The Financial Services Bill: Competition and Competitiveness

Briefing Note

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Summary

- The main direction of the Financial Services Bill (FSB) on reforming Financial Regulation, entailing the setting up of the Prudential Regulation Authority (PRA), should be welcomed. But there are two desirable amendments which should be made:

    1. The new Financial Conduct Authority (FCA) rightly has an objective to promote effective competition in the interests of consumers. However, given that the FCA is also responsible for other global financial service industries, it should carry out its general functions in a way that supports the competitive position of the UK.
    2. A competitive market for the provision of banking services should be an important part of the PRA's banking safety objective.

- HM Treasury resistance towards including any direct references to international competitiveness and domestic competition arises because of the reluctance to be associated with supposed 'light-touch' regulation.
- This stems from a mis-diagnosis of the primary causes of the crisis in the UK. These were: poor corporate governance in major banks, loose monetary policy, and lack of oversight on banks' balance sheets.
- Banks are only a part of Britain's financial services industry. The massive investment management industry, the Life and General Insurance industries, Lloyds', stock brokers, hedge funds and all the other business service activities provided in London, came through the 2007/09 crisis in reasonable shape and without requiring any tax payer support. These industries are substantial contributors to the wealth of the nation and should be regarded as great national assets.
- The limited benefits of separating retail and investment banking should also be recognised. In particular, if retail and investment banking were to be separated, a failure of a major investment bank could still have a major knock on effect on the retail banking system.

The need for a competitive banking industry

The main thrust of the Financial Services Bill on reforming Financial Regulation, currently going through its Parliamentary stages, is to be welcomed. In particular, it is right to transfer back to an adequately resourced Bank of England responsibility for supervising the banks' financial stability, safety of their balance sheets, their exposure to risk and their business practices, via the new Bank of England vehicle, the Prudential Regulation Authority.

But the Treasury may be wrong on two issues:

- Will the proposed regulatory reforms damage the international competitiveness of Britain's financial services industry?
- Is the need for a competitive domestic market in the provision of financial services, particularly banking services, sufficiently emphasised?

What is right in the Bill is the Competitive Objective for the Financial Conduct Authority (FCA) to promote effective competition in the interests of consumers; self-evidently, across the whole spectrum of banking, investment management, insurance and other financial services, a healthy domestic competitive market is both necessary and desirable. Until now, particularly in the banking sector, consumers have suffered both in terms of poor service and high charges as a result of a cartel.

The FCA is, however, also responsible for all of the investment management industry and other major areas of financial services whose markets are essentially institutional and international. For these industries, an objective not to impose regulatory measures which place these areas at an international competitive disadvantage would be appropriate. These sectors are internationally mobile, and many jobs, tax revenues and international invisible earnings are potentially at risk.

With regard to the responsibilities of the PRA to supervise the banks in the interests of financial stability, it is evident that part of the UK's problem has arisen from the lack of a competitive market – the banking sector having become cartelised. Cartels are always dangerous in terms of leading to bad practice and collusion. The long-standing trend towards a cartelised banking system, encouraged by Walter Bagehot over 100 years ago, had its logic in terms of spreading banking risk and avoiding the collapse of local banks leading to areas of prolonged local depression. It was, however, reinforced after the Barings collapse, by the then Chancellor of the Exchequer, Ken Clarke, changing the Bank of England Lender of Last Resort doctrine to apply only to banks too large to fail. This undermined competition and increased moral hazard as we saw to our cost in 2007/09.

A healthy, competitive market for the provision of banking services is therefore an important part of the PRA's banking safety objective, as the designated heads of the PRA and FCA agree. It should, therefore, be on the face of the legislation. To the unlikely extent there could be conflict between the objective of financial stability and not damaging Britain's international competitiveness in the banking sector, this will need to be finely judged.

A final part of the Bill which needs to be improved is the regulation of Life Companies. Life Companies have been included under the PRA as regards their balance sheets but, as with the Banks, the FCA – the successor regulator to the FSA – will be responsible for regulating all their retail customer business. It is important that the Life industry will have appropriate representation on the PRA Board, which has been overlooked in the Bill (the Government has committed to address this). The key point here is the need, when necessary, to suspend promptly the Solvency Requirements for Life Companies in the event of a stock market crash, in order to avoid the requirement for Life Companies to continue to have to sell equities, creating a stock market downward spiral.

