

NARROW BANKING

The Reform of Banking Regulation

John Kay

Acknowledgements

I am grateful to Amar Bhidé, Ian Byatt, Don Cruickshank, Kevin James, Mervyn King, Michael Lafferty, Richard McManus, Paul Smee, Adair Turner and Martin Wolf for comments on an earlier draft. It will be obvious that responsibility for the opinions expressed here is entirely my own.

Introduction

In 2008, the British government, like the governments of other western countries, was faced with the alternatives of watching economic collapse or granting massive subsidies and guarantees to financial institutions. Despite bailouts of almost incredible magnitude, considerable disruption to economic activity has occurred. Many ordinary people, in no way involved or responsible, have lost their jobs or much of the value of their savings. It is unforgivable that this should have happened, and unacceptable that it should ever happen again.

The public interest in financial services has several components. Consumers are entitled to expect that the financial services industry will provide reliable services of good quality at low prices. Instability is inseparable from speculative markets, but the real economy must be protected from the most serious consequences of instability in the financial sector. The industry should operate profitably and be internationally competitive, with the result that it makes a substantial contribution to, and no demands on, the public purse. None of these objectives has been achieved. The need for radical reform of the structure of the industry and the way it is regulated is therefore self-evident.

Proposals for regulatory reform must be judged today primarily by the strength of the assurance that they can offer that mistakes made in financial institutions cannot in future inflict such

damage on innocent individuals and businesses. By this criterion, the measures in the White Paper published by the British Treasury in July fail even to register on the scales.

The measures discussed in this paper are designed to secure these public interest objectives. Their most urgent purpose is to protect the non-financial economy from financial instability. But they have the further objective of securing better value for money for customers from a healthy industry. A competitive marketplace is one in which well run businesses earn profits through domestic and international competition, and badly run businesses go to the wall. That is the process by which the market system promotes innovation and economic progress, and suppression of that process damages innovation and economic progress.

There is no necessary inconsistency between a more competitive environment and economic stability. The proposals made in this paper develop the concept of narrow banking – often described as separating the utility from the casino. The model of narrow banking is one in which all retail deposits are secured on safe assets. The intention is that in the event of a future failure such as that at Northern Rock or RBS, an administrator could immediately take over the retail activities of the bank, and would find within the bank the material and financial resources to do so. The financial needs of individuals and non-financial businesses would continue to be met at little or no cost to the taxpayer. It is

important to distinguish sharply between the continued provision of essential services and the continued existence of particular corporate entities.

The term narrow banking sounds restrictive; the concept of a utility boring. But as I have worked through the implications of such a model, I have come to realise that the implications are not restrictive or boring. The opportunities are liberating and exciting. A much needed restructuring of the financial services industry would establish a retail sector focussed on the needs of consumers, rather than on the promotion of products and the remuneration of producers. We could look forward to an industry in which new technologies are used, not just to reduce costs, but to deliver better services. We should establish a market in which customer satisfaction is the measure of success. That would be an outcome very different from our recent experience. But it is an outcome we can – and must – achieve.

How we got here

Within the City of London, and to some degree outside it, there is nostalgia for a time when the Bank of England acted as coordinator of a self-regulating club of financial institutions. The implicit deal was that financial institutions were permitted to act as a cartel in return for a commitment to conservative behaviour. In times of difficulty, they would provide mutual support, which the Bank would coordinate, in order to maintain financial stability. The Bank of England, in turn, acted as advocate of City interests within government.

That model functioned, with some degree of success, for most of the twentieth century. But it could not, and did not, survive the globalisation of financial markets and the deregulation and intensified international competition which followed. These changes had occurred well before 1997 and it is a mistake to think that the transfer of supervisory responsibilities from the Bank of England to the FSA was the decisive change. What is true, however, is that the Bank of England retains from that earlier time a prestige and authority which the FSA is never likely to match.

That prestige and authority is of some advantage in the exercise of regulatory functions. The size and significance of the Bank's advantage should not, however, be exaggerated. It is far more important to decide what regulators should do than to decide the name of the organisation in which they do it. If we are clear

about the nature and scope of regulation, which at present we are not, then the design of regulatory institutions will follow.

Regulatory activity in banking has since 1988 been focussed around the Basel agreements. Basel is the home of the Bank for International Settlements, the prime mover in coordinating international discussions. The key criterion is capital adequacy. Capital requirements may be relaxed if the bank has sufficiently robust internal risk management systems. The procedures which meet these criteria of robustness are generally based on the 'value at risk' methodology pioneered by JP Morgan.

These rules proved worse than useless. Banks entered the crisis with capital generally in excess of the regulatory requirements. These provisions proved not just inadequate, but massively inadequate, for the problems they faced. Risk management systems based on value at risk comprehensively failed to describe either the nature or the intensity of the financial crisis that began in 2007. During the crisis, several banks continued to report compliant capital ratios although the pricing of their equity and subordinated debt indicated that the market believed they were insolvent. Certainly their continued existence depended entirely on government support. With their reported capital ratios eroded, and the threat that the required regulatory ratios would be increased, all banks reacted by reducing lending into the recession. Risk management systems based on value at risk comprehensively failed

to describe either the nature or the intensity of the financial crisis that began in 2007.

Capital adequacy rules not only failed in their primary objectives but also had other material adverse effects. The explosion of asset securitisation and the use of off-balance sheet vehicles (SIVs and conduits) were both developed to evade the Basel rules. Such regulatory arbitrage increased complexity and diminished transparency in the financial system. The effect was to conceal what was happening not just from regulators, but from the senior management of banks.

Banks which had more capital than was needed to comply with regulation came under pressure to reduce their so-called 'surplus' capital. The trend to capital inadequacy was aggravated by the mistaken belief that the efficiency of a bank was measured by its return on shareholders' equity. Reducing equity was easier than increasing returns. Regulatory sponsorship of specific risk management techniques allowed senior managers in banks to delude themselves that the controls implied by these techniques were adequate.

In an uncertain world, asset values will also be uncertain, and the margins of uncertainty are very wide. The measurement of capital is not, and never will be, simultaneously exact or objective, and economically meaningful. The risk associated with a portfolio of assets is only very loosely related to the aggregate value of the

assets. A loan to the British government involves no risk while the potential loss from a derivative contract may be much larger than the value of the contract. And it is a basic principle of risk analysis that the aggregate risk of a portfolio cannot be measured by adding up the risks of individual elements.

The relevant criterion is the potential loss from the varieties of economic exposure in a bank's balance sheet. Banks sought to address this problem for their own internal purposes through sophisticated and complex calculations using data specific to their own experiences and practices. They failed in that endeavour even though these banks were seriously attempting to find the answer, not seeking to find ways round structures which had been imposed on them externally.

No rules on capital adequacy, however complex, can account even approximately for the varying circumstances of all the banking institutions in the world. This problem is fundamental and is not soluble, even if committees sit in Basel until the River Rhine, or at least the local hostelrys, run dry.

It is at first sight puzzling that so much effort should be devoted to an activity which is futile in principle and has manifestly failed in practice. The Basel agreements, and the growth of financial services regulation more generally, have caused the emergence of a regulation industry. That industry comprises regulatory agencies, the compliance departments which are now a

major part of all financial institutions, and an army of consultants and lawyers who mediate between the two. All these groups gain power and prestige from the complexity of their activities. They have an interest in the continued expansion of established systems of regulation, and have been given an opportunity to achieve that by the current crisis.

The assessment of capital requirements, and the management of risk, are properly matters of individual business judgment, to be made by managers in consultation with their lenders and their shareholders. They should be among the most important matters of business judgment in financial institutions. The devastatingly negative consequence of regulatory prescription in these areas is that such prescription has undermined business disciplines and the risk management responsibilities of senior executives. Rather than imposing controls on their own traders, the senior management of financial institutions has conspired with those traders to evade controls which have been imposed by outside agencies. The outcome is a culture which regards control systems as bureaucratic burden rather than administrative tool.

In the last two years, managers of very large businesses have, with every appearance of sincerity, blamed regulators for the failures of their own risk control systems. The lesson for regulation generally is that regulation which is not well directed and not effectively enforceable is not harmless simply because it is useless.

Such structures impede the development of market solutions and internal processes designed to address the problems which regulation itself fails to handle.

The lesson of the failure of the Basel accords is not that the regime should be elaborated beyond the 400 pages of text in the current accords. It is that the whole system should be swept away, and the responsibility for capital adequacy and risk management put back where it belongs – in the hands of the executives of banks, who should then carry heavy and exclusive responsibility for failures of control. There must be a better way. There is. It involves a combination of tighter, but more narrowly focussed regulation and a larger role for competition and market forces.

The purposes of financial services regulation

The present crisis is the direct and indirect result of losses incurred by major financial services companies in speculative dealing (proprietary trading) in wholesale financial markets.¹ The objective has been to seek trading profits for the institution (and for its employees, not necessarily in that order of priority) from the exploitation of asset mispricing and regulatory arbitrage. Proprietary trading is not concerned with, or is incidental to, the provision of services relevant to the business needs of its customers. Stand alone institutions which seek profit in this way are called hedge funds.

Most retail and investment banks, and some insurance companies – operated their own internal hedge funds. In common with other hedge funds, those within banks made substantial losses in the market turbulence of 2007-8. Many hedge funds were wound up. But losses that were merely damaging to hedge funds were life-threatening to banks. And the consequences of the failure of these internal hedge funds were far more wide-ranging.

The effective gearing (leverage) of most hedge funds was lower. Borrowings of hedge funds were limited by the prudence of their managers and their principal brokers. Borrowings by banks, however, enjoyed the benefits of a large retail deposit base, which would have ranked equally with other creditors in any liquidation. The existence of that retail deposit base created an expectation –

which proved justified – that the liabilities of the bank were effectively guaranteed by governments.

Box A

Deposit protection

Deposit protection is provided in the UK under the Financial Services Compensation Scheme which offers compensation in the event of the failure of an FSA authorised UK financial institution. The scheme raises funds through levies on other authorised firms based on their turnover in regulated business. There are five pools corresponding to different kinds of institutions and a mechanism for distributing very large claims over the whole industry.

This scheme works well for small defaults such as those of crooked intermediaries. It has also handled the failure of small deposit-taking institutions quickly and sensitively. It is not designed to handle the failure of large banking institutions. The FSCS has been faced with major liabilities as a result of the failures of Kaupthing, Bradford and Bingley, and Landsbanki (although Landsbanki was a branch of an Icelandic bank, rather than a UK based bank, depositors can claim on the FSCS for amounts in excess of the compensation provided by the Icelandic government up to the amount which would have been available under the FSCS).

In practice, the UK government has met almost all deposit protection liabilities. In 2008-9, the FSCS paid out £19.9 bn and levied £171m. It plans levies of £464m in respect of deposit protection in 2009-10. Some funding has taken the form of loans from the Bank of England to the FSCS, and other funding for payments outside the scope of FSCS rules is directly from the Treasury. Much of this public expenditure will be recovered in the winding up of the failed businesses. Nevertheless, although the ultimate costs cannot today be reliably estimated they will certainly run into several billions of pounds. The costs of bank bailouts – loan guarantees, toxic asset insurance, and recapitalisation – have all been met directly by public agencies.

The recent White Paper on financial services regulation² proposes an element of pre-funding of FSCS, but postpones this until at least 2012. But this is not real: the existing liabilities of the scheme to the Bank of England will not be discharged in the foreseeable future, or probably at all. In the US, banks pay risk

related levies to FDIC, but the premia are absurdly low relative to the risks and costs. The large failed US banks would have paid four basis points, or less. The costs of handling the 1980's savings and loan collapses were effectively met by the US taxpayer, as have been the TARP and similar programmes.

