The Regulation of British Retail Banking Utilities

Andy Mullineux

Department of Accounting and Finance, Birmingham Business School,
University of Birmingham, Birmingham, UK

Abstract

Purpose – To consider in the light of the post August 2007 banking crises, how 'fair' access to retail banking services for British households and small and medium sized enterprises (SMEs) can be assured.

Design/methodology/approach – The current responsibility for assuring the bank customers are 'treated fairly' belongs to the Financial Services Authority (FSA). The paper argues for the establishment of a banking commission to regulate retail banks as utilities, leaving the FSA to concentrate on prudential ('risk based') supervision of bank and non-bank financial institutions.

Findings – If access to payments services is infrastructural and access to finance is regarded as essential in a modern society, then retail banks should be regulated as utilities.

Originality/value – The banking crisis led to calls for banks to maintain lending to SMEs and households (especially mortgages). This implies that access to finance, like access to water and electricity, should be assured and that customers should be protected against the 'monopoly' powers of large suppliers. Hence, retail banks are utilities and should be regulated as such.

Keywords – Banks, Regulation, Supervision, Competition, Utilities.

Paper type – Viewpoint.

1. Introduction

This article develops the arguments contained in articles previously published in this journal on the regulation and governance of retail banking in Britain and access to finance (Mullineux 2000, 2006, 2007; Mullineux and Mayo, 2001; Llewellyn 2005; and Edwards, 2006) and related material published elsewhere (Mullineux, 1987, 1992, 1994; Mayo et al, 1998; and Mullineux and Terberger, 2006). It argues that, in the light of a series of adverse Office of Fair Trading (OFT) and Competition Commission (CC) rulings and the debacle that has been revealed in the post August 2007 banking crisis, the regulation of British 'retail banking' (in particular the provision of banking services to households and small and medium sized enterprises, SMEs) needs re-thinking. This has implications for the regulation of the wider banking and financial system in the UK.

In short, the payments systems are infrastructural and enjoys considerable economies of scale (Mullineux. 1987, section 2.2, pp 47-58) and access to finance (money transmission or payments services, and credit, and perhaps also insurance) has to assured to avoid 'financial exclusion', unnecessary closures of SMEs in recessions, and the opportunity for all to engage in entrepreneurial activity.

Because access to water and electricity have to be assured in modern societies, they are regulated as 'utilities'. The supply of retail banking services should thus be regulated as a utility. This will involve regulation of the quality and pricing of retail banking products. The Cruickshank Report (2000) recommended the establishment of the payments systems regulator. The Financial Services Authority (FSA) is to take a stronger role in the regulation of the (hitherto voluntary) Banking Codes for the provision of banking services and products to households and SMEs, and SME representatives and the banks agreed with the government a stricter code relating to SMEs in January 2009. The FSA already requires the banks and non-bank financial institutions (NBFIs) it supervises to 'treat customers fairly'. It also has a responsibility to promote the improvement of 'financial literacy'.

The FSA is primarily mandated to be a 'prudential supervisor' of the risk taken on by banks and NBFIs. System wide (systemic) risk is the responsibility of the Bank of England, whose role in this sphere is being enhanced in the light of the current banking crises. The recommendation of this paper is that a banking commission ('BankCom') be established to take over from the FSA the regulation of the provision of retail banking services and products to households and SMEs and perhaps also the mandate to increase financial literary. The UK already has a number of experienced utility regulators that can provide models and examples of 'best practice'. The current Banking Codes for households and SMEs could form a basis for an agreed set of rules and practices and the Banking Codes Standards Board (appointed by the banks themselves) could provide a useful overview of the strengths and weaknesses of the codes and a source of staff for BankCom, as could APACs, the banks' association for managing the payments systems.

BankCom would naturally liaise with the OFT, the CC, and the Financial Ombudsman Service (FOS), especially given the increased concentration in British banking following the crisis induced Lloyds TSB/HBOS merger to form Lloyds Banking Group, on matters relating to competition and restrictive practices. It would also liaise with the Bank of England, the FSA and the Treasury (and possibly also the auditors of banks or the Financial Reporting on Council, the auditors' regulator) on matters relating to prudential regulation and supervision. Finally, BankCom might be expected to have an input on the corporate governance structures of banks to assure adequate representation of depositor, consumer, and indeed taxpayer, interests and the general suitability, in terms of levels of training and independence, of non-executive directors.

