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Observations on the UK Banking Industry☆

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ABSTRACT

The UK Secretary of State for Business, Innovation and Skills, Dr. Vince Cable, MP, speaks about the problems and issues of the UK banking industry. The lack of attention given to banking in economics is criticised. The excessive size and concentration of UK banking are pointed out. Solutions are being pondered. The secretary of state speaks about changes and the way forward in the UK banking sector, pointing out increased competition due to new challenger banks and institutions, government policy initiatives, and the re-creation of relationship banking via initiatives to create local, community banks.

Mervyn King tossed a hand-grenade into the debate about banking, with comments on the future of RBS. Yesterday we had the major vote in the European Union Council of Ministers about bonuses – an issue that reverberates from day to day. Let me however start by going back a little bit.

As [Prof. Don Nutbeam,] the Vice-Chancellor pointed out, I once did economics. One of the best courses I ever did at university was a course on money and banking, given by a man called Charles Goodhart, who had since become a member of the monetary policy committee. And then I discovered that a generation later very very few universities taught banking as part of economics courses. It was regarded as very boring and of no relevance whatever to the real world, because of course banks were totally stable, uncontroversial and nothing ever happened in that field. So it was not necessary to teach students about it. For about twenty years a generation of students was taught about rational financial markets and that problems automatically correct themselves and that there is no need to worry about the way banks function.

That's all changed. I started to get interested in banks as a problem (I have no real background in it, I came out of the oil and gas industry) round about 2000. There was a wonderful report by a man called Cruickshank (2000) who pointed out, rather out of the blue, that the British business banking system just didn't work very well. It was monopolised, the banks were earning a large economic rent, it was highly inefficient and uncompetitive and something should be done about it.

Well, nothing was done about it. Some of us started attacking the government of the day, saying you should be implementing the recommendations, but in any case it was a boring subject and the banks were very big and powerful and nobody wanted to contradict them. So the problem went away, politically anyway.

Until it came back in 2007 – the beginnings of the crisis. You may remember Northern Rock. I got heavily involved in that at that stage and have been living with the subject ever since, trying to understand it. I wrote a book a couple of years later, called The Storm (Cable, 2009), which was partly an attempt to educate myself in understanding why this crisis happened. And I think the point to begin with is that banking collapses are very unusual, certainly in the UK. We went through the big trauma of the 1920s and 1930s, the Great Depression: the British banking system did not collapse, as it did in the United States. In fact to understand in a British context what happened when banks collapse on a systemic scale you have to go back to the early part of the 19th century. And actually the best British description of a bank collapse is in the columns of John Stewart Mill. Nothing much since. And that was almost two centuries ago.

But of course there have been financial crises in other countries, most recently in Japan, in Scandinavia, which had a big banking collapse twenty-odd years ago (they recovered from it quite quickly, but it was quite big while it lasted). The Far Eastern Asian countries went through a crisis in the 1990s, and the consequences of these things are very profound. We have now discovered this in the UK. Because the banking sector in the UK was massive. I know academics will pick me up and will say this is a slightly sloppy measure but if you simply take the balance sheets of the UK-based banks, the big Four, as a share of GDP, you [get] something of the order of 400 or 500 percent. Now that of course includes a lot of complex derivatives and double-counting and it is not an accurate

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measure, but it gives some measure of the scale of the British banking sector at the time of the crisis. It was I think probably second only to Iceland and even more than Ireland.

We were exposed to the risks of the banking sector. We can argue till the cows come home about who is to blame for all that, but that's what happened. And as a consequence, when one of the big global banks was in difficulties: RBS, which was actually in balance sheet terms the biggest bank in the world, at that time (Barclays almost went down, together with quite a few mortgage banks), the consequences for the UK have been catastrophic. And we are still living with it. The metaphor I often use is that we have suffered the economic equivalent of a heart attack. And heart attacks have long-term consequences. You can be saved, and the British economy was saved from collapse, but we are still wired up to drip-feeds with steroids: monetary policy. And we are still ailing.

The two major consequences that we have are first of all this massive structural deficit in the budget caused by the fact that a high percentage of government income derived from the finance sector and secondly the fact that banks are damaged and are not lending normally to productive bits of the economy. Those are the two central issues that the government is grappling with in its economic policy.

In terms of the banking sector itself we are in a very difficult position, because the banks are being pulled in two different directions. On the one hand we are wanting the banks to lend to business, because how else do you get growth and recovery? But on the other hand the banks are retrenching and they are retrenching under pressure from the regulators who want them to hold more capital, who want them to sort out their balance sheets and reduce their risk. And they are contradictory objectives. If I can choose a slightly vulgar metaphor, which somebody gave me a few weeks ago that I think catches it rather well: The banks are being simultaneously fed with drugs to stop diarrhoea and to stop constipation, and both are happening at the same time. At the moment the anti-diarrhoea drugs are working better than the others so as a result credit is not going out through the system. But there are contradictory medical objectives being pursued on the same body. You can see the problem. So that's by way of background.