The reality is that the costs of major bank failures will fall principally on the public purse. There is little justification or rationale for recovering a small fraction of these costs through levies on solvent institutions, which are essentially arbitrary and distort competition. It would be better and simpler for government to accept direct liability for deposit protection. The important corollary is that government (not financial services companies) should also derive the financial benefit from these guarantees, and the net costs should be minimised (preferably at zero or below). The proposals set out in the text are designed to achieve this result.

Viewed from another perspective, the explosion of wholesale market activity created bank balance sheets which were much larger – in some cases several times larger – than their deposits from or loans to customers. Capital which would probably have been adequate for likely losses on lending to non-financial customers was completely inadequate in the face of major dislocations to wholesale money markets.

That dislocation occurred in 2007-8, a consequence of the loss of confidence in both assets and institutions. The underlying value of many of the assets on these balance sheets could not – in the absence of market euphoria and optimistic appraisal by rating agencies - be assessed easily if at all. Such uncertainty cast doubt on the value of all the liabilities of the institutions concerned. Many wholesale financial markets simply dried up. When assets are

complex and idiosyncratic, and therefore have no ascertainable objective value or market price, the conventional distinction between solvency and liquidity has little meaning. Many banks were both insolvent and illiquid.

In the view of some financial institutions, the crisis was caused by accounting rules that obliged them to disclose this information. In fact the principal causes of the failure were that banks had expanded their balance sheets excessively and were victims of severe management deficiencies. Banks lost money on activities that were poorly controlled and underestimated the capital and liquidity which these activities required.

No one who points the finger at management failure, however, should underestimate the management challenges involved. The problems were not confined to a single institution, but experienced generally. People who conduct speculative trading are often, by nature, undisciplined, opinionated, and greedy and do not fit well into the structures of large corporate organisations. The majority of hedge funds are small, and appropriately so.

It is, however, relevant to note that many of the managers of large financial institutions were absurdly well remunerated for duties they failed to perform. Not all managers were inept, and some businesses weathered the storm more successfully than others. Nevertheless, business models that rely on outstanding, rather than ordinary, management for their effective functioning are

not sufficiently robust to be allowed to play a central role in the provision of a country's economic infrastructure.

The issue of robustness is central. No systems, however well designed, can eliminate mistakes and failures. While good systems seek to reduce the likelihood of mistakes and failures, a central feature of all well designed engineering – and biological – systems is that they are robust to the failures that will inevitably occur.

Robust systems are structured so that their failures can be contained within a single component, or so that error correction mechanisms come into play. In other interconnected utilities, such as water or electricity, substantial resource – both of technical ingenuity and capital expenditure – is devoted to ensuring that such failsafe measures exist, which is why major disruptions are rare. Financial services are different. But they should not – and need not – be different.

Robust engineering systems are designed with modularity – so that one component can fail, and be replaced, with little damage to the whole. They have independent back up systems. They are loosely coupled, so that small disruptions are easily absorbed. All financial institutions apply these principles to their technology, but similar measures are not in place – or widely thought relevant – to the substantive operations of these institutions, or for the financial system taken as a whole.

As a result, relatively minor incidents – a funding deficiency at a second rank institution like Northern Rock, the collapse of Lehman, a business which served no important role in the delivery of financial services to the public, or the unsuccessful speculations of a small group of people with AIG, a very large insurance company – proved massively disruptive. Modern developments in financial markets have made the system less, not more, robust. This is the central problem that the financial services industry must address, and through systemic reform. The suggestion that government should respond to all such failures by flooding the system with cash is not one that can be accepted.

The credit crunch is the second major financial crisis within a decade. It follows on the bursting of the new economy bubble in 2000. That crisis was in turn preceded by the Asian financial meltdown of 1997. None of these incidents are likely to be repeated in precisely the same form, and if the next crisis is to be averted or ameliorated we need to ask basic questions about the business models and regulatory structures that have allowed these events to take place.

There are three broad groups of market failure in financial services:

- fraud: Financial services activities are particularly attractive to sophisticated criminals. Preventive and punitive activity against fraud is essential.

- systemic risk: Failure in one part of the financial system is liable to have serious effects on other activities and institutions.
- information asymmetry: Many consumers of financial services have a poor understanding of the products they buy. They are vulnerable to exploitation and susceptible to mistake in what may be some of the most important transactions of their lives.

There are grounds for serious concern about the detection and punishment of financial fraud in the UK. The reputation of the Serious Fraud Office is poor, following a series of collapses of high profile cases which have led to reluctance to prosecute even when serious issues are at stake. Conrad Black and the NatWest three were convicted in the US for activities that were mainly conducted in the UK, where no charges were brought.

Enforcement activity in financial services is excessively focussed on market malpractice – abuse of market participants by the public, or by market participants of each other, rather than abuse of the public by market participants. The failure by the SEC to act against Bernard Madoff raises broad questions about direction and competence. A regulatory system that cannot deal with straightforwardly criminal behaviour will inevitably struggle when confronted with complex errors of judgment in respected

institutions. But fraud and near fraud have not been central to the current crisis. Issues of systemic risk have.

Systemic risk

The phrase systemic risk is widely used but rarely precisely defined. In a loose sense, systemic risk describes the tendency for the failure of a financial services business to have an impact on many other businesses. But such impact would be felt as a result of a failure by any large firm in a modern economy. The specific problems which arise in financial services fall into three broad categories - macro-prudential supervision, retail bank runs, and counter-party risk in wholesale markets.

The financial world is particularly prone to fads and fashions. Ostensibly sophisticated agents reinforce each other's conventional opinions. They then change these opinions, frequently and abruptly. Such instability has been characteristic of financial markets throughout history, and has frequently caused economic damage.

Alan Greenspan, Chairman of the Federal Reserve Board from 1987 to 2007, argued that regulators should not even attempt to restrain the instability of financial markets, because they could not have a better understanding of asset prices than market participants. This claim derives from ideology rather than evidence, and Greenspan himself now appears less convinced of its merits.³

It was not difficult to observe that the New Economy bubble was, indeed, a bubble or that banks were taking excessive risks in 2005-6. Many people in and outside financial services understood

these things perfectly well. The FSA and the Bank of England delivered explicit warnings about excessive risk taking ahead of the credit crunch.⁴

Coordinated international action to raise interest rates in 1998 and again in 2005 might have helped mitigate the excesses which followed. Politicians acted reprehensibly as cheerleaders for both the new economy bubble and the housing boom. But there are few votes in taking away the punch bowl when the party is in full swing. Nevertheless, as William McChesney Martin, one of Greenspan's predecessors, famously observed, this is a responsibility of central bankers.

Macro-prudential regulation based on intervention at the level of the individual firm is another matter altogether. It is not clear what those who seek a greater role for this kind of supervision have in mind. Do they envisage, for example, that regulators might have intervened to block the issue of new internet stocks in 1999, or to restrict bank lending in 2006? What might the nature and terms of such intervention have been? Or the political consequences?

Action by the FSA to slow Northern Rock's expansion, or to block the competing attempts by RBS and Barclays to acquire ABN-Amro, would have led to complaints at the highest political level. It should not be assumed that the FSA would have enjoyed support in these circumstances. The knowledge that large financial services companies have direct and strong political connections, and use

them, has been and continues to be a significant influence on regulatory activity, as does the threat of judicial review.

No public agency should have financial stability as its goal. It is not evident what would be meant by its achievement. If financial stability means stabilising securities prices, then it is neither possible nor desirable to accomplish that purpose. There might be value in central banks offering guidelines to ranges of fundamental values – for currencies, for example, perhaps even for house prices – and being influenced in their policy judgments by deviations from these ranges.⁵

But this is debatable, and it is even more debatable whether agencies should require the firms they supervise to act on such guidance. It is one thing for government to influence a climate that gives rise to exaggerated optimism or excessive pessimism, and quite another for it to stop executives acting on what an agency considers to be widely optimistic beliefs.

If financial stability means ensuring that no large financial institution will ever fail, then it is probably possible for government to achieve this, but not desirable that it should. Business failure is a necessary by product of economic dynamism. The appropriate public policy objective should not be to secure financial stability but to minimise the costs of financial instability to the non-financial economy.

The primary source of such costs today is booms and busts in lending activity. From 2005 – 2007, there was feast, from 2007 there was famine, and the economic consequences of both were severe. This behaviour is caused mainly by the contagious and febrile nature of the conventional wisdom of financial markets. The consequences are aggravated by capital adequacy rules – the profitability of the boom makes more lending possible, the losses of the bust require that lending be contracted. This adverse effect might be reduced if, as is widely suggested, capital requirements were varied cyclically.

But such a measure largely misses the point. The capital adequacy rules are imposed, not on lenders, but on deposit taking institutions – reflecting a historic position in which one activity was the mirror image of the other. But this equivalence is no longer valid, and it is likely and desirable that in future it will be less valid. Any attempt to influence lending through capital controls is likely to be a further stimulus to regulatory arbitrage, escaping the control and creating profit opportunities through useless complication. The most important policy measure which would help address this instability to stimulate a wider and more diverse range of lending institutions. This might offset the present tendency for decisions to be taken by similarly minded people in a small number of businesses who watch each other's behaviour closely.

There have been runs on banks since there have been banks. The events of 1933, when all the banks in America were closed as Roosevelt became President, are engraved on the minds of American policy makers. There were no bank runs in Britain during the Great Depression. The queues outside Northern Rock in September 2007 were the only bank run in modern British history.

When most businesses fail, what remains is shared among the creditors. When a queue forms outside a bank, the people at the front of the queue get their money back in full, and those at the back may find there is nothing left. If there is to be a queue, it is vital to be at the front rather than the back. That means that any whiff of doubt about a bank causes the queue to form. It also implies that a run on one bank is liable to be quickly followed by a run on another.

The answer that the US adopted after 1933, which has been followed around the world, is a government sponsored deposit protection scheme for small savers. The run on Northern Rock occurred because Britain's deposit protection scheme was inadequate – only savings of £2000 were covered in full - and there was no mechanism other than general insolvency law for dealing with a failed bank. It was impossible for the Chancellor of the Exchequer or Governor of the Bank of England to give an immediate and unequivocal assurance that the deposits were safe. The run was immediately halted when the Chancellor did give such

an assurance, on the basis that appropriate legal authority would be provided retrospectively.

Britain has now implemented full protection for deposits of £50,000 and introduced a special resolution regime for potentially insolvent banks. These measures, which exist in most other countries, should have been put in place years before. The failure to do so is the product of a combination of resistance on the part of banks and a British philosophy that 'it will be all right on the night'. It wasn't all right on the night, a discovery which at present seems all too likely to be repeated in the not too distant future.

Deposit protection offers effective security against contagious bank runs. Despite the gravest international financial crisis certainly since the 1930s and perhaps in history, there has been no replay anywhere of the events of America's March 1933. The main issue in recent discussion of systemic risk has been counter-party risk in wholesale financial markets.

A financial services business that trades actively may have at any moment a very large number of unsettled obligations. A futures contract, or a derivative product, will often have a life of months or even years. There will always be amounts which are due, but which have not yet been paid, or received. The administrator of a failed company is still entitled to recover all debts of the company, but will meet the liabilities only to the extent that he is able to pay.

