

# Breaking up the banks

In the interests of competition, should systemically dangerous large banks be forced to split up? **George Bull** investigates

**THERE HAS BEEN** much debate about the structure of the financial services industry but little real reform to date. In his address to Scottish business organisations in Edinburgh in October, governor of the Bank of England (BoE) Mervyn King called the current arrangements impractical, remarking: “The case for a review of how the banking industry is structured and regulated is strong.” But are we any closer to progress or are we, as Professor Michael Mainelli FCSI, author of *The Road to Long Finance: A Systems View of the Credit Crunch*, says: “wasting a good crisis”? “Anyone who proposed giving government guarantees to retail depositors and other creditors, and then suggested that such funding could be used to finance highly risky and speculative activities, would be thought rather unworldly. But that is where we now are,” King said. “It is in our collective interest to reduce dependence on so few institutions that engage in so many risky activities.” He suggested that the utility aspects of banking – payment systems and deposit taking – be hived off from more speculative ventures, such as proprietary trading. Writing in the *FT* in December, Niall Ferguson, Professor of history and business at Harvard University, described King’s comments as a “brave and important challenge to the status quo”, and says that the real question was not “whether we need utility banking, but what form it should take”. On the other hand, rumours on Threadneedle Street suggest that King’s comments were

made only in the spirit of furthering the debate. The key is to mitigate the potential fallout from the connectivity of financial organisations, whether by addressing individual firms or the whole network. Increased regulation in the form of contingent capital and resolution plans, or ‘living wills’, as suggested by the Treasury’s white paper, is already gaining ground, but is regulation enough?

## Lack of structural reform

Mainelli says there is too much focus on complex regulation, and little focus on structural reform. He says: “\$9trn has been spent globally on increasing money supply. The FSA now seeks to follow large systemically important financial organisations, rather than question whether their size itself might be a sign of regulatory failure. Living wills are an exercise in returning to 2005’s growth, with a better idea of how to clean up the mess when it happens again.” Even King says it is almost impossible to calculate how much contingent capital would be appropriate to avert a systemic failure.

## Competitive edge

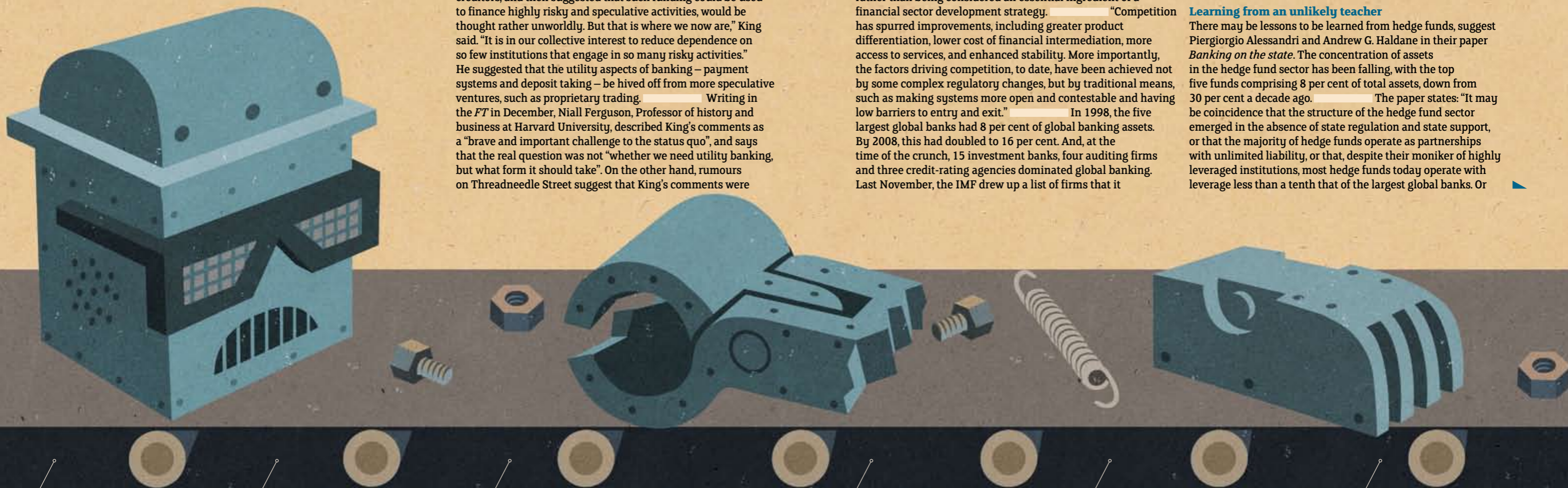
Mainelli believes that the missing ingredient is competition. “Regulation does not, nor should it try to, stop bad decisions,” he says. He advocates competition as the first level of regulation, and argues that “anti-trust and competition commissions need to be at the heart of reform, not just the BoE, the FSA or EU financial regulators.” Stijn Classens, in November’s IMF working paper, *Competition in the Financial Sector: Overview of Competition Policies*, supports this view. He says: “Too often, competition is seen as an afterthought, rather than being considered an essential ingredient of a financial sector development strategy.” “Competition has spurred improvements, including greater product differentiation, lower cost of financial intermediation, more access to services, and enhanced stability. More importantly, the factors driving competition, to date, have been achieved not by some complex regulatory changes, but by traditional means, such as making systems more open and contestable and having low barriers to entry and exit.” In 1998, the five largest global banks had 8 per cent of global banking assets. By 2008, this had doubled to 16 per cent. And, at the time of the crunch, 15 investment banks, four auditing firms and three credit-rating agencies dominated global banking. Last November, the IMF drew up a list of firms that it