The implications of the separate regulation of retail banking for banking structures (e.g. the combination of retail banking with wholesale and investment banking) would have to be considered. Implications for regulation of 'retail insurance' (pensions already have a specialist regulator, it should be noted) would also have to be considered. Retail banking and 'retail' insurance products and services might, for example, be jointly regulated by a banking and insurance commission ('BankInCom').

2. Background

The government nationalised Northern Rock (NR) in February 2008 and then Bradford and Bingley's home loan arm[1] in late September 2008 in response to the wholesale funding problems they were facing as a result North Atlantic liquidity squeeze that began in August 2007 (Mullineux, 2008a, b, c).

The banking crisis went global following the collapse of Lehman Brothers, a major US investment bank, in mid September 2008 and the UK government responded with bank recapitalisations in a October 2008. As a result, the UK government accumulated shareholdings in two major banks of approximately 70% in RBS and 43% of the merging Lloyds TSB/HBOS (Lloyds Banking Group). The government's stake in the banks is being managed by a company specially created the Treasury, called UK Financial Investments (UKFI). The goal of UKFI is to unwind the government's stake and make a profit for British taxpayers. The time scale is unclear given the deepening of the crisis since NR's 'temporary' nationalisation and the challenge in the courts of the basis on which the government is to determine the price to be paid for its shares[2].

In return for the capital injection, the government elicited a somewhat vague promise from the RBS and Lloyds Banking Group to maintain lending to small borrowers and households at 2007 levels. It soon became clear that mortgage, credit card, SMEs and other lending was falling short of 2007 levels and that banks were widening margins between lending and borrowing (deposit and savings) rates. They were also increasing risk spreads over base and standard variable rates, so that the cost of borrowing was falling nowhere near as fast as 'base rates', which the Bank of England began to cut aggressively in the last months of 2008. Conditions for access to unsecured, especially credit card, debt were also tightened and credit limits reduced without warning.

The credit crunch proper[3] had started. A credit crunch can lead to a downward spiral as restricted credit supply induces failures amongst SMEs, which are largely dependent, on banks for finance, and larger firms. As anticipated identifiable losses mount up, banks are required to set aside capital (specific provisions) to write them off and to set aside additional capital (general provisions) against a generally expected increase in write-offs, as a result of a recession for example. This forces banks to restrict their supply of lending further, to raise risk premiums and to demand more collateral (whose value may well be declining with asset, particularly house, prices). A downward spiral can thus be expected unless the banks can gain access to additional capital. The cost of raising new capital in declining markets will, however, be increasing.

In January 2009, it became clear that the recession was deepening rapidly. Large companies were laying off workers and cutting planned investment and the British Chambers of Commerce[4] published a dire warning about the prospects of SMEs. Further government intervention seemed to be required, but what form should it take? Should the bankers be induced to lend by the provision of government backed loan guarantees? Should the Bank of England start financing the government by buying its bonds and the corporate sector by buying commercial paper, bills and bonds? Should one or more of the big banks be nationalised so that the government could direct its lending? Should the government create its own investment bank to lend to the business sector? What would be the implication of one or more of the above for the prospects of UKFI to make a profit on the government's investments on the taxpayers' behalf in the aforementioned British banks?

3. **How did we get into this mess?**

The cause of 'The Credit Crunch' (henceforth simply 'the crunch') was the collapse of the 'shadow banking system' built up since the early 1980s through the increasingly widespread adoption of 'securitisation' and, more recently, derivatives constructed from securitised assets (Collateralised Debt Obligations, CDOs). Securitisation involves issuing securities (e.g. bonds) backed by 'receivables' (interest and capital repayments) on the underlying assets, most commonly mortgages, but also credit card and automobile loan 'receivables'. The first mortgage backed securities (MBSs) were issued by the Federal National Mortgage Associate ('Fannie Mae') in the US in 1981. Private sector issuers (often Wall Street investment banks) soon emerged and the process of securitisation based on receivables was adapted to other assets. The CDOs allow pools of MBSs to be 'sliced and diced' to form 'derivatives' with various risk profiles, from triple 'A' (top) credit ratings to very high risk ('toxic') assets. The commercial banks could issue the MBSs and CDOs with the help of investment banks, often retaining the 'toxic waste', and could invest in such securities themselves using off balance sheet 'conduits' and 'structured investment vehicles' (SIVs). These tended to be funded by relatively short term borrowing. By borrowing short, at lower interest rates, to lend long, at higher interest rates, the banks could use the off-balance sheet vehicles, which required little capital backing, to create liquidity via 'maturity mismatching' and 'playing' the (normally positive) 'yield curve', in classic banking fashion. Hence the term 'shadow banking'.

