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DISCUSSION PAPER

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WHAT'S KEEPING
BRITISH BANKS FROM
SUPPORTING
ECONOMIC GROWTH?





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WHEELS SPINNING, GOING NOWHERE

WHAT'S KEEPING BRITISH BANKS FROM SUPPORTING ECONOMIC GROWTH?

An economic recovery in the UK demands that the incoming Bank of England governor, Mark Carney, (who takes up his post in July) runs a loose monetary policy. This sounds uncontroversial. Indeed, it is what the Bank professes to have been doing since early 2009, when the bank rate was reduced to 0.5 per cent and quantitative easing (QE) was initiated. But a simultaneous and ongoing massive tightening in bank regulation has meant that this official 'looseness' has not translated into cheap or available credit for individuals and businesses.

UK lending has been in absolute decline for over four years now. This is historically unprecedented. Loans outstanding are still falling – and this is a key driver of recessionary behaviour among businesses and private individuals: if credit tomorrow will be less available and more expensive than today, why swim against the deflationary tide?

Various Treasury-sponsored schemes have tried to rectify the problem of low official rates being lost in translation to the real economy. Funding for Lending is the most significant, Help to Buy the most recent. But the Bank has been pedalling so furiously in the opposite direction, through its regulator (the Prudential Risk Authority) and its new macro-prudential body (the Financial Policy Committee), that credit conditions have been consistently toughened. Carney will need to call a halt if any unconventional monetary policies are to have a chance of succeeding.

While banking is an inherently risky business, there is one essential question that has not been asked: how safe do banks really need to be? Happily, and contrary to much of the media and political narrative, what needed to be done to make banks less risky was put firmly in train at the peak of the crisis almost five years ago. A narrative of stability that presses on regardless of the costs incurred is exactly the 'stability of the graveyard' that the chancellor seeks to avoid.

The UK cannot afford the luxury of chasing a zero-risk banking system. It already has a system that is safer than it has been for decades. Now it has an opportunity, with Carney's impending arrival, to back out of its current economic dead-end. He will need the political backing to declare victory over banking demons and move on.

That was then: dealing with the banking crisis

The last Labour government did not see the banking crisis coming. What it did do was an excellent job of judging what needed to be done – and what should not be done – in the few short weeks after Lehman Brothers collapsed. Management groups were thrown under the proverbial bus; billions of pounds of fresh capital injections into banks were demanded. As a result, the healing process began very quickly.

Importantly, the private sector was kept involved. Nationalising banks completely is not to be done lightly, as is clear from the current government's drift into attempting to run RBS. Between coalition politics and national debt accounting, the chances of civil servants running a 'better' bank are low.

The diagnosis

What ailed the banks in 2008 were several interlinked issues. It is worth listing them briefly, as the changes over the past five years are crucial to our case.

1. There was little tangible common equity in several of the banks. In early 2008, RBS, Barclays, Lloyds and HBOS had £65 billion between them.

2. Assets at these four banks had grown by more than £2.5 trillion in the previous four years, through rapid organic growth and acquisition which brought new and less-well-known risks onto balance sheets.
3. Several of the banks had very high levels of short-term wholesale funding. Borrowing for a day is the cheapest form of finance, but relying on hundreds of billions of this left the banks exposed to abrupt cashflow issues.
4. Most of the banks held very little cash on hand.
5. Several of the banks had large concentrations in two areas of risk: complex, structured securities, such as the infamous collateralised debt obligations (CDOs), and commercial property.

This combination of factors meant that as the financial markets deteriorated concern built up that banks could become insolvent – concern which soon expressed itself in the banks becoming illiquid.

Why the response worked

What was done in the wake of the crisis dealt effectively with each of these issues. The Credit Guarantee Scheme provided long-term funding and as a result rapidly improved the market's confidence in the ability of the banks to access funding. It worked, and was fully repaid in 2012 at a tidy profit to the Treasury.

Huge amounts of equity were required of the banks in short order – £40 billion was raised from the private sector and £60 billion from the Treasury. Only RBS relied wholly on the state.

And even in the case of RBS, the balance of state versus private action was judged well. Injecting more equity in 2008 would have driven an accelerated sell-down of the bank's assets – into a terrible market. Full state ownership would likely have required the closure of the investment bank, then a £1 trillion behemoth. Far better to run it down against realised profits over time, which is just what has been done: the assets of this division are now a quarter of what they were, with the run-down paid for by pre-impairment profits of £8 billion and the assets sold for £10 billion over expectations.