Counter-party risk compounds the riskiness of financial transactions because transactions which seemed to net out no longer do so. Other financial services businesses that were expecting contracts to be fulfilled one month, three months, a year from now will suddenly discover that balance sheet exposures differ from those they had expected. The risks associated with the market for credit default swaps (CDS) – which has grown very rapidly in recent years – have caused particular concern.

The failure of Lehman was a traumatic event for financial markets because the scale of Lehman's trading revealed the reality of counter-party risk. Not only did participants lose out: they understood that other institutions might fail, with similar or more extensive consequences. The world of wholesale financial markets was suddenly more risky than had been imagined.

The average reader may be asking 'what does any of this have to do with me?' and it is a good question. The answer is that many people believe that the problem of counter-party risk is of such magnitude that regulatory authorities should intervene to ensure that such risks do not materialise. Put bluntly, they think that taxpayers should bail out any institution whose counter-party risks are sufficiently extensive – 'too big to fail', as this view holds Lehman was, and as the US Treasury concluded AIG was. Put more bluntly still, they think that taxpayers should act as unpaid insurer of most transactions in wholesale financial markets.

When spelled out, this proposition is so preposterous that the fact that it can be seriously entertained provides a revealing insight into the political power of the financial services industry and the degree of panic which seized policymakers in 2008. The description of the behaviour of traders and salesmen in books like Michael Lewis's *Liar's Poker*, or more recently, Tetsuya Ishikawa's *How I Caused the Credit Crunch* is, unfortunately, not much exaggerated. Other autobiographical accounts purvey a similar message. Most ordinary people will respond with revulsion at the absence of ethical values, anger at how much such people are paid, and disgust at the lifestyle associated. That these activities take place at all is hard to bear: that they should be subsidised by ordinary working people is, or should be, inconceivable.

Every commercial transaction – a house purchase, or an eBay auction – involves counter-party risk – Will the buyer pay? Will the seller deliver the goods? As the examples of house purchase and eBay illustrate, both market and regulatory mechanisms exist for dealing with these problems.

In financial transactions, the traditional mechanism for handling counter party risk was the exchange. You could only buy or sell shares through a member of the Stock Exchange, and if you did the Stock Exchange guaranteed settlement – if your broker failed to pay, or to deliver the stock you had bought, the obligation would be discharged as a collective liability of Stock Exchange

members. The Stock Exchange was a private club that regulated the affairs of its members and could, and did, expel them for misconduct or lack of appropriate financial strength.

The growth of financial services regulation in the last two decades has led to the nationalisation of a range of functions which were previously the responsibility of self regulatory agencies – such as exchanges – and even of the control systems of financial institutions themselves. These functions are not, in the main, more effectively performed by public agencies. The issue in every case is whether the greater power of enforcement that comes from statutory authority offsets the informational disadvantage experienced by an external regulator, and mostly it does not.

But the formation of the FSA and the establishment of a statutory financial services compensation scheme led to the assumption by public agencies of responsibility for what had previously been handled by self-regulation.. The London Stock Exchange is now a private company whose shares are listed on the London Stock Exchange. Some other exchanges, however, continue to perform traditional functions including that of acting as insurer of counter party risk.

Since the 1970s much of the growth of financial markets has been in derivative securities, and many of these are traded 'over the counter', which means that they are not necessarily standardised or dealt through exchanges. Market mechanisms have

been created for minimising the resulting counter-party risk. Derivatives trading companies net exposures between any two counter-parties. Compression vendors serve a similar role in the CDS market. The near collapse of Long Term Capital Management was dealt with (as such matters traditionally were) by a consortium of sound financial institutions operating under Federal Reserve auspices but without access to public funds. In effect, the counterparties agreed a sharing of profits or losses (ultimately these were profits) among them.

The development of such market mechanisms is not only the route ahead, but the only possible route ahead. Government subsidy for all or most financial sector counter-party risk is not acceptable. Not just because this is not an appropriate government expenditure, but because the existence of such support undermines the imposition of risk disciplines within financial institutions and the evolution of market mechanisms to deal with counter party risk. The notion that supervision will in future prevent failures such as those of Long Term Capital Management or Lehman and therefore this problem of moral hazard will not emerge is an engaging fantasy.

In some respects, ambiguity about the scope of government support leads to the worst of all possible worlds. Market participants believe that government will intervene to undermine their losses but there is no explicit promise. Fannie Mae and Freddie Mac, the US government sponsored mortgage insurers, illustrate

the costs. These bodies traded without government guarantees, but markets thought the US Treasury stood behind them. As a result, the companies were able to build up balance sheets of astronomical proportions on the back of relatively cheap borrowings, to the considerable benefit of their shareholders and, conspicuously, the executives who ran them.

Although a specialist agency – employing over 200 staff – had explicit responsibility for the supervision of the two companies, such supervision was ineffective in the face of the lobbying power of the regulated institutions. When Fannie Mae and Freddie Mac collapsed, the US government confirmed the market's expectations and took over their liabilities, thus imposing costs on US taxpayers which may run into hundreds of billions of dollars.

The bankruptcy of Lehman, followed immediately by the rescue of AIG, has magnified the scale of the problem. The economic costs of the uncertainty and disruption that followed Lehman's failure were substantial. But the exemplary value of the failure, in encouraging market participants to control risks and assess counter party exposure, was also very substantial, and this was the reason why the US Treasury was ready to allow Lehman to fail. Markets now, however, believe that governments take the view that allowing the bankruptcy of Lehman was a mistake, and that in similar circumstances in future a bail-out would be offered. The result is that the public has experienced the disruption caused

by the Lehman failure but has not gained the benefits of intensified concern to manage and monitor counter party risk among financial institutions.

Regulation and supervision

Regulation should focus on the public interest, and particularly on the interests of the public as consumers of financial services. This requires that regulation should aim to secure innovative and good quality services at low prices, primarily through the promotion of competitive markets. Regulation must also guarantee the availability and integrity of the central utility of the industry – the payment system and the services associated with it.

This specification of tasks is very similar to the specification of regulatory functions for other utilities, and suggest a structure similar to that which exists in those other industries. Proposals by the US Treasury, and the Conservative Party in Britain,⁶ to establish a consumer oriented regulatory agency are clearly on the right lines. Macro prudential supervision is properly a responsibility of the Bank of England. It would be better if microprudential supervision were not undertaken at all.

The financial services sector is only one of many regulated industries. Yet it is rare for discussion of financial services regulation to make reference to experience gained in other areas of regulation. We regulate utilities, such as gas, electricity, telecommunications and water; we regulate the transport infrastructure – railways, airports and airlines: we regulate broadcasting and pharmaceuticals.⁷

History shows that regulation works most effectively when it is focussed on a small number of clearly identified public policy problems. Most other industries are regulated, not supervised, and neither regulators nor the businesses concerned normally use the term supervision.

The remit of supervision is general rather than specific. Supervision seeks to impose a particular conception of good business practice across the industry. In financial services, the terms regulation and supervision are used almost interchangeably. Yet they are not interchangeable. Supervision is, by its nature, wide-ranging: regulation is focussed.

Supervision is subject to creep – a tendency for its scope to grow. Supervision involves a form of shadow management; but it is almost inevitable – and wholly inevitable in the financial services industry – that shadow management will be at a disadvantage to the real management in terms of the competence of its staff and the quality of information available to it.

Despite the wide scope of supervision, it is not an effective method of regulation. Supervision is subject to regulatory capture, an inclination to see the operation of the industry through the eyes of the industry and especially through the eyes of established firms in the industry. Because the supervisor's conception of best practice is necessarily drawn from current practice, supervision is supportive of existing business models and resistant to new entry.

Extensive and intrusive: yet ineffective and protective of the existing structure of the industry and the interests of its major players. That describes financial services regulation in Britain (and in other countries) today.

Compare the board of the Office of Water Services, which regulates the privatised water companies of England and Wales, with the board of the Financial Services Authority. The board of OFWAT has nine members of whom two were previously employed in the water industry. Three members have substantial experience in the regulation of other industries. The other four have backgrounds in other private industries, academia, and government.

Eight of the eleven members of the FSA board had or have senior positions in financial services companies. The Deputy Governor of the Bank of England sits *ex officio*. The other two members are former executives of non-financial businesses.

The difference in board composition is an appropriate reflection of the different responsibilities of the agencies. If the primary responsibility is supervision, the primary qualification is management experience in comparable businesses. The objective of water regulation is to represent the public interest against the industry and it is knowledge of the public interest, not of the industry, that is required. The problem in Britain is not that the industry members of a regulatory board act as advocates of their

vested interests – most try hard to behave in a public spirited manner. But their way of thinking is inevitably the way of thinking of the institutions in which they have spent the largest part of their time.

There is also a public interest in the promotion of a profitable and internationally competitive financial services industry. This activity, called sponsorship in most other industries, should be distinguished from regulation and kept separate from it, as it is in most other industries. In the BSE crisis over infected beef, a government department responsible for both consumer protection and industry sponsorship voiced misleadingly reassuring statements until the problem became too serious to ignore. The crisis was a particularly forceful example of the dangers of linking sponsorship with regulation. The results were damaging to both the interests of the industry and the interests of the public. Much the same has been true in financial services.

Textbooks of regulatory history point to the lessons of the US airline industry.⁸ The need for regulation to secure passenger and public safety has been evident from the earliest days of civil aviation. It seems plausible – it is true – that planes will be better maintained by strongly capitalised companies with sound business models. It is only a short further step to perceive a need to review pricing policies, the qualifications of prospective new entrants, and the need for their services. And so on. Airline regulation spread to

cover almost all aspects of the operation of the industry. Industry leaders met to discuss issues such as seat pitches and the composition of meals.

In the United States in the 1970s, this structure was swept away by a broad based Congressional coalition. The right believed that market forces would serve customers and promote innovation better than regulatory solutions. The left believed that regulation had become a cartel, a racket operated on behalf of large, inefficient, long-established companies.

Both these beliefs were justified, as subsequent experience showed. The deregulated market, initially unstable, grew very rapidly. There were many new entrants: some incumbents failed, others thrived. Consumer choice expanded, and prices fell. Passenger needs are today generally better served, while aircraft are safer than ever.

The financial services industry should follow this example. Regulation should seek to work with market forces, not to replace them. Not because free markets lead to the best of all possible worlds – in financial services, as in many other industries, they plainly do not. But it is much easier to channel a flow of water into appropriate downhill channels than to push it uphill. Competition where possible, regulation where necessary, and supervision not at all, should be the underlying principle.

There many lessons to be learnt for financial services from both the management and regulation of other industries. We need to stop thinking of financial services as a unique business, whose problems are *sui generis*, and whose economic role is one of special privilege. The historic deal, which limited competition in return for prudent behaviour, has been abrogated. Today, both consumer protection and macroeconomic stability will be best served by the policies to promote competition which are rightly favoured in other sectors of the economy.

Box B

The costs of supervisory failure

There are many disadvantages of regulation as supervision, or shadow management. One is that government is in danger of being held responsible for failures of actual management, and hence financially liable for the losses incurred.

Barlow Clowes was a Ponzi scheme which collapsed in 1988: the organiser, Peter Clowes, was sentenced to ten years in prison. The fraudulent BCCI was closed by the Bank of England in 1991. The life insurer, Equitable Life, closed to new business, and most policyholders received less than they had been led to expect. After the run on Northern Rock in September 2007, the company was nationalised after much procrastination.