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considered to pose systemic risk because of their size. Injecting competition into the sector requires examining this concentration, with a discussion of real competition mechanisms, such as narrow banking, re-privatising retail banks into separate entities, requiring audit firms to provide indemnities for audits, and removing any special status for credit rating agencies. Mainelli argues that it is necessary for governments to break up firms that are ‘too big to fail’ and too big to regulate. Society could afford a continual low-level string of failures, rather than periodic catastrophes and expensive rescues of a few dominant players. Systemic failures simply distort competition further. In an article in *The Independent on Sunday* in December, Matthew Bullock, chief executive of building society Norwich & Peterborough, says: “It’s difficult to make money when you are seeing the money you receive from your investments reduce, while attracting new capital is becoming more expensive because of those banks that are sitting on a £150bn cash pile from the Government bailout.” Arguably, the main role of governments is not to bail out banks, but to ensure that banks demonstrate that they are safe; and, if they are not, to do something about it.

## Learning from an unlikely teacher

There may be lessons to be learned from hedge funds, suggest Piergiorgio Alessandri and Andrew G. Haldane in their paper *Banking on the state*. The concentration of assets in the hedge fund sector has been falling, with the top five funds comprising 8 per cent of total assets, down from 30 per cent a decade ago. The paper states: “It may be coincidence that the structure of the hedge fund sector emerged in the absence of state regulation and state support, or that the majority of hedge funds operate as partnerships with unlimited liability, or that, despite their moniker of highly leveraged institutions, most hedge funds today operate with leverage less than a tenth that of the largest global banks. Or



Illustrator: John Holcroft

**March 1776**  
Adam Smith discusses competition law in *The Wealth of Nations*

**March 2000**  
Cruikshank Report highlights the dangers of downgrading competition

**February 2009**  
Martin McElwee and Andrew Tyrie MP’s *Leviathan at Large* raises questions about the FSA’s remit for encouraging competition

**July 2009**  
The Conservative party announces it would give the FSA’s power to the Bank of England

**September 2009**  
Lloyds TSB and Royal Bank of Scotland had received combined £40bn in direct government aid, to date

**October 2009**  
Mervyn King suggests splitting banks amid calls to reinstate Glass-Steagall

perhaps it might be that the structure of this sector delivered greater systemic robustness than could be achieved through prudential regulation. If so, that is an important lesson for other parts of the financial system.”

**New age of banking**

Speaking at the Social Market Foundation's New Finance Debate, economist John Kay commented that, ten years ago, it was accepted that retail banking wouldn't be competitive – for example, just three banks now hold 77 per cent of deposits in the UK. This was a small price to pay for financial stability. “But if this model isn't generating stability anymore, then is it such a good deal?” So, what might a fragmented landscape look like? Some experts have called for a form of Glass-Steagall, under which banks would have to separate their commercial and investment arms. “The harder part is utility banking,” Mainelli says. “Banks would be unable to trade with your money, so could instead charge a fee for security and services. This then leaves questions around credit: how much can a bank lend? Where can it lend it? The regulator may restrict this to gilts, for example.”

**A call for a form of 'narrow banking' misses the point**

It is unlikely that universal banks will welcome such calls. Stephen Green, group chairman of HSBC, speaking at a Standard & Poor's Investor Forum recently, describes “too big to fail” as “an unhelpful term”, saying: “All banks are too big to fail in the strict sense. In any case, there was no common denominator of size or structure among institutions that collapsed as a result of the crisis.” He agrees that so-called 'living wills' deserved further consideration, but adds: “A call to return to a form of 'narrow banking' misses the point that markets and customers are global, with complex and multiple financial needs. It is unrealistic and inefficient to demand that business customers, for example, use a range of institutions for these services.”

**Are we getting there accidentally?**

Ironically, experts believe that King may be getting his way on separation by default, as tighter capital regulations on risky activities will make larger divisions unprofitable enough for banks to ditch them. But beyond the short-term regulatory reactions, competition must be at the heart of the debate. It is unclear whether, after the election, any new governing party would enforce living wills and ensure that 'risky' banks would be cut down to size. What is clear is that doing nothing will, as Mainelli has warned, waste a good crisis. ■

**October 2009**

Treasury clashes with King. Announces splitting the banks "not right for the 21st century"

**November 2009**

30 global financial groups, including six insurance companies and 24 banks, put on systemic risk list

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