Then, in 2009, the banks were aggressively stress-tested. At some level, this merely formalised what Lloyds management was doing as it went through HBOS's books and was forced to issue five profit warnings in the five months after its takeover was announced. With new management at RBS also going through the books with a fine-tooth comb, UK bank impairments spiked massively. But these peaked by the middle of 2009 and have since fallen by four-fifths. Contrast this with the banking system in Spain, which has been allowed to roll over its problems and where, as a result, impairments continued to rise year-on-year through at least to 2012.

The results in the UK were rapid. By late 2009, HSBC and Barclays had raised over £20 billion and Lloyds was able to raise £8 billion from private investors, mainly British institutions. By the time of the general election in 2010, bank shares were trading above the levels at which the government had invested.

This is now: moving the goalposts of banking regulation

Since the general election, in 2010, the Coalition government, supported by and empowering the Bank of England, has reworked the rules on banks' capital, funding and liquidity – repeatedly. The Vickers Commission was established in the Coalition's first days. Perhaps initially a way of kicking any decisions into the long grass, it soon became clear that the commission was likely to propose radical changes to banks' structures as well as their capital and funding arrangements. Anticipation of the Vickers findings had a paralysing effect, followed by a deflationary one, as banks moved their businesses to accommodate ringfencing through 2011.

George Osborne's next radical invention was the Financial Policy Committee (FPC), which first met in June 2011. Staffed by Bank insiders and 'independents' who proved to be even more loyal to Bank of England governor Mervyn King's views than the insiders, the FPC asserted that banks were more risky than the market believed and that their published figures were untrustworthy. The FPC also insisted on believing it is possible to demand that banks improve their capital-to-risks ratios significantly without this being likely to have any impact on their lending behaviours – and it has maintained this belief in the face of the real-world evidence to the contrary.

Remember, banks are companies too

At this stage it is important to remember that banks behave like other companies. Let's consider Lloyds. At the time of its rights issue in 2009, it was raising money from British institutions on the basis of a business plan that the Treasury, the Bank and the FSA had been all over. Lloyds assumed that:

- It should aim for a loan-to-deposit ratio of 140 per cent, radically below the 190 per cent ratio held at the time of the HBOS acquisition.
- An equity-to-risk-assets ratio of 8 per cent would be appropriate, a third above pre-crisis levels. With the capital it held after writing off £30 billion of bad HBOS loans, Lloyds was effectively aiming for more than twice its pre-crisis loss absorption capacity.
- It should be holding around £50 billion in cash on hand.

With these hard constraints, Lloyds expected to grow its loan book from 2010 onwards, returning to profitability and restoring dividends in 2011.

However, the demands of the various bodies that Osborne's Treasury either introduced itself or supported the Bank to bring into being were that Lloyds should:

- Bring its loan-to-deposit ratio down another 40 percentage points, to 100 per cent.
- Raise its equity-to-risk-assets by another 50 per cent.
- Repay the Bank's crisis-era funding (the Special Liquidity Scheme) early.
- Double its cash on hand.

These were all achieved by the bank by mid-2012. However, the fairly obvious cost to the economy was that to achieve these 'stability benefits', Lloyds reversed its intended course and shrank its loan book, rather than growing it. At the same time, the increased costs of funding made its loans to customers more expensive.

One can debate whether the position of banks in 2013 represents a better trade-off between risk and growth than the one envisaged in 2009. What is much harder to assert is that the banks today are dangerous, or that requiring them to become even safer will come at little cost to credit availability in the economy.

Worse, the banks have learned that loans made today – which will be on the balance sheet for years to come – can be much less profitable than initially assumed if the rules keep changing. For example, a loan made by Lloyds with its 2009 balance sheet that had an expected return on equity of 12 per cent (a return rather lower than achieved by typical non-financial companies and a reasonable proxy for the level of profits required by equity investors in most stocks) would, on the balance sheet Lloyds was required to run by 2012, represent a return on equity of only 5 per cent.¹

No let-up in the pace of regulatory innovation

If that were a sunk cost then perhaps we could move on. But even now the rules continue to change. The FPC's latest statement, in March 2013, provides an almost-perfect illustration. The FPC changed the amount of capital banks need to hold against mortgages. Crucially, however, it did not do so on the basis of evidence but simply according to a belief that the banks' own calculations had come to an answer that was too favourable. When such arbitrary judgments are possible, there is no way for a bank to anticipate this sort of regulatory change.

