



Centre for Policy Studies

A REVIEW OF THE UK BANKING INDUSTRY

Oliver Lodge

THE COMPETITION COMMISSION'S BANKING REPORT

A CASE STUDY

Sean Williams

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The opinions expressed by the contributors are their own and do not necessarily reflect the organisations they represent.

The Review Team has consulted widely with other leading figures in the banking industry. This report is an abridged version of the Review Team's more detailed paper, *The UK Banking Industry: a comprehensive survey*, which is available from the Centre for Policy Studies, 57 Tufton Street, London SW1P 3QL. Telephone 020 7222 4488. Website www.cps.org.uk Price £50.

FOREWORD

I am extremely grateful to the eminent members of the Review team – leaders from the banking industry, the law and regulation – for the time and effort they have contributed to the Banking Review over the last year and a half.

I asked them to undertake this task in order to inform thinking in a demanding area of policy, both in response to the Government's several recent initiatives and reviews, and for the long term development of policy. I asked them for an unbiased and professional assessment of current and future trends.

I believe that the full Report will be of particular value to regulators and practitioners. This shorter summary of the Report attempts to condense the team's research in complex and difficult territories.

There have been 18 inquiries and interventions into the banking industry since 1997... This bombardment should cease.

With some justification, the banking industry has felt bombarded by the series of Government inquiries and interventions. As this paper points out, there have been 18 such initiatives since 1997. They have consumed large amounts of top executive time and have deflected banks from more customer focused activities. Several of the inquiries have overlapped with each other in timing and objectives. All this has taken place, moreover, at a time when the winds of technological change have been blowing strongly over the banking system.

In essence, this bombardment of interventions should cease. Voluntary regulation of banking business conduct should be allowed to take effect,

following the enhancements recommended in the Julius Report. It is important that these deliver sustained improvements in business standards and are seen to do so. Otherwise the pressure for statutory regulation of banking business conduct will grow.

The Bank of England's prudential regulation of the banking industry has continued under the same team who have transferred to the FSA. But problems for the industry are looming. Basle 2 – the new international proposals for changes in banks' capital requirements – could lead to conflicts between the anticipated EU Directive and FSA policy. And there remain implicit moral hazard problems with regard to major banks, which in effect enjoy competitive advantages in the area of prudential regulation over smaller banks. The competition issues on which the Labour Government has focused recently are marginal in relation to the larger picture of the major changes and technological developments in the banking and wider financial services industries.

Recently, leading members of the banking industry appeared before the House of Commons Treasury Select Committee. They answered effectively the questions that were raised – further evidence of an innovative and competitive banking industry. In particular there is no case for the Office of Fair Trading (OFT) to have additional regulatory powers in relation to payment systems.

Finally, the banks have played a key role and are providing a substantial financial contribution in delivering a reform of the benefits payment system, replacing the outdated and vulnerable Order Book system with the “Universal Bank” concept. They have done the same in response to the Government's agenda to help alleviate financial exclusion through the development of basic bank accounts. These contributions have not been given adequate public acknowledgement, either by the Government or by banking industry commentators.

Howard Flight MP
June 2002

OVERVIEW

Banking is undergoing rapid and unpredictable change. New information and communications technologies have already caused profound changes in the banking industry. And their impact will continue to accelerate.

Banking today is only one form of intermediation in financial transactions, one which will change rapidly in future. It is important that policy makers, regulators and practitioners understand banking in this context and see the bigger picture.

Banking is also an industry beset by intervention. Since 1997, the Government has imposed on the banking industry a bombardment of regulatory reviews. Each one of these has aimed to change the operation of markets, as they are today, to satisfy a conflicting set of policy objectives and interest groups. The result is to reduce competition, to hobble banks in responding to market pressures and to ossify markets that need to change.

Rather, the focus of public policy should be on encouraging innovation and competition so that banking can respond with increasing speed and effectiveness to customer needs and technology change. This should focus on the specific constraints and impediments, which may be barriers to change. That is the opposite of what all the Government's initiatives have achieved.

The reality is that the focus of all the Government's recent reviews of the banking industry in the UK is marginal in relation to the big picture of major changes and developments in the financial services industry. The evidence of the last 40 years is that the more open economies of the US and the UK have experienced major innovation and development in financial services sectors, indicating healthy and competitive marketplaces.

Computers and the Internet have accelerated the pace of change. Physical banking operations are in decline. The need for branches and for their support staff has reduced over the last decade and will continue to contract.

As a result of such underlying influences, the structure of banking has been in a constant state of flux. Over the last 30 years, the scale of operations required in the financial services sector, in order to deliver lower cost services and products and adequate profitability, has grown substantially. The weight of evidence is that consolidation has been driven by market forces and reduced costs to customers.

In this context regulation has to be adaptable to change. For example, it is essential that the safety and stability of the UK financial system are protected. It is appropriate that the authorities, the Bank of England for centuries and the FSA now, should seek to achieve this by regulation. Inevitably this has implications for competition. A consequence of prudential capital requirements is that it is more difficult for some potential competitors to enter banking markets. However, such regulations need not inhibit effective competition. Indeed the Competition Commission in its recent Report on Small and Medium Enterprise (SME) banking concluded that capital requirements were not a significant barrier to entry.

Specific regulations can become unnecessary barriers to innovation and product development. These need to be amended. For example, the UCITS Directive emanating from the European Commission, and, more particularly, its historical application by the Treasury in the UK, has meant that it has not been possible to develop Money Market Fund accounts, with chequing facilities, in the UK mirroring these developments in the US. In the US, by contrast, Money Market Funds have become very popular, allowing people to get money market rates of return on balances, while at the same time having convenient cheque book access to money. They have provided the main competitive pressure on the deposit side of banking.

However, much of the Government's intervention has stifled competition. There could be no better example of this than their recent decision to impose direct price controls on business banking activities, which will deter new entrants and deter competition.

Rather than their interventionist agenda being driven by lobby group pressure and their own political campaigning, the Government should seek to identify the specific constraints on competition and innovation and deal with them intelligently.

CHAPTER ONE

THE BANKING CLIMATE AND COMPETITION

The banking industry has come under intense scrutiny in recent years. Eighteen separate inquiries and investigations have focused in turn on almost every aspect of banks' activities. In the last three years, the banks have been scrutinised or significantly impacted by:

- The Cruickshank Banking Review
- Competition Commission Inquiry into Banking Services to Small and Medium-sized Enterprises
- Payments Systems Regulation proposals
- OFT investigation of LINK interchange
- OFT investigation of credit card interchange fees
- European Commission investigation of Visa interchange fees
- Financial Services and Markets Act
- Review of ATM consumer charges
- DeAnne Julius review of banking consumer codes
- The Government's proposals for a Universal Bank
- Myners' review on institutional investment
- Sandler review of long-term savings and life assurance
- DTI debt taskforce

- Enterprise Bill to amend insolvency law
- Credit Unions Central Services Organisation
- CAT standards
- Regulation of mortgages
- Basic bank accounts as recommended by the Government's Policy Action Team 14

The impact of these, and the recommendations that follow them from Government, have far-reaching consequences on both the banking and financial services markets and the stability of the sector as a whole. In each case, the Government is attempting to satisfy competing objectives. Across the piece, the measures are often in conflict with each other and do not reflect the changing realities of banking today.

Both the personal banking market and the small business banking market are undergoing rapid change. The 18 Government initiatives have obstructed the trends to increased competition in the industry.

The personal banking market has seen tremendous changes in recent years. The banks' position as the traditional suppliers of banking services has been challenged by competition from an array of new entrants, new channels and new products. Competitors have come from near at hand, such as building societies and overseas banks, and far outside banking, such as insurance companies, clothing and grocery retailing.

The business banking sector is undergoing similar changes. The market has seen significant new entrants in Alliance & Leicester, Abbey National and the newly merged Halifax Bank of Scotland (HBOS), each developing its product offering to distinguish itself from those already operating in the market.

At the same time, there has been a revolution in electronic banking, one that is more advanced in the UK than almost anywhere else in the world. The range of transactions that can be conducted on-line is rapidly expanding and already encompasses inter-bank transfers including payment of bills, management of standing orders and direct debits, ordering of new cheque/paying-in books, and the facility to stop cheques, amongst others. There is a plethora of Internet, postal and telephone banks, often offering higher interest rates on deposits or lower credit charges in return for limited or no branch access. Not only have these new delivery channels facilitated new entry, but they have also required current market players, operating from more traditional branch facilities, to change their service offering. Customer take-up of these new channels has been high. During 2001, 36.9% of customers arranged or purchased banking services by telephone, and 18.9% over the internet; the UK is projected to have over 13

million internet banking customers by 2005. This is combined with a rapid growth in the number of ATMs. There are now 32,000 ATMs in the UK, an increasing number (now 7,500) on sites away from bank branches, such as supermarkets, railway stations and petrol stations. The expansion of the network is set to continue, with an increasing number of non-bank providers, such as the Post Office and Securicor. These trends have fundamental implications for traditional branch banking.

Demand across financial services has been stimulated both by the information revolution of the Internet and the greater coverage of personal finance and money issues in the press. Not only has the consumer become generally better educated and more discerning, he can also access a wealth of comparative data on products and services, allowing him to shop around. The result has been extensive customer service initiatives across the industry, as product and price have become more commoditised. Differentiation is now also sought on service quality. Customers are now far less loyal to their main account-holding bank, often unbundling their product requirements and purchasing their components from many different suppliers.

Consumer demand and activity in the market is evidenced most apparently by the current levels of current account switching in both the personal and business markets. Business account switching reached an unprecedented high of 7% in 2001 (up from 4% in early 2000); the personal account market has seen switching rise from 1.7 million to 3 million adults in the 12 months to November 2001. Add to these figures the natural turnover in the market (e.g. start-up businesses and those ceasing to trade), then the “churn” is even more substantial.

REGULATORY ISSUES

Attempts to promote transparency across the sector are largely welcomed by the industry. These kind of measures generate competition by ensuring delivery of a consistent standard of information to consumers, and may also serve to erode the perception of an impenetrable ‘mystique’ surrounding banking services, making them more accessible.

However, proposals to require banks to share branches could be counter-productive. While banks can be encouraged to come to sensible arrangements for sharing access to branches in rural areas, requiring banks to serve the small business customers of their competitors in their branches in all areas could pose a serious threat to branch networks. If the OFT requires that banks make all their branches available to any small business at any time, at prices that do not reflect the economic cost of branch services, then a radical consolidation of branch networks could ensue. This would be highly disadvantageous to business and personal customers alike.

Measures that damage customer interests, such as price controls on SME banking, will distort market behaviour, will stifle competition and will deliver no benefits to customers. The major business banks are now facing the prospect

of large proportions of their small business customer bases being unprofitable. This will inevitably have significant consequences in their availability, in the way services are offered or in how they are priced.

By contrast there is a case for voluntary regulation to improve and discipline standards of business conduct, which the voluntary codes and the Banking Codes Standards Board are addressing. In principle, the voluntary codes have the potential to be more flexible and effective than statutory regulation. However, unless they address the issues and are seen to do so, the pressure for unwelcome statutory will grow.

Combining essential regulation of the industry to minimise risk, and the voluntary codes and behavioural monitoring that would further enhance competition and generate consumer confidence is the optimum way to support such a crucial industry. This would generate a competitive climate in which the banks could continue to do business successfully.

CHAPTER TWO

THE IMPACT OF TECHNOLOGY

Technology is changing the fundamental economics of banking, just as is the case with many other industries. The pressures inducing structural and operational change in the industry are not incremental in nature (a continuation of past trends in a steady evolutionary path) but represent a paradigm shift where the total impact of the pressures is greater than the sum of the components. While many of the pressures operating on the industry can be viewed as potential threats, they also widen (rather than close down) the strategic options available to competitors and the choices they have to make.

Technological innovation is revolutionising banking: change is not incremental in nature, but a paradigm shift.

