

Banking After Vickers

Introduction

Since 2008 banks have rarely been out of the news or political debate. But much of the discussion has focused on questions of either the remuneration of top bankers or on wider issues of financial stability – specifically on avoiding a repeat of the events of 2008 and the need to put so much taxpayer money at risk again.

The Vickers' Commission (formally the Independent Commission on Banking or ICB) has attempted to address the financial stability issues in the UK, whilst questions on pay have continued to dominate the headlines in recent weeks. However there is another, less discussed, issue with the banking sector – how can it be reformed to support growth in the real economy.

This briefing identifies four key areas (investment, SMEs, rebalancing and green growth) where banks are failing to support to the real economy and the UK's of recovery. It aims to start a discussion on what the problems are and to promote a fuller debate on the potential solutions.

Vickers and after

The mandate for the ICB was fairly limited and specific. It was asked to formulate policy options with a view to:

- reducing systemic risk in the banking sector, exploring the risk posed by banks of different size, scale and function;
- mitigating moral hazard in the banking system;
- reducing both the likelihood and impact of firm failure; and
- promoting competition in both retail and investment banking with a view to ensuring that the needs of banks' customers and clients are efficiently served, and in particular considering the extent to which large banks gain competitive advantage from being perceived as too big to fail.¹

Three of these four criteria refer specifically to the question of preventing a repeat of the crisis of 2008 and avoiding further tax-payer funded bailouts. Only the fourth looks at the wider place of banking in the economy and even then the Commission was limited to examining the role that further competition could play in 'ensuring banks' customers and clients' were 'effectively served'.²

Unsurprisingly, the final report of the ICB then focused almost entirely around the question of preventing a financial crisis. As outlined in their interim report the Commission choose to focus their recommendations around three areas:

- making banks better able to absorb losses;
- making it easier and less costly to sort out banks that still get into trouble; and

¹ Terms of Reference, Independent Commission on Banking

² When making recommendations the ICB was asked to take into account the effect on the 'wider UK economy'. However the specific remit remained narrow and focussed on competition.

- curbing incentives for excessive risk-taking.³

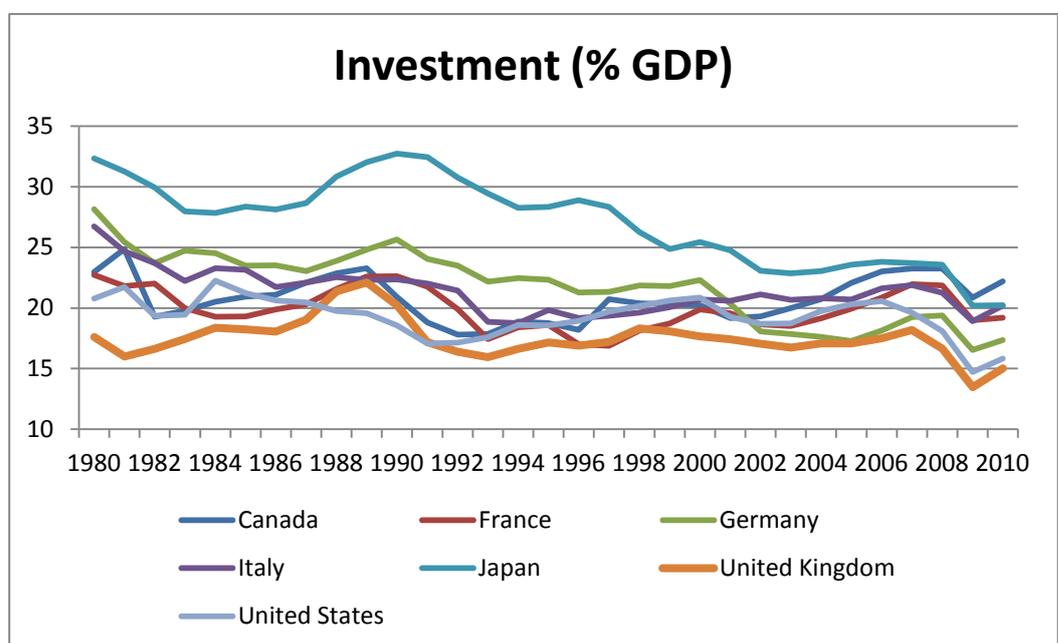
All three sets of proposals focused on financial stability and whilst the ICB has expressed some hope that more competition in the sector (a key recommendation) will lead to an increased supply of credit, at lower interest rates, to small and medium sized enterprises (SMEs) in particular it remains to be seen if this will actually occur. It was simply not within the remit of the report to fully consider how banks could better support business and how credit flows could be unlocked and boosted.