The FPC also changed the basis of capital on which a bank is to be judged, effectively bringing forward certain changes that reduce banks' current capital ratios. And the FPC 'sucked forward' potential losses from the future on certain loans without matching them with the revenues from those portfolios. These are all arcane calculations, but all have the explicit goal of making the banks look worse in order to support a demand that they hold more capital against their businesses.

Each of those changes was unpredictable; none could be modelled. In the face of repeated tightening of the constraints within which they operate, the simplest thing for a bank's management to do is just to have less of the things the bank may get charged for (loans) and to hoard cash and capital.

Some at the Bank of England have suggested that requiring banks to hold very substantially higher equity levels would have little impact on the cost and availability of credit. Their theory is that a bank with more equity would be accorded a lower cost of equity (in other words, shareholders would expect lower returns because their investment was less risky). There is a grain of truth in this view: riskier companies are typically expected to offer better potential returns. However, banks remain more complex, opaque and highly geared than typical industrial companies. It is observable that the FTSE as a whole (excluding the banks) has a present cost of equity of 10–12 per cent, depending on how it is calculated. It seems implausible that banks will ever be accorded a materially lower cost of equity than non-financial companies in general, and there is no evidence of banks in any country – even those with high levels of equity – being valued at substantially higher levels than other companies. To suggest that the experiment is one worth considering in the UK – and hundreds of billions of pounds are at stake in this particular debate – is to value an obscure theory over experience and the evidence of the world in action.

¹ We have estimated this using the changes to the bank's balance sheet in the interim – that is, an increase in required equity of 50 per cent; a 20 per cent increase in the typical risk weight of a loan; a shift in funding mix from a 140 per cent loan:deposit ratio and half of wholesale funding being short-term to a 110 per cent loan:deposit ratio and only 30 per cent of funding being short-term; and changes in the market cost of deposits and funding in the intervening period.

Wheels spinning, going nowhere

The FPC's most recent demands neatly cancelled out the Help to Buy scheme which had been the centrepiece of George Osborne's budget just two weeks previously. By transferring the risk of loss on higher loan-to-value mortgages from banks to government, what Osborne is seeking to do, in effect, is to turn high-risk loans into low-risk loans for the banks. But the FPC then introduced a minimum risk weight for banks' mortgage books, based on its belief that banks with low-risk mortgages were not holding enough capital against them. So, more or less simultaneously, the government has lowered the amount of equity a bank has to hold against a mortgage while the FPC has raised it.

It is as if the chancellor is pressing down hard on the accelerator while the FPC yanks on the handbrake. The result is a lot of smoke from the wheels, but no forward progress.

A patient rehabilitated yet still confined to bed

Shareholders reward companies for growing businesses that make the highest returns and for pulling resources out of those that make the lowest. The Bank of England has continually expanded those areas of banks' businesses that make low returns and so – unsurprisingly – shareholders have responded by pulling resources out. Providing the companies and their owners with reasonable confidence in a stable set of rules would allow them to price effectively and restart their growth.

Why are we, the authors, so confident that banks are only behaving *as if* they were financially troubled companies and are not actually broken? A review of the most recent figures compared to those available around the time of the crisis shows some huge differences.

- Tangible common equity at RBS, Barclays and Lloyds has doubled to £130 billion.
- Assets at these three banks have shrunk by £1.7 trillion in the last four years, and low levels of new business mean the loan books are well seasoned.²
- Short-term wholesale funding has fallen by 80 per cent. For the UK system as a whole, the gap between loans and deposits has fallen from £700 billion to £nil since 2008.
- Liquid assets and cash on hand have risen by £300 billion.
- Complex, structured securities have been written off or sold, or have matured. Commercial property exposures have halved and the banks have taken over £40 billion in provisions against their UK portfolios.

The authorities have looked for evidence of underprovisioning and found none. At its November meeting, the FPC asserted that it expected an FSA analysis to show billions in underprovisioning at the banks. It did not find it. Nevertheless, the FPC adjusted by instead changing the rules to fit its argument at its March meeting.