In a recent Report,¹ the European Central Bank offers a comprehensive and succinct analysis of how technology is influencing the banking industry. Its opening sentence sets the scene:

The developments in information collection, storage, processing, transmission and distribution technologies have influenced and continue to influence all aspects of banking activity... Information technology developments have an impact on practically all aspects of banking and can be regarded as one of the main driving forces for change in the banking sector.

¹ SOURCE DETAILS PLEASE

There are six major aspects of the impact of technology:

- how technology is influencing competition and the degree of contestability (potential competition) in banking;
- the impact of technology on economies of scale;
- the economics of branch networks;
- the emergence of multi-media and how technology alters the nature of the interface between bank customers and their banks;
- how technology, combined with a process of de-construction, has implications for optimal organisational structures of banking firms;
- the implications of these trends for the structure of the financial system and, in particular, whether a single dominant model for the banking firm is likely to emerge.

TECHNOLOGICAL PRESSURES ON COMPETITION

Several technological factors have increased the contestability of banking markets. The development of information technology increases the supply, and lowers the cost, of information, and enables new entrants to access and process information. The development of technology-based credit-scoring techniques, coupled with greater access to information, enables new entrants to assess credit risks without having the experience gained through managing a borrower's bank account over a period of years. The unbundling of products and services into their component parts enables new entrants to compete by subcontracting some of the processes involved in financial services and to effectively buy-in economies of scale from outside. As new forms (particularly telephone and computer-based) of delivering banking services have emerged and developed rapidly, the need for a branch network has become less significant as an entry barrier. It also means that distance between supplier and consumer becomes less significant. In some banking markets (notably wholesale lending), the steady globalisation of banking markets has made local (national) markets increasingly contestable as large borrowers have access to global banking markets.

TECHNOLOGY AND ECONOMIES OF SCALE

Economies of scale in banking occur in individual bank processes (cheque clearing, credit card administration, etc.). There are only limited economies of scale in banks (in that large banks do not consistently have lower average costs than smaller banks). So, while competitive pressures are forcing banks to lower their costs, there are different ways of achieving economies of scale in bank processing other than by being a big bank. A central strategic issue for financial firms of all sizes is how, therefore, to secure the competitive imperatives of economies of scale in processing.

TECHNOLOGY AND BRANCH NETWORKS

Developments in technology mean that there are now too many banks and building societies on the high street. Delivery strategies are evolving at two levels: branch networks are being rationalised, and banks are widening the range of delivery options.

TECHNOLOGY AND CUSTOMERS

The potential impact of the Internet on the banking and retail financial services industries is substantial. The marginal cost of some transactions is virtually zero, with most of the work being done by the customer. Distance between customer and supplier becomes meaningless and of no economic significance. The consumer pays the access costs. As an increasing number of rival banks and financial firms open websites and home pages, the cost of information to the consumer and the search costs for rival services and products become very low. This increases competitive pressures in the market. In addition, the transaction costs when customers change banks are reduced which is likely to have the effect of eroding customer loyalty. It further erodes the necessity of having a branch network to supply financial services and further erodes entry barriers.

TECHNOLOGY AND MULTI-MEDIA

A particular dimension to the impact of technology in financial services focuses on multi-media. This is potentially a major change in the way banks operate because, as the ultimate product providers, stand at the end of a queue of relationships with the customer after the technology providers who control the interface medium. Such a picture is a radical, though readily feasible, departure from the traditional view of an integrated financial institution providing services and products to its customers with which it has a dedicated link without the intermediation of other companies in the value chain.

TECHNOLOGY AND BANK STRUCTURES

Technology is also changing optimal organisational structures for financial firms though in different ways for different firms. The traditional structure of a financial firm is of joint-production (vertical integration) with the firm undertaking all aspects of the business from origination to processing. The deconstruction process (whereby financial products are deconstructed into their component parts: origination, manufacture, administration, processing, etc.) focuses on what might be termed contract banking which implies financial firms creating internal and external markets for processes. Some processes may optimally be undertaken internally while others are subcontracted. In the contract banking model, the firm has two sets of contracts: between itself and customers (service standards, price, etc.) and also with internal and external suppliers of the components that make up a financial product or service. Contract banking implies a bank offering a full range of services but where the bank co-ordinates inputs from a wide range of different companies. The value added by the bank contractor is in the management of these contracts.

At its extreme, the virtual bank emerges. This has an interface with its customers and seemingly supplies a set of integrated services and products. And yet it does nothing itself other than manage a set of contracts with external suppliers. It is a buyer of other firms' products and services and a co-ordinator of contracts and services. It is, in effect, a broker between the customer and the ultimate supplier of services. This may mean that comparatively small virtual banks can exist alongside large banks. They may provide the full range of banking services with the customer being unaware that the bank is in truth a network of alliances with specialist providers.

COMPETITIVE PRESSURES

The evolution of national banking systems, and the business of banks in particular countries, is always and everywhere influenced by a combination of country-specific and global pressures. In the years ahead the relative role of these two sets of forces is likely to change with global pressures becoming more decisive than country-specific factors. This is partly because the dominant pressures, such as technology, are themselves global in nature.

In practice, the timing, speed and intensity of the pressures vary from country to country and in some countries regulation continues to offer a degree of protection to the value of the banking franchise. Nevertheless, as competition becomes increasingly global in nature, and many of the pressures of change are universal, no nationality of banks will be immune from the pressures operating on the banking industry. It will radically transform banking in the years ahead.

CHAPTER THREE

BANKING SERVICES TO SMALL BUSINESSES

The particular focus of government has been banking services to small businesses. Public concerns were at their height during the recession in the early 1990s, when there was a strong sense that banks were not doing enough to support their small business customers. The then Chancellor called in the banks' chief executives, and the Bank of England has been monitoring relationships ever since.

It is axiomatic that banks are crucial in the provision of finance to SMEs. As businesses grow, they will typically have to seek external sources of finance to complement their internal revenues and the main external provider of capital for most firms will probably be a bank. Bank finance in the form of overdrafts and term loans is the most significant form of external finance for small enterprises.²

It has long been argued that a gap exists between the demand from SMEs for loan capital or debt and the supply of such finance by the banks. Banks typically demand collateral as a quid pro quo for lending capital to a business in order to minimise their losses if the firm collapses. However, not all those individuals who seek bank loans will have appropriate collateral to offer. Hence, a debt gap is said to exist for small or start up businesses. It has also been contended that there is a lack of competition in the provision of banking services in the small business market.

² See R. Wilson, *Business Finance*, Institute of Directors, 2002.

However, both the Cruickshank Review and the Competition Commission Inquiry found that in reality the debt gap does not exist. Both found a ready supply of bank lending to small firms, better than in many other countries according to the Cruickshank Review, with about 95% of requirements being satisfied according to the Competition Commission. In a recent quarterly Institute of Directors (IoD) Business Opinion Survey, only 14% of the 500 IoD members who were interviewed reported that a lack of credit or finance was the factor most likely to limit output over the coming three months. Generally speaking, directors are more concerned about staff shortages and a lack of orders and sales. According to research produced by the ESRC Centre for Business Research at Cambridge University, 84.2% of their sample approached the banks for finance. Just 9.8% of their sample were unsuccessful in their quest for bank finance.

In any event, the Government continues to provide the Small Firms Loan Guarantee Fund (SFLGF), which was introduced in 1981. The SFLGF, now subsumed in the Department of Trade and Industry's Enterprise Fund, provides a guarantee to encourage banks to lend to businesses which are unable to borrow money because they lack collateral or a track record. The take-up has declined in recent years, in part reflecting significant practical problems. Addressing these problems would arguably be the most helpful Government initiative in support of SME credit.

Access to finance is not a major problem for the majority of businesses in the UK.

In short, access to finance is not a major problem for the majority of businesses in the UK at the present time. The market in the supply of banking services to SMEs can be improved by the promotion of competition and by helping small business customers to switch their accounts more easily. Otherwise, this is not a market in desperate need of reform.

In this context it is all the more surprising that the Government has imposed such statist measures upon SME banking providers. The control of pricing in the market, in the form of a requirement to pay interest on current account balances, will necessarily have adverse impacts on other aspects of business banking activities. It may come in the form of increases in other prices, reductions in service quality, or, more particularly, restrictions on the supply of credit and discouragement of new suppliers of credit. No case has been made by the Government that the result of their intervention will be better than the market conditions that prevailed previously. By distorting market behaviour in this way, the probable outcome is a market that will function less well in future with fewer lending providers.

CHAPTER FOUR

BANKING REGULATION

The underlying regulatory regime in banking should be separated from the barrage of recent Government interventions and initiatives. It can be considered in three parts: conduct of business regulation, which for banks has taken place voluntarily through the Banking Code; prudential regulation by the FSA (formerly the Bank of England); and competition regulation, under the auspices of the Competition Commission and the OFT.

THE BANKING CODE

The question arises as to whether the Banking Code, being a voluntary code, is an effective means of ensuring fair treatment of banking customers and regulating conduct of banking business. Although, technically, participation in the Banking Code is optional, in reality the optionality is quite limited. If any substantial bank chose to opt out of the Code, there would be so much publicity that the bank would have to defend itself with some vigour. Similarly, while the formal mechanisms of enforcement are weak, the impact of publicity has generally been sufficient, even in recent times, to result in compliance.

A number of developments have taken place recently in the way the Banking Code works and further material revisions are under consideration. The Banking Code Standards Board was formed in late 1999 and has introduced a level of independence not previously present in the governance of the Code. In addition, the publication of the Julius Report last year has set a range of recommended actions to enhance the Code's effectiveness. The combination of these two developments makes this year a crucial test for the Code and the Standards Board. If satisfactory implementation of the independent recommendations is forthcoming, criticisms of the Code and its governance should be neutralised.

PRUDENTIAL REGULATION

There is no suggestion that prudential regulation should be reallocated to any other authority than the FSA, and any such concept seems improbable, unless the relevant department were to transfer back to the Bank of England. The advent of the FSA has removed the multiple regulation by transferring regulatory authority both from the Bank of England and the SROs to the FSA. Notwithstanding the substantial cost of the process of establishing the FSA, the concept has been widely accepted and, significantly, the Conservative Party has made it known that it would not seek to reverse the process. The question is whether the FSA has adequate autonomy to set standards appropriate to UK banks. For example, the Basle II Accord, although not in itself legally binding, will be implemented by the EU through a directive, which the Government will be obliged to implement in this country. This cannot be delegated to a code, but must be introduced in a binding form by a statutory body. Thus the autonomy of the FSA will be restricted.

COMPETITION REGULATION

Traditionally, competition regulation has been distinct from the consumer protection regulator. This has helped to preserve the clarity of the prudential role of the FSA. Competition regulation continues to be the role of the Competition Commission and the OFT. The decision of the Chancellor to appoint the OFT as the regulator of the payment systems recognises that this regulation rightly relates to competitive practices rather than consumer protection. However, it would add another regulatory burden to payment systems, which (as explained below) would be both unnecessary and undesirable.

CAN OVER-REGULATION RESTRICT COMPETITION?

As Martin McElwee and Andrew Tyrie observed in their paper on the FSA:³

Competition is usually the best regulator. A firm which acquires a bad reputation will simply lose its business to its competitors. Those firms with a strong reputation for integrity will attract more custom and become models for success...

But such is the complexity of the financial service industry that individuals are forced to place trust in those advising them on, and dealing with, their money. The principle of *caveat emptor* remains an important one, but it must be modified to give those who deal in the financial sector a reasonable degree of confidence that the product or advice they are getting is legitimate.

So, where are the danger points in the statutory regulation we have in this country? Is it assuring quality or restricting competition?

³ M. McElwee and Andrew Tyrie MP, *Leviathan at Large*, Centre for Policy Studies, 2000.