The collapse of the US housing price 'bubble' in 2005/06, following a sustained rise in the US interest rate set by Federal Reserve, and the re-setting of the first wave of low introductory, or 'teaser', interest rates, led to an increase in the default rate on the 'subprime' mortgages[5]. This undermined the assets backing the MBSs and the CDOs. The banks were left directly and indirectly, via off balance sheet vehicles, holding impaired assets. The value of these assets was difficult to gauge; especially the CDOs because they were 'over the counter' bespoke products, rather than standardised exchange traded products. By August 2007, the major US and European banks were becoming concerned about the counterparty (credit) risk involved in lending through the (essentially international) interbank markets to each other and the 'North Atlantic Liquidity Squeeze' ensued [6]. The central banks had to step in to provide liquidity in place of the interbank money markets.

Things got dramatically worse following the collapse of Lehman Brothers, which was a 'prime broker', and thus one of the hubs of the shadow banking system, in mid September 2008. Concern about the counterparty risks that banks were exposed to in dealings with each other reached fever pitch and the shadow banking system collapsed. The commercial and universal banks were left holding unknown (to outsiders) quantities of impaired assets on their books and the degree of impairment was unknown (to the banks and their supervisors).

To avert a widespread systemic crisis, governments in Europe and the US decided in October 2008 to inject capital into selected or volunteering banks and to guarantee their debt (bond) issuance. The impaired assets however remained on the banks' books and the US government was forced to divert funds intended (under the Troubled Assets Relief Programme, TARP) to 'buy' (at a discount) impaired assets from the banks to the re-capitalisation of banks instead. European 'fair value' or 'mark to market' accounting rules for banks' assets were relaxed in 2008 to conform with the prevailing US rules, adding to the opacity relating to the value of risky assets held on European bank balance sheets.

The choice seemed to be between the government providing yet more capital to allow the banks to gradually write down the impaired assets[7], with no guarantee of increased willingness to lend until they had done so, or using a state backed 'bad bank' solution to take the assets off the bank's balance sheets (as successfully done in the 'Nordic Crisis'[8]). However, in January 2009, the UK government launched a series of loan guarantee programmes and a programme for insuring the banks against losses on impaired assets held on their balance sheets, which seemed to be modelled on the US bail outs of Citigroup and Bank of America towards the end of 2008. Full details of the UK government bank loss insurance programme (the 'Asset protection Scheme') and had not emerged at the time of writing, but the aim seemed to be to postpone the need for immediate write downs (required in the 'bad bank' solution) in the hope that asset prices will begin to recover in the not too distant future. Further, the 'bad bank' solution works best following full nationalisation (imposing losses on shareholders), as in the Nordic case. It may well be that the UK government does not want the shareholders (primarily institutional investors such as insurance and pension funds) to bear the consequent losses for fear of the impact that it would have on these increasingly fragile (due to share price falls and dividend cuts) long term savings vehicles. Temporary nationalisation and some further recapitalisation may yet be required before re-launching the banks as 'going concerns'; but this would have been 'cleaner' had Lloyds TSB not been encouraged to merge with the troubled HBOS to form the Lloyds Banking Group, leaving the government to nationalise only RBS and HBOS.

Whatever the method chosen, banks cannot and should not be expected to return quickly to their 2007 levels of lending. They cannot because the collapse of the shadow banking system has left a hole and requires the banks to 'de-leverage' and to rely much more heavily on retail deposits. Further, a condition on banks receiving government 'bailouts' in many other countries is that they boost their domestic lending, as required in the UK. This means that the wholesale funds from foreign banks, on which the UK relied, will not be forthcoming in the near future. In addition, it is estimated by the Confederation of British Industries (CBI) and British Bankers Association (BBA) that up to 40% of UK lending to SMEs, and a considerable proportion of lending to the UK households, was made directly by foreign banks The UK banks will simply be unable to make up the shortfall and should not be expected to do so because there was clear evidence of 'overlending' in the mortgage and credit card markets, leading to 'overindebtedness', as a result of 'irresponsible' and 'predatory' lending. Further, there was evidence of penal charging of those unable to service their debts.

Indeed, a series of CC and OFT investigations have found that banks have clearly <u>not</u> been 'treating their (household and SME) customers fairly'. The banks had in fact been cross-subsiding the 'free banking' offered to the middle income groups by overcharging others. They had been lending irresponsibly, mis-selling products and they had been giving SMEs a raw deal (The Cruickshank Report, 2000; and Competition Commission, 2002), shutting costly rural bank branches and making a good profit as a result. Not only were the MBSs and CDOs mispriced, but so too were the core mortgage and current account products!