In all these cases, the principal responsibility for the problems lies within the management of the businesses concerned. Clowes was a fraudster and BCCI was corrupt. Equitable Life and Northern Rock were both dominated by autocratic chief executives and pursued ambitious business strategies now seen as unduly risky. It is possible, though not indisputable, that earlier regulatory action could have reduced losses to depositors at BCCI, policyholders at Equitable Life, investors in Barlow Clowes, and shareholders at Northern Rock.

In all these instances, there has been heavy pressure on government to pay compensation. In the case of Barlow Clowes, the failures of regulation at the (then) Department of Trade and Industry appear to have been egregious. Compensation to investors was paid following a damning report by the Parliamentary Ombudsman. The FSA and Bank of England have statutory immunity against claims based on regulatory failure. Nevertheless the liquidators of BCCI brought a lengthy and exceptionally costly case against the Bank of England – the case ultimately collapsed after extended court hearings.

Following the precedent set by Barlow Clowes, the demands for compensation for Equitable Life policyholders have been directed through the Parliamentary Ombudsman, who has produced an extensive report detailing alleged regulatory deficiencies. In the case of Northern Rock, the FSA's own report has acknowledged some regulatory shortcomings. The demands of shareholders are focussed on the terms on which the failed company was taken into public ownership.

If a regulator as supervisor is, to any degree, to review the business judgments of managers of the regulated entity, it is difficult to resist the argument that there is some shared responsibility for errors in business judgment. That argument was presented, with varying degrees of force in each case. Barlow Clowes was a relatively small affair: but the scale of compensation was large relative to the amounts paid in respect of ordinary criminal injuries, which include cases of severe bodily harm. In each of the other cases, the amounts of money potentially at issue run into billions of pounds. Given the earlier history of Barlow Clowes, it is thought-provoking to ask what would be the situation if the Madoff fraud – in which the failures by the SEC do appear to have been serious – had occurred in the UK.

Breaking up the bank

The largest source of systemic risk in the crisis of 2007-9 has been within individual financial institutions themselves. At Royal Bank of Scotland, the group engaged in the trading activities that brought the bank to the edge of collapse employed barely 100 of the group's 170,000 staff. At AIG, 120 people in the financial products division, based in London, caused the effective failure of America's largest insurance company. Contagious consequences spread through the whole company.

You see the same bewilderment at RBS, in AIG, in other failed businesses such as Halifax. People who have worked hard and successfully for a business for many years discover that their efforts, and in some cases careers, have been destroyed by activities about which they knew nothing and which they correctly regard as peripheral to the primary business purposes of the organisation.

The most urgent, and in many respects simplest, mechanism of regulatory reform is to require firewalls and firebreaks between different activities. This reflects the strategy of establishing a financial system more robust to failure. Such a change means reversing, at least in part, the conglomeration which was the central consequence of the deregulatory 'Big Bang' of the 1980s.

The traditional role of the bank was to take deposits, largely from individuals, and to make loans, mostly to businesses.

Deposits were repayable on short notice but loans could not in practice be called in immediately. Even a well run bank was therefore potentially vulnerable if many depositors demanded their money back simultaneously. Banks maintained extensive liquid assets and the Bank of England, in common with other central banks, offered 'lender of last resort' facilities. The guaranteed willingness of the central bank to provide funds against good quality assets means that a solvent bank need not fear failure.

In the modern era, financial innovation allowed banks to trade both credit risk and interest rate risk. These developments were at first called disintermediation and subsequently securitisation. They meant that the credit and interest rate exposures which traditionally had been contained within banks, and made banks inherently risky, could be reduced or eliminated through markets.

There was quick recognition that such disintermediation also undermined the traditional conception, and role, of a bank. Some thoughtful commentators believed that the financial institutions of the future would be narrow specialists. An important book published in 1988 by a young McKinsey partner, Lowell Bryan (now director of the company's global financial services practice) defined that firm's view at the time. The title was *Breaking up the Bank*.⁹

Bryan was half right, half wrong. All of the individual functions of established banks (with the possible exception of SME lending) are now also performed by specialist institutions. In many

cases these functions are best performed by specialist institutions. Monoline credit card companies are among the most competitive and innovative consumer lenders. Specialist mortgage banks, based on wholesale funding, have offered market leading products. Supermarkets have diversified into simple financial services, such as deposit accounts. Private equity houses (venture capital firms) have transformed the provision of finance for start-up businesses. Successful proprietary traders set up their own businesses, attracting institutional money to hedge funds.

But, seemingly paradoxically, the trend to specialisation was accompanied by a trend to diversification. Traditional banks became financial conglomerates. They not only sold a wider range of retail products but also expanded their wholesale market and investment banking activities. The bizarre consequence was that while the deposit taking and lending operations of banks could – and did – use new markets to limit their risks, speculative trading in the same markets by other divisions of the same banks would increase the overall risk exposure of the bank by far more. But this is to get ahead of the story.

The most dramatic consolidation was that in which America's largest retail bank, Citicorp, became Citigroup, the world's largest financial institution, absorbing investment bank Salomon, broker Smith Barney, and insurer Travelers, and providing virtually every financial product available. Of the four large British banks, only

Lloyds retained a UK retail focus. Building societies took advantage of deregulation to convert into public limited companies and diversify from their specialism in residential mortgage finance. Germany had always had universal banks, but they had been conservative in style; Deutsche Bank reinvented itself on essentially Anglo-Saxon lines. Crédit Lyonnais's rapid growth in the 1990s led to the first major failure of a modern conglomerate bank. Its French competitors also diversified and expanded internationally, albeit less disastrously.

In 2007-8, the process by which retail banks became financial conglomerates ended in tears. Almost all the businesses concerned experienced share price collapses, rounds of emergency capital raising, and became reliant on explicit or implicit government support to continue operations. But these financial conglomerates not only failed their shareholders: their customers had been victims of endemic conflicts of interest for years. At the very moment in 1999 that the 1933 Glass Steagall Act which separated commercial and investment banking was repealed, the New Economy bubble was illustrating once again the abuse which had led to the Act's passage in the first place – the stuffing of retail customers with new issues from worthless companies which were corporate clients.

Within every diversified retail bank, there was evidence of the fundamental tension between the cultures of trading and deal-making – buccaneering, entrepreneurial, grasping – and the

conservative bureaucratic approach appropriate for retail banking. It was a conflict in which the investment bankers and traders generally came out on top.

That is, perhaps, the heart of the matter. The attractions of financial conglomerates are more evident to the people who run them than to their customers, employees, shareholders – or the taxpayers who have been faced with bills of startling magnitude by their failure. The opportunity to gain access to the retail deposit base has been and remains irresistible to ambitious deal makers. That deposit base carries an explicit or implicit government guarantee and can be used to leverage a range of other, more exciting, financial activities.

The archetype of these deal-makers was Sandy Weill, architect of Citigroup. The Glass-Steagall Act was repealed for the more or less explicit purpose of allowing Weill's Travelers Group to merge with Citicorp, after which Weill rapidly moved to eject his co-CEO, the urbane retail banker, John Reed. Weill's own retirement was hastened by the reputational problems that afflicted Citigroup after the merger. In 2007, Weill's successor, Chuck Prince, made a famous summation of the credit expansion in observing that 'when the music's playing, you've got to get up and dance'.¹⁰ It was evident by then that the world's largest financial services business was unmanageable and effectively unmanaged.

In Britain, Sir Fred Goodwin of Royal Bank of Scotland presided over one of the few successful mergers between retail banks, acquiring and revitalising the ailing NatWest Bank. Hubris took over, however. Pitching his company to analysts as 'the supreme predator', Goodwin led the takeover of the Dutch bank ABN-Amro at the moment the credit bubble began to burst. After recapitalisation, the British government owned more than 70% of RBS shares. Bob Diamond, an American investment banker who became the dominant force in Barclays, flew a little less close to the sun. In what was, at least in his eyes, a stunning coup he captured the remains of Lehman's US operations after that bank's collapse.

Citicorp, like RBS, has received massive government support because the organisation is viewed as 'too big to fail'. But neither a democratic society nor a market economy can contemplate private sector organisations that are 'too big to fail'. Such a company represents a concentration of unaccountable private power, answerable neither to an electorate nor to a market place.

And 'too big to fail' destroys the dynamism that is the central achievement of the market economy. Any form of selective government support distorts competition. To win such subsidy today, the firms concerned must, like General Motors and Citigroup, be both large and unsuccessful. It is difficult to imagine a policy more damaging to innovation and progress.

In principle, there is no reason why disruptive innovations and radically new business models should not come from large, established, dominant firms. In practice, the bureaucratic culture of these organisations inhibits major innovation. Revolutions in business generally come from new entrants. Many of today's market leaders – Microsoft and Google, Vodafone and Easyjet – are companies that did not exist a generation ago. These companies could not have succeeded if governments had been committed to the continued leadership of IBM and AOL, AT & T and British Airways.

In UK banking, by contrast, all the leading banks today are the result of mergers between the banks which were the leading UK banks a century ago. The expansion of UK banking operations by the Spanish bank Santander through the acquisition of former building societies in the current crisis may be the most significant new entry into UK banking since the nineteenth century. Only the oil industry (which was insignificant in 1900) has shown stability of industrial structure remotely comparable to UK retail banking.

The assertion that in future the activities of large financial services businesses will be supervised so that the businesses involved will not fail represents a refusal to address the issue posed by the emergence of managerially and financially weak conglomerates based on retail banks. Even if the assertion that supervision will prevent failure were credible – and it is not – the

outcome would not deal with either the political problem or the economic problem that 'too big to fail' raises. An organisation 'too big to fail' can show little regard for its investors, its customers, or for elected officials – and the rows over bonuses are a clear, if trivial, illustration of the issue. On the other hand, supervision that succeeded in ruling out even the possibility of organisational failure would kill all enterprise.

There should be a clear distinction in public policy between the requirement for the continued provision of essential activities and the continued existence of particular corporate entities engaged in their provision. In today's complex environment, there are many services we cannot do without. The electricity grid and the water supply, the transport system and the telecommunications network are all essential: even a temporary disruption causes immense economic dislocation and damage. These activities are every bit as necessary to our personal and business lives as the banking sector, and at least as interconnected.

But the need to maintain the water supply does not, and must not, establish a need to keep the water company in business. Enron failed, but the water and electricity that its subsidiaries provided continued to flow: Railtrack failed, and the trains kept running. The same continuity of operations in the face of commercial failure must be assured for payments and retail banking.

Financial services companies must be structured so that in the event of an overall failure of the organisation the utility can be readily separated from the casino. That means the establishment of distinct narrow banks. These might operate as stand alone entities or as separately capitalised subsidiaries of financial holding companies. The claim that innovation in modern financial markets makes it essential to have large conglomerate banks is precisely the opposite of the truth – these innovations make it possible not to have large conglomerate banks. The activities of managing maturity mismatch, and spreading and pooling risks, which once needed to be conducted within financial institutions, now can, and should, be conducted through markets.

But surely finance is not like electricity? The notion that the financial system is a utility brings an immediate frown to the faces of financiers, who no doubt reflect on the comparatively modest (though now less modest) profits of utilities and salaries of their executives. But the financial system is a utility. The more closely you look at it, the more extensive the parallels between finance and electricity.

The essential feature of both finance and electricity is a system which links, in real time, the initially mismatched demands of suppliers and customers. In both industries, there is a choice between two broad structures, hierarchy or markets. Coordination can be achieved by a single integrated organisation – which in

practice must be publicly owned or behave as if it were a public agency rather than a private business. Or coordination can be accomplished through a competitive market place, with a core monopoly utility – the grid, the payment system –tightly regulated on price, service quality, and access.