But what I want to talk about today relates more directly to your conference, because while this issue of the banking collapse is being dealt with, and the regulatory implications, there is a longer term issue for the UK about the basic structure of banking. Even if we hadn't had this collapse we should be dealing with it, which is the fact that we have had a very very high concentration of ownership. 75% of personal accounts and 85% of business loans originate in four banks. One of them is now largely nationalised, one is semi-nationalised, Barclays are at least partly owned by a Middle-Eastern country, which rescued them in the crisis and HSBC are a big international bank. Those four banks between them effectively dominate the banking market place in the UK, enormously in contrast with the United States, where I am sure you have heard in the earlier sessions there is a tradition of community banks, not always stable – a lot of US banks folded at various times in recent history - , but [the banking sector is] certainly much more diverse, markedly in contrast with the German Sparkassen system – I met your speaker [Dr. Schackmann-Fallis] in Germany quite recently.

It is a wonderful system, actually, and in so many other ways: the German model, the localised, decentralised banking, together with apprenticeships, together with Fraunhofer [Institutes] for innovation, represents a superb model of how to run a modern industrial country. But anyway, we haven't got that. We got a totally different system. The UK's banking structure is just horribly inappropriate.

We used to have local banking through building societies of course. That only dealt with mortgage lending rather than business lending. But we did have genuine community banking. The de-mutualisation of building societies was one of the great disasters of modern economic policy. Every single one of those de-mutualised building societies collapsed or has been absorbed in another bank, not a single one survived. And in the meantime those that did stay in the mutual sector have been increasingly amalgamated. You now have giant mutuals like Nationwide and to some extent Co-op. Co-op [Bank] isn't quite a mutual in that sense. And the small, localised town building society with a very strong local identity has become a very reduced figure in the British banking scene. So that's where we start from. What can we do about it? What is happening? How do we get away from a structure that was over-centralised, disconnected from local communities, uncompetitive?

I would just like to say, first of all, something about the trend, some things that are beginning to happen that are healthy and encouraging in creating a more diverse banking ecology – you could put it like that. And secondly about the policies that we hope will drive diversity, and thirdly something about genuine local banking and how we can progress to it.

In terms of what is actually happening at the moment there are some good things happening. We are now at last getting some new banks coming into the UK, particularly in the business lending area. Metro, which started in London, is now spreading in the South of England, does personal and business lending. You got Handelsbanken, the Swedish Bank, with very high quality business lending, Aldermore, Shawbrook, operating different models, but coming in, competing – together they have only got 1 or 2 percent of the market, it is not a big deal, but they are growing rapidly. And they recognise there is a real need in the UK for more competition and diversity and they are beginning to fill it.

Secondly, there is a lot of non-banking lending going on. Out of sheer desperation quite a lot of companies are simply going round the banks. So you are now getting peer-to-peer lending: Groups of local business people, sitting on cash savings, don't want to put it in the bank, so they are looking for local businesses who they can lend money to on an informal basis. Quite a lot of that is going on. You have got crowd finance on the internet. Entrepreneurs starting up today are most unlikely to go their local branch of NatWest. They are more likely to plug into the internet, identify a crowd source and raise money that way. More productive, probably a lot cheaper. We are getting the revival of forms of funding like factoring and invoice discounting. They are relatively expensive, but they work for many people. We are getting a revival of interest in equity: there is an institution called the Business Growth Fund that I met this morning, which is actually funded by the banks. They have got I think 2 billion or so to spend, 3 billion, and they are investing it in equity ventures of rapidly growing medium-sized companies, filling a big gap in the market that used to be filled by an institution called '3 Is'. So you are beginning to get diversity and choice, but it is so far small-scale. So those are some of the good things that are happening.

Secondly, government policy is trying to push us more and more in that direction. More diversity, more competition. The FCA – there are a lot of acronyms in this area – the Financial Conduct Authority, one of the bodies that's come out of the FSA, which failed, really, in the crisis, has now got a mandate to promote competition. The FSA itself, the existing regulator, is committing itself to clearing away the obstacles to establishing a new bank. If you talk to some of the people like Aldermore for example, the horror stories they have in getting established, in getting approval, the capital requirements they have to meet, massively disincentivising new banks… that is gradually being whittled away. The regulators have realised that they were hopelessly biased towards helping big institutions. They are trying to reverse that.

In addition to that there is the payment system, which acts in a monopolistic way. This is the point that Cruickshank pointed out that if you are a new bank and you are trying to get into the clearing system which is what you need to do if you are clearing cheques, basically it operates like the old British Telecom network monopoly. Getting access to it is expensive, it's capricious and it squeezes out the newcomers. So you have to break up that monopoly. And again there is now acknowledgement that we have to act on that. And switching. Extraordinarily difficult to switch your bank accounts in the UK if you are a business or an individual, I think the figures show that people are less likely to change their bank account than they are their husband or wife. It is very very difficult and often leaves you in a mess.