Rewriting the contract

The headlines surrounding Don Cruickshank's report into the state of the UK banking industry have tended to concentrate on his accusation that the industry is making "supernormal profits" of £3-5bn a year. At the root of this estimate are dense and complex calculations about profitability over the business cycle and the cost of capital, calculations which the banks will do their utmost to refute. But while the maths of return on capital are abstruse, other parts of Cruickshank's case are straightforward. Why, given the recent excellent profits made by UK banks do completely new players not enter the market? The unwritten rules, Cruickshank argues, (see interview p.24) make partnership with an existing bank a condition of market entry.

The most interesting section of the report describes how this state of affairs comes about and is maintained. Cruickshank's argument will sound familiar in many countries: You begin with the absolutely justified public policy objective of systemic stability. Bank lending, based as it is on a mismatch of short term liabilities backed by long term assets, is intrinsically vulnerable. On top of this, large banks run a panoply of other risks (market, credit and operational) which can threaten their solvency. Individually this is bad enough, but banks' exposures to each other through the payment system raise the possibility of a single failure triggering a contagious collapse. In response governments and central banks offer an implicit guarantee to prevent "systemically important" banks from going bust. To reduce depositors' incentive to suddenly withdraw their cash the government insures their deposits. To ensure a strong, meaning well-capitalised and profitable, banking system governments turn a blind eye to the development of a cartel. In order to make sure that these guarantees are not abused governments appoint regulators to make banks behave "prudently". By increments, Cruickshank argues, the systemic stability rationale is extended to afford the banks a level of protection from competition which "they have a fiduciary duty to their shareholders to exploit".

The regulatory contract

At the core of all this is the "regulatory contract" of which Cruikshank is so critical: banks deliver a public good, in terms of the stable provision of money and credit to the economy, in return they are allowed to insulate themselves from competition and, to a certain extent, write their own rules in a way which would be inconceivable for another industry.

Cruikshank's conclusions are damning. On many issues valid criticisms can be made. Notably, in terms of international comparison, the report finds that UK banks provide quite a good service. Nevertheless, in his analysis of the way the "regulatory contract" has operated he is probably broadly right.

In the UK and around the world banking

has often been dominated by a "club" of banks. For banking regulators this can have advantages. Club members are easier to arm-twist and cajole into line. In the UK the Bank of England, with few formal supervisory powers, steered such a system more or less safely for decades.

No longer true

However in recent years the traditional rationale for this protection has come into question. For a start, as Cruickshank points out, many of the concerns on which the classical model of banking supervision rests no longer hold up. There is ample academic evidence that the fear of classical bank runs has always been overstated.

A recent FSA paper by Professor David Llewellyn found scant empirical evidence that solvent banks have been caused to fail by bank runs. Recent spectacular bank failures have owed more to simple dishonesty and fraud. Most importantly, technological developments have reduced the possibility of systemic risk being propagated through the payment system. Real-time gross settlement systems reduce large outstanding inter-bank balances and hence reduce risk. All these are good reasons to roll-back some of the protection which banks have enjoyed.

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The experiences of the Japanese banking system is enough to quash the argument that a protected, and therefore profitable, banking system will be in better shape to compete globally.

In February 1998, Cruickshank argued that one way to effect change was for the Financial Services Authority to have a primary objective to encourage competition. This did not happen, and it is not clear that giving the FSA another primary objective would be a good thing. The FSA's current objectives, requiring it to both protect consumers and maintain confidence in the system, already conflict.

The current situation is that responsibility for ensuring competition will involve a combination of the FSA, the Office of Fair Trading, the Competition Commission and the Treasury. It is not at all clear that they will be able to deliver the kind of regime shift which Cruickshank wants. One of his main recommendations, that banks' services to small businesses should be referred to the Competition Commission, means another long investigation. If the Treasury lacks the strength, after the horrors of the Financial Services and Markets bill (FSMB), to push this all through during the run-up to the next election, it will not be a huge surprise. Probably Cruickshank's best idea in this regard is for the Treasury to review, after two years the effects of the FSMB on competition in the industry.

Some readers may be wondering why so much of this edition is devoted to an issue of apparent concern to only a few banks in the City. Mr Cruickshank, rightly conscious of his remit, restricts his analysis to the UK banking market. But, there is ample reason to think that internationally the largest banking groups play the trump card of "systemic stability" to similar effect. The difference is, that while the UK has the power to order this kind of investigation and require draconian remedies, there is no comparable authority internationally. Rewriting the contract nationally will be hard work, doing so internationally will be even more difficult. However, as the OECD pointed out in its most recent *Financial Market Trends*[1] the consequence of the current wave of mergers in financial services may well be " a situation in which practically all significant institutions" are "too big to fail". This is hardly a recipe for financial stability.

1. Financial Market Trends, No.75 March 2000