In the process of authorising competitors, the regulatory framework can cause direct and indirect costs. The latter, the difficulties of understanding the authorisation process for instance, should be easy to deal with. The former, however, are more difficult. The level of the financial implications has to be sufficient to assure quality without being a barrier to suitable competitors. That is a judgement for the regulators to make.

The regime should avoid discrimination between competitors. This might occur in a number of ways. First, the rules could indirectly favour large players. For example, it could be argued that the proposed Basle 2 capital requirements may allow banks with sophisticated risk models to have lower capital ratios. But generally problems of this sort are not common.

In addition, the regulatory approach itself may be a barrier to a competitive market. While the regulatory system should not be a club for those inside it, the intensity of regulatory interference has to reflect the risks posed by an institution. A new market player may have a higher risk profile, due to a greater probability of failure, justifying greater regulatory intensity of prudential supervision. There are no easy solutions to this. Regulation needs to be as 'light touch' as possible and expressed in simple and clear terms. It should maximise the transparency of the regulatory process and require justification for any differential treatment between market players. A radical approach would be to require specific coverage of differential treatment issues in all FSA consultations on rules and guidance, complete with cost/benefit analysis specific to this issue. These measures should help smaller providers compete.

No specific regulation is entirely beneficial, very often because of the resultant reduction in the range of services available and the reduced number of players in the market. Regulation should encourage the availability of services accompanied by adequate information, so that consumers can make informed choices from a competitive range.

MONEY MARKET FUNDS: HOW REGULATION CAN RESTRICT COMPETITION AND CONSUMER CHOICE

One example of the unwarranted restrictions on product availability imposed by regulation is the problems with Money Market Funds. Under the application by the Treasury of EU requirements, Money Market Funds are obliged to value financial paper at market prices on a daily basis. As a result, they cannot offer a constant "par value", unless their investments are restricted to traditional bank deposits. This requirement has prevented Money Market Funds competing with the traditional banking sector in the financial paper markets. This kind of unnecessary regulation, which restricts product competition, should be eliminated. This requirement does not exist in the US, where Money Market Funds have provided major competition to traditional banks on the deposit side of the business. Ireland has interpreted the UCITS Directive to permit straight line amortisation of the returns from money market investments made by Money Market Funds which has resulted in Ireland having developed a substantial institutional Money Market Funds sector.

BANK LENDING: A LIGHT TOUCH FOR REGULATION

One area in which the extension of regulation might be called for is lending activities. The UK has traditionally not regulated lending as part of its framework of banking or financial services regulation, with the exception of residential mortgage lending, which will become regulated in 2004. This is because the people to protect have been perceived to be the people depositing money rather than the ones borrowing it. Quite separately, the UK has had consumer credit regulation dating back to the 1970s under which some lenders need to be licensed for their lending whether or not they are also authorised by the FSA. Is this structure appropriate?

One option would be to require authorisation of lenders and to impose conduct of business regulations. This seems an unnecessary burden on a lightly regulated sector. Alternatively, it might be appropriate to promulgate a set of principles – “ten commandments” – in a voluntary code. This approach should be built around a combination of requiring compliance with high level principles of conduct, an activist consumer education programme and providing regulators and consumers alike with real teeth to enforce the high level principles. These high level principles could include, for example, a requirement that a lender must not make a loan without a clear warning to the borrower if the loan would be manifestly unsuitable for the borrower, given the facts actually known to the lender. This might help to avoid what are perceived to be the social risks of inappropriate lending.

Who should be responsible for such regulation? For simplicity and to save customers confusion, it would be better to transfer consumer protection regulation from the OFT to the FSA. However, a light touch, high level approach to regulation would be a contrast to the FSA’s historic approach. There might also be a concern that getting the FSA to oversee the “lower grade” product proposed in the case of lending could undermine the value of the remainder of the FSA brand. In addition, transferring responsibilities between OFT and FSA would be to move the cost of regulation from the Treasury to the industry, which would not be entirely welcome by the industry itself.

The FSA should seek ways of reducing barriers to entry for new competitors in the banking industry and should introduce more flexibility to permit the US style Money Market Funds.

In conclusion, although radical surgery may not be needed in the area of the regulation of banking, there is undoubtedly scope for improvement. The FSA should seek ways of reducing barriers to entry for new competitors in the field and should introduce more flexibility into its collective investment scheme regime to permit US style Money Market Funds. Finally, regulation of lending should be tightened up by the introduction of a basic regulatory regime to cover all lending activity.

CHAPTER FIVE

PAYMENT SYSTEMS

Payment systems – comprising money transmission and payment card schemes – have been among the present Government’s chief targets for regulatory intervention. Following the Cruickshank Report, the Government is proposing legislation under which the OFT would act as the regulator of payment systems. They would exercise continuous scrutiny and direct regulatory intervention, in an approach similar to that used in the privatised utilities, such as OFWAT for the water industry or OFGEM for gas and electricity. This would be an additional regulatory burden on the sector, over and above the OFT’s existing competition powers.

Direct regulatory intervention in the utilities was necessitated by the fact that they were privatised as monopolies or near-monopolies, and are in many respects permanent natural monopolies (e.g. the water distribution networks, the gas pipelines). The payment systems sector is anything but monopolistic and it is hard to see a parallel justification for a utility-style system of direct regulation.

In payment systems, there is no single distribution channel or network through which all payments must flow. On the contrary, there are a number of competing platforms. Various payment card schemes compete actively against each other: MasterCard and Visa as credit card schemes, Switch and Visa as debit card schemes, LINK and the proprietary systems of banks and building societies in providing cash machine card (ATM) services.

In addition to competition *between* schemes, there are further dimensions of competition *within* schemes. Numerous banks act as issuers of payment cards to consumers, resulting in a huge variety of different card products. Banks also compete against each other to provide the services of acquirers – that is, providing a banking service to retailers who accept credit or debit or charge cards from consumers in payment for goods or services. Acquirers compete to attract the custom of retailers/merchants in terms of the speed of processing and reimbursement, the guarantees against fraud or default, and the level of the merchant service charge, which the retailer has to pay.

Moreover, the sector differs from the utilities in the pace of technological change. There is continual innovation in the development of new payment products, faster processing, more secure anti-fraud controls, and so on. Technological change encourages further competition, too, with Internet banking, for example, facilitating new market entry and new services.

Indeed, the competitive dynamics of payment systems are such that particular care and sensitivity needs to be exercised in the application of competition policy. For example, the success of a payment scheme depends on banks co-operating with each other (whereas in general, competition policy is intolerant of co-operation between competitors). Schemes benefit from network effects, whereby consumers derive greater advantages from a scheme the more banks participate in it. Contrary to the assumptions of competition policy in other areas, consumers of payment systems services are not best served by a highly fragmented market structure.

In the payment systems sector, therefore, competition is best encouraged by a ‘light touch’ - and not by the heavy hand of utility-style regulatory intervention. Unfortunately, the Government’s moves have gone in the opposite direction, favouring greatly increased direct regulatory intervention in the sector, based on a detailed set of prescriptive rules to be drafted by the Treasury.

In place of the heavy-handed, *dirigiste* approach that is currently envisaged, competition policy in the payment systems sector should be developed with regard to two key principles:

- first, competition policy must not be applied in such a way that it stifles innovation and other pro-competitive outcomes;
- second, with effective competition laws in place, additional regulatory controls are unnecessary and can be counterproductive.

The implications of this can be seen by considering a couple of practical examples. Real damage to consumer interests could be caused by inflexible application of competition policy.

The first is the question of multilateral interchange fees. An interchange fee is payable by the acquirer (the retailer's bank) to the issuer (the cardholder's bank), to meet costs such as transaction processing or payment guarantee, and to allow a redistribution of costs incurred in the joint supply of the card. The level of this fee is politically sensitive, because it ends up being paid by the retailers, who are quick to represent their particular interests to Government.

On the face of it, interchange fees set by payment scheme appear to be an example of collective price fixing. Most participants use the rates set by the schemes either as the applicable interchange fee or as a fall back rate. In reality, however, interchange fees are only a transfer price, a balancing mechanism by which the costs of joint supply are shared between suppliers. Without some kind of transfer pricing system, the schemes could not function effectively.

The relevant charges are not the interchange fees but those paid by end users, the merchant services fees paid by merchants and interest rates paid on credit card accounts by cardholders. Both are set in competitive markets. Prohibiting or reducing the interchange fee will merely shift the burden of payment from merchants to cardholders.

The Government seems to believe that retailers will pass the benefits of lower interchange on to all customers in the form of lower prices of goods. This is a most unlikely scenario. It is more likely that retailers will pocket the benefit and increase their profits. The payment schemes, faced with lower income from merchants, will have to increase credit card fees and interest rates to cardholders. This will be very unpopular with cardholders – with obvious political implications. It could also result in lower usage of credit cards. If this results in lower levels of spending in shops, retailers won't be happy either.

A second example is the question of whether a payment scheme should be obliged to grant to third-party competitors (such as banks outside the scheme, or other schemes) rights of access to the scheme's network or access to specific facilities or technologies which the scheme has developed.

However, in a non-monopolistic market, such as that of payment schemes, where there are no essential facilities, the imposition of network access obligations would be inappropriate and, indeed, counterproductive. Far from bringing consumers the benefits of competition, it is more likely to stifle innovation and retard efficiency.

This is largely because of the problem of 'free riding'. If third parties are allowed to enjoy the fruits of a scheme's investment in infrastructure or technology, they will not make such investments themselves. Moreover, if a scheme is obliged to share the fruits of its investment with others, it has a disincentive to invest. The network access obligation, which is intended to bring consumers the benefits of increased competition, ends up with the opposite outcome. The incentives to invest in new infrastructures and facilities, and to develop new technologies, fall away, and consumers lose the benefits, which they would otherwise have enjoyed from such investment.

Existing competition laws are capable of dealing with any market problems that may exist in the payment systems sector, and of doing so in an intelligent and flexible way. The haste with which the Cruickshank Report decried the inadequacy of the “existing framework of competition law” is bizarre and ill-informed, considering it was published just 20 days after the Government’s new competition legislation had come into force. Current competition law has all the powers necessary to deal with payment systems.

The post-Cruickshank proposals for a new regulatory regime to control payment systems are both unnecessary and damaging.

One of the key differences, however, in the Government’s proposals for the separate payment systems regulation is the threshold for intervention. The threshold, above which firms are considered to have a dominant position, has been reduced from the competition law concept of dominance (about a 40% market share) to 25% market share. This gives the regulator the power to control the commercial conduct of individual businesses even where they do not have a dominant position. This has no economic justification.

In short, the post-Cruickshank proposals for a new regulatory regime to control payment systems are both unnecessary and damaging. They are not needed to achieve the benefits which competition can bring, in terms of innovation, efficiency and consumer welfare. On the contrary, they risk jeopardising those benefits.

CHAPTER SIX

BASLE 2

The international banking regulation agenda is currently dominated by a single significant item: reform of the 1988 Basle Capital Accord, a reform justifiably billed as the most significant development in international banking regulation for the past decade. The dynamic nature of modern international finance has caused profound changes in markets and risk management practice, causing a growing consensus in favour of a new Accord. This resulted, in June 1999, in the Basle Committee on Banking Supervision issuing a proposal for a New Capital Adequacy Framework.

The effort devoted to this exercise by the global banking community has been, and will be, considerable. The costs associated with implementation will be large. Some estimates suggest that industry implementation costs will exceed the spend on Y2K compliance, reaching hundreds of millions of pounds.

In theory, the new Accord marks a watershed. Allowing the use of internal ratings-based (IRB) risk assessment as the basis of regulatory capital calculations is a prime example of this. In future, banks will be able to base their regulatory capital requirements, to varying degrees, on their own assessment of risk.