The Bank and the banks

The Bank of England has consistently failed to grasp how commercial banks actually work. Banks do not, for example, lend or stop lending on the basis of a specific capital level. For all their unique features, banks actually behave exactly as other companies do. They are expansionary when they believe they will be rewarded through a higher share price for being so. The UK, by comparison, is stuck in reverse – the banks know they will not be rewarded for growing if the cost in terms of dilution for shareholders is too great.

2 A 'well-seasoned' portfolio contains a high proportion of loans against which a large number of payments have already been made and which, therefore, are more likely to continue being paid off than loans just made.

The consequences of banking paralysis

The lack of lending is a social problem

The cost of a typical mortgage – in terms of the spread of interest rates over the Bank of England bank rate – has risen from 0.2 per cent to 3 per cent; at the same time, deposits required have tripled and loans for those with weaker credit histories have completely vanished. Interest-only loans are about to disappear, moving mortgages further out of affordable reach for many. We don't assume that everyone has a right to credit. Nonetheless, the exclusion of large parts of the population from homeownership is sudden and striking. With housing in short supply, the natural effect is to raise the cost of renting, and now renting is more expensive relative to owning than it has been for decades.

For those with the 30 per cent deposit to put down and the financial standing to be eligible for a loan, the economics of buying to rent are compelling. The flipside is that, as rents rise relative to incomes, those who are renting are less able to save and will never be able to accumulate the deposit necessary to buy. A lifetime of living in ever-smaller flats is in prospect.

Those who have capital are able to invest it at high rates of return; those who do not are doomed to slip further and further away from becoming homeowners. Were the public rental sector there to take the strain this would perhaps be of less concern – but of course it is not.

The underbuilding of homes ever since the introduction of the right to buy in 1984, which has worsened in the last couple of years, means housing is expensive in the UK relative to other countries. This is not the same as a housing bubble. If two million new homes were built, this would surely drive down prices in many areas. But to underbuild by 100,000 or more homes every year while also restricting credit is a recipe for increasingly Dickensian conditions. Indeed, one lender reports that the major trend is for people to make ends meet by downsizing or taking in lodgers – this trend is well established and ongoing.

Meanwhile, non-bank lenders have stepped into the gap in personal loans left by the banks, which have tightened their lending criteria sharply since 2008. Banks were charging 8–9 per cent on such loans (including the now-infamous payment protection insurance). Now, payday lenders may be charging 2,500 per cent. In short, there are very real costs to making banking too narrow for the population's needs.

SMEs are suffering unnecessarily

Companies with confidence in the rules under which they will be operating are more expansionary than those always peering nervously around the corner to spot the next change coming. Even now, UK banks are peering around that corner at the most recent set of FPC demands and the risk of more beyond.

This is particularly debilitating for their operations concerning small and medium-sized enterprises (SMEs). Growing these operations is cost-intensive: typical loan sizes are small, and because the companies are naturally of lower credit standing than the largest companies they therefore require close monitoring. Although loan durations are typically short, it is normal for small businesses to roll over loans at maturity – so a bank can flex the terms or pricing of a two-year loan at the point it comes due, but will normally expect to have to be willing to extend a new loan at the time. Few companies repay working capital loans as growth is naturally working-capital intensive.

The SME portfolio is also naturally the one most directly driven by the performance of the UK economy. In a classic vicious/virtuous cycle, banks are more likely to be willing to grow their SME books if they have more confidence that the UK can grow – and this in itself is tied directly to the availability of credit from other banks. Fixing the rules at current levels – which all the big banks are compliant with (and most are substantially ahead of) – would give each bank more confidence in the behaviour of its peers and so reawaken animal spirits.

In short, the lack of finance for small businesses compounds the UK's struggle to return to growth and penalises entrepreneurs. There is no need for these costs to be rising today, but they continue to do so.

Yesterday's problems: challenging the rhetoric of risk

Other worries about the banks – the concentration of the market in the hands of the big four and the 'too big to fail' problem (if a bank blows up, it will take the nation with it) – are also less of a concern than current rhetoric might suggest.