In 2008/09 the banks were in fact under pressure from institutional investors and credit rating agencies to expand their 'buffer stock' of capital and bad debt provisions above and beyond the FSA's, regulatory requirements. This made the reduction of the regulatory capital requirements by the FSA in January 2009 and suggestions for anti-cyclical capital reductions in recessions redundant[9]. Until the impaired assets are removed for the banks' balance sheets or 'marked to market' prices prevail, the buffers will be required and they will restrict bank lending capacity.

Further, the government demanded a high return of 12% on the preference shares it issued in October 2009 to RBS and Lloyds Banking Group and put on hold dividend payments by the banks it supported, giving the banks an incentive to repay the government's 'investment' as soon as possible. As part of the January 2009 package of measures to get banks lending again, the 'interest' on the preference shares was substantially reduced to 5% and the RBS preference shares were swapped for ordinary shares, increasing the government stake in RBS to 70%. The institutional investors, which enjoyed sizeable bank dividend payments in recent years, clearly desire a resumption of dividend payments as soon as possible. The banks thus have an incentive to widen margins and use retained profits to boost capital with a view to paying off the government investment and to avoid having to raise further capital from the market or foreign 'Sovereign Wealth Funds'. It is to be noted that the retail banking businesses of the big British banks continues to be profitable – the largest losses are being reported in corporate and investment banking.

4. Why were the banks bailed out?

The British commercial banks, especially their retail banking operations, dominate the payments system and are the major providers of credit to households and SMEs. The payments system is essentially infrastructural in a modern society, and access to credit is arguably a basic human right, as alleged by the 2006 Nobel Peace Prize winner, Muhammad Yunus (2008). Credit facilitates 'consumption smoothing' over the 'life cycle' and in the face of fluctuating incomes. It also extends to people not endowed at birth with capital the opportunity to engage in entrepreneurial and business activity. 'Access to finance' is thus akin to access to electricity, gas, water, and telephone (and postal) services. Retail banks are thus 'utilities' in a modern society and should be regulated as such.

Hence, banks were bailed out because continued access to finance (by households and SMEs) was under threat and also because big banks were 'too big (to be allowed) to fail' without causing substantial 'collateral damage' (if you will excuse the pun) or perhaps even a 'systemic' collapse of the British banking system (and consequently the payments or money transmission systems).

Historically, the British 'clearing banks', recognised the social obligation implied by their favoured position (ownership and control of the payments system and access to Bank of England support). This was still evident when the Bank of England launched the 'Lifeboat' bail out of the secondary banking system (a sort of nascent shadow banking system) in 1973 with the full cooperation of the 'Big 4' banks. Following the October 1986 'Big Bang' deregulation of 'The City' and the deregulation of the building society sector, which started in the same year[10], the big British banks have become less willing to recognise their social obligations and more focused on profit seeking, share price enhancing, behaviour. This was of course also true of the de-mutualised building societies that became 'mortgage banks', such as Northern Rock, Halifax (especially as part of HBOS) and Bradford and Bingley.

5. *Of Keynesion Economics and the Economics of Keynes*

As 2008 progressed and we moved into 2009, the thoughts and sayings of Keynes were increasingly invoked in diagnosing the problem and proposing solutions. The true meaning of Keynes' economic writings has long been debated and contrasted with the theories of his 'Keynesion' disciples.

There is a clear risk that monetary policy (via interest rate reduction) will be revealed to be 'pushing on a string'. Not only can 'long and variable lags' before monetary policy effects are felt be expected, but the 'banking channel' (for transmitting those effects) is clearly impaired and the 'balance sheet channel' is operating in the wrong direction in the household sector due to the negative wealth effects of falling house prices (MacDonald et al, 2008) and falling stock market prices (reducing the value of pensions). Further, cuts in interest rates hit savers, including pensioners who rely on interest income to fund consumption. People saving for retirement or other purposes must thus save a larger proportion of their income, and consequently consume less, to meet their targets. Unless company investment or government expenditure takes up the slack, there will be a decline in economic activity.

Keynesians warned of a 'fallacy of composition' in the form of a 'paradox of thrift'. Individually, it is rational to save more, but the larger the proportion of households that do so, and the more consumption is reduced as a result, the less the income, consumption and savings <u>in aggregate</u>, and the deeper the recession. As the recession gathers force, company investment normally declines, leaving only increasing government expenditure to fill the increasing gap in aggregate demand.