In both electricity and finance, there has been a shift from hierarchy to market, from public monopoly to private ownership and competitive markets. Until the 1970s in Britain, and to a later date in France and Germany, cartelised retail banking operated as a privately owned public utility. In electricity, the adoption of a more competitive market structure was a deliberate, planned choice: in banking it happened more accidentally, with unintended and now disastrous results. (In an interesting anticipation of events in financial markets, Enron developed an investment banking model in electricity markets, caused large scale disruption to electricity supplies on the west coast of America, and then went spectacularly bust). It is salutary that the activities of Enron caused instability in electricity markets but its demise did not.

Electricity is not less complex than finance, and the range of skills required to deliver electricity is wide-ranging. The technical knowledge required to judge safety in a nuclear plant is very different from the expertise required to maintain stability in a high voltage transmission network. Few people have both, and it is not

likely that those who do also have the managerial skills needed to run large organisations.

The same diversity of required skill is true of banking. Much has recently been made of the need for 'banking expertise', but banking expertise is no more specific than 'electricity expertise'. Modern banks – especially financial conglomerates – need a very wide range of technical knowledge and organisational capabilities, and must look to different people for different skills. They also need more effective outside challenge to their conventional thinking that they have received. In the present crisis, and even more in the years that preceded it, the financial services industry suffered far more from lack of management skills than it did from lack of expertise in financial services.

The market mechanism for securing competent management is the prospect of failure. A special resolution regime must enable the activities of the narrow bank to be continued under public supervision or administration – supervision is obviously appropriate at this point – while the remaining activities of the company are liquidated. In some cases, the operation of the utility activity may require injection of public funds. In no circumstances should there be public support, or government underwriting, of non-utility activities. The normal principle should be that financial institutions that cannot function without government support or subsidy, including so called 'lender of last resort' facilities,¹¹ should be put

into resolution. If they are unable to rectify their problems without public assistance the corporate entities concerned should be wound up and their senior management removed.

Narrow banking

Narrow banking is often described as 'a new Glass-Steagall'. The Glass-Steagall Act, passed in the US in 1933, required the separation of investment and commercial banking. Its most famous consequence was the division of the House of Morgan into a commercial bank, J P Morgan, and an investment bank, Morgan Stanley. The sentiment behind the expression 'a new Glass-Steagall' – the separation of utility from casino banking – remains entirely appropriate, but that specific measure would not now achieve the desired purpose.

The Glass-Steagall Act had been outdated by the increased scope and complexity of financial markets well before its final repeal in 1999. Although few of the activities which have led to the failures of predominantly retail banks in 2007-8 would fall within the scope of retail banking as traditionally conceived, many of them could properly be classified as commercial rather than investment banking. It is in proprietary trading that conglomerate banks have made catastrophic losses, but these activities differ only in scale and motivation, not inherent nature, from the treasury operations which a commercial bank might properly undertake in its normal day to day business.

The description below is an illustration of how narrow banking might be defined, intended to give sufficient detail to permit

discussion of the specifics of how the proposal might be implemented effectively and its advantages and disadvantages.

Narrow banking implies the creation of banking institutions focussed on the traditional functions that the financial system offers to the non-financial economy

- payments systems (national and international), for institutions of all sizes
- deposit taking, from individuals and small and medium-sized enterprises.

Only narrow banks specialising in these activities could describe themselves as banks. Only narrow banks could take deposits from the general public (deposits of less than a minimum amount, say £50,000). Only narrow banks could access the principal payments systems (CHAPS or BACS), or qualify for deposit protection.

Narrow banks might (but need not) engage in consumer lending, lend on mortgage, and lend to businesses, but would not enjoy a monopoly of these functions. Narrow banks could be subsidiaries of other companies (including financial holding companies) and initially generally would be. Thus Barclays Bank might be the narrow banking subsidiary of the Barclays Financial Group. Over time, it is likely that while some narrow banks would be members of a group of financial companies, some would be

members of other groups, especially retailing groups. Others still would be stand alone institutions.

In a free market, narrow banking would have emerged spontaneously and immediately. As a result of recent history, depositors would strongly favour conservative, transparent institutions which eschewed complex financial instruments and demonstrated comprehensible balance sheets and organisational structures. The reason this outcome has not emerged is that government intervention has distorted the market. All savers enjoy equal deposit protection, however risky the activities of the institution with which they save. Those who save with large financial conglomerates enjoy the further reassurance that comes from frequent reiteration of the slogan that these businesses are 'too big too fail'. The outcome of market forces has been suppressed, and the natural outcome of market forces – narrow banking - should be imposed by regulation.

Narrow banks would be regulated, not supervised. The regulator would monitor compliance with the rules governing narrow banks, but would not review the business strategies of banks or take a view on whether they are well run businesses. If the regulator doubted the ability of a narrow bank to meet its obligations, the preliminary steps of the resolution procedure would begin. There are several ways in which the activities of narrow banks might be constrained: explicit restriction on the range of

activities of a narrow bank, special rules governing creditor priority in liquidation, and reserve requirements.

In other regulated industries, the best approach to definition of the regulatory regime has been the prescription of a licence. Legislation would define the obligations of the regulator. The primary obligations would be the protection of depositors and regulation of the prices and terms of access to payments systems. The obligations of licensees – the narrow bank and the managers of payment systems managers – would be defined in their licences.

The licence might define the regulated activities of the narrow bank – deposit taking and access to the payment system. There would be a class of activities which would be prohibited – particularly acting as issuer of securities and securities trading for purposes other than the facilitation of narrow banking objectives. The debate between principles and rules, which has been extensively discussed in financial services, is the product of a regime based on supervision, not licensing, and would disappear.

Some licence obligations would be of a general nature – protection of the interests of depositors – and others would be specific – the terms of access to the payment system. The licence would be capable of amendment, but not easily –utility legislation provides for amendment by agreement or, failing that, reference to the Competition Commission.

The constitution of the regulatory authority, and its composition, would look more like that of OFWAT than the existing FSA. Not only would the board and staff be drawn from a wider range of backgrounds, but the specific expertise that would be valued in board members would be regulatory rather than financial services expertise. The same would be true, though to a lesser degree, of the senior executives of the agency. A substantial category of activities would neither be explicitly permitted nor prohibited. But if these activities grew to be the principal part of its business the company would cease to be eligible for a narrow banking licence.

An objective is to prohibit narrow banks from engaging in proprietary trading. But I have already noted that trading is hard to define, because distinguishable only by its scale from the necessary treasury functions of any bank. This does not mean that legal restriction is wholly ineffective. If the scope of a narrow bank's wholesale market activity became inappropriately large, a warning to the board of the licensed institution concerned would normally have the desired effect.

If these restrictions on the activities of retail banks had been in place before 2007, they would have limited the trading losses incurred by retail banks. These losses might still have been large, and there might in addition have been substantial losses from bad lending. While this form of narrow banking would provide greater

protection for depositors (and the taxpayer who stands behind the depositors) than currently exists, that protection would still be inadequate to protect the taxpayer interest. Such restriction would not provide sufficient protection for depositors, or have prevented the failure of Northern Rock.

An additional measure would give retail depositors (and, in their shoes, the deposit protection scheme) priority over general creditors in a liquidation. That requirement has many attractions. It almost certainly would have prevented the Northern Rock failure: if the retail deposit base had enjoyed priority, and since the pool of securitised mortgages was not available to creditors, the assets to which Northern Rock's unsecured creditors would have had recourse would have been very limited. In these circumstances, it is unlikely that wholesale markets would have extended credit to support that company's rapid expansion (provided, of course, those markets did not gain reassurance from the belief that Northern Rock was 'too big to fail').

In this way, the measure uses market forces rather than supervisory judgment to enforce appropriate business discipline. Northern Rock would have been obliged to maintain substantial liquid assets to support its retail deposits, but a diversified, well capitalised bank like HSBC would have been able to operate much as before.

Effective market discipline is contingent on a clear understanding that governments will not subsidise failed banks. The events of the last two years represent a huge step backward. It is likely that the damage which has been done to market discipline on risk-taking by indiscriminate government support will in the long run, and perhaps quite soon, outweigh any benefit derived from increased supervision. It is essential that government move as quickly as possible to define and limit the scope of intervention, and put in place structural measures that make these limits credible.

It is inevitable that politicians will be under pressure to give subsidies to failing businesses. Even if the failed business itself enjoys little political sympathy or support, there will be pressure from other companies to prevent a bankruptcy that would entail widespread financial and employment losses. A government that does not want to save AIG may nevertheless want to save Goldman Sachs from the consequences of AIG's failure. In financial services, however, the employment issues are generally less significant than in – say – manufacturing or retailing, since the retail activities of the bank will normally continue under different ownership and management.

It is difficult to overstate the economic damage imposed by the 'too big to fail' doctrine. The direct cost to taxpayers is evident enough (although the bills have mostly yet to be paid). 'Too big to

fail' gives an artificial advantage to large firms and to conglomerates, with predictable effects on prices and service quality. By favouring established firms, it chills innovation in products and business processes. It encourages risk taking, and encourages the employment of risk takers in large retail institutions. Within them, it encourages the senior management to focus on trading activities at the expense of customer service. Many of these effects are already evident. The objective should be that in future government support of failed and failing banks should be at least as rare, and at least as stringent, as government support of failed and failing non-financial businesses.

The most effective way to ensure that public subsidy to failed financial institutions is not required is to insist that retail deposits qualifying for deposit protection should be 100% supported by genuinely safe liquid assets. Ideally, this means government securities, since nothing else has assured safety and liquidity. The model presented here does not require this restrictive view of asset quality. But this restriction is both feasible and desirable.

The inclusion of other assets would require a regulatory assessment of asset quality. Undoubtedly there are good quality corporate credits, and even good quality synthetic securities but granting regulatory significance to ratings by private agencies proved a disastrous mistake, stimulating extensive regulatory arbitrage. These ratings should no longer play any role in financial

services regulation. The effect would be to ensure that agencies have to demonstrate the value of their services to investors in the marketplace. The agencies themselves should not be regulated.

Insistence on adequate security for government guarantees is a logical response to the use of the government guaranteed deposit base as collateral for speculative activities. The government currently underwrites retail deposits in return for a position as unsecured creditor of the bank. The difference between the market prices of the two kinds of obligation is a measure of the subsidy to banking institutions.

Since the subsidy is larger the worse the quality of the bank's assets, the subsidy represents a severe distortion of competition which increases, perhaps substantially, the overall level of risk in the banking sector. This is the mechanism that allowed Icelandic banks, with poor quality lending books, to compete unfairly with UK domestic institutions at the substantial expense of the UK taxpayer. Narrow banking eliminates this costly and damaging distortion of competition, and does so far better than risk related premia (which whenever implemented has proved wholly inadequate to reflect the actual risks involved). There is a case for private provision of deposit insurance, but at present there is no credible provider.

Narrow banks would be free to engage in retail lending activities. They would have to raise funds for these purposes in wholesale markets, through securitisation and conventional

borrowing. Narrow banks would make their own decisions, guided by the availability and price of funds, as to the equity capital they needed to support their lending. In the short term, it would be likely that much wholesale funding would be provided by government, as it is today. In the long run the quality of the lending books that narrow banks would establish should enable them to obtain funds on the fine terms formerly available to soundly managed and well capitalised financial institutions. As I describe below, money market funds might be a substantial source of such wholesale funding.

