Disquieting repercussions

PETER WILLIAMS LOOKS BACK AT THE EVIDENCE GIVEN BY THE ACT'S JOHN GROUT TO THE TREASURY SELECT COMMITTEE ON THE VICKERS REPORT.

If the recommendations of the Vickers Report into the UK's banking sector are implemented, there will be huge changes for banks and a knock-on effect on banking relationships for corporates. Parliament is exploring what that will mean and has summoned various experts to appear before it, including John Grout, the ACT's director of policy and technical.

Appearing before the parliamentary Treasury Select Committee in October, Grout warned that the real economy, as well as the banking sector, was already reacting to changes in the banking sector. The committee is picking over the blueprint produced by the Independent Commission on Banking (ICB), chaired by economist John Vickers.

Grout told the committee how companies had started responding to Moody's credit downgrading of the British banks to single A. The ratings downgrade is a result of Vickers suggesting that the government's implicit guarantee for UK banks should be removed. The objective, as the ICB put it, is "to get the taxpayer off the hook".

"We have seen a lot of companies seeking to reduce their dependency on borrowing from the now two single A banks," said Grout. "We have also seen companies beginning to experience difficulty in having sufficient credit limit allowed by their bank for both deposits and conducting derivative and other risk management product business. Companies are inviting in Japanese banks they have not previously dealt with to bring in more possibilities. This adjustment is under way."

However, while Grout welcomed those moves, he warned that it would not be good news for the flow of credit into the economy if investors demanded that banks today made their balance sheets look as they are likely to be configured in 2019. Although when asked by the committee how that could be prevented, he said it was very difficult.

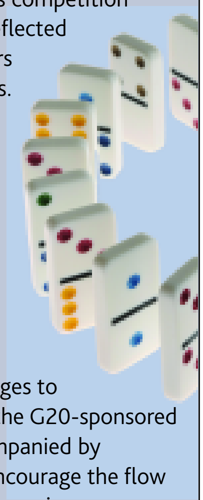
Grout also told the committee that early clarity was needed on the issue of the timing of the implementation of the Vickers Report and its relationship to the timing of the Basel III implementation through the EU's Capital Requirements Directive IV: "As early as possible in the process, we need clarity on what the rules will be at the end. The necessary adjustments by both the financial institutions and customers will take a long time."

Companies wanting to borrow for the long term need certainty, and Grout used the example of building a factory and funding working capital requirements. He added: "Corporates need to see that the banks they are currently dealing with will still be there and able and willing to do things for them further down the track. We won't have that clarity until all the changes are clear. We need that as soon as possible; implementation can come later."

The ACT's key points on the forthcoming reform of the UK banking system

THE ACT'S WRITTEN EVIDENCE TO THE TREASURY SELECT COMMITTEE WAS AS FOLLOWS:

- The ICB final report is pragmatic and "seemingly balanced".
- While the changes to day-to-day banking for corporates of all sizes will not be huge, it would be beneficial to remove uncertainty by taking clear decisions and progressing legislation in order to allow for a longer period of orderly implementation.
- If the banks are unwilling or unable to lend, companies, led by treasurers, will have to adjust their own capital structure and depend more on equity or capital markets.
- Although corporate gearing in the UK has fallen back in the last year, it is still historically high. ACT members say that they are planning to reduce gearing, partly to move to a more robust structure able to withstand uncertainty and partly for fear of lack of bank funding or availability of capital markets in the years ahead.
- There are concerns over the capacity of the markets to provide this new capital for companies and over the cost, particularly at a time when the banks too will be raising capital and governments will probably be more highly indebted themselves.
- There is an argument that if the banks have to hold additional layers of loss-absorbing capital this will come at a cost, and that with reduced gearing their returns on equity can be preserved only by raising their lending rates significantly.
- Treasurers accept that before 2008 the amounts charged for credit and risk were underpriced and that it may be "correct", in some sense, for prices to have risen. But clearly treasurers and their companies have a very strong interest in keeping the cost of credit down – it ultimately drives the viability of what they can invest in and thus jobs and economic activity generally.
- Competition: Even for larger companies competition in banking is lacking and this may be reflected in the returns banks have in recent years expected to make on corporate services.
- There is a risk that the competitiveness of the UK wholesale banking sector may be damaged by the Vickers reforms in that the wholesale banking side would no longer benefit from the efficiencies of scale, the synergies, the valuable retail deposit base and some of the cross-selling opportunities.
- It is important that any structural changes to the UK banking system in response to the G20-sponsored changes or the Vickers Report be accompanied by significant and practical measures to encourage the flow of finance to smaller and mid-sized companies.



WHAT THE RING-FENCE WOULD MEAN Prior to Grout's appearance before the committee, the ACT had submitted written evidence (see box, this page). One of the MPs on the committee, George Mudie, picked up on the ACT's point that any structural changes in banking regulation (in particular the Vickers proposal for a ring-fence) must "be accompanied by significant and practical measures". Mudie wanted to know what the ACT meant.

Grout pointed out that businesses use a lot of services from banks, not just lending or as a home for surplus funds. "The way in which those risk management services are provided, the systems that support trade finance activities – such as issuing letters of credit, guarantees, dealing with bills of exchange – all need to be thought about," he said.

If the Vickers Report is implemented, Grout raised different possibilities over what could happen to these services. They could be duplicated on either side of the fence or separately contracted in from another subsidiary of the bank's holding company. He told the committee: "These practical issues need to be thought through and sufficient time allowed for implementing the regulatory proposals." He added that time was needed to see if extra competition would come into the market either from overseas banks or from banks avoiding retail activities so as not to be caught by the ring-fence.

PRICING THE RELATIONSHIP Grout also focused the select committee on the likely different impact of Vickers on large and small companies. He told the MPs that large companies could certainly use other sources of funding and had access to non-UK-based banking. He said: "Large companies can shift the relationship between the funds they raise overseas for deployment overseas and funds they raise in the UK for deployment overseas. That is one example of the adjustments that you will see on the customer side which is easier for larger companies."

He added that smaller companies had much less freedom: "They have less access and their negotiating powers are less. Banks tend to bundle the products which they sell to the smaller end of the market."

As Grout explained, it is very hard for bank customers to understand in detail the cost of the whole relationship which they are obtaining from their banks. This again is particularly true for smaller businesses, which often contractually undertake to use only the lending bank for any ancillary services. It is an obligation which Grout pointed out would be illegal in the US but was tolerated in the UK.

We will have to wait for the select committee's report to see how far it has taken on board the comments of the ACT. What impact the select committee will have on the future shape of UK banking also remains unknown at this stage.

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See the December/January issue of The Treasurer for a profile of John Grout.