So good citizens should save for their retirement, but not (in a recession) just yet! This is tough on those for whom the date of retirement is looming! Indeed, a corollary of the growing 'overindebtedness' in the UK was frequent government warnings of '<u>undersaving</u>' for retirement! There is clearly a 'co-ordination problem', but households cannot be expected to solve it, especially in a world where state pensions are being replaced by a 'privatised' pension system; which depends on the survival and generosity of employing firms (and partial government guarantees (via the Pensions Protection Fund) if they fail).

There is further 'paradox' here. To make a profit, the banks borrow short term, by taking deposits repayable on demand or at relatively short notice, and extend generally longer term loans at higher interest rates. Their lending capacity depends on their ability to attract deposits. Because their access to wholesale interbank deposits has declined dramatically with the collapse of the 'shadow banking' sector and inflows from foreign banks, they must raise retail deposits (savings). The more the households deposit savings with banks, the more the banks can lend (if demand for loans is indeed sustained in the recession). Further, as interest rates and asset prices fall, there is a 'flight to cash' and a larger proportion of savings is deposited with banks (rather than in equity based funds), unless confidence in the banking system is lost and the cash is hidden under mattresses instead! So more saving means more bank deposits, and to make a profit the banks must lend these deposits at margins and spreads, that covers for risk related losses and raise additional income by charging fees for payments and other current account related services.

In sum, the shareholder owned deposit taking banks must lend to make a profit. Their capacity to do so now depends on attracting retail deposits and on the demand for loans by households and SMEs at prevailing risk related interest rates. It is the demand for loans that is more questionable in a 'liquidity trap', which is perhaps where we are in the UK in February 2009. We will return to the issue of fees later, but note that, as the Bank of England base rate approaches zero, the banks' interest rate margins and spreads will be compressed and they will be tempted to raise fees to boost profitability.

SMEs are not only facing the tightening of credit conditions by banks, but a decline in access to trade credit, due to late payment by the firms to which they supply, and the tightening of credit insurance conditions for credit advanced to their suppliers.

Keynes attributed a great deal of importance to 'animal spirits' and indeed the 'irrational exuberance' of the 'credit bubble' years has given way to its opposite ('excessive pessimism', or 'fear'), and there is a possibility that the major recession that began in 2008 may yet turn out to be a 'depression'[11].

6. How should the Governments respond?

Keynes' inspired thinking would advocate boosting aggregate demand, but how? If there is insufficient consumption and private sector investment, then government consumption and/or investment can be increased in an attempt to fill the gap. British government consumption expenditure has been plentiful in recent years, so Keynesian purists would tend to advocate government infrastructural investment, especially as Public Private Partnership and Private Funding Initiative investments are in difficulties as a result of the crunch. There are long gestation lags in infrastructural investments, so fiscal means to boost consumption (and private sector investment) might be also considered, as these have a quicker impact. The UK government introduced VAT ('sales') tax reductions in November 2008 in order to boost consumption. The US introduced a 'lump sum' tax rebate in late 2007. It is not clear how far such stimuli galvanise consumption, rather than facilitate saving, especially if they are regarded by taxpayers as 'one off' or temporary, and thus to be recouped in the future ('Ricardian equivalence'). Income tax cuts may in fact be more beneficial if they are regarded by the public as more difficult to reverse.

Reductions in taxes on businesses related to employment may in fact be most beneficial to firms and those whose jobs are protected as a result. Tax incentives to promote private sector investment are unlikely to have much impact in a recession. Other possibilities included vouchers that are redeemable with proof of purchase or special incentives to buy cars or to replace old cars and the like. Such initiatives are being actioned or considered in a number of countries. Indeed the US stimulatory package agreed by Congress in February 2009 includes tax incentives for car and house purchases.

It is worth noting that countries with larger 'welfare states' have stronger 'automatic stabiliser' mechanisms because tax revenues fall further, and government expenditure (on unemployment etc) increases more, in recessions. Hence, the government stimulatory packages required in the US and China are likely to be proportionately larger than in Germany, for example, and the need for private precautionary saving is likely to be greater too.

7. What else should be done?

The Bank of England could consider buying government Treasury bills and bonds ('underfunding') as a means of 'quantitative easing' (expanding the money supply) if it feels further interest rate reductions are undesirable (or impossible once zero is reached). It could go further and buy commercial paper, bills and bonds as it has done in the past[12]. It will also newly buy <u>newly issued</u> mortgage backed securities to boost the housing market as a result of the governments adoption in January 2009 of the recommendations of the November 2008 'Crosby Report' commissioned by the Treasury.