In the United States, around \$5 trillion of bank deposits are federally insured, equivalent to around 35% of US GDP. In addition, money market funds have assets of around £3.5 trillion. There are, incredibly, no measures of the scale of insured deposits in the UK but it would seem likely that their current size is a little less than UK national debt of about £700bn. This latter figure is likely to double over the next five years. The volume of government stock required to provide collateral for UK bank deposits is therefore large, but not unmanageably large, relative to the scale of the UK gilts market.

The demand from narrow banks and other sources for government guaranteed debt might exceed the amount of debt the government needs to issue and to meet its funding needs. This is true in current market conditions, and might be true in the long

term despite the likely revival of confidence in the financial sector and the growth in government borrowing. If so, the government should borrow more than it needs and lend the money back to first class lending institutions. This is strongly preferable to the issue of free credit insurance for private sector liabilities, and would enable government support of the financial system to be better targeted than now. Government might still be, as now, a supplier of wholesale funds. But the aim should be to become a price taker in the inter bank market – government would let the market decide the value of its guarantee, and taxpayers would benefit from the premiums (as, since they bear the costs, they should).

Would restriction of the investments of narrow banks significantly reduce the returns paid to UK savers? There is no reason why a sound bank should pay more for retail deposits, net of the cost of attracting and collecting them, than it pays for wholesale money. Historically, LIBOR has exceeded base rate by, on average, only a few basis points. In normal conditions there should be little effect from the restriction of narrow banking assets on the rates paid on deposits.

The best rates on offer to retail savers have typically exceeded both base rate and LIBOR, despite the costs of administering these deposits (although these retail rates are usually only offered for deposits, such as internet deposits, for which the costs of administration are very low). High rates are in some cases

offered by banks which cannot access wholesale funding on competitive terms – as with the Icelandic banks. These banks should not have been permitted in the past, and certainly should not be permitted in future, to solicit UK retail deposits under government guarantee. Their operations would not have been viable under narrow banking. High rates may be promotional rates which will be reduced after an introductory period, or offered by banks which are trying to enter the retail savings market in an aggressive manner. These latter practices could be expected to continue.

Any negative effect on rates for savers of a move to narrow banking would, therefore, be the direct result of government no longer offering deposit insurance free. The cost of the guarantee would be shared between the depositor and the bank, depending on the solidity of the bank and competitive market conditions. In normal circumstances, the price for such deposit insurance would not be large. In current market conditions, however, the value of such a guarantee would be significant. This is the market operating as it should.

Narrow banks might, but need not, engage in lending activities appropriate to retail financial institutions, particularly consumer lending and mortgage finance. They might, but need not, lend to small and medium size enterprises. Funding for these lending activities would have to come entirely from wholesale

markets, and the banks' own capital. There are already specialist institutions which offer credit cards and mortgages based on wholesale funding. An expansion of such finance could take the form of securitisation, or be achieved through more traditional forms of money market funding. Since there would be no regulatory advantages to one form of finance over another, market forces would determine the outcome.

Specialist lending businesses might focus on small and medium sized enterprises, a business until now dominated by the retail banks. The traditional link between deposit taking and lending established by the knowledgeable bank manager based in the local community has largely disappeared, as lending processes have become specialist and based on credit scoring rather than personal acquaintanceship. (Indeed the relationship has been reversed – the bank uses its knowledge of SME customers to target their owners as prospects for the sale of personal financial services).

Specialist SME lending activities might be linked to private equity houses. When private equity was called venture capital – before it was hijacked into the buyout of large established businesses – private equity was becoming a promising source of early stage finance in the UK, comparable to that available in the United States. Government could usefully promote the development of such businesses, perhaps based, for example, on

relevant divisions of the Royal Bank of Scotland or the struggling Irish banks.

It might be expected that in due course much of the finance for both the consumer and SME lending would come from money market funds. Sophisticated savers with larger amounts to deposit should have the option of giving up the government guarantee and obtaining slightly higher rates. This would be best achieved by the development of money market funds of the kind that exist in the US and would reduce the quantum of insured deposits. Pension funds and insurance companies, which are currently substantial holders of gilts, would also be natural providers of funds to specialist lending institutions. Money funds and savings institutions would be expected to develop skills in judging the quality of the credit assessment of lenders. The market would take over the role of supervision.

The US government has been trapped into providing guarantees (supposedly temporary) for US money market funds. There was no realistic political alternative, given that the US financial system was awash with subsidies to much less deserving causes.

But the UK government should avoid similar involvement. State guarantees for money funds reduce incentives for the managers of funds to perform their central role, as monitors of the quality of management and lending books of specialist lending

institutions. These subsidies are also unfair to customers who have accepted lower returns in order to obtain the benefit of explicit guarantees. It may be desirable to avoid the US structure, which seeks to maintain the NAV of funds constant at \$1, because this makes the fund look similar to a deposit, and either confuses customers or creates an expectation of government guarantee. It is important to create very clear blue water between deposits, subject to government guarantee, and funds, which may be subject to market fluctuation.

Banks in the UK should be required, as US banks are, to notify the amount of their insured deposits to government or its designated agency. All statements to depositors should state the existence of the guarantee and the agency through which it is offered. Other funds, of whatever nature, seeking retail money should be required to state that neither the principal sum nor the projected return is guaranteed by the UK government.

The long term objective would be to dismantle all other financial services regulation. Capital requirements would be abandoned, and the licensing of wholesale market activities by public agencies would relate only to the approval of individuals and institutions as fit and proper persons. Issues such as market abuse that did not fall within the scope of the criminal law would be a matter for private activity by self-regulatory institutions.

The international dimension

EU banks (for these purposes the EU includes Iceland and Norway but not Switzerland) operate internationally under a 'passport' regime. Homeland and Otherland are both EU states. If a Homeland bank takes deposits in Otherland, it can do so through a branch in Homeland. In that case it is subject to the regulation of Homeland and depositors from Otherland qualify for deposit protection under the Homeland scheme. Or the bank can establish an Otherland subsidiary, in which case the subsidiary (though not, of course, the home bank) will be regulated by Otherland and depositors must seek repayment from the Otherland government if the Homeland bank fails to do so.

Fortis operated throughout Benelux, but when its position became precarious the Belgian and Dutch governments took control of the operations in their own countries. There was sufficiently little integration of the substantive activities behind the common facades that the separation of the national components appears to have been easily achieved.

One of the two large Icelandic banks – Landsbanki – had a UK branch while the other – Kaupthing - owned a UK subsidiary. The Icelandic regulator lacked both the competence and the will to act and the UK regulator did not restrain Kaupthing. When Landsbanki failed, the resources of the Icelandic deposit protection scheme were insufficient. The UK authorities then understandably but still

inexcusably used anti-terrorist legislation to freeze Landsbanki's UK assets. The Treasury was no doubt mindful of reports that substantial Lehman assets had been repatriated to the US hours before the collapse of that business. The UK also took control of Kaupthing UK, which led to the immediate failure of the parent: there will be a considerable deficiency in the liquidation.

The resulting bills will be shared among Icelandic taxpayers, UK taxpayers, and other UK banks and building societies, and will run into billions of pounds. The UK will have substantial liabilities for both Kaupthing and Landsbanki. These Icelandic banks were minnows among global financial institutions and had significant operations in only a few countries.

The incident should be treated as a wake-up call. There are no adequate measures to deal with a major international banking failure. What would have happened if the struggling Royal Bank of Scotland, whose principal retail operation is the English NatWest bank, had been headquartered in an independent Scotland? It is only necessary to frame the question to want to go to great lengths not to have to answer it.

Home country regulation makes every member of the EU dependent on the skills of the weakest regulator. Host country regulation is inadequate because the host does not have enough control over a large financial institution based elsewhere. Adair Turner, Chairman of the Financial Services Authority, has shrewdly

observed that in banking there needs to be either more Europe or less.¹² The single market would be best served if there were a common European regulatory regime with a single regulator in whom all member states had confidence and a single Europe-wide scheme for deposit protection. But there is no realistic prospect of satisfactory agreement on this in the foreseeable future.

In the meantime, as the Governor of the Bank of England has noted, banks operate globally but die nationally. Major banks have operated in wholesale markets with little regard for national origin or national frontiers, but failing banks exert – and can exert – political pressure for subsidy in the country in which their head office is located. The will to protect depositors exists only in the country in which the depositors reside. Icelandic taxpayers ask why they should be liable for payments to UK depositors of Landsbanki, and they are right to ask that question. This demonstrated and justified unwillingness of taxpayers to subsidise overseas adventures of irresponsible financial institutions registered in their jurisdiction leads to the absurd proposal from the European Commission – which the UK blocked – that member states could be ordered to subsidise weak financial institutions registered in that state.

The implication is that until the conditions for an effective single market can be fulfilled – specifically, genuine willingness to accept a single European regulator and to pool the costs of banking

failures on a Europe-wide basis - cross-border banking must be restricted. The interim objective should be to allow member states to pursue different policies with the least possible damage to competition and to the single market. The current unwillingness to face reality implies the certain prospect of costly future bailouts.

The need to conduct cross border activities through narrow banks is essentially the conclusion which the Turner Review reaches from analysis of the Icelandic fiasco, and that conclusion is inescapable. The Turner Review does not pursue the logic of its argument to its next stage – which is that the UK retail operations of all international banks, even those headquartered in London, should be conducted through narrow banks. This omission is perhaps not surprising since the alternative is to acknowledge that the FSA cannot guarantee to prevent the failure of London based international banks. But, of course, there can be no such assurance without UK government subsidy.

The best route ahead, therefore, would be not only to allow, but to strongly encourage, overseas banks (such as Santander) to establish retail banking operations in the UK. Such competition would also be welcomed from continental European retailers or insurers. But this welcome is on the basis that as deposit takers they will operate as narrow banks and be subject to the same regulation as UK narrow banks.

The corollary is that the UK government should make clear that it does not allow companies which are not narrow banks, of whatever nature and wherever registered, to solicit deposits from retail customers in the UK (though such companies may, of course, manage money funds). If other countries choose to allow UK financial institutions which are not UK banks to seek deposits within their own territory, the UK government will not guarantee their soundness – as it cannot - or accept liability for their obligations – as it should not.

Other EU member states should be encouraged to take a similar view. If they choose instead to take refuge in pieties about the value of international coordination of supervision then the UK should take the necessary steps to protect UK depositors and UK taxpayers from the consequences of procedures that have demonstrably failed in the past and will continue to fail in future. The politicians who have declined to address these questions, or to engage in serious discussion of them, will bear a heavy burden of responsibility in the next crisis.

It is very desirable that better regulation of financial services should be pursued on a cooperative international basis. However to act only on the basis of international agreement is to act at the pace set by the country with the most powerful financial services industry lobby (a tough competition, in which the UK is no laggard). If the

UK (or any other country) is to become serious about regulatory reform, it must be prepared to act unilaterally.

There is a major difference here between wholesale financial markets, which are global, and retail financial markets, which remain national. Even when retail financial institutions operate in Otherland, their operations in that country are much more like those of institutions in Otherland than their own activities in Homeland. Thus there are few practical difficulties about unilateral action in the regulation of retail banking, though there are some legal difficulties, since EU directives and other international agreements suppose (and, to be fair, hope to encourage) a breakdown of national market segmentation that does not currently exist.

Regulation on the basis of narrow banking would work well if all countries adopted it, and it would also work well for the UK if the UK adopted it even if other countries did not. But would the unilateral adoption of narrow banking by the UK put the UK at a competitive disadvantage in financial services?