In reality, the absence of an objective means of validation, or a common policing function or authority, has led to an attempt to create a consistency of outcome through the definition of standard inputs to, and standard operation of, the regulatory model. The result has evolved into a complex structure of rules that attempts to prescribe a very dynamic reality. Not surprisingly, the banking industry balked at the costs of compliance, such as the cost of bringing internal systems into line with the regulatory model and possibly running parallel regulatory capital systems at the same time.

Notwithstanding the problems, it is expected that the final Basle package will have the support of the UK banking industry. This should not suggest satisfaction with every detail, but that in the round, the reform package would be a positive development for the UK banking industry. Therefore, the focus should be on influencing the shape of a Directive, which will implement the new Accord.

The final Basle package is likely to be broadly acceptable to the UK banking industry. The focus should be on ensuring that the EU Directive which will implement the new Accord does not damage banking competitiveness within the EU.

An important part of the future agenda is ensuring a consistent application of the Basle 2 Accord around the world. The scope of regulatory arbitrage, which would allow some jurisdictions a competitive advantage in the form of less rigorous regulation, should be avoided. It would be a threat to international banking business in the UK.

In this context, the analysis suggests three high-level lobby objectives:

- **Parallel implementation:** currently the foremost concern is the parallel implementation of the new Basle Accord and any new EU Directive. This will be achievable, only if the implementation date is reset to 2006 and the proposed Directive secures consensus support in time for that.
- **Flexibility in amendment:** a second priority is to ensure that the Directive is structured in a manner that would allow the timely accommodation of change, driven either by constant market innovation or regulatory need.
- **Consistency in application:** finally a mechanism and process should be developed to support the consistent application of the new regime. This will require the establishment of a global body to facilitate a rigorous ongoing process of peer group review and a role for supervisory disclosure as a mechanism for enforcing supervisory discipline. If regional or national bodies are solely responsible for interpreting the new Accord, serious divergences in interpretation will emerge, damaging competition in international markets.

CHAPTER SEVEN

THE UNIVERSAL BANK

The Universal Bank is the name given to a reform of the payment of social security benefits. It is not a bank at all. In an effort to save £500 million in costs of benefits payments, the Government has prevailed upon the banks to establish basic bank accounts and to contribute to the development of Post Office Card Accounts, in place of the traditional Order Book process. This could cost the banks £500 million a year to implement. They have received no credit for this.

At present, some 13 million people collect their social security benefits by presenting a paper “Order Book” at their local Post Office. Like many other great British institutions, the public is deeply attached to the benefit books, and the ritual of the weekly visit to the Post Office.

However, the system has fundamental weaknesses. “Instrument of payment” fraud is one of them – counterfeiting books, and the interception of Order Books in the post – which has recently been estimated to cost the Government over £100 million per annum. In addition, the Order Book system is expensive for paying departments (principally the Department of Work and Pensions) to administer, some £550 million per annum of which approximately £400 million is paid directly to the Post Office. The Government therefore had a strong interest in finding an alternative benefits distribution mechanism.

Customers, however, find Post Offices convenient. The system is free to the end user. They do not need a bank account in order to receive their benefits. The system allows benefit claimants to ring fence their money. Many claimants trust the Post Office whereas they do not trust banks. The Order Book system provides a simple reminder to people of when their benefit is due.

The UK banking industry has been content to let sleeping dogs lie. It is true that they have co-operated with the present Government's social exclusion initiative, and now offer "basic bank accounts" (BBAs). However, they have not, in general, marketed these BBAs actively, as they do not offer an opportunity to make profitable returns.

For the Post Office, administering the current Order Book system represents around one third of the business of the Post Office branch network. Most Post Office branches are in effect operated on a franchise basis. The sub-postmasters holding the franchise also have an interest in the Order Book system.

There has already been one major failure in attempting to replace benefit books as a mechanism for distributing State benefit. This involved giving each benefit claimant a "Benefit Payments Card" which could be swiped at a Post Office counter, enabling the claimant to withdraw his cash. This initiative ran into severe problems. It was too ambitious, attempting to use a new funding mechanism (the public finance initiative) and to do too much – providing both a new benefit payments system, and the modernisation of the Post Office point of sale capability. The Benefit Payment Card was a "statist" solution in which the UK banking industry played no part. This is in marked contrast to the present plans for Universal Banking Services.

The nature of the solution agreed between the current Government, the banking industry and the Post Office was set out in the Memorandum of Understanding in 2001. It said that:

- the banking industry would improve access to financial services by making their basic bank accounts available through the Post Office network. This is a substantial investment in assisting with the Government's agenda of alleviating social exclusion;
- in addition they would make a financial contribution to the Post Office Card Account (POCA) totalling £180 million over five years;
- the Post Office would provide a Post Office Card Account for those people who are unbanked or are unable to open the basic bank accounts referred to above;
- the government would make a financial contribution to ensure the success of the Post Office Card Account.

To open a Post Office Card Account, a claimant would need a Personal Identification Document, to be issued by Government. This document would be issued following discussions between individual claimants and their case officers designed to identify which was the most appropriate form of account for their needs.

The Government can now commence its replacement of the Order Book system in the knowledge that there are alternatives available to those who do not wish to have their benefits paid into bank accounts.

This solution marks a significant step forward from the Order Book. All payments, whether the claimant has a standard, basic, or POCA account will now be routed through BACS, the standard UK mechanism for Direct Debits, Standing Orders and salary payments. The Government should therefore avoid the risk of instrument of payment fraud. Moreover to the extent that the Government can persuade benefit claimants to use basic or standard bank accounts, it will avoid distribution costs altogether. Even for the POCA account, which it is required to fund under the Memorandum, it will receive a significant contribution from the banking industry. The IT infrastructure in Post Offices will allow them to undertake money transmission transactions for banks at post office counters.

Should all those eligible to use the standard or basic accounts do so, the annual cost to the banks would be between £400 million and £650 million (assuming each account costs between £30 and £50 a year to administer).

The banking industry could stand to lose significantly in financial terms under this deal. Indeed it would seem churlish and counter-productive not to acknowledge the role and financial contribution the banks will have to play both in benefits distribution and in reducing social exclusion through the provision of BBAs. The sums involved, are large: if all 13 million customers decided to use standard or basic bank accounts (which, as we have seen is unlikely), the total costs to the banks could be as high as £1 billion. Incremental costs would be £400-£650 million if each account costs £30-£50 per annum.

Perhaps the irony of this solution is that it was the last Conservative Government that embarked on a “statist” solution, highly reliant on bespoke public sector IT systems, whereas it is the current Government that has pioneered a more co-operative solution. Both the public and private sectors have a role to play, in a way that seeks to leverage and to exploit the unique skills of each to provide the benefit customers with what should, in 2003, be a secure, largely fraud-free benefit distribution system.

There are four important implications of this initiative:

- a public/private solution is difficult to deliver but is preferable to a state only solution;
- the Universal Bank is attempting to reconcile several different objectives and cannot be equally successful in meeting all of them;

- the key role which the Banks are playing in delivering this solution has been underplayed and underacknowledged;
- the migration of 13 million benefit recipients from one system to another has to be effectively planned and thought through.

CHAPTER EIGHT

CONCLUSIONS

The banking industry is facing a period of accelerating change. The fundamental economics of the industry are being revolutionised by the impact of technology. The way banks relate to their customers, the way they deliver services, the way they organise or procure activities, all of these are being recast by technological and competitive pressures.

This is not an industry stuck in an uncompetitive mire. New products, new channels and new competitors are proliferating. The challenge for the banking industry is to live up to the rising levels of customer knowledge, demands and expectations.

The Government has inundated the banking industry with regulation. The result has been to increase the burdens on banks, obstruct innovation and in some cases impede competition.

The current Government has inundated the industry with intervention. It intends to impose inappropriate utilities-style regulation of the pluralist payment systems market. It has imposed direct price controls on SME business banking. It has introduced new regulation of mortgage products. It has reviewed a plethora of other banking activities. The result of all this has been to increase the burdens on banks, to distract their attention and resources from innovating and serving customers and in some cases to impede competition.

Rather, policy should be focused on stimulating banks to improve and develop their services and to improve their standards of business conduct. This requires successful voluntary self-regulation. That is the route to a dynamic banking sector in future.

PUBLIC POLICY PROPOSALS

1. There are tensions between the objectives of banking safety regulators and competition regulators, albeit that the resulting balance of power has achieved a reasonable British compromise. This policy tension needs to be recognised and constantly reviewed.
2. The principle that competition is the best regulator should be established. New entry into banking markets should be encouraged not discouraged, subject to regulation providing an acceptable level of banking safety in the interests of the consumer as well as the wider economy.
3. An “in principle” stance against consolidation on competition grounds flies in the face of technical advances and market forces. It should be revisited.
4. The Government should undertake a fundamental review of its current proposals for legislation following the Cruickshank Report.
5. Specifically, the Government should not give the Office of Fair Trading new powers to act as a direct regulator in the payment cards and money transmission sector. This would be harmful to the sector and to consumers, imposing new costs and dangerously weakening the incentives to invest in innovative technologies and facilities.
6. The Government should study the payment systems again in five years time to review the impact of innovation and market developments and the experience of other countries as well as the UK.
7. The UK should apply the UCITS Directive to allow US-style money market funds to develop, copying the example of Ireland, as a means of introducing greater competition into banking services on the deposit side.
8. Restrictions on bank charges or requiring the banks to pay a particular level of interest on accounts, such as those held by SMEs, or obliging the banks to share their branches should be opposed. The Government should instead focus on encouraging competition and new entry into the SME banking market.
9. It should be made as easy as possible for an SME customer to switch from one bank to another. Banks should be required to meet a minimum industry standard on their practices in respect of customers who wish to switch accounts. There should be a specific timetable for the completion of switching and penalties/compensation should apply to banks if they fail to comply with the timetable or if they make errors in the process of arranging a customer to change his bank.

10. Additionally, a portable credit history for SMEs should be developed by the banks to ease the ability of SMEs to switch their banks if they so choose.
11. Banks should be required to provide on a regular basis information on money transmission charges, loan interest rates, charges and terms, and current and deposit account interest rates to an institution such as the British Bankers Association (BBA). The BBA could then compile the data into an overall list for comparative purposes. Such comparative information would help the market to function more effectively and would be a major force for competition.
12. The voluntary Banking Code, properly enhanced in accordance with the Julius Report recommendations, promises to be the most effective arrangement for conduct of business regulation of banking. It is important that they work and are seen to work, to avoid unwelcome statutory regulation.
13. The FSA should continue their approach of publishing coherent guidance on the authorisation application process and the criteria it will apply. It should continue its commitment to plain English and reducing the size of its rules. However, consideration should also be given to the following:
 - the merits of creating a Banking Small Business Panel in addition to the general FSA Small Business Practitioner Panel to give an institutional voice to the smaller banks within the regulatory process;
 - either a duty on the FSA to explain in its annual report how its regulatory policies have regard to the adverse effects on competition of regulation in relation to new market entrants or specific coverage of differential treatment issues in all FSA consultations on rules and guidance and cost/benefit analysis specific to this issue;
 - measures which remove the barriers to the flow of information between potential consumers and the smaller bank, for example, benchmarking of services by FSA.
14. Lending should be subject to a "ten commandments" style of regulation. Lenders should be subject to an obligation to comply with certain high level principles but there is no requirement for authorisation for this activity (some may of course be authorised by FSA for other activities such as deposit taking) and no full conduct of business regime.
15. The Basle Accord should be implemented in the world financial community at the same time. There needs to be substantive debate over the course of 2002 between the major EU institutions, the industry and other interested parties, with a possible implementation date of 2006.

16. It is essential that the expected EU Directive on Basle 2 can be speedily updated if the new regime is not to become quickly outdated, creating new stresses within the regulatory system that are currently difficult to foresee. A solution lies in the proposals made in the Lamfalussy Report.
17. A mechanism and process to support the consistent application of the new regime globally should be developed. We favour a global body to oversee implementation rather than regional bodies such as the EU. If regional bodies have responsibility for interpreting the Accord, serious divergences in interpretation could emerge.
18. A public/private solution to the Universal Bank is difficult to deliver but is preferable to a state-only solution.
19. The name Universal Bank should not have been allowed to develop. The Post Office Card Account is merely a digital alternative to the benefit Order Book.
20. The key role which the Banks are playing in delivering this solution has been underplayed. They should receive real credit and public acknowledgement of their role in building the solution.