The government needs to set the terms of the promised guarantees to bank lending and bond issuance carefully. The guarantees will not be costless to the taxpayer. Losses on the UK's Small Firm Loan Guarantee Scheme (SFLGS) were not insignificant and losses can be expected to be higher, the more generous the guarantee terms offered. In the case of the SFLGs, which was set up to stimulate SME lending and overcome 'credit rationing', the guarantee fee is paid by the borrowers[13]. Some of the proposed schemes intend to charge the fees to the banks, rather than the borrowers.

It is debateable whether there is a need to stimulate the provision of mortgage finance before house prices have fallen to a level at which first time buyers can afford (in terms of income to house price ratios) to enter the market. Is there really a pent up demand for mortgages that are priced correctly to reflect risk?

Note also that, as unemployment rises, income growth slows and the number of potential first time buyers is likely to decline. This should accelerate the fall of prices towards 'equilibrium'.

The nationalisation of one or more banks could be considered since the Bank of England does not have the capacity to take on the task of lending itself. But, government directed lending has failed in many countries before. It is notable, however, that some of the larger local authorities, such as Essex County Council, have considered establishing local authority banks to lend to SMEs. Birmingham in fact had a municipal bank, which was incorporated in the Trustee Savings Bank Group; which was in turn merged with Lloyds to form Lloyds TSB. Birmingham has recently considered creating a new municipal bank.

This suggests that the government might contemplate relieving pressure on the Bank of England by creating its own 'industrial bank'. Germany[14] and France still have state banking institutions and, following the 'Macmillan Report' in 1931, the UK government created two institutions in 1945: The Industrial and Commercial Finance Corporation (ICFC), to provide medium to long term loans to smaller companies; and the Finance Corporation for Industry (FCI), to provide larger medium to long term loans. These institutions were part owned by the major banks and by the Bank of England and were merged in the early 1980s to form Finance For Industry (FFI) and finally fully privatised and sold to become Investors in Industry and then '3i', which concentrated on private equity and (until recently) venture capital investment, rather than medium to long term debt finance to small to medium sized companies. Perhaps, as advocated by the CBI, the government should establish a new industrial bank to help rebalance the economy by promoting industrial production and 'real', rather than financial, innovation and engineering, in order to fill the gaps left by the decline of the financial sector? The supply of loans to SMEs has long been a concern in the UK, which the SFLGS was designed to address[15].

During the 1990s recession, associations representing SMEs complained that the big banks were not passing on investment rate cuts and were tightening lending conditions. The Treasury and Bank of England investigated and the Bank of England was mandated to monitor the lending practices of banks to SMEs and to produce an annual report entitled: "Finance for Small Firms". The final (eleventh) report was produced in April 2004 and the Bank closed its Business Finance Division so that it could concentrate on its monetary and financial stability roles. The 'Forward' to the final report concluded that access to finance was not a barrier for most SMEs and that, to ensure effective competition between banks, there was a need to ensure that businesses understood that it was now easier (as laid out in the SME Banking Code) to change banks if they were unhappy with the services provided. Signing off, the Bank concluded that the principal objective of supporting an improvement in the financing relationships between banks and SMEs had been achieved and that the government's Small Business Service agency (set up in 2000 and overseen by the Department of Trade and Industry, DTI) would in future take responsibility for monitoring SME access to finance. Active contact with small firms would however continue through the Bank's regional agents. Neither the SBS, nor the DTI exist any longer. It would appear that the Enterprise Directorate within BERR (The Department for Business Enterprise and Regulatory Reform) is the government agency now responsible for SME access to finance. It should undertake an urgent review of the situation!

8. 'Free Banking' and Cross-subsidisation

The BBA keeps threatening the 'end of free banking', which is founded on the cross-subsidisation of high payments usage, low account balance users ('young professionals') by low payments usage, high balance, users ('elderly widows'), punitive charging, and selling overpriced payments protection insurance etc.

Cross-subsidisation is generally inefficient. The banks should charge a fair price for services supplied and used and pay a money market related interest on deposits in order to avoid encouraging over use of under priced services and disincentivising saving. The banks sometimes argue that the unrecovered costs of services provided is implicit interest (which is untaxed, of course) and so customers who maintain positive balances benefit. This may be true, but banks must then cross-sell other (overpriced) products, such as payments protection insurance, to make a profit. It is time the tax authorities took an interest as well as the competition authorities.