The challenges facing the UK

Four key challenges can be identified as evidence that the UK banking sector is not supporting the real economy. These are: our low levels of fixed investment; limited access to credit for SMEs; ongoing sectoral imbalances within the UK economy and unmet need for finance to enable green growth. Any comprehensive reform of the sector, or development of new institutions, needs to be aimed at addressing these challenges.

Low investment

The chart⁴ below shows the level of fixed investment in the G7 economies from 1980 till 2010. As can be seen the UK's level of investment has been either the lowest or second lowest in the G7 for thirty years. In fact the problem even predates 1980, and was a frequent issue in political-economic discussions from the 1950s until the 1970s.

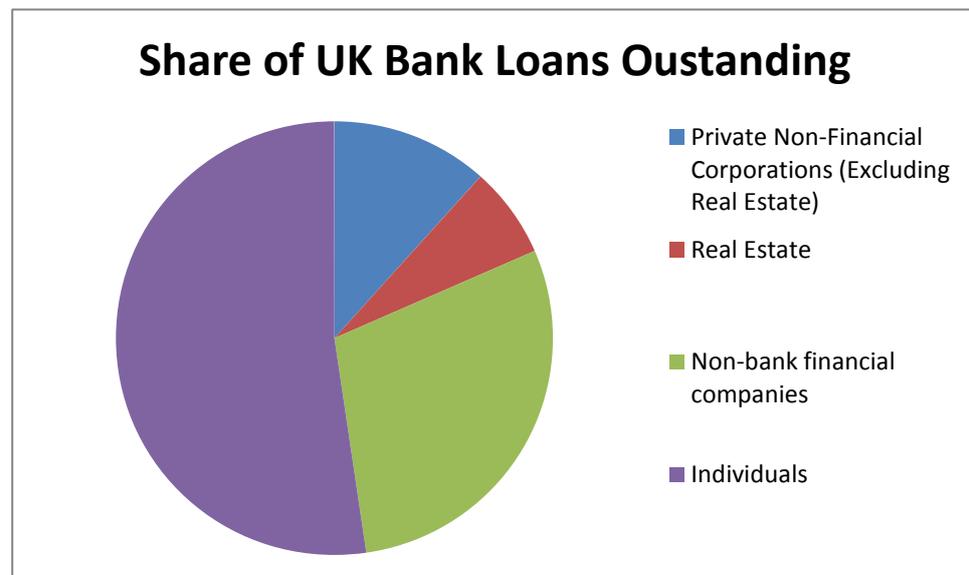


³ ICB Final Report

⁴ Data taken from IMF, World Economic Outlook Database

Of course the banking sector alone cannot be blamed for this low level of investment, and there are likely to be other factors at work. As the TUC has regularly highlighted the ‘short term focus’ of British corporate management can lead to the favouring of immediate results and profits over longer term investment.

However it is likely that banks have played a part in our ongoing investment shortfall, as levels of bank lending to private non-financial corporations in the UK are low. The chart below shows the share of outstanding loans from UK resident banks to UK private sector (non-bank) residents.