**THE COMPETITION COMMISSION'S
BANKING REPORT**
A CASE STUDY

Sean Williams

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CHAPTER ONE

INTRODUCTION

The Government's rhetoric is full of the language of enterprise and competition. Yet its approach to achieving these laudable goals in practice is often far from the ideals of liberal market economics. Instead of cutting back regulations and freeing up markets, it is increasing regulations and actively intervening in markets.

This approach is based on a belief that free markets can be improved by manipulation. It assumes that, by analysing markets rationally and intervening in them judiciously, competition can be encouraged and greater national competitiveness achieved.

This interventionist and rationalist approach to the microeconomy is fundamentally flawed. Markets cannot be analysed with certainty and cannot be manipulated without adverse consequences. No set of experts is expert enough to make this work. It is impossible for any regulatory, competition or planning authority to synthesise all the information required to come to an accurate assessment of what is happening in a market in detail. That is why market mechanisms excel: they allow dispersed economic agents to use dispersed information in response to specific needs.

This paper considers these issues in relation to one particular aspect of the Government's conduct of the microeconomy, competition policy. It uses the particular example of the Competition Commission's most recent competition inquiry, into banking services to small businesses, to illustrate the implications of this interventionist and rationalist approach for the management of competition policy in all industries.

In the SME banking inquiry, the government has imposed direct price controls on a competitive market, in a manner that damages competition and customer interests, and on the basis of unsound and unproven case. It will exact a penalty of billions of pounds on the banks' shareholders. This inquiry is a demonstration of the ability of experts, however well-intentioned, to get it wrong.

As a result of the SME banking inquiry, the Government will impose price controls on a competitive market in a manner that will damage both competition and consumer interests. It will also exact a penalty of billions of pounds on the banks' shareholders.

It is clear also, from the Government's changes to competition policy proposed in the Enterprise Bill, that they are intent on embedding this interventionist and rationalist approach more firmly in future. Its plan is to make competition authorities more independent (less accountable) and more proactive in their intervention. While this may make the process less political, it will make the problems of inappropriate intervention more likely and more invasive, without addressing the fundamental iniquities of the process.

There is an alternative. Competition should be assessed by clear rules on the basis of proven evidence and by means of a fair process, not on the basis of arbitrary judgements of unaccountable experts through a deeply flawed process. Competition and enterprise should be encouraged through liberalisation and not manipulated by government intervention.

CHAPTER TWO

RECOMMENDATIONS FOR COMPETITION POLICY

In a sense none of the following recommendations are radical, as they mirror standard procedure in other forms of inquiry processes. It is perhaps surprising that they do not apply already in a field of inquiry in which people can be deprived of such huge sums of money.

The standard principles of fair process should apply to competition inquiries.

- The roles of judge, jury, prosecution and investigation should all be split from each other:
 - The investigating functions should be held by the Office of Fair Trading, its role being to investigate whether there are grounds for bringing a case forward for an inquiry. This role should explicitly not be performed by one-off appointees of Government ministers, such as Don Cruickshank, who may be susceptible to short-term political imperatives.
 - The functions of the Competition Commission should be split between two separate organisations. One organisation should be responsible for analysing and building a case for the “prosecution”, a case in other words that competition is ineffective – the Competition Inquirors; a completely separate organisation, with separate support staff, should be responsible for hearing the cases and coming to a judgement – an Inquiry Panel.
 - The role of the Chairman of an Inquiry Panel should be modified relative to the other members of the panel. He should perform a role more closely modelled on that of a judge, while the other panel members should in effect become more akin to jurors

- Inquiry Panels should hear the case for the “prosecution” and the case for the defence impartially. The defence must have the right to hear the case against them and to challenge it.
- The Competition Inquirors should be required to provide a reasonable burden of proof. It should not necessarily be to the same standard of proof beyond reasonable doubt as in a criminal case, but at least some burden of proof that a case has been made.
- The Competition Panel must be obliged to assess the cases impartially, weighing up the relative strengths of each case neutrally, with no presumption in favour of the case of the Competition Inquirors.
- The defendants must have the right of appeal. The appeal must be able to challenge the substance of the judgement on a fair basis. It should not just be a right of judicial review, which can only overturn judgements if procedures have not been followed correctly, or if the Commission has been manifestly irrational.
- Clear rules as to what constitutes anti-competitive practices should be defined in advance. It should be possible for businesses to conduct themselves with a clear understanding of what is allowed and what is not. It is unfair to subject them to arbitrary judgement after the event on practices that they would have happily discontinued had they known in advance.
- Specific rules should be propounded as to what is prohibited. For example, price fixing is clearly anti-competitive and is already recognised as such. Another example might be selective pricing, which could be outlawed and is outlawed in some countries. Making profits above the cost of capital should explicitly not be outlawed.
- The Competition Panel should have no right to impose any penalties that impede competition. In particular, they should not have the right to impose price controls, when doing so will discourage actual or potential new entrants.

In short, the process must be fair, accountable and free from political interference.

CHAPTER THREE

BACKGROUND

For many years, the standards of services provided by banks to small businesses have been matters of concern. Antipathy to banks is endemic. Bank bashing is an international sport, one at which the British excel. These concerns were at their height in the early 1990s, when high interest rates and economic recession drove many businesses to closure. There was a strong sense at the time that banks had exacerbated the problems of their struggling customers by charging too much and calling in loans too soon. The Chancellor called in the bank chief executives to obtain assurances. The Bank of England has been monitoring relationships ever since.

In 1998, the Government set up a review of the banking industry chaired by its appointee, Donald Cruickshank. This came to the view that banking services to small and medium-sized enterprises should be investigated by the Competition Commission. A formal competition inquiry was initiated in March 2000. After 19 months of deliberation the Commission delivered their report to the Government in October 2001, the longest competition inquiry report ever produced by a wide margin – nearly 1,400 pages long.

The Government has accepted their recommendations. The recommendations consisted of a plethora of behavioural remedies designed to address perceived issues in the conduct of competition in the market, covering issues such as the ease of switching between banks, the terms of accounts and so on.

However, in addition there were two potentially damaging impositions. The first was that the major banks should study the feasibility of providing open access to their branches to customers of other banks. This remedy is designed

to break down the perceived barrier to entry into the market constituted by ownership of bank branches. The second was a requirement that banks should either provide free banking services, or pay interest on credit balances in current accounts, to business customers. This remedy, which consists of direct price controls in a free market, sought to address what the Commission perceived to be overcharging by banks. It was designed to reduce the profits of the four largest clearing banks by about £500 million per year.

Much of the public reaction to these proposals was positive, seeing it as a triumph of small businesses (good) over banks (bad). Despite some scepticism, the majority of commentators did not seem concerned about the real implications of the Government's actions. In particular, the Government has drastically compromised the property rights of the businesses in question. They have required them to use billions of pounds of their assets for the benefit of the customers of their competitors. They have tried to appropriate billions of pounds of equity value through price controls designed to reduce profits.

Was it fair or justified for the Government to intervene in these ways? Was the process, by which such a decision was reached, fair and impartial?

The issues are not just matters for the particular businesses in question, which happen to be banks. They apply to all businesses in all industries. Can any corporation be safe in the conduct of its business any longer, free from arbitrary government intervention in the name of competition?

CHAPTER FOUR

UNFAIR PROCESS?

Imagine seeing in a newspaper that you were suspected of having committed a criminal offence. You receive a letter from the authorities saying that they are going to investigate whether you had committed an offence. Before the offence is specified, you are required to provide all the information you have to the authorities in response to a huge questionnaire.

You search your records: have you ever committed a criminal offence? What might the authorities think is a criminal offence out of all the things you have done? You turn to some highly respected lawyers. They tell you that what constitutes a criminal offence in this world is a matter for the authorities to judge: there are no set rules as to what is an offence and what is not. Having a clear conscience, you send the authorities all the information you have.

You then receive a letter from the authorities which says that you, and an unspecified number of other people, may have done a number of things which they may consider – or may not – to be criminal offences. They ask you to provide your case in writing and to come to a hearing. You are not allowed to confer with any of the other people involved. You write a long letter saying that none of the things they think you have done should be considered offences of any kind.

You come to the criminal hearing. In this world, the judge, the jury, the directors of prosecution and the heads of the police investigation are all the same people, a panel of five men and women, only one of whom is an expert in criminal law.

You are rather alarmed by this. How can these people take an impartial view of the facts and the case, and judge you fairly, when they combine all these roles with so little expertise?

You respond to cross-examination by the panel, who try to work out whether the things that you have done constitute a criminal offence. You don't know how to answer their questions, because you are never told the case against you. You are never told why the things they are worried about might constitute criminal offences. You don't know what any of the other defendants may be saying in their defence, whether they are saying the same sorts of things as you or whether they are incriminating you. They are heard separately.

You have to attend a number of hearings. Before any case is made against you, the panel members ask you to comment on the penalties that they might want to impose on you. You are asked to comment on whether community service helping elderly people would be more or less suitable than community service helping children. You are also asked whether you would prefer to be hung by the neck or decapitated by guillotine.

You complain that none of these punishments are remotely appropriate because you have done nothing wrong. The authorities merely respond that what you say may well be true, but this is your only opportunity to influence the panel's decision on the punishment so you might as well get on with it.

Once you have made your case, the authorities then come back and ask for more information. They particularly want to know about your bank account and how much you have put away over the last three years. It is actually quite a healthy sum, but then you are paying off debts, which have been outstanding for ten years and have to be paid off soon.

The authorities then retire to deliberate. After a period of interminable waiting, in which you have no idea of your fate or of what you can and cannot do, they finally issue their verdict. They find that you, and a few others, are guilty of a series of small criminal offences over many years, which together amount to a big offence. They know this, not because you have actually done anything much they can point to, other than a few unpaid parking fines, but because you have been able to put too much money away out of your earnings. For these offences, you have to do various pieces of community service and also life imprisonment in an unpleasant prison.

You are very upset about this. You have done your level best to be a good citizen your whole life. You have gone to great lengths to help the authorities with a number of their pet projects, at some considerable cost to yourself. No one ever told you that any of the things you have done which the authorities now consider to be criminal offences were wrong. If you had known, you could easily not have done them.

But you are also very upset about the fact that there is actually no proof that you have done any of the things you are accused of, except for the parking fines. In particular, you feel the authorities have not taken into account the fact that you are still paying off your debts and that the amount of money you have been able to put away is not excessive compared to what other people have been able to do.

You turn to your lawyers again. Unfortunately, they tell you, you have no right of appeal, not unless you can prove the authorities took leave of their senses or failed to follow the procedure they were supposed to. You have to go and do time.

You are stunned. There are no rules setting out what you are and are not allowed to do; no opportunity to defend yourself properly in hearings; no proof of a case against you; no right of appeal. It is a process where the judge, jury, prosecution and investigation are all the same people. It is not fair.

Substitute the word “competition” in place of the word “criminal” and that is what the competition inquiry process constitutes in this country today. A Kafka-esque process if ever there was one.

The banks were investigated because a government appointed adviser recommended that they should be. The Competition Commission came forward with a long list of possible issues as their opening hypotheses. The Competition Commission panel conducting the inquiry does not engage in assessing competing cases for and against a defined set of charges, based on evidence. They go through a process of validating their hypotheses. They do not have to explain their reasoning or provide evidence. They just have to show that they have heard the submissions of the parties in coming to their own point of view. The structure of this process is such that even the most intelligent and fair-minded of panel members is likely to come to a one-sided conclusion. That is exactly what has happened in this case.