In order to 'treat (all) customers fairly', bank charges for all should be fair and punitive charging should be banned. Further, the elderly tend to build up high balances in low interest accounts which they cannot (due to declining mental faculties or growing physical impairments) be expected to 'micro-manage' using the telephone or the internet. They may not be able to visit branches either. The growing population of increasingly elderly people should be offered 'sweep accounts' that move excessive current account balances to higher interest paying savings accounts automatically each month. The banks should not be allowed to profit from the accumulation of balances in low interest accounts held by the elderly. In all fairness, the banks should actively offer such services (by visiting the homes of the elderly to explain the facilities to them and to advise them (impartially) on how to make use of them).

If the agenda of treating (bank) customers fairly is to be seriously pursued, and given that the payments system is part of the infrastructure of a modern society and that access to credit is a basic human right, then the retail banking industry needs to be regulated as a utility and a specialist regulator should be established. A banking commission ('BankCom') would regulate the provision and pricing of retail banking services and products (including current accounts and mortgages) to households and SMEs. It would convert the current voluntary banking codes into a set of rules and then enhance and embellish them to assure customers are treated fairly. The FSA could then concentrate on the prudential supervision of banking risks. The FSAs role in enhancing financial literacy might also be taken on by 'BankCom'.

'Free banking' is a peculiarly British phenomenon. The 'end of the free banking' would not mark the 'end of the world', far from it!

Apart from fees from the provision of payments and related retail banking services, the profitability of retail banking depends on the revenue from the difference (margin) between interest rates earnt on loans and paid on deposits, less costs. British banks have reduced costs through branch closures in the last ten years. This has reduced ease of access to finance for those not proficient with the internet and living in remote rural or poor urban areas.

In the current recession, the banks have tried to boost profits from retail banking (to offset losses from wholesale and investment banking), through the raising of their margins by not cutting lending rates as fast as Bank of England base rate cuts and cutting savings rates faster. This is of course a form of cross-subsidisation and calls into question the combination of retail banking with wholesale and investment banking. The proposed BankCom should require the retail banking business to be segregated to prevent such cross-subsidisation and should take a view on the size of branch network required to provide adequate access. It could promote branch sharing agreements amongst banks, for example.

The British retail banks have also been pushing up risk premia and thus 'spreads' over base rate that borrowers can expect to pay. This is naturally prudent risk management behaviour. To reduce the spreads, the government has introduced a scheme to guarantee 'working capital' loans to SMEs. The scheme charges the fee to the banks and, perhaps not surprisingly, the banks seem loathe to use it and are imposing tougher and tougher collateral requirements on SME borrowers (in the light of falling house values, the main source of collateral). They are thus overriding the 'limited liability' of SMEs by forcing them to put more and more private wealth on the line, not for equity finance, but for working capital! This does not bode well for the success of the programme, and seems plainly unfair.

As interest rates fall (to 1% in early February 2009) the margins (and spreads) of banks will come under pressure, given the pressure to treat both savers and borrowers fairly, and a fall in bank interest rate revenue can be expected. The temptation will be for the banks to seek fee income to compensate. This should be done in a transparent way that is fair to all (and the consumer watchdogs and the competition authorities should be vigilant).

9. Beyond the crisis

There have been clear regulatory and corporate governance failures in retail banking. The FSA should be relieved of its responsibility to ensure that retail banking customers (households and SMEs) are 'treated fairly' so that it can concentrate on the job of supervising bank risk taking. A series of CC and OFT reports demonstrate clearly that many retail bank customers have not been treated fairly in the last decade or so and the FOS has recently expressed concern that mis-selling complaints about payments protection insurance and being 'deliberately obstructed' by their vendors.

Quite simply, retail banking should be treated as a utility and regulated as such by a specialist banking commission to ensure access to payments services and credit on fair terms. The new agency could also take over from the FSA the responsibility for promoting financial literacy. Such arguments can probably be extended to other parts of the retail financial services sector, including 'retail' insurance', and indeed there is already a pensions regulator.