Arguments of this kind must be taken seriously, given the international success of the UK in financial services. But these arguments should not be accepted uncritically: we should no longer make the assumption which has driven UK government policy for the last decade, and appears to continue to drive policy, that what

is good for established businesses located in the City of London is good for the UK.

Whether or not banking in the UK is reorganised on narrow banking lines, UK financial institutions engaged in retail banking in other EU member states must be required to do so through subsidiaries rather than branches (they mostly do so in any event). The consequence is that these overseas activities of UK banks would be supervised by the states in which deposits are collected. Liability for any failure would fall on the deposit protection schemes of these other countries. There is no reason why UK taxpayers should be liable for losses incurred by UK registered companies in other jurisdictions, and it is likely that this is how UK taxpayers would perceive matters if such claims were made.

A more difficult issue is posed by the position of UK based banks in wholesale markets. UK based banks would be at a competitive disadvantage if they were not allowed to use their taxpayer-guaranteed deposit base as collateral for their wholesale market activities while their competitors could. There is truth in this argument, and although the best answer would be that all countries should refrain from providing such subsidies, all countries will not.

Such competitive subsidies are a clear breach of prohibitions on state aids within the EU. The problem is again one of ambiguity, created and aggravated by the political power of the financial

institutions, and the panic that has crippled policy makers. In 2005 the European Court ruled that explicit state guarantees of the activities of German Landesbanken were a violation of the EU treaties. Such guarantees are now being phased out.

At the time, however, other major European banks preferred to deny that their liabilities were underwritten by their governments (although the events of 2007-8 showed that in fact they were). The Landesbanken have not been adequately regulated or supervised and, like other financial institutions, repeatedly lose large amounts of money in activities extraneous to their core business.

The weaknesses of the Landesbanken, which are sometimes used as an argument against narrow banking, are in fact a cogent argument in its favour: when the Landesbanken operate as narrow banks, they do a good job. But the existence of these institutions in their present form is bound up with broader questions of the relationship between the German Federal government and the Länder, and the resulting skirmishes are one of the many obstacles to the formulation of rational banking policy at the European level.

Most wholesale market activities in the City of London today are conducted by firms whose principal retail operations lie outside the UK. Thus the issue of cross subsidising wholesale activities through government subsidy of retail deposit taking relates mainly to a single UK company – Barclays – through the global investment banking operations of Barclays Capital. (HSBC, which also has large

and successful investment banking operations, would be little affected by a requirement to operate its UK retail operations through a narrow bank because its UK retail operations are much smaller in relation to the overall size and resources of the bank). The enforcement of narrow banking would require that Barclays Capital sink, or swim, as a standalone entity without recourse to the resources of Barclays retail arm. From the perspective of UK depositors and taxpayers, this must be the right solution.

Financial sector reform is largely a matter for two countries – Britain and the United States. The dominance of these two jurisdictions in global financial markets is such that even if other countries are not obliged to follow the lead they set, other countries are obliged to operate within the framework Britain and the United States define.

This outcome is, understandably, widely resented. International discussions of regulatory issues and of structural reform have in reality little to do with the declared objectives, or the establishment of a more stable financial system better adapted to the needs of customers. The debate represents the use of international political institutions to achieve national advantage: and for these purposes national advantage means the advantage of producer groups based in, or influential in, the countries concerned. This self-interested bickering is an inevitable consequence of the degree of capture of regulatory institutions and politicians by

industry interests. Until this stranglehold is broken, well-meaning efforts to secure more international cooperation in the regulation of financial services are likely to do more harm than good.

Payment systems

Payment systems are the essential utility that the financial services industry provides to households and non-financial businesses. In the United States in March 1933, this utility failed. It has not done so anywhere during the 2007-9 crisis.

There are four principal payment schemes in the UK¹³

- **The real time gross settlement system** (RTGS). Only a system which operates in real time can give immediate finality to a transaction (i.e. ensure that the recipient has the money regardless of the status of the bank or the payer). All high value transactions are made in this way. CHAPS (clearing house automated payment system) is operated through the Bank of England and jointly owned by the participating banks and the Bank of England. It has been estimated that CHAPS m accounts in Britain for 90% of transactions by value but only 0.2% of transactions by volume.
- **The batch payment system**, by which payments between banks are aggregated in a clearing house. Net settlements between banks are made at intervals using the real time system. These mechanisms include the functions of the old paper-based settlement systems (BACS – bankers automated clearing system) and the Link (ATM) system for obtaining everyday cash. The clearing house is owned by the major banks.

- **the card system**, which principally functions through two networks, VISA and Mastercard. Both networks were originally established and owned by banks, but developed a strong identity of their own and have been floated as independent companies. VISA Europe, however, is still owned by member banks. In reality, the card system is mainly administered by a small number of technology-based processors such as First Data although the issue of cards and making of payments is channelled through banks
- **the cash system**, owned and operated (under statutory monopoly) by the Bank of England through banks as agents.

In addition, small independent payment systems have developed to meet specific needs which are not met, or met only at disproportionate cost, by the principal payment systems. Paypal (owned by eBay) allows individuals to make low value transactions with an element of real time finality; Western Union and other providers provide dedicated channels for modest international transactions such as migrant remittances. Mobile phone based payment systems are now a significant element in the financial systems of poor countries such as Kenya where the mobile phone network is almost the only effectively functioning infrastructure.¹⁴ They can be used for small transactions in the UK. Stored value cards (such as an Oyster card) can be substituted for cash payments.

Payment systems are numerous, and proliferating, principally because the core systems have been slow to innovate and respond to changing needs. The Faster Payments System, designed to allow payments of routine bills, wages and salaries to be made on a time scale of less than three days, came into operation only in 2008 and is still seriously limited in its scope. Card based systems have developed in parallel to, rather than as an integral part of, the principal payment systems. Many innovations are coming from businesses outside financial services, such as eBay and PayPal, from transport undertakings and their suppliers, and from phone companies.

The future could be different. There are two basic payments needs. One – the traditional role of cash – is for a portable mechanism of payment. Value is guaranteed; transactions can be undertaken anywhere, and can be anonymous. The other requirement, for higher value payments – the traditional role of the current account – requires access to the purchaser's deposit or line of credit with a financial institution.

Both needs can now be efficiently met by modern information technology. The first requirement needs an electronic wallet and the wide replacement of cash by prepaid storage cards. The second needs an online connection to a centre linked to financial institutions, providing low cost, real time, final electronic transfer of funds between individuals and businesses. If both systems were

fully developed all payments could be made by waving a card or clicking a mouse. A world of simple, secure and cheap money transfer in which cash was mostly confined to illicit transactions would look very different. The social implications and savings to business could be substantial.

It is probably in the retail sector, rather than in wholesale markets, that opportunities for financial innovation with substantial economic and social impact are to be found today. But issues in retail banking receive little attention relative to those which arise in wholesale markets: certainly there are a hundred articles on the valuation of derivatives to every one on the benefits of real time gross settlement. And when bankers talk about innovation in financial markets, they are almost always talking about new products in wholesale markets (sometimes about new sales techniques in retailing) and almost never about improvement in the provision of core financial services. This emphasis is another reflection of the Cinderella status of retail banking.

Different countries have reached different stages of evolution in payment systems. Cheques are no longer used in Japan or the Netherlands: stored value cards are popular in Belgium. Britain and the United States, the principal innovators in wholesale financial markets, are laggards in the development of payment systems, and this is probably not a coincidence.

Established banks do not have, or do not see themselves as having, much to gain from change, and many have struggled with the implementation of new technology platforms. Restricted access to the existing payment systems makes new entry in retail financial services more difficult. Charging structures for transactions frequently lack transparency and rarely bear any relationship to underlying costs.

In Europe, banks were slow to respond to the creation of the Eurozone. They underestimated the political imperative of making the single currency a reality in the daily lives of ordinary Europeans. Such a transition required a shift from clumsily linked national payment systems to a single European regime. The foot-dragging prompted the European Commission and Parliament to take control of the issue, with positive results, culminating in the creation of the Single Euro Payment Area in 2008.

In his report on UK banking in 2000, Don Cruickshank correctly identified the organisation of the payment system as a major obstacle to the development of a competitive retail market. He recommended that a payments regulator be established with power to set price caps and determine access provisions, on the lines of the utility regulators which exist for other infrastructure industries. This proposal was initially accepted by the government. It was, however, successively watered down in the face of industry lobbying, culminating in the establishment in 2007 not of a

regulator but of a Payments Council, a membership organisation controlled by the industry (though with some independent representatives).

It is time not only to revive Cruickshank's recommendation, but also to go further than he proposed. Narrow banks should in future be the only conduit to the payments system. Under narrow banking extensive reserve requirements are imposed on narrow banks. The principal reason for distinguishing real time gross settlement from delayed net settlement – the different amounts of collateral required to support transactions – consequently disappears. At the same time, a regulator might review the interchange fees imposed on merchants for credit card transactions – which have the effect of setting a floor to merchant acquisition charges.

It would be for the market, not the regulator, to decide the future shape of the payments system. But the regulator can, and should, give full rein to market forces. In other industries, such as electricity, the separation of the network from its suppliers has had a positive effect on competition, efficiency, and innovation. The UK has experienced a modest pace of innovation. New entrants to retail financial services have been obliged to partner well established firms to establish a market position. New developments in payments have taken place outside the established framework.

There is considerable scope for enhancing competition, efficiency and innovation in this sector.

The utility model, which divorces control of the underlying infrastructure from product providers, is a useful parallel. The objective might be Britpay plc, regulated by Paycom. Britpay might be owned, or perhaps franchised to, a consortium of technology companies rather than a consortium of banks, or perhaps be floated as an independent business. Breaking up the banks opens up a new range of options. There is plenty room for excitement in narrow banking.

The future shape of the financial services industry

Consumers are poorly informed about financial services products, easily misled, and have frequently been offered inappropriate services or ones that represent poor value. Many of them do not like dealing with financial matters. This information asymmetry provides a substantial justification for the regulation of financial services.

It is often suggested that the answer to information asymmetry is more information, and regulators have required providers to offer much more extensive descriptions of products and practices. But information asymmetry is found in many markets for complex goods and services, and persists because consumers have neither time nor inclination to seek or absorb more information. Many people who deplore public ignorance in financial services matters would hesitate to open the bonnet of their car, or to distinguish their larynx from their thorax. The consumer is confident in purchasing products such as automobiles or medical services, about which he or she knows little, as a result of the efforts producers invest in developing good reputations with their customers, and because users are able to access the skills of trusted intermediaries.

Producer reputation and reliable intermediation are the mechanisms through which markets handle information asymmetry. If there is a problem in financial services – and there is – it is

because producers have had little regard to their long run reputation and because intermediaries have not deserved the trust of consumers. There is wide discussion in the financial services industry of the need to restore trust. Such discussion rarely focuses, however, on changes in the structure or behaviour of the industry. The issue is perceived as one of public relations. But the problem is one of substance, not appearance.

It is not appropriate, or realistically possible, for public agencies to prescribe in detail the conditions and methods by which financial services products are sold. Regulation is necessary, supervision is undesirable, and so regulation should work with market forces rather than to supplant them. The principal successes of the financial services regime since 1987 have used this approach. The 'naming and shaming' of major providers for misselling pensions and endowment mortgages has encouraged the firms concerned to protect their reputations by reforms of their internal processes.

Regulators have also enjoyed success in improving the performance of intermediaries. But the process is slow. By 2012 – twenty-five years after the present structure was instituted – the FSA may have succeeded in ending the custom by which bribes from providers were the principal means of remunerating intermediaries. The fundamental problem, however, is that individual financial advice of even moderate quality is prohibitively

expensive for a mass market. The general public can be best served, in financial services as in most other product areas, by the presence of effective retailers.