CHAPTER FIVE

ERRORS OF MARKET ANALYSIS

The Competition Commission's findings from their investigation into SME banking hinge on one main conclusion: that the banks make "excessive" profits and therefore must be overcharging their customers. This conclusion is unsound, as demonstrated in the next chapter. It is also unconnected to the Commission's analysis of the market and the structure of competition, which by themselves are insufficient to justify the Commission's adverse findings on competition.

FINDINGS

The paradox for the Commission was this. The market was widely perceived to be uncompetitive by external observers. This was mainly as a result of the concentration of the market, a perceived lack of switching and the vocal complaints of a number of consumer interest groups. The media and political climate further magnified these impressions. Given this situation, the Commission would probably have suffered a loss of credibility if they had given the industry a broadly clean bill of health, particularly after the supermarket investigation was seen as a whitewash.

However, on examining the market, the Commission were unable to find any significant examples of anti-competitive behaviour on the part of the banks. To quote from Derek Morris:⁴

⁴ Dr Derek Morris is Chairman of the Competition Commission and was Chairman of the Inquiry Panel of the SME Banking Inquiry.

We found the services were generally well supplied: there was good quality of service, ready availability of lending and quite reasonable terms and I think most small businesses recognise that. The problem was that they were being overcharged.

In particular, the Commission found:

- good quality of service, including service to ethnic minority businesses;
- high levels of customer satisfaction;
- ready availability of credit on reasonable terms;
- no financial advantage being taken by the banks from the clearing cycle;
- no obstacles being put in the way of customers switching by the banks;
- no negative findings on closure of bank branches from a competition standpoint.

In this context, what the Commission could come up with in terms of adverse market findings was very little.

Indeed, many of the issues – such as price discounts to retain customers and to win new business or free banking periods for start-ups and switchers intended to attract them to the bank and overcome their switching costs – would be seen by businessmen as evidence of intense competition, not as a lack of competition.

Other issues are not practised universally and were not seen as problems by customers in the Commission's own research. For example, not all banks had a general requirement for businesses to have a current account if they want to borrow or use a deposit account. For one issue – the different services offered to personal and business customers – the Commission accepted that it would not be justified to require banks to remove this distinction.

Some issues are minor in the extreme: “Failure to promote *the scope* for savings from use of set-off or sweep facilities to *all* the SME customers who could benefit from them”. The words in italics are needed to overcome the fact the banks do routinely promote set-off and sweep facilities to their customers. “Fail to provide a breakdown of overdraft interest charges on statements” even though the interest rates on overdrafts are clearly stated in the facilities letter sent to clients when they open an account and are readily available by speaking to the customer's relationship manager.

All of the remaining issues (and some of the above issues) rely to a large degree on the excess profitability finding which is largely unconnected to the market analysis. These include the concerns that banks are said to: not pay interest on current accounts; offer low deposit account interest rates; maintain a structure of charges unrelated to costs; and overcharge customers.

BASIS FOR LACK OF COMPETITION

The Commission's yardstick against which the level of competition was measured was that:

- there should be a large number of providers
- consumers actively and frequently shop around and switch providers;
- competition should be focussed largely on price factors;
- it is preferable for there to be a single price for all customers – avoiding all discounting, negotiation, differentiation, bundling and special offers which are considered anti-competitive;
- marketing expenditure is not in the consumer's interest and usually excessive (and therefore not deductible from an assessment of excess profits).

The banking industry does not fit these characteristics precisely, and as a result, the Commission took the view that the market was therefore uncompetitive. But this is an assumption: it is not proved in the report. It is to assert that a particular view of the characteristics of “fully-effective competition” is to be favoured over another equally plausible point of view, that intense competition is possible in markets with few suppliers. Above all, there are valid reasons why a market does not *necessarily* have the above features and yet remain competitive.

MARKET CONCENTRATION

There is no doubt that the SME banking market is concentrated. The big four banks hold over 80% of the market. However, this in itself is not sufficient to demonstrate that the market is uncompetitive. There can be intense competition even between few suppliers. Indeed, the Competition Commission itself did not find market concentration to be a problem in all cases. In Scotland, where the top suppliers have an even higher share, and where SME customers are on average charged more, they came to no adverse competition finding. Either the Commission were unreasonably biased towards Scotland – see below – or concentration itself is not the issue.

SWITCHING

The Commission concluded that there was a lack of switching in the marketplace. The evidence suggested that between 4% and 6% of customers switched suppliers each year. While this may appear to be quite low, it has to be seen in the context of the extraordinary high levels of “customer churn” in the SME banking market. Most SMEs do not last more than three years. Consequently about 20% of the SME customer base is new to banks each year. Moreover, many customers use more than one supplier for different services. So the low levels of switching have to be seen in the context of a highly volatile customer base.

Levels of switching would be a valid concern of the Commission, if banks were preventing SMEs from switching and if they are able to exploit their customers as a result. The Commission felt that the lack of switching was caused by several factors:

- the perceived complexity of switching;
- the perceived significance of maintaining a relationship with a bank;
- the ability of SMEs to negotiate lower charges in return for keeping their business with their current bank;
- the preference of SMEs to keep their purchases of current accounts and loans with the same bank;
- limited price sensitivity.

None of these factors is the result of any practice carried out by the banks. In fact the first two issues are perceptions rather than real barriers to switching. The other issues are preferences of SMEs and do not prevent them switching in any way.

The key question is whether banks are able to exploit SMEs even if they do not actively prevent them from switching. The economic literature on this topic suggests that low levels of switching tend to result in different market structures but do not allow exploitation. Low levels of switching do not reduce the level of competition but changes its focus, increasing competition for new business and start-ups relative to established customers. In markets where there are high switching costs, competitors will tend to offer new customers an incentive (such as free banking periods) to overcome the perceived or actual barriers to switching. The natural response to the possible loss of a customer in such circumstances is to offer them a discount to persuade them to stay. In this way, competitive pressures remain effective on providers.

To put it another way, the Commission do not establish that there is any significant public interest detriment in the form of competition that currently takes place in the market. Nor do they show that there would be any public benefit from a form of competition that complies with their preconceived notions of what a competitive market should look like.

PRICE SENSITIVITY

Another example of the Commission's attachment to preconceived notions of proper competition is its focus on price factors rather than service factors. This is despite the conclusions from their own research, which showed that quality of service is more important to SMEs than price.

Competition will naturally focus on the issues that are important to customers, and it is recognised that the banks have made improvements to their service since the last recession. The fact that customers give a higher priority to service and quality issues than to price does not mean that price is unimportant. In a market like banking, whether banking is fit for purpose for the customer is a matter of judging the quality and levels of service provided. Relative pricing can only be assessed once these other factors have been taken into account. That is why customer surveys in this market typically yield the result that price is third in order of importance in decision making. There was plenty of evidence that for specific generic services, such as a deposit or a loan account, or for categories of customers such as new start-ups, price was the most important factor. In this research, the quality and nature of the product had already been defined. In these circumstances, price competition was highly important.

In fact, as the report itself indicates, there is substantial price competition to gain the business of start-ups: prices of banking services have been driven down to zero. Because of the high rate of churn in the SME sector, competition for start-ups is highly significant in relation to the market as a whole. With 20% of the customer base being new each year, after a few years the majority of customers will have experienced free banking. By preferring competition based on similar terms to all customers, the Competition Commission seeks to replace actual market competition with their particular notion of “fully effective competition”. There is no basis for thinking that this will improve the operation of the market, and every reason for thinking it will likely make matters worse for customers, on average.

BARRIERS TO ENTRY

The Commission concluded that there were significant barriers to entry to the market. This is despite the fact that there are three substantial declared new entrants into the market, including Halifax Bank of Scotland, Abbey National and Alliance & Leicester.

In any market there will be some requirements to enable any entrant to compete:

- physical assets, such as branches in the case of banking;
- human capital, such as relationship managers;
- intellectual property, such as credit assessment skills; and
- intangible assets, such as brand reputation and access to customers.

In the Commission’s view, all requirements for operating in the SME banking market were considered barriers to entry. This is despite the fact that all the declared new entrants have the required resources to a considerable extent, including branch networks, credit assessment skills, brands and access to customers.

Many of the “barriers” the Commission identified are financial set-up costs rather than practical barriers to entry. There are no practical or legal restrictions preventing a new entrant from making the investment to acquire customers, to build a brand or buy branches, if necessary. Indeed, in the last ten years, over 5,000 branches have been closed by established banks, so there is clearly no shortage of appropriate premises if it were worth new entrants investing in them.

The Commission does not connect the existence of these set-up costs to its analysis of the profitability of the market. New entrants will make the necessary investment if they see the potential to make appropriate profits once they have entered the market. The lack of new entrants for most of the 1990s can be explained by the very unattractive profit records of the incumbent providers. They had to wait until profits had recovered and stabilised after the last recession before they were confident that entry into the SME banking market would offer attractive returns. It is not surprising, therefore, that it was not until the late 1990s that significant new entry was planned in a committed way.

Furthermore, these costs of entry are also not unique to new competitors – the existing competitors incur the same customer acquisition costs, must maintain their brands and their branch networks. The Commission does not demonstrate that the investment in the necessary assets falls more heavily on new entrants than incumbent competitors (with the possible exception of the recruitment of new customers).

CHAPTER SIX

ERRORS OF PROFITABILITY ANALYSIS

Because of the weakness of the market findings, the Competition Commission relied to an unusually large extent on their analysis of profitability to support their findings. In other words, because they did not find any direct evidence of a lack of competition in the market, they used what they perceived to be excessively high levels of profitability to support their case that competition was less than fully effective. So it becomes crucial to their case whether or not profits are indeed excessive in SME banking.

THE USUAL STANDARD

Drawing conclusions on the degree of competition in a market from an analysis of profitability is a difficult and controversial area. There is a high degree of uncertainty in the measurement of profits, especially for business units for which no statutory accounting information has ever been available.

Theoretically “excess profits” should be the result of specific practices that distort competition and not, as in this case, used to demonstrate the existence of competition problems. The OFT’s guidelines for the application of the Competition Act describe a manner in which profitability should be used as an indicator of market power. On this issue they state that:⁵

⁵ Assessment of Market Power Guideline (OFT 415), paragraphs 6.3 and 6.4.

An undertaking's conduct in a market or its financial performance may, in itself, provide evidence that it possesses market power. It might, for example, be reasonable to infer that an undertaking possesses market power from evidence that it has:

- consistently raised prices in excess of costs; or
- persistently earned an 'excessive' rate of profit.

High prices or profits alone are not sufficient proof that an undertaking has market power: high profits may represent a return on previous innovation, or result from changing demand conditions. As such, they may be consistent with a competitive market, which requires that undertakings are able to take advantage of profitable opportunities when they exist. However, persistent significantly high returns, relative to those which would prevail in a competitive market of similar risk and rate of innovation, may suggest that market power does exist. This would be especially so if they did not stimulate new entry or innovation.

The key issues in this guidance are in the phrases “persistent significantly high returns” and “*relative* to a competitive market”.

PERSISTENT HIGH PROFITS?

In the SME banking report, the Commission failed to prove any persistence in levels of profits. They only assessed profits over three years, three years at the top of the economic cycle. This is not what is normally meant by “persistent”, particularly when account is taken of cyclical factors. SME banking is a highly cyclical business. The only way in which the Commission sought to allow for cyclical effects was by adjusting the bad debt rate. This is an inadequate approach, as is discussed below.

It appears that the Commission were working outside the OFT guidelines for the Competition Act, which, although it provides a different legal framework from the Fair Trading Act, is intended also to control anti-competitive behaviour and the abuse of market power.

SIGNIFICANTLY HIGH PROFITS

How high does profitability have to be to be “significantly high”? An analysis by the OFT of previous Competition Commission and Monopolies and Mergers Commission reports showed that the Commission only concluded that profits were “high”, “very high” or “excessive” when profits were significantly greater than the comparator used – on average 60% and a minimum of 18% above the comparator.