Even excluding inter-bank loans, non-financial, non-real estate companies represent only 1% of outstanding bank loans in the UK. The low instance of bank lending may well be linked to the low level of investment, especially when the data in the table below (which considers the structure of financial markets across the G7) is considered⁵:

⁵ Adam Posen, Getting Credit Flowing, speech, October 2009

	Canada	France	Germany	Italy	Japan	UK	US	Average
Stock Market Capitalisation ^(a)	1.47	1.02	0.57	0.50	1.06	1.41	1.44	1.07
Private Sector Bond Market Capitalisation ^(b)	0.30	0.51	0.34	0.60	0.38	0.16	1.20	0.50
Short term Private Sector Securities ^(c)	0.11	0.22	0.21	0.01	0.07	0.16	0.26	0.15
Banking Sector Concentration ^(d)	0.56	0.58	0.71	0.35	0.46	0.60	0.34	0.51
Banks per Million Persons ^(e)	2.95	7.90	22.60	12.49	6.66	8.50	31.70	13.26
<p>(a) As ratio of GDP. Data as of end 2007, Source: World Bank Financial Structure Dataset</p> <p>(b) As ratio of GDP. Data as of end 2008, Source: Bank Calculations and BIS</p> <p>(c) As ratio of GDP. Data as of end 2008, Source: Bank Calculations and BIS</p> <p>(d) Assets of three largest banks as share of assets of all commercial banks. Data as end of 2007, Source: World Bank Financial Structure Dataset</p> <p>(e) Source: Bankscope, IMF and Bank Calculations</p>								

The UK has a much lower bond market capitalisation than any other G7 nation meaning that companies in the UK are dependent upon banks for debt finance. Whilst it could be argued that large UK public equity markets compensate for lower levels of bank finance, this interpretation would be somewhat misleading – of the top 15 companies by market capitalisation in the FTSE 100 none operate primarily in the UK. The large size of the UK equity markets at first glance appear to suggest that UK companies are less reliant on credit, but this misses the point that ‘UK equity markets’ do not necessarily support ‘UK focussed’ companies. With underdeveloped corporate bond markets, an equity market dominated by foreign operating firms and little bank lending to non-financial firms, there may well be a link between the availability of finance and the low level of investment in the UK economy.

The Government’s National Infrastructure Plan⁶ has identified 500 projects with a cost of over £250bn that need to be completed in the next decade in order to modernise the UK’s infrastructure and ensure its competitiveness. Whilst there is some hope that pension funds and sovereign wealth funds might be encouraged into making these investments, the Treasury only expects them to contribute around £30bn. The remaining £200bn+ will almost certainly have to be funded through bank lending. A £200bn increase in bank lending to non-financial corporations would represent an increase of about 60% of the stock of loans over a decade. While this level of change currently seems unlikely, without such an increase much of the National Infrastructure Plan may go unfulfilled.

⁶ National Infrastructure Plan, HM Treasury, 2011

SMEs

As repeated Bank of England Credit Conditions Surveys have made clear, many SMEs are currently struggling to access bank credit. While there is debate as to whether this represents a constrained supply of credit to SMEs or a lack of demand, recent evidence suggests the latter is more likely.

In early 2011 the government sought to address this issue through the 'Project Merlin' agreement with major banks. However the Merlin lending targets were gross, rather than net targets – meaning that if repayments outpaced new loans it would be entirely possible for the major banks to meet their targets whilst net lending continued to fall to fall.

Both the Federation of Small Businesses and the Engineering Employers Federation⁷ have recently called for more action to ensure the flow of credit to small and medium sized businesses, and the Government's plan for 'credit easing' announced at Conservative Party conference and clarified in the 2011 Autumn Statement seems aimed at addressing this. Under current proposals the Government will provide up to £40bn of underwriting to SME loans with the exact implementation timetable remaining unclear. There is also a question of whether credit easing will deliver £40bn of new lending or a reduction in the interest rates on £40bn of existing lending.

Data from NESTA⁸ suggests that SMEs are the major drivers of innovation and ultimately productivity in the economy. Whilst a shortage of credit to SMEs may be manageable in the short run, it risks doing long term damage to the UK economy.

And the shortage of bank credit is especially worrying given the under-developed nature of the UK's venture capital sector⁹, a type of finance that would usually focus its investment on the SME sector. Bank credit is often the only source of external funding available to UK SMEs.

Rebalancing

The fact that UK growth was unbalanced before 2008 is now widely acknowledged, and rebalancing is the stated objective of all the major political parties. There are two elements in rebalancing, both of which impact upon the banking sector.

