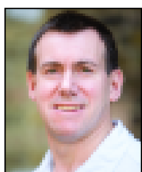
A chorus of disapproval

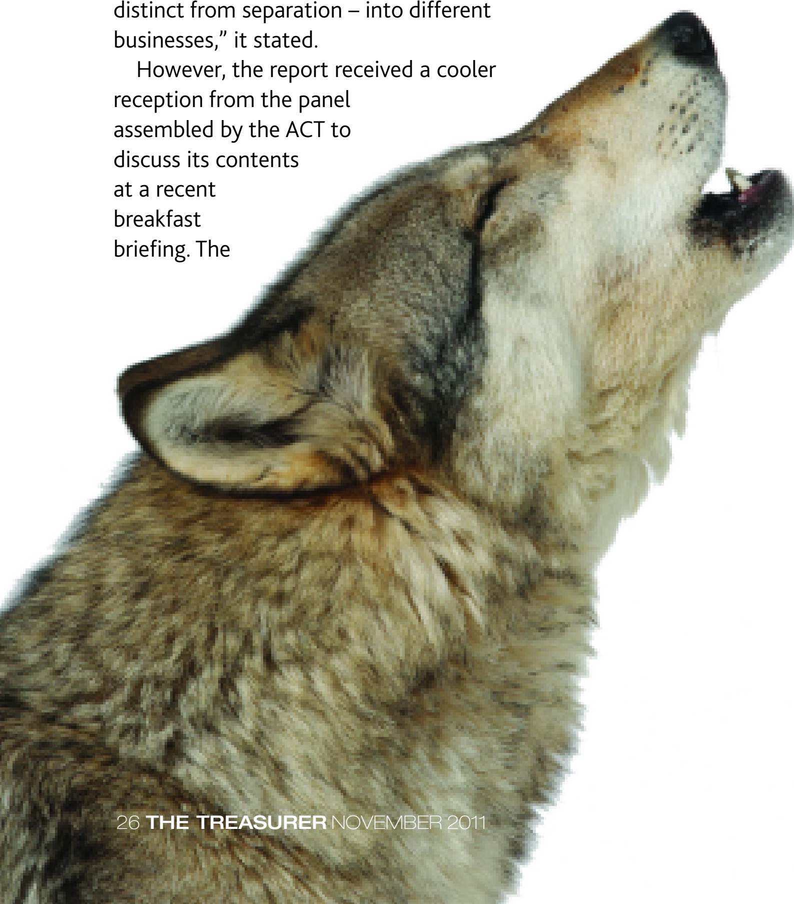


THE VICKERS REPORT GOT A FRIENDLY OFFICIAL RECEPTION FROM THE ACT, BUT THE PANEL AT A RECENT BREAKFAST BRIEFING CONVENED TO DISCUSS ITS RECOMMENDATIONS WAS LESS IMPRESSED, AS **GRAHAM BUCK** HEARD.

The publication in September of the final report on the banking sector by the Independent Commission on Banking (ICB) got a favourable reception from both the government and opposition. The ACT also greeted it, welcoming the "pragmatic approach" taken by Sir John Vickers and his team.

"The Commission has done a good job in its recommendations for how a ring-fence between retail and wholesale banking should be positioned and function, given that UK resolution proposals for distressed banks already require separability – distinct from separation – into different businesses," it stated.

However, the report received a cooler reception from the panel assembled by the ACT to discuss its contents at a recent breakfast briefing. The session was introduced by the ACT's policy and technical director John Grout, who noted that companies have had some time to plan for the new world envisaged by Vickers in which bank capital will be harder to access and, even when it is available, more expensive than before.



The fact that the interim version of the report released in April flagged most of the issues in Vickers' final draft helped further in dispensing with any element of surprise.

"Our response to the final report was basically to tell ACT members 'don't panic'," said Grout. "Coming out of the G20 via the Basel Committee, MIFID II and other legislation, it's just part of a huge underlying iceberg."

Grout's fellow panel members were Eric Anstee, chief executive of investment group City of London, Peter Hahn, a lecturer in the faculty of finance at City University's Cass Business School, and Paul Myners, a former chairman of Marks & Spencer and selected by Gordon Brown to join the last government as treasury minister with responsibility for the City. Representing the ICB was one of its members, Greg Thwaites, who has been with the Bank of England since 2001.

Thwaites told the audience that since the ICB was set up last year by the incoming coalition government, it had held a total of 130 meetings with the banks. This was in line with its remit to review financial stability and competition in the banking sector and the separation of retail banking from wholesale operations.

The cost of the financial crisis between 2007 and 2009 had been huge, he said, with the impact still feeding through to the business world. However, banks are still able to borrow relatively cheaply, thanks to a general perception that they will be bailed out should they get into trouble. Once this guarantee is removed, borrowing will inevitably become more expensive.

"The ICB wants the banks to be better able to absorb losses, to curb their appetite for excessive risk-taking, and also to make it easier to rescue distressed banks," he declared. "Bank debt will, in future, have to be better able to absorb losses and a certain proportion of bank

funding will have to come from long-term debt." Corporates will still have the convenience of banking with a single bank if they wish.