In this case, however, the Commission judged all long-run profitability above the cost of capital to be excessive (paragraph 2.415), subject to a 3% margin for error. This is not the standard by which the presence of possible market power has been judged in prior competition inquiries. It is the test applied in utilities regulation. In this report the industry is not being judged on the exercise of market power, but by reference to a theoretical standard of a “fully competitive market”, which is undefined, as if it were a utilities-style natural monopoly.

HIGH PROFITS RELATIVE TO OTHER MARKETS

In contrast to many previous cases, the Commission refused to compare the profitability of the industry with other industries to understand whether bank profitability is significantly greater than that found elsewhere. It is not just that they did not do so: they indicated that they could not do so (paragraphs 2.409 and 2.410). This is a surprising position to take, given that in the preceding report, on supermarkets, they compared returns with those both in other industries and in other countries.

The advantage of making such comparisons is that they provide a benchmark of the level of returns. If the Commission had used such comparisons, they would have seen that profits in SME banking are not out of line with that of other industries, but are in fact close to the average for FTSE100 companies over the last five to seven years and below average over longer periods. Compared with other industries, there is no basis for asserting that SME banking is excessively profitable.

The OFT guidelines indicate that levels of risk and innovation should be taken into account. SME banking is among the riskier businesses and levels of innovation, particularly in the Internet age, are not obviously below average. So while this sort of comparison is not perfect, it is strongly indicative of banking's relative profitability.

It is an extraordinary assertion that making a return of more than 3% above the cost of capital is a sign of a lack of competition.

UNCERTAINTY

A particular difficulty with a reliance on profitability analysis is the uncertainty involved in many of the assumptions. This means that, if the Commission are to avoid a false conclusion of market failure, they should allow a significant margin of error. In this report, however, the Commission not only had to make subjective assumptions for almost all of the inputs into its profitability calculations, but it also allowed little margin for error. They allowed only 3% above the cost of capital to be on the safe side. It is an extraordinary assertion that making more than 3% above the cost of capital in the long term is a sure sign of a lack of competition, not one that many business leaders would endorse.

In a further effort to shore up their case, the Government asked Sir Bryan Carsberg to advise on various accounting issues in the Commission's report. While his letter has been taken to indicate that the Commission treated the accounting issues reasonably, in fact what it says is that a wide range of alternative assumptions can be made when assessing profitability. This means that a range of "reasonable" estimates for return on capital could be derived for the industry. The Commission does not allow for this uncertainty or estimate the extent of the range.

It may well be the case that different, reasonable assumptions would have led to a similar outcome below the cost of capital in some or all of the years studied. But the Commission did not do the required analysis. This is a failure of reasoning. There is no way of assessing, from their analysis, what the likelihood is that the chosen remedy will force returns to below the cost of capital and lead to expropriation of capital. No reasonable authority should impose a remedy/regulation without first checking that the remedy/regulation will not, with any reasonable likelihood, have the effect of expropriating capital.

By the Competition Commission's standards, 22 out of 38 industry sectors have achieved excessive profitability.

The fact that the Commission have taken this approach has wide ranging implications for other companies and industries and for public policy. The example of regulation of utilities, which has played a part in turning state-owned natural monopolies into industries of competing private sector providers, has been turned on its head. Regulation, specifically price regulation, has been applied to an industry of competing private sector providers, driving it in the direction of a regulated utility.

An analysis of companies on the stock exchange by the industry sector for the year 2000 shows that by the Competition Commission's standards 22 out of 38 sectors achieved excessive profitability. In other words, if SME banking is excessively profitable, then so are most other businesses. By this standard of excessive profitability, most industries should be on their guard lest they are subject to a competition inquiry.⁶

⁶ See Appendix 1 for full scrutiny of the problems inherent in the Commission's profitability analysis.

CHAPTER SEVEN

THE COMMISSION'S REMEDIES

As a result of their analysis of competition in the market and the levels of profitability, the Commission proposed a plethora of remedies, which the Government has accepted. These can be thought of in three parts: a laundry list of behavioural remedies; an access to branches remedy; and price controls.

BEHAVIOURAL REMEDIES

The behavioural remedies the Commission proposed are largely sensible and, in many cases, already covered by the BBA's recently introduced code of conduct. These cover matters such as:

- measures to encourage and ease switching of accounts;
- provision of portable credit histories to SMEs (which some banks have already started to offer);
- a requirement not to make having a current account a condition of having a loan or deposit account (which some banks do not do anyway);
- publication of pricing information (which is already published in any event);
- more information on bank statements.

The remedy requiring banks to offer loans and deposit accounts without requiring the customer to hold a current account is an attempt to unpick the cross-subsidies the Commission perceives as taking place between products.

However, by making this requirement, they are potentially incurring unforeseen consequences. Some banks monitor current account activity to assess credit status on a continuing basis. Without this ability, the credit assessment and monitoring processes may have to be more complicated and costly for the customer.

However, in general this is a sensible set of remedies – many of which were already in train – which will address the actual complaints of small businesses.

ACCESS TO BRANCHES

The most important of the behavioural remedies relates to the requirement to study the feasibility of a national scheme to allow customers of competitors access to branches. This idea is designed to reduce barriers to entry into the market. It is, however, a misdirected effort. All three of the major declared new entrants already have extensive branch networks. Moreover, if these or any other new entrant had wanted branches, there have been over 5,000 on the market in the last ten years. So there is clearly no shortage.

Although the matter was considered extensively during the inquiry, the Commission could not come up with a formulation of the remedy that seemed to them to work. This, in itself, is a statement of how complex the issues are. What the Commission did do was require the banks to come up with the solution, but only on terms that the OFT would approve.

The implications of this remedy will not be clear until the terms of the scheme have been agreed. The scheme could oblige banks to offer access to any customer at any branch at any time, or access to a specific customer at a specific branch by prior arrangement. It could involve reciprocal arrangements or one-sided. It could allow the charges to match costs or require access to be offered at below cost. In all the permutations of these options, the outcome is different.

Very open access at charges below costs could result in huge consolidation of branch networks in the medium term, exactly the opposite of what is intended. If open access is widely used by non-customers, it would be expected that SME traffic would migrate to the best located branches, making it more likely that other branches would close. If banks are obliged to provide services at below their true economic cost, then it should be expected that branches will have to be closed. These are serious consequences for SME customers. It remains to be seen how the implications will unfold.

PRICING CONTROLS

The main remedy was a requirement on the four main clearing banks to provide SME customers with:

- either a current account that pays interest on credit balances of not less than the Bank of England base rate minus 2.5%;
- or a current account free of money transmission charges;

- or a choice between the two.

The Commission was aware that banks might seek to avoid the impact of this remedy by putting up other prices. So they stipulated the OFT should review their pricing behaviour in three years time to make sure that they have not done so. This is combined with a requirement that the banks have to notify the OFT of any price changes in the intervening period.

This remedy is designed to relieve the banks of about £500 million a year in profits before tax. This is equivalent to about £350 million of after tax earnings. At the current price earnings ratio of the FTSE of 22 times, this is equivalent to over £7 billion of equity value.

A penalty of this magnitude is completely unjustifiable. It is also totally counter productive.

- it will not assist or encourage competition. In fact it will do the opposite. The smaller players, including HBOS recently, have declared that price controls will make it more difficult for them to enter and compete in the market. No new entrant could approach the market now with an offer focussed on the credit balances of SME customers;
- it does not address any of the underlying competition problems identified. Instead it attempts to address a perceived issue of overcharging by treating the symptoms not the cause. It will help to entrench incumbent providers in the long run;
- it does not even address the issue of overcharging. If the banks were able to overcharge customers as a result of market power, they would still be able to do so after this remedy is put in place;
- it will not even benefit SMEs. Although they will receive interest on current accounts, there are likely to be many unforeseen consequences of this remedy. Other prices may increase, service standards may be reduced, lending availability may be curtailed and the level of competition will be decreased. All of these are clearly against their interests. None of them is (as yet) subject to the regulators' proposed controls.

The Competition Commission's remedy is to impose price controls on specific services in a competitive market.

This remedy is price control on specific services in a competitive market. As a general proposition, imposition of a constraint on one aspect of business activity will have significant effects on other activities, which are economically related to the controlled activity. It appears to be a manifest error to proceed on the assumption that the constraint can be imposed and that other things will

remain equal. Yet this is what the Commission is doing in their assessment of the impact of the remedy. For example, they do not quantify effects of the current account interest remedy on business deposit accounts, despite the fact they acknowledge there will be an effect. The requirement for an OFT review in three years time is to acknowledge that competitors will inevitably take action in response. It is futile to hope that the market will not take action in response to such direct intervention.

Shareholders will be relieved of £7 billion of equity value.

Regulatory intervention of this magnitude is not justified.

A regulatory intervention of this magnitude cannot be justified. The case does not support it. The Commission have created a fictional figure for excessive returns, based on arbitrary adjustments to profits and capital, based on an illogical and unsubstantiated case. This is a completely inadequate basis for planning to relieve shareholders of £7 billion.

CHAPTER EIGHT

CONCLUSIONS

This review of the Competition Commission's Report into Banking Services to Small and Medium Sized Enterprises shows the fundamental flaws inherent in the rationalist and interventionist approach to microeconomic policy.

The Commission panel consisted of high calibre experts. There is no suggestion that they had anything but the best of intentions in their work or that they failed to give it anything less than their best effort.

But what has transpired is detached from the realities of the market they were studying:

- a market in which 20% of customers are new each year is thought to be characterised by low levels of switching;
- a market in which competition has driven the prices of some products to zero – free banking – is thought to lack price competition;
- a market, in which the examples of poor competitive practice are trivial in the extreme, is found to be so uncompetitive that a £7 billion penalty is thought appropriate;
- an industry in which returns are below average for most of British industry is found to be excessively profitable;

- an industry which is highly exposed to the economic cycle is assessed on the basis of three boom years alone;
- an industry, which is crucial to the economy, whose resilience in the next recession will be vital to the general economic well-being, is prohibited from making returns sufficient to sustain its activities over the cycle.

The most likely explanation of the problems with the Commission's conclusions is the nature of the process itself. The Commission process is one of validating hypotheses. It began with a set of possible issues and concluded in line with these issues in almost all cases. It did not have to prove their case. It did not have to judge impartially between competing cases. The process does not allow for that.

Is it fair to treat businesses in this way? When £7 billion of shareholders' equity is at stake, proper judicial procedures are appropriate, involving clear rules, fair process and a burden of proof. If, for example, the businesses in question had known that selective pricing, such as free banking and negotiated discounts, were considered to be anti-competitive, they could have avoided these practices. If they had done so, would they have been guilty of any significant failing, except making profits above the cost of capital at the height of the economic cycle. Is this a competition crime?

APPENDIX ONE

THE COMMISSION'S PROFITABILITY ANALYSIS

To understand how the Commission should have been able to come to its surprising conclusions, it is necessary to dig further into the details of how they have calculated profitability. This appendix looks at how they have adjusted profitability and then how they adjusted the capital base, artificially to increase the observed levels of returns.

The banks were asked to provide profit and loss account information going back 12 years. The Commission then adjusted these figures in three ways:

- to allow for cyclical effects on bad debt rates;
- to adjust for relative efficiency of different providers;
- to make various other adjustments to the actual profit figures.

PROFITABILITY ADJUSTMENT 1 – BAD DEBTS & CYCLICALITY

SME banking is a highly cyclical business. It was not unusual that small firms were hit by the 1990s recession: they are very exposed to the general economic climate. When the economy turns down, small firms close. It is an unpleasant fact of life.

Despite the very obvious cyclicity of the business, the Commission rejected the view that profits have to be looked at over an economic cycle, even though

they accepted that “profitability over a short period may be unrepresentative” (paragraph 2.369). They looked at profits over three years only.

