The Future for Finance
Reform in the Financial Services Industry

Martin Upton
In this podcast we explore the prospects for the financial services industry following the outcome of the General Election in May.

As you'll be aware the election resulted in a 'hung' parliament with no single party able to command an overall majority in the House of Commons. In consequent negotiations, lasting several days, parties sought to form a coalition government that could provide a workable majority in the House of Commons. Finally on Tuesday 10th May a coalition government formed out the Conservatives (who had secured the largest number of seats amongst all the parties) and the Liberal Democrats was announced with David Cameron, the leader of the Conservative Party, becoming Prime Minister and Nick Clegg, the Leader of the Liberal Democrats, becoming Deputy Prime Minister.

In the subsequent assignment of government posts Conservative George Osborne became Chancellor of the Exchequer, with David Laws of the Liberal Democrats taking the Number 2 position in the Treasury as Chief Secretary. Vince Cable, who had acted as Treasury Spokesman for the Liberal Democrats prior to the election, was appointed Secretary of State for Business.

So what are the prospects for the financial services industry and, in particular, for reform of its regulatory bodies in the wake of the formation of the Con:Lib coalition?

Prior to the election the Conservatives had advocated the return of banking supervision to the Bank of England from the Financial Services Authority (the FSA) who had taken over these responsibilities after the Labour Party took power in 1997. The perceived failings of bank regulation by the FSA, which arguably contributed to the near-failure of Northern Rock Bank in 2007 and to the systemic crisis in the financial services industry in 2008 and 2009 underpinned the Conservatives case for this re-assignment of responsibilities. The Conservatives also suggested that a bank tax should be introduced.

The focus of the Liberal Democrats prior to and during the election was the separation of investment and retail banking: the argument was that the risky activities of the investment banking sector should not be set in a business environment where they could undermine the conventional retail banking activities, for personal and business customers. This same policy was also alluded to by the Conservatives in the election campaign.

Additionally the Liberal Democrats called for tight limits on bank bonuses with a cap of £2,500 per year on cash payments, with no bonuses being paid to board members and with no bonuses being paid by those financial institutions making losses.

So what is now happening in the light of the formation of the Con:Lib coalition?

Certainly the coalition negotiations resulted in the 'horse-trading' of policies and some dilution of policy objectives as the Conservatives and Liberal Democrats sought to locate common ground on financial and economic matters.

Although outline policies were announced on May 20th, with further details coming in the Queen's speech on May 25th, the full extent of the outcome will evolve in the coming weeks with more details expected in the Chancellor's 'emergency' budget statement on June 22nd.

One clear decision that's been taken is to announce the formation of an independent commission to investigate the separation of retail and investment banking. The commission is expected to take a year to form conclusions on this matter – so no early action on this policy area should be anticipated.

It was also announced that a 'bank tax' will be introduced although how this will be computed is as yet unknown. Some media reports suggest that this will aim to raise as much as £8 billon per year, and would help take some pressure of the need to increase other taxes. The case for such a bank tax, to provide funds for future possible bail outs of financial institutions, is also being advocated by the International Monetary Fund and President Obama's administration in the United States. This development was quickly followed on May 26th by the announcement by the EU Internal Market Commissioner, Michel Barnier, advocating that all EU member states introduce a bank levy. This would provide member states with funds to ensure that the costs of managing future banking failures would not have to be met by taxpayers.

Additionally those banks where the Government is a large shareholder – like the Royal Bank of Scotland and Lloyds Banking Group – will be given targets for lending to small- and medium-sized businesses – once again a policy advocated by the Liberal Democrats during the election campaign.

Although no specific details have been announced yet, the expectation is that some constraints on bank bonuses will also be introduced The Coalition Government's statement on May 20th referred to measures to curb 'unacceptable' bonuses. The resultant measures are unlikely to be as draconian as suggested by the Liberal Democrats during the election campaign due the desire not to drive London's investment banking activities overseas.

The Coalition Government has also promised to take action on unfair bank and financial institution charges including excessive interest rates on credit and store cards.

As regards the re-allocation of regulatory responsibilities the implications from the Queen's Speech are that the Bank of England will retain the task of ensuring the stability of financial markets as well as having a role, as overseer, of the regulation of financial institutions. It seems that the actual detail of institutional regulation will remain with the Financial Services Authority – so the pre-election plan of the Conservatives to pass the FSA's responsibilities to the Bank of England has clearly been watered down. To be frank the Bank of England is unlikely to have an appetite for absorbing the full extent of institutional regulation – involving regulating each entity from the biggest investment banks to small-scale financial advisory firms in the provinces. High-level oversight of financial regulation seems a more appropriate role for the Bank.

There have also been some suggestions (albeit not from the Coalition Government) that some big banks will be required to break themselves up into smaller sized institutions – indeed the EU requirements for the Royal Bank of Scotland and Lloyds Banking Group, announced in November 2009 presage a partial break-up of these banks that have large UK Government shareholdings.

The rationale for 'smaller is better' is that it creates more competition and reduces the risk of a major financial calamity if one bank gets itself into difficulties - if a large bank fails then inevitably there is a financial crisis, perhaps not so if a smaller bank fails. Critics of this approach would argue that the banking crisis in the UK started with the near failure of Northern Rock and that the Northern Rock was not, and is not, a big bank!

More encouragement for the 'smaller is better' ethos for banks following the General Election may also be coming from the Bank of England. One senior official has observed that he can see no benefits - in terms of economies of scale - in banks having a greater aggregate asset size than $10 billion. Given that, for example, HSBC Bank had an asset size of $2,364 billion at the end of 2009 and that the Nationwide, the UK's largest building society, had an asset size of £199 billion in October 2009 this assertion is quite eye-opening.

As the Coalition Government works on its reform plans the banking sector has been making defensive noises. The response to the threats of a bank tax, capped bonuses and the separation of investment and retail banking operations could be that banks relocate wholly or partly from London to overseas locations with friendlier tax and regulatory regimes. The consequence would be a huge loss of tax revenue for the Government – and, given the parlous state of public finances and the record budget deficit the Coalition Government is grappling with, this threat may well be a high-value ‘trump card’ for the banks.

Once again the conflicts between regulation and financial dependence that lie in the relationship between the UK Government and the financial services industry are being exposed in the debate about the Coalition Government’s policy agenda. Watch this space!