⁷ Autumn Statement submission, FSB & EEF, November 2011

⁸ High Growth Firms, the Vital 6%, NESTA 2010

⁹ BIS, Survey of Venture Capital, 2009

Sectoral rebalancing refers to lessening the contribution of financial services (and ultimately frothy asset markets) to UK growth and boosting that of, amongst others, manufacturing. More broadly sectoral rebalancing can also be taken to mean lessening the dependence of the UK on consumption and instead moving the economy towards a greater reliance upon investment and exports.

But as noted above UK banks have traditionally been more willing to lend to financial companies and against property (residential and commercial) than to non-financial firms. Without a change in this behaviour, it is difficult to see how the UK economy can successfully rebalance towards exports and investment.

The other dimension of rebalancing is regional inequality. The South East and London have taken an increasing share of UK growth in recent decades¹⁰, a picture replicated in recent employment and unemployment figures. A similar picture emerges in bank lending. Whilst regional lending figures are not available in the UK a BIS study in 2010 found that¹¹, “Surveys of established businesses also have found regional disparities in both the provision of unsecured lending and refusal rates.” Loan applications outside of London and the South East are more likely to be turned down. Given the disparities in personal wealth and the number of established businesses in the regions it is likely that retained earnings and personal savings are also less available outside of London and the South East. In other words there are far fewer sources of capital available outside of the already successful regions. Without a change in this picture it is unlikely that the UK economy can geographically rebalance away from London and the South East.

Green Growth

BIS estimate that there are £200bn of green projects¹² that require funding over the coming decade in order to meet the UK’s carbon targets. Banks have traditionally been wary of funding these projects due to regulatory uncertainty, rapidly changing energy costs in recent years and the long-term nature of many of these investments at a time when funding markets are somewhat unpredictable. Some of the larger proposed ‘green’ investments (not even included in the BIS £200bn figure) require large amounts of lending. The Severn Tidal Dam project for example is estimated to cost £30bn – much larger than any one bank is currently prepared to lend, whilst the syndicated loan market (whereby banks split the lending between several banks) is currently not functioning as well as it prior to the crash did given banks lack of trust in each other, making it unlikely that this mechanism will provide a source of funds.

Recognising the market failure in this area the Government is pressing ahead with the Green Investment Bank to channel funding into this sector. However the

¹⁰ See for example the most recent Eurostat regional GDP figures, November 2011

¹¹ Evaluation of Small Firms Loan Guarantee Scheme, BIS, 2010

¹² Broadly defined but primarily in waste disposal and energy – BIS, Green Investment Bank Consultation, 2011

'bank' will effectively act as fund, constrained from borrowing by the Treasury until such a time as the UK public debt/GDP ratio is falling (currently estimated to be 2015/16). In the meantime the Bank's funding is barely 1.5% of the identified needs for the sector.

Conclusions

The government's Green Deal and National Infrastructure Plan alone identify £450bn worth of physical investment required in the UK economy over the next decade. The current outstanding stock of bank loans to non-financial firms (excluding real estate) is just £322bn. This is without considering the need for more lending to SMEs. The required financing needs to meet just the UK's infrastructure and green investment targets over the next decade is more than the entire stock of loans to non-financial, non-real estate related businesses. There is simply no way these targets will be met without serious reform.

The UK's current financial structure features under developed bond markets, under developed venture capital markets and an equity market that is dominated by foreign firms raising capital in the UK. The banking sector is highly concentrated and traditionally focused on lending against property and to financial firms.

Leaving aside questions of financial stability there is an urgent case for reform of the sector to support rebalancing (sectoral and geographical), help SMEs to grow, fund green projects and increase the low level of investment in the UK economy.

Various proposals for reform seeking to address these challenges have started to be made including proposals for specialist SME lending banks (possibly state backed), a State Investment Bank, an increased role for the Green Investment Bank, regional banks constrained to lend in certain jurisdictions and the creation of bond markets for SMEs. The exact policy mix to begin addressing the problems of the banking sector not supporting the real economy requires further investigation, but the challenge after Vickers is to move beyond the debate on financial stability.