The reasons they gave for not doing so were because the past might include factors unlikely to be repeated in future: economic conditions, managerial errors and poor efficiency. It is inevitably true that the future will be different to the past. However, the problem with not basing an assessment on the historical facts is that the assessment became fundamentally judgemental. Adverse economic conditions may occur in future just as much as in the past. The same goes for managerial errors. The efficiency of banks in the last recession reflected the state of technology and competition at that time, just as it does today. There is no evidence to show that the future will be less risky than the past. There is quite a lot of evidence that the future will be more risky. In fact, the Commission acknowledges (paragraph 2.380) that the evidence submitted showed the riskiness is increasing and corporate insolvency is rising, but they take no account of it.

The only way in which it was prepared to allow for long-term cyclicity was in relation to bad debts, which clearly move by huge amounts in a recession. However, instead of relying on the historical facts about bad debts, the Commission decided to come to their own judgement as to the long-term average.

It put forward three considerations for rejecting the historical facts in favour of its judgement (paragraph 2.375). First, it asserted, in the last recession monetary policy was aimed at the external value of the pound not internal economic conditions. This is both false and irrelevant: monetary policy was used to rid the economy of inflation before, during and after the ERM debacle; in any case, such a policy might well occur again, especially in the light of the possible entry into the single currency.

Second, it argued that banks are now more efficient in assessing credit risk. While this is true, it has done nothing to change the underlying riskiness of SMEs. Improving credit assessment is a zero-sum game. If one bank does not do it, it ends up with all the worst risks to the benefit of the other banks. If all banks do it, then no bank is better off. The underlying riskiness of the SME sector is unchanged, so the risks incurred by all banks collectively is the same. In the next recession, the number of firms going out of business will increase and bad debt costs will rise. No amount of investment in risk assessment will avoid this. The benefit of improved risk assessment is not in reducing the underlying riskiness but in the better pricing of risk. It will come through in better lending margins not lower bad debt rates.

Third, it could find no bank with forecasts of bad debts rising to the levels of the last recession (paragraph 2.376). That is not surprising. It would not have found any bank with an accurate forecast of bad debts in advance of the last recession either.

Some banks provided forecasts of bad debts to the Commission. Sometimes there were central expectations, based on continuing economic stability, and recession scenarios. The Commission used an estimate close to the banks' central expectations. What it has effectively done is to assume that economic stability will continue indefinitely and that there will be no recession.

This is obviously false. This approach is then combined with remedies designed to reduce profits to the level of the cost of capital. This means that, if there is a recession, banks will be forced into making returns below the cost of capital and not being able to recover those losses again in years of recovery. This is a fundamentally unstable economic model, which, if it came to pass, would prove catastrophic for the economy.

LACK OF ADJUSTMENT – OTHER EFFECTS OF CYCLICALITY

The only adjustment the Commission made to allow for cyclical effects was for bad debts. However, bad debts are not the only adverse consequence of a recession for banks. An economic downturn affects every other aspect of the business as well. Customers trade less (lower transactions), they borrow more and deposit less.

One of the banks was able to prove that their profitability before bad debts was strongly influenced by the macroeconomy. It provided evidence (noted at paragraph 2.385) of a strong relationship between profitability before bad debts and economic growth. This showed that 80% of the variability of profits was explained by macroeconomic factors. It showed that a burst of economic growth tended to increase profitability, but that the increase was competed away by the second year. It showed that the underlying trend in profitability over 12 years was downward, suggesting that competitive pressures are reducing profitability, when the noise of the economic conditions is isolated.

The Commission seemed to overlook this evidence. Its own assessment of the link between profits and the economy looked at a number of irrelevant variables and found no connection. This proved nothing. This is a serious failure of analysis in a critical area of uncertainty in the Inquiry.

PROFITABILITY ADJUSTMENT 2 – EFFICIENCY

The second adjustment the Commission made related to efficiency. They argued that firms in an uncompetitive market might have higher costs than they should do. This is fair enough. However, they sought to assess relative efficiency on the basis of cost-income ratios. This approach is deeply flawed.⁷

So, by using the cost-income ratio in this way, either a business would be found to have a high profit margin, in which case the Commission would think it

⁷ The cost-income ratio of a business is mathematically the same as one minus the profit margin:

$$\text{Cost-income ratio} = \text{cost} / \text{income} = 1 - (\text{income} - \text{costs}) / \text{income} = 1 - \text{profit margin}$$

excessively profitable, or to have a low profit margin, in which case the Commission would think it inefficient. If it is inefficient, the Commission would reduce its costs, increase its profit margin, to the point at which the business is found to be excessively profitable. It is the classic catch-22, caught for high profits and caught for low profits. It is illogical.

There are many factors that could influence the cost-income ratio: relative prices, business mix, quality, accounting treatments, levels of investment spend etc. It is impossible to adjust for all of these factors with any degree of confidence and produce a reasonable assessment that one operator is more or less efficient than another.

Prices, however, are by far the most important factor to adjust for. Efficiency is a measure of the inputs required to produce output. Income (which is defined as a quantity multiplied by a price) is only a measure of relative output if differences in relative prices are allowed for. You can't measure relative efficiency without adjusting for relative prices. The Commission refused to make this adjustment (paragraph 2.396d), despite the fact they went to great lengths to compare relative prices.

It also rejected the argument (paragraph 2.396e) that cost allocation methodologies might distort cost-income ratios. It asserted that it was unlikely that any bank had knowingly understated the costs of providing the services. This misses the point entirely. The point is that if two perfectly efficient SME banks allocated costs between their activities in different ways, both of them would be found to be inefficient. Even if all costs are properly accounted for within the SME bank, if costs are allocated differently within the SME bank, then banks will be found to be inefficient.

Two identical and perfectly efficient providers would both be found to be inefficient if they allocated their costs differently. For example, if business A allocated more cost to product 1 than product 2 and business B the opposite, business A would be found to be inefficient in producing product 1 and business B in product 2. By the Commission's methodology, both businesses would have been found to be relatively inefficient in the production of one product and would have had their cost-income ratios reduced, and profits inflated, accordingly.

PROFITABILITY ADJUSTMENT 3 – RESTRUCTURING COSTS

The third adjustment the Commission made was to the basic facts as to which costs should be included in the calculation of profits. It took the view that restructuring costs, the one-off costs of making a business more efficient, should not be included (paragraph 2.400c). This is an extraordinary position. These costs represent an on-going operating cost and were incurred in most years. In more recent years the accounting treatment had changed, because of accounting rules, not because of a change in the nature of the costs. The Commission dismissed this fact.

The implication of this is that not only are businesses not allowed to make more than their cost of capital, but also they have to pay for the costs of increasing efficiency themselves. In the long run this would reduce the level of their returns below the cost of capital. This is an economically illiterate and unsustainable position.

SUMMARY OF PROFIT ADJUSTMENTS

By these three adjustments, the Commission inflated the actual profits the banks made by about 30% to a theoretical level that suited their case. None of the three adjustments are anything other than arbitrary and judgemental, not proven or supported by logical argument.

CALCULATION OF CAPITAL BASE

The second part of the process of calculating returns was to assess the capital base on which the profits were made. The problem with this inquiry was that there were no separate business entities where the levels of profits and capital could be observed. The SME banking operations were parts of the overall business banking activities of the banks in question. So all the revenues, costs and capital had to be allocated to the segment appropriately. In the case of the capital base this is a highly uncertain exercise.

The Commission chose to use shareholders funds as the measure of equity from the statutory accounts as the measure of capital (paragraph 2.246), adjusted only for intangibles. This approach is reasonable, except as regards intangibles.

CAPITAL BASE ADJUSTMENT 1 – INTANGIBLES

The Commission's measurement of intangible assets is extremely narrow. They took the view that the depreciated replacement cost was the appropriate way to value intangible assets. The only cost categories they were willing to consider were staff recruitment and training costs, customer acquisition costs and IT expenditure. They took an extremely narrow attitude to the kinds of expenditure that qualified. As a result they only allowed 13% of equity to allow for intangible assets.

The reality is that it is too difficult to measure intangible assets accurately. There are many aspects of the way in which businesses conduct themselves that contribute to their intangible assets. It would be more effective to allow for intangibles by comparing rates of return with other companies, industries and countries, in an assessment of whether they were "excessive". This has the merit of allowing for intangible assets without having to quantify them.

This is a key area of uncertainty in the inquiry. A wide range of other reasonable assumptions about intangible assets (or any other element in the analysis) could easily have shown banks to be making less than 3% above cost of capital, even in the "bonanza" years of the late 1990s. No sensitivity analysis was done. Since the considerable uncertainties are clearly involved, this is a failure of reasoning on the part of the Commission.

CAPITAL BASE ADJUSTMENT 2 – CAPITAL ALLOCATION

The issue of how the total amount of capital should be allocated to the business activities being reviewed is crucial to the estimate of the rates of return. Allocate too little and the rates of return will be exaggerated.

The Commission used the regulatory asset base as the basis for allocation (Basle 1 risk-weighted assets). Banks have to hold certain levels of assets to satisfy prudential regulatory requirements. These levels of assets are determined at a whole bank level, based on the amount and type of lending that the bank does. The Commission used the share of regulatory capital requirements as a basis for allocating equity to the activities they were analysing.

The problem with this approach is that regulatory asset requirements are a poor measure of actual capital requirements. No bank allocated capital to business units on regulatory asset requirements alone. The universe of external experts agrees that regulatory asset requirements under Basle 1 are a crude measure of risk and an inappropriate basis for allocation. It only looks at the risk of lending. It applies very broad-brush weightings. It takes no account of the actual risk of loans or of the operational risks of the banks. That is why the Bank for International Settlements is currently progressing a new standard for regulatory capital requirements (“Basle 2”).

In order to dismiss the banks’ evidence on this point, the Commission pointed to the fact that each of the banks submitted different numbers for their capital requirements and that there is continuing debate about the methodology for the new Basle 2 requirements. It used this uncertainty to justify their approach.

The banks employ numbers of experts, who spend much of their time assessing capital requirements of their activities and have done so for many years. The Basle 2 Committee, consisting of the world’s leading experts on the subject, have been studying more appropriate ways of assessing capital requirements for many years. However, the Commission, with no experience in the sector, on the basis of an examination over a year at most, conducted by inexperienced analysts, chose to employ their judgement and take a different view from these experts. It is possible that they came to a better judgement on these matters, but it is improbable in the extreme. The result is that the Commission allocated capital well below the level that the banks actually allocate to business units and which some banks publish in their annual reports and accounts.

The correct deduction of the uncertainty about the capital base is that capital allocation is by its nature an uncertain exercise. The logical response to this uncertainty is to make allowances for it and recognise that alternative methodologies would come to much higher figures for the capital base. Instead, the Commission plumped for their own approach, even though all the evidence suggested it was wrong.

LACK OF ADJUSTMENT – PROFITABILITY OF SCOTTISH BANKS

One last aspect of the profitability analysis is worth considering. This is the Commission's approach to assessing the profitability of the Scottish banks.

The Commission's central conclusion was that the four largest clearing banks in England and Wales were making excessive profits and therefore overcharging their customers. However, the Commission concluded that the Scottish and Northern Ireland banks were not making excess profits and were not overcharging their customers. It is difficult to understand how this conclusion is consistent with the remainder of the Commission's findings:

- the Scottish market was found to be more concentrated than the English and Wales market – a key concern of the Commission;
- the banks in Scotland employ the same pricing practices, which the Commission found to be anti-competitive, as the English banks;
- the prices for banking services were found to be higher in both Scotland than in England. It does not appear to make sense to conclude that customers in England are being overcharged, when customers in Scotland, who pay higher prices, are not being overcharged.

This is an extraordinarily partial analysis. One of the Scottish banks refused to provide a split of profits between regions, yet its Scottish activities were excused for no good reason.

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