Hahn observed that the report marked a shift from the old days – when frameworks were established by the government and technocrats set the rules – to today's environment where the government now sets the rules and technocrats implement them.

"I was keen to see more of a blue-sky approach from the ICB, with complete rebuilding from the ground up," he admitted. "The report's focus is on fixing past problems, but possibly doesn't do enough looking forward."

He suggested that UK bank lending to SMEs was "totally idiosyncratic" and Vickers should have addressed how it could be made more efficient and more economic. "Instead, it encourages small businesses to deposit their money with the German banks."

Another ICB shortcoming was a relatively brief overview on technology in banking. Vickers could, for example, have questioned the need for every bank to have its own separate and independent computer system. "Why couldn't they share one overall system instead, in the same way as a utility such as National Grid?" Hahn asked.

NO EFFECTIVE ANSWERS Paul Myners was no less critical. The ICB's role – and the tests against which its report must be evaluated – lies in creating a more effective banking system with greater resiliency and less capacity for destruction. The Vickers Report "hasn't found effective answers" to these basic issues, he concluded.

The report acknowledges that the UK's banking system is highly concentrated, containing little to facilitate greater competition. "There is the suggestion that Lloyds should work more closely with National Australia Bank, although it's evident that NAB isn't particularly interested in the UK," Myners noted.

He was also unimpressed with the report's advocacy of ring-fencing, describing it as an extension of the 'living wills' concept that had so far made little progress in the UK. Ring-fencing is unlikely to prove effective unless and until living wills become better established. Nor did Vickers offer a convincing argument for why ring-fenced and non-ring-fenced banks should remain together – possibly reflecting an underlying assumption that eventually they would separate.

However, possibly Myners' strongest criticism was of the ICB's failure to question seriously whether banks would be able to raise extra capital without any difficulty. "There is a great lacuna in Vickers," he said. "The cost of equity has increased but it expects banks to raise greater amounts. The bail-in debt market is almost non-existent and yet it is assuming that very substantial amounts can be raised."

He even cast doubt on whether the report's contents would get beyond the recommendation stage. "The timetable is very long, although we could see enabling legislation before the 2015 election. However, in the US Paul Volcker's report has effectively been emasculated and we might easily see the same thing happen here."

Anstee was also unimpressed by the report whose objective, he noted, was not only greater stability but more effective channelling. The market is currently facing huge liquidity problems, but this is another issue that Vickers does little to address. "The report calls not only for more capital but also for a broader capital base," he pointed out, "so the last thing we need is a greater restriction in liquidity, which is effectively what it proposes."

The banks are already very evidently failing to lend to small to medium-sized enterprises (SMEs) and the situation is likely to deteriorate further. There is already increasing evidence of their reluctance to get involved with any major infrastructure projects.

In a summary after the presentations, Grout predicted a swathe of mid-sized companies would face problems. "Most of the companies being represented here are large and can access the bond markets to lessen their reliance on banks. But many of the smaller companies that will face difficulties are in the supply chains of larger ones."

Hahn agreed. The prolonged period in which risk was underpriced and the perception of bank equity as low risk has ended. "If a bank is trading below book value, it should shrink in response in order to gain greater stability," he said. "That means that we will have to look to other capital providers in future."

However, Thwaites said that although bank funding had been artificially cheap in the pre-crisis era and banks would be more expensive to fund in future, the only option was to keep subsidising them. The ICB had reviewed radical options – such as transforming the banks into mutual funds – but rejected them as impractical.

Questioned by Anstee, he confirmed that the Vickers team had considered the repercussions for the banks of a higher cost of capital: "We believe that they could be recouped fairly easily – £7bn is not that great an amount."

Asked whether the new ring-fenced banks would bear a greater resemblance to a major building society such as the Nationwide, Thwaites said that the UK banking sector was likely to have more similarities to those of Australia and Canada, both of which are fairly concentrated and survived the crisis relatively unscathed.

"But the Australian and Canadian banks can't really be regarded as the equivalent of ring-fenced banks," Myners pointed out. "It has more to do with those countries' asset-based economies."

By contrast, in the UK less than 4% of all bank assets are allocated to lending to UK corporates. "That's something else that Vickers doesn't comment on, along with why UK banking has become so complicated," he added.

EXTRAORDINARILY LIGHT ON DATA Several of the figures used by the ICB, such as an estimated 0.1% increase in the cost of lending, appeared to be "quite weak" and there was an absence of modelling in the report, which was "extraordinarily light on data".

Nor was Myners impressed by Thwaites' revelation that every banking chief executive that met with the ICB had stressed they neither wanted nor expected to be given a government guarantee. "It's only because they don't want to have to pay for one!"

Myners' conclusion? "I doubt if any other country in the world is likely to copy Vickers," he said. "HSBC must already be debating the case for relocating outside the UK. And if we persist with its recommendations HSBC may well decide to cease doing business through HSBC plc and switch to its French bank, Credit Commercial de France [CCF], thereby avoiding all the additional requirements."

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As The Treasurer went to press, John Grout gave oral evidence to the Treasury Select Committee on these issues. See him giving evidence at **http://bit.ly/pbQGwt**. *The next issue of The Treasurer will contain a full report of the committee's hearings.*