In sum, a new agency should be established to regulate the provision and pricing of retail banking (and perhaps wider financial) services and products, modelled on the agencies that regulate the other utilities in the UK, such as water and electricity. In parallel, consideration should be given to the corporate governance of retail banks in order to ensure that their executive and non-executive directors have adequate training and experience and are remunerated in a way that does not encourage excessive risk taking. Adequate representation of <u>all</u> stakeholders in retail banking (depositors, borrowers and other retail banking service users, or their representatives (e.g. 'consumer watchdogs'), institutional shareholders and small shareholder representatives, for example) should be assured. Because large retail banks are 'too big (to be allowed) to fail', and thus enjoy implicit insurance which they do not pay for, government representation on behalf of the taxpayer is also appropriate. Alternatively, a tax levy for the implicit insurance could be charged and the government could rely on the FSA and 'BankCom', suitably subsidised, to look after taxpayers' interests.

As a corollary, retail banking should be separated from non-retail banking business, such as investment banking. This is also the conclusion of the Association of Chartered and Certified Accountants (ASSA, 2008). If some of the resulting retail banks (or wider retail financial service providers) are judged 'too big too fail', then perhaps they should be broken up; unless, as seems likely, economies of scale require large retail financial institutions, which must be more heavily regulated in order to mitigate 'monopoly power'.

Before such a proposal can be actioned, it is necessary to deal with the current[16] situation in which the major banks still have 'toxic assets' of unknown quantity and value on their balance sheets and there is significant government ownership of two of the major British banks. The result of Japan's prevarication in the 1990s was a 'lost decade' of growth. In contrast, the Nordic 'bad bank' solution (undertaken in Norway and Sweden, see Davis 1995) was much more decisive and less costly to the taxpayer and it resulted in a much quicker return to growth[17]. There is thus a lot to be said for nationalisation of the most troubled banks, removing the bad assets to a government owned 'bad bank', recapitalising them and then re-privatising, or perhaps even 'mutualising'[18] them, and putting them under the purview of 'BankCom' and the FSA. The government owned bad bank would hold the toxic assets until prices for them are determined and they can hopefully be sold at not too much of a loss. The key to the success of a 'bad bank solution' is that it buys time; which the British banks do not have because they are required to report on their financial position twice yearly. The government, in contrast, can take a longer term perspective.

Notes

[1] Bradford and Bingley's deposit and savings accounts have been taken over by Bank Santander, a Spanish bank, to be run alongside Abbey National and Alliance and Leicester; which it had previously taken over.

[2] The government is basically arguing that NR would not have been a 'going concern' had the Bank of England not lent it money following the 'run on the bank' in September 2007.

[3] The banking crisis and ensuing recession become known as 'The Credit Crunch'. Historically, however, the term has been used more narrowly to reflect a reduction in access to credit and the tightening of credit conditions by banks, particularly to SMEs, as a recession develops (Klieson and Tatom, 1992). In current usage it also covers the pre-October North Atlantic liquidity squeeze and the wider recession.

[4] See Financial Times, 13/01/2009, P.4.

[5] Mortgages extended to house buyers previously regarded as 'unbankable' (see Mayo et al, 1998).

[6] See Mullineux (2008a, b, c)

[7] Which were in fact accumulating as the recession deepened, causing increased defaults on business and consumer lending.

[8] See Davis, 1992, Chapter 8, pp 256-263.

[9] Though building up capital and provisions for future bad debts in booms would impede the inflation of bubbles.

[10] See Mullineux (1987, Chapters 4 and 5).

[11] There are rules of thumb (three consecutive quarters of declining GDP) used in defining recessions, but there is no widely accepted definition of depressions, which are, thankfully, much rarer. See Dow (1998) on major recessions.

[12] See Mullineux (1987, Chapters 2 and 4) on 'overfunding' and the 'bill mountain' of the early 1980s.

[13] The extent of the SFLGS guarantee by the government and the fee charged to the SME borrowers has varied over time. Broadly, the usage of the scheme is more, the greater the proportion of the loan guaranteed and the lower the fee.

[14] See Mullineux (1992).
[15] See Mullineux (1992 and 1994).
[16] February 2009.
[17] However, the scale of a Swedish crisis (bad debts as a proportion of GDP) was significantly smaller than Japan's crisis and the value of the commercial property loans that lay at the root of the Swedish crisis, and thus the collateral underpinning them, was much easier to value than today's complex 'toxic assets'.
[18] See Llewellyn (2004) on the governance of mutual financial institutions.

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About the author

Andy Mullineux is Professor of Global Finance and Director of the Global Finance Research Group and the Finance Group of the Department of Accounting and Finance in the Birmingham Business School at the University of Birmingham. He has published extensively on monetary policy and business cycles as well financial restructuring and regulatory and supervisory reform in developed and emerging market economies. Andy Mullineux can be contacted at: a.w.mullineux@bham.ac.auk