Market concentration

The banking system is concentrated. But once the disposals of TSB (by Lloyds) and Williams & Glyn's (by RBS) have been completed, market shares in SME banking will be no more concentrated than in the 1920s or 1960s. Both are viable stand-alone businesses with strong regional market shares and low loan-to-deposit ratios; both will come to market with strong capital levels. The UK will have fewer banks than it did immediately pre-crisis, but as many significant players as has proven durable in a century. A fragmented banking system may (only may) be less risky, but it is also more suited to the small-scale UK of the 18th century than the interconnected one of today.

Banking is typically a concentrated business. Customers trust long-lived, branch-based institutions; a bigger database is clearly better than a smaller one; doing enough business to see the shape of the whole market is a huge advantage. Most major economies have around 2–6 banks dominating retail and corporate lending and deposit-taking. Those that did best through the crisis – Canada, Australia, Brazil – all have banking markets with similar concentrations to the UK.

The US and Germany are frequently cited as counterexamples, but rather these are anomalies. The US exception is underpinned by historical restrictions on banking across state lines. Within any given state, market shares are typically high. Wells Fargo and Bank of America have almost half the California market between them; Citizens (an RBS subsidiary) and Bank of America almost 60 per cent of Rhode Island. In Germany, the hundreds of Sparkassen (savings banks) are geographically separate – each area has just one; similarly the Raiffeissen (co-operative) banks. With these two groups holding more than two-thirds of household deposits, the German retail market in any given town is, in effect, significantly more concentrated than in the UK.

Historically in the UK, inconvenience presented a significant barrier to the movement of accounts between banks: direct debits were difficult to move and customers had to conduct the process themselves. This is now gone. What remains is a general disinterest by the public in moving: in any given year, divorce is more likely than moving your current account. The reason is that for most people the cost savings to be made by moving a bank account are too small to be worth chasing.

With Nationwide now offering current accounts, there are half a dozen high street banks in the UK; the banking market is less concentrated than that of supermarkets. The

competition authorities have ongoing oversight of the banks' behaviours. Trying to create more competition by breaking up today's institutions would certainly cause years of lost lending – management cannot grow and break up at the same time – and would fly in the face of international practice.

One might also note that the rapid expansion of competition in mortgage lending in the 1990s was strongly linked to the collapse in lending standards of the 1994–2007 period. Northern Rock's massive rise in market share, from 2 per cent of the net flow to almost 30 per cent, was a better indicator of bad loan and financing practices than any macroprudential regulator could hope for.

'Too big to fail'

When RBS and HBOS teetered on the edge, there were no real options for the government other than bailout or mayhem. The losses of these companies were essentially absorbed by shareholders and subordinated bondholders, but the risks built up in big banking were disproportionate. Scroll forward to today – after the Banking Act, five years of official rhetoric and the bail-in in Cyprus – and there can be little doubt that in the UK bondholders and large-ticket depositors in a failed bank would expect to bear the losses incurred. And it is this expectation that is the key: institutions or individuals knowing the risks are far better placed to absorb the hit, should events ever demand it.

The risk of loss increases the convexity of banks' cost of borrowing; that is, when things deteriorate, they do so at an accelerating pace. A higher cost of borrowing for the bank rapidly makes it less profitable, increasing the risk that losses eat into capital, in turn increasing the risk that bondholders are not repaid. Being more conservative thus becomes more important.

UK banks have responded comprehensively by shrinking their assets and by raising more of the highest quality deposits. Deposits used to be expensive relative to wholesale funding, but once it became clear that having lots of deposits reduces the cost of what wholesale funding a bank does need (the 'HSBC effect') banks embarked on an aggressive campaign to build deposits. 'Too big to fail' has been substantially resolved; seeking to press this agenda further can only take more credit from the system.

Another Minsky moment? Not for many years

The banking system (and the Bank, the government and the FSA) arrived in 2008 with an unfounded confidence engendered by 15 years of unbroken economic growth and rising asset prices. All assumed that Mervyn King's 'NICE' (non-inflationary, consistent expansion) years were a forward-looking statement. As inflation had come under control and growth had been strong and predictable, households, companies and investors had become more forward-looking. As they became more confident that their income would be higher in real terms next year and again the year after, and that the asset they wished to borrow against the value of would be rising as well, they were willing to take on more debt in the here and now.

The banks easily met the demand for more debt: wholesale funding markets were flooded with cash. As inflation fell, the return available on risk-free