Misdiagnosing the crisis

The Treasury is, however, resistant towards including any direct references to supporting international competitiveness as an objective of the FCA. The reason for this is that not damaging, let alone supporting, international competitiveness is seen as an adjunct to "light touch regulation", which is now under criticism as a major cause of the banking crisis. This point is irrelevant to the need for a healthy, domestic market in banking services. This represents a misdiagnosis of the causes of the banking crisis.

Two major British banks failed in the crisis and had to be bailed out by the tax payer; and one also by acquisition. HSBC, the largest bank in the world, came through the banking crisis relatively unscathed. Barclays did not require any taxpayer support. Three points should be noted:

- First, the two banks which failed were led by over ambitious characters who "bust" their banks. In both cases, there was clear evidence of a lack of adequate Corporate Governance and strong enough Boards to have constrained the Chief Executives.

- Second, there was an acute failure of monetary policy in both the UK and the US. When there is too much money around there is always the tendency for banks to lend imprudently. Going back as far as 2003 there was clear evidence that consumer debt and house prices were rising too quickly – prima facia evidence of monetary excess. At the time, the response of the Authorities was that the single objective of the Bank of England, as laid down by the Labour Government, was to achieve an inflation rate of around 2.5%. This put the Bank of England in the position that it was not going to do anything about monetary excess, if inflation remained around 2.5%. This was the answer I received from the Governor of the Bank of England at the time. Lending, borrowing and bank balance sheets grew far too much and capital ratios fell dangerously low, leaving the Banks exposed to "runs" and insolvency in the event of material loan losses.
- Third, there was a major failure of banking regulation; there was no effective supervision by either HM Treasury or the Bank of England of what banks were doing; or of the composition of banks' balance sheets and their risk profiles.

Though the Vickers Report has suggested some good reasons for separating retail and investment banking, it needs to be remembered that it was the lending side of banks activities which caused the losses and the problems, not the investment banking activities. Moreover, the Hedge Funds came through the crisis without major problems or calling on the tax payer for financial support. Separating the banking and investment banking activities of the major banks is no guarantee of avoiding major lending losses in the future, should we for example have another period of excessive monetary growth. The "light touch" was in monetary policy, the responsibility of Government. Moreover, the investment banks which failed and caused so much trouble – Bear Stearns and Lehman – were independent investment banking (and not retail banking) operations. The point here is that if major investment banks fail in the future there will be an inevitable knock on effect on the banking system: for example, banks cannot provide fixed-rate, fixed-term mortgages without using derivative contracts.

It must also be remembered that banks are only a part of Britain's financial services industry. The massive investment management industry, the Life and General Insurance industries, Lloyds', stock brokers, hedge funds and all the other business service activities provided in London, came through the 2007/09 crisis in reasonable shape and without requiring any tax payer support.

This underpins the point that something was wrong with Britain's banking industry. As pointed out above, while the two specific, "guilty" banks, suffered from the problem of inadequate Corporate Governance and weak Boards, enabling over ambitious Chief Executives to take foolish decisions; behind this lies the problem and dangers of a banking cartel and the "moral hazards" of "too big to fail". While adequate competition in the provision of banking services is by no means a solution to all the issues and problems, it is of importance in the objective of reducing the "moral hazard" issue and achieving better financial stability.

The crisis in Britain and America's banking system was not the result of "light touch" regulation but rather the wrong monetary policy. It might be added that this in turn was in part a function of the massive trade imbalance between Asia (and particularly China) and the US and Europe, the results of which were to inflate US and UK banking balance sheets, which monetary policy failed to address or offset.

Conclusion

The Financial Services Bill needs to get the issues of domestic competition and international competitiveness right. For the reasons set out above, an objective for the PRA of a healthy, competitive banking system should be a component of its greater financial stability and safety objective.

Britain's national interest also requires the institutional side of our Financial Services industry to remain internationally competitive – otherwise business and jobs will go elsewhere with the accompanying loss of tax revenues and invisible earnings. There is no sensible justification for financial regulation which has this effect.

By way of a footnote, the big act of faith is that the new PRA (and FPC), and the Bank of England as a whole, will rise to the challenge of successful and effective supervision of our banking system. The Bank of England's recent record was a disaster. It did nothing to constrain excessive monetary growth over nearly a decade; it failed to spot the impending banking crisis and banking run in the summer of 2007; and initially refused to recognise what was happening in 2007/08 because its economic model said all was well. For anyone who had lived through the 1974 banking crisis, it was very clear from the summer of 2007 that a major banking run had started. It is to be hoped that the Bank of England and its various Committees will equip themselves with sufficient resources and intelligence to understand what is going on in the banking system and to head off dangerous trends in time.