-on question: is the proposal that banks would not be able to participate in any transactions with counterparties from outside the EEA? This is absurd, and quite possibly contrary to other obligations under trade treaties. And our banks are inescapably involved in the international financial system.

### **The ICB's view- and the reality**

From the end of the 1990s on, policymakers and regulators were keen to

help provincial standard-bearers for financial services replace the industrial jobs which went in the previous two decades; a well-intentioned policy to right an undoubted social wrong. That is what we see from the conspicuous geographical coincidence: Northern Rock, Bradford and Bingley, Dunfermline, RBS, HBOS – not investment banks, but regional intruders who overstretched themselves in nuts-and-bolts banking.

These institutions all came from rust-belt Labour constituencies; they cultivated the Blair-Brown administration and were cultivated by them. Both Blair and Brown represented former mining communities, which made them keenly aware of the problems of Britain's de-industrialisation. It was of the essence of the New Labour project that the private sector be used to serve the public interest. But policymakers and regulators ended up overlooking the risks.

The ICB is silent about all this, instead creating the straw man of investment banking risks, for which it is only able to find evidence by including the irrelevant example of Lehmans (see below). The heart of the report's analysis lies in box 2.1 (pp31-33). This presents a view of the history which is self-serving and disingenuous. Thus, Vickers has positioned himself as part of the problem and his narrative should be robustly challenged.

## Why did selected banks fail?

<b>Northern Rock</b>	
<p><b>ICB Report</b></p> <p>In June 2007, following balance sheet growth of &gt;20% p.a., only 23% of [Northern Rock's] funding was from retail deposits, with the majority being wholesale funding (e.g. securitisations, covered bonds). As wholesale funding markets froze in autumn 2007, the Bank of England provided emergency liquidity assistance before [Northern Rock] was taken into public ownership in 2008.</p>	<p><b>The reality</b></p> <p>This overlooks the fact that Northern Rock was a high-profile standard-bearer for the banking ambitions of Newcastle and the regeneration of the northeast in general. It had excellent relations with the government and senior regional parliamentarians. It pursued the UK's most aggressive bank funding policy, combined with the opacity of off-balance sheet SPVs. <i>It was brought down because of its overexposure to the interbank market</i> and was nationalised a few hours ahead of the UK's first retail bank-run in 140 years. The government was obliged to over-react because the banking monopoly had successfully resisted proposals to pay for private insurance for depositors; and the UK lacked regulatory experience with a "resolution regime" for winding up failed retail banks. The ICB's ring-fencing proposals would only have caught Northern Rock if they were taken more seriously than the unheeded regulations existing at the time.</p>

<b>Bradford and Bingley</b>	
<p><b>ICB Report</b></p> <p>Silent, other than a throw-away comment on competition. This overlooks the failure of a business which would lie within the proposed ring-fence.</p>	<p><b>The reality</b></p> <p>In a less noisy way, Bradford and Bingley was also a standard bearer for the banking and regeneration ambitions of South Yorkshire. It pursued the UK's most aggressive house-lending policy, leading to <i>overexposure to high-risk property loans</i>. <i>Ring-fencing would have done nothing to alter any of this</i>. It also suffered from poor quality capital which was reliant on high-risk paper. After a failed rights issue, it lost its independence to Santander in a fairly orderly process.</p>
<b>Dunfermline</b>	
<p><b>ICB Report</b></p> <p>Also silent as above.</p>	<p><b>The reality</b></p> <p>The misfortunes of Dunfermline, a mutual building society, were largely eclipsed by bigger stories elsewhere. It was drawn into <i>high-risk commercial property deals</i> and bought a book of self-certified retail loans at the top of the market. <i>Ring-fencing would have done nothing to make this better</i>. The authorities presided over its takeover by Nationwide, also in a fairly orderly process.</p>

## Lehman Brothers

### ICB Report

[Lehmans] was heavily exposed to US sub-prime mortgages and over 30 times leveraged – a combination which led creditors to stop providing funds as large losses began to materialise. When in late 2008 it ran out of liquid assets to sell to meet this withdrawal of funds, it filed for bankruptcy.

### The reality

This is true as far as it goes, but fails to engage with US regulatory failure (specifically, government policies aimed at increasing sub-prime lending). In any event, it has nothing to do with the ICB or the UK, which had no jurisdiction over Lehman's core operations, *upon which ring-fencing would have had no effect*. The story has no place in the report, in which it serves simply to draw attention to the risks of investment banking. By including such an irrelevant example, the report inadvertently betrays the weakness of its analysis, as *no evidence from the UK exists to support its conclusions*.

## RBS

### ICB Report

[RBS] bought most of ABN AMRO under a largely debt-financed deal which left it with limited equity at end-2007: 4% of risk-weighted assets (RWAs) – 1.2% of assets. It suffered large losses from proprietary trading, structured credit, derivatives and write-downs of goodwill from recent acquisitions. It raised £12bn of new equity from existing shareholders in 2008 but this proved insufficient. The Government injected a further £45bn of equity and insured some assets against extreme losses.