I recently spent time with a large, professional, dairy farmer. His farm was subject to a variety of inspections by government officials. Not supervisors – none were concerned with whether his business was well run (it is). The purpose of their visits was to address specific public interest concerns – to ensure compliance with legislation on health and safety, to test his animals for tuberculosis. But the inspections that concerned the farmer most were those made by the cooperative to which he sold his milk and most of all inspections by Marks and Spencer and Waitrose, who were the ultimate buyers.

This is the regulatory role which good retailers play in modern business. They succeed by being sensitive and responsive to the needs of their customers on the one hand, and demanding in the price and quality they expect from their suppliers on the other. Their existence does not eliminate the need for statutory regulation, but it reduces it. In areas such as product safety the vigilance of retailers acts as a powerful supporting control mechanism. To the extent that the farmer's business is supervised, it is supervised by retailers. The efficiency with which such supervision is performed is a key competitive advantage of a good retailer.

Retailing of financial services has been very different. Historically, banks were horrified by the notion that they were retailers at all. As with many other cartelised or monopolised industries – think of the nationalised telephone network – banks treated their customers as applicants for their services.

More recently, however, the culture has become sales driven, but undesirably so. Retail activity is an outlet for product. 'Life insurance is sold, not bought' was a slogan of the insurance business, as ignorant salesman on commissions bludgeoned customers into buying inappropriate products. This long and disgraceful tradition infected the conglomerate banks when they sought, in the 1980s, to become 'bancassurers'. Banks emphasise the importance of cross-selling of products: but such discussion almost always describes the advantages to the bank, not the advantages to the customer. Products offered through cross-selling are rarely competitively priced.

Both the dot.com bubble and the sub prime mortgage crisis were the result of giving sales forces substantial incentives to peddle products that were unsuitable for customers but enabled the providers to report substantial, if often illusory, profits. Banks have too often been guilty of petty abuse of customers, as in the levying of penal charges for minor overdraft or credit card lapses and the pushing of overpriced payment protection insurance.

It is hard to resist the conclusion that the selection of retail products offered is driven more by the margins earned than by the needs of customers. The two principal 'funds supermarkets' – which negotiate discounts on fund charges and pass most of them on to customers – are Cofunds and Funds Network, developed not by retailers but by fund providers themselves. Exchange traded funds – which allow retail customers to build diversified portfolios at very low cost – are one of the most useful modern innovations for the small investor. But although Barclays was the global leader in the development of these instruments, a customer could successfully access them through a Barclays retail outlet only with some difficulty and only if he or she were already well informed.

All retailers survive, of course, from profits on the products they sell. But a strategy of focussing on high price goods because they offer larger retail margins is the opposite of the business model pursued by successful retailers such as WalMart and Tesco. These firms have instead pursued volume growth through competitive pricing, building a sustainable long term relationship with their customers through a justified reputation for value for money. A more competitive market, facilitating new entry, would not only allow but encourage businesses to adopt a similar approach to financial services. It is likely that WalMart and Tesco would be among them.

Regulators have had some success in curbing excesses – the most egregious practices of life insurance salesmen have been ended, for example. But viewing the performance of the industry as a whole it is hard to conclude that customers are better treated than they were twenty years ago. As one historic problem is eliminated – the misselling of personal pensions – a new one emerges – encouraging households to take on unaffordable debt. The product driven culture is a predictable consequence of vertical integration in the financial services industry.

Indeed the problem goes deeper than vertical integration. It is not in the interests of lending institutions for their customers to take out loans these customers cannot repay. The driving force in the sub prime crisis was the profitability of securitised products for the individuals who sold them, at both wholesale and retail levels. These instruments were created in investment banks, and the investment banking operations of conglomerate banks: organisations more appropriately regarded as collections of greedy individuals than as corporate organisations with an interest in sustaining the reputation and value of the business. Their transactions oriented culture corrupted the retail sector, whose long run viability depends – as does most retailing – on the development of trust relationships with customers.

It is hard to think of a worse response to this problem than the award of large subsidies to the failed conglomerate institutions

responsible, combined with a pretence that similar problems will in future be prevented by a system of supervision dominated by financial services interests. The future health of the financial services industry depends on the creation, or perhaps re-creation, of a customer-focussed retail sector. The assessment of the value of new products is best carried out, as in most of the economy, not by manufacturers or regulators but by competent retailers in close touch with the needs of their customers.

Some of these retailers from other sectors will themselves have a major role to play in the future of the financial services industry – or at least will do so if market forces, rather than political lobbying, is allowed to determine the future shape of financial services. Firms such as Marks and Spencer, Tesco and Sainsbury have made forays into the provision of financial services, but so far they have mostly been content to shelter under the umbrella of the ample margins available on established products. They have not yet been aggressive in either pricing or product development. Supervisory restrictions closely related to established business methods are, and are bound to remain, an obstacle to innovation. These retailers, and businesses like them, are likely purchasers or founders of narrow banks. Other utility retailers, notably mobile phone companies, might also see an opportunity.

In the short run, it is likely that narrow banks would mostly be subsidiaries of financial holding companies. But if retail banking

activities were effectively ring-fenced from investment banking, it is probable that traders and investment bankers would lose interest and the subsidiaries would be sold or floated. Their interest in the retail sector is in the money, not the business. Other financial services companies, such as insurers who choose to focus on retail operations, might be potential operators of narrow banks.

The excesses of the last decade raise questions as to whether ownership by a listed company is an appropriate structure for a narrow bank. In financial services the short-term profit orientation of such companies in financial services has hurt the reputation of the industry, the wider economy, and ultimately the businesses themselves. There is an issue here, but the success of retailers outside financial services in developing the confidence of customers provides some reassurance that it is possible for listed companies to take a longer term view.

Still, it is now apparent that the conversion of the mutual building societies to public limited companies did, in the end, inflict considerable damage on the UK financial services sector. All the large societies which converted either failed or were absorbed into large financial conglomerates. This reduced competition and the institutions which were eliminated had achieved significantly higher levels of customer satisfaction than their listed counterparts.

The clock cannot be turned back. But there was no compelling business argument for conversion. The societies were,

in the main, strongly capitalised and well able to grow their business organically or to access capital markets. But as bank share prices rose after the recession of the early 1990s it became evident that substantial windfall gains could be created for customers by sale or flotation. When Lloyds' purchase of the Cheltenham and Gloucester Building Society demonstrated the possible scale of the windfalls, it was effectively impossible to resist pressures to offer them. (It is a strange footnote that Nationwide, the least attractive conversion candidate because it was seen as a poorly managed business, is today the largest specialist mortgage bank).

There is no case for subsidy or artificial protection of mutual or not for profit financial institutions. But there is a strong argument for establishing a legal framework which would prevent the realisation of the assets and goodwill of businesses for the benefit of a single generation of customers. Mutuals would then compete with profit-making companies on the merits of the alternative business models, and would not be destabilised by extraneous factors.

It is sometimes argued that narrow banks would be boring, and would be attractive only to untalented people. 'Retail is detail' is a mantra of shopkeepers. The challenges of financial services retailing are likely to be boring for people whose eyes light up at the

description of a CDO squared, the calculation of the value of an exotic derivative, or the prospect of a large corporate acquisition.

But that is the problem. People such as these, talented though they may be, should not be running retail financial services businesses. The people who should be in charge of these businesses are customer focussed. Not at all untalented, they recognise that retail is detail and derive their satisfaction from identifying the needs of their shoppers and meeting these needs more effectively. Many such individuals are already employed in the financial services sector. It is time to give them their opportunity, free of the distorting and – in the last decade, massively disruptive – influence of the deal makers, traders and investment bankers, who dominate financial conglomerates.

Narrow banking is desirable not just because it provides a sounder basis for regulation of the banking industry, important though that issue is. The implementation of narrow banking would provide a catalyst for the restructuring of the financial services industry - a restructuring which would create a sector focussed on innovation and service directed to the needs of its customers.

Conclusions

The case for narrow banking rests on the coincidence of three arguments. First, the existing structure of financial services regulation (supervision) has failed. Consumers are ill served, the collapse of major financial institutions has created the most serious economic crisis in a generation, and the sector has been stabilised only by the injection of very large amounts of public money and unprecedented guarantees of private sector liabilities.

It is time to learn lessons from the more successful regulation of other industries. Those lessons point clearly to the need to retreat from supervision and to regulate through the mechanism of relatively simple, focussed structural rules.

Second, the most effective means of improving customer services and promoting innovation in retail financial services is market-oriented. It is based on the ability of strong and dynamic retailers to source good value products from manufacturers and wholesalers and to promote consumer oriented innovations. The growth of financial conglomerates, a consequence of earlier measures of deregulation, has not been in the interests of the public or, in the long run, of the institutions themselves.

Third, a specific, but serious, problem arises from the ability of conglomerate financial institutions to use retail deposits which are implicitly or explicitly guaranteed by government as collateral

for their other activities and particularly for proprietary trading. The use of the deposit base in this way encourages irresponsible risk taking, creates major distortions of competition, and imposes unacceptable burdens on taxpayers. Such activity can only be blocked by establishing a firewall between retail deposits and other liabilities of banks.

This is a game for high stakes. The financial services industry is now the most powerful political force in Britain and the US.¹⁵ If anyone doubted that, the last two years have demonstrated it. The industry has extracted subsidies and guarantees of extraordinary magnitude from the taxpayer without substantial conditions or significant reform. But the central problems that give rise to the crisis have not been addressed, far less resolved. It is therefore inevitable that crisis will recur. Not, obviously, in the particular form seen in the New Economy boom and bust or the credit explosion and credit crunch, but in some other, not yet identified, area of the financial services sector.

The public reaction to the present crisis has been one of unfocussed anger. The greatest danger is that in the next crisis populist politicians will give a focus to that anger. In the recent European elections, these parties of dissent gained almost a quarter of the British vote, and made similar inroads in several other European countries. The triumph of the market economy was one of the defining events of our lifetimes. We should be careful not to

throw it away. It is time to turn masters of the universe into servants of the public.

19,918

¹ There are now several good descriptions of the events of 2007-8. I have found the Turner Review, Milne (2009), and the collection of articles in *Critical Studies*, edited by Jeffery Friedman (2009) particularly useful.

² HM Treasury (2009).

³ Compare Greenspan (2002) and Greenspan (2008).

⁴ See, for example, the observations in 2006 by John Tiner, chief executive of the FSA, and Sir John Gieve, Deputy Governor for Financial Stability.

⁵ As in Frydman and Goldberg (2008)

⁶ Conservative Party (2009).

⁷ See Bishop and Kay (1992) for a comparative survey of regulatory experiences across other industries (including financial services), Barth *et al* (2006) is a discouraging survey of international experience of financial services regulation.

⁸ Kahn (1988, second revised edn.).

⁹ Bryan (1988). Litan (1988) expounded similar arguments.

¹⁰ Interview in *Financial Times*, 9 July 2007.

¹¹ The traditional lender of last resort function, as described by Bagehot in 1873 after the collapse of Overend Gurney, has been made redundant by deposit protection and disintermediation. The term is now used in a general way to describe central bank support of failing financial institutions.

¹² In his presentation of the Turner Review.

¹³ A comprehensive description of the UK payment system is in Rambure and Nacamuli (2008)

¹⁴ See www.safaricom.co.ke

¹⁵ A powerful exposition is provided by Johnson (2009).