### The reality

This gets the sequence completely wrong. RBS was one of the two principal standard-bearers for the proud history of Edinburgh banking. Its CEO, Sir Fred Goodwin, became close to the government of the day and Gordon Brown in particular. Under his leadership, the bank followed an *extraordinarily aggressive combination of funding, lending and acquisition policy*. It ended up overexposed to a portfolio of high-risk activities including property loans, *which ring-fencing would have done nothing to alter*. It also relied upon funding from the interbank market and was the sole major UK victim of “alphabet soup” products, in that it imprudently bought them to improve its margin. Already weak, it was brought down one year into the crisis, after it qualified for the “winner's curse” by paying top dollar for the investment bank operations of ABN Amro. It was recapitalised by ministers spooked by the Northern Rock affair a year earlier and the more or less coincident TARP proposals in the US.

<b>HBOS</b>	
<p><b>ICB Report</b></p> <p>At end-2007, 56% of [HBOS'] funding was wholesale (more than half of which was short-term) and it had a very thin layer of equity capital: less than 6% of RWAs and only 2.7% of assets. Increasingly unable to replace maturing wholesale funding, it was acquired by Lloyds TSB in early 2009.</p>	<p><b>The reality</b></p> <p>This misses most of the story. Bank of Scotland was Edinburgh's second standard-bearer. It merged with Halifax, which had a similar role to Bradford and Bingley in its ambitions for regeneration in South Yorkshire. The merged bank, HBOS, embarked on the country's most aggressive combination of funding and lending policies. This left it overexposed to the usual combination of <i>dud property loans which ring-fencing would have done nothing to alter</i>, as well as funding from the interbank market. Its purchase by Lloyds is mysterious: perhaps Lloyds CEO Sir Victor Blank felt that that he couldn't say no to the government a second time – Lloyds had declined to rescue Northern Rock a year earlier and Gordon Brown was leaning on them hard. In return Lloyds got the extraordinary concession of an agreement to waive an MMC referral, though in part this has been rolled back by the European Commission, which called for the group to divest at least 600 branches. Once Lloyds discovered the full extent of HBOS' distress, it had to be recapitalised by government.</p>

**What are the real problems?**

The UK is undoubtedly overbanked and *the UK banking system is undoubtedly oligopolistic*. There are already high regulatory barriers to market entry, to which the implicit protection afforded by mandated ring-fencing would be a further force against competition; when failed institutions essentially have their market share guaranteed, how are new players meant to break into the market? For decades, the retail banks disgraced themselves by claiming that they were “too big to fail” as part of their campaign to resist private deposit insurance. The consequence has been the collapse of their reputation and a bad system which insures one hundred percent of deposits to £85,000, so demolishing such discipline as might come from depositors exercising their judgement. *The retail banking monopoly is best addressed with anti-cartel regulation*. The ICB addresses this, but only as its third priority and getting lost in details.

The banks may also be *undercapitalised*; this is the ICB's second priority, where the report proposes substantial increases in

capital, discussing but taking no position on the problematic concept of “risk-adjusted capital”. *The report has nothing to say about these deficiencies in capital regulation*, which encourage internationally co-ordinated systemic risk and regulatory arbitrage. Instead, it dwells on its proposals for *extraordinary and quite possibly unrealistic restrictions in funding*.

Regulators and bank users are ill-informed about banks' real risks. *We need to reintroduce a culture of transparency*, in particular through the intensified application of *principles-based disclosure and regulation*, demolishing the former regime of compliance by process-oriented box-ticking; as well as through the *macro-prudential reporting* recommended by Vickers and others. But without principles-based disclosure and compliance, the structural proposals of the ICB are likely to prove unavailing; with them its recommendations could turn out unnecessary or heavy-handed.

Rather than address these fundamental problems, the report reinforces the problems of the past. *We have not been short of regulation over the last fifteen*

years, but it was ill conceived or unheeded. Regulation was ill conceived in being *process-oriented*, and *rules-based* rather than principles-based, as well as subject to *uncertainty* as to responsibility between the FSA and the Bank of England. The solution to this lies in the reinforcement of old-fashioned banking supervision, as the former “tripartite system” strikingly failed to provide.

I would also place weight on certain operational details, including *proprietary trading with customer funds* (I would have no real objection to Vickers’ proposed restrictions) and *dealings in derivatives*, where Vickers notes the counterparty (or credit) risk, but fails to engage with the idea that this risk that is dispelled by full recording and disclosure, instead simply ruling out such transactions for ring-fenced banks.

Finally and as Vickers recognises, we need to introduce a “resolution regime”, making possible the *orderly winding-up of failed banks*, so avoiding any repeat of the panic of 2007-08 and its legacy of moral hazard. The ICB devotes much ink to its “bailing in” proposals, with which I have little argument, but *ring-fencing is largely irrelevant to this*.

## **Conclusion**

The ICB’s priorities are wrong and the report ends up facing the wrong way. Its analysis is based upon a *self-serving view of history*, from which it draws the *wrong lessons*. The report proposes *more regulation*, without giving thought to the way in which *past regulation failed*. Rather than examine how regulators can do their job better, it simply places more duties upon them, paving the way for their further disrepute.

The report’s central proposal – ring-fencing – addresses *a problem that the UK banks didn’t have* during the crisis, without applying itself to their *real weaknesses* then and now. Better founded proposals – for *transparency and competition* – would do much to make its structural reforms unnecessary. And without such proposals, its recommendations are likely to come to

grief. Worse still, *ring-fencing runs the risk of encouraging moral hazard*, while the ICB’s thinking does nothing to address the *systemic risk inherent in the deficiencies of internationally co-ordinated capital regulation*. All in all, it’s a botched opportunity. Fortunately we have eight years to develop a more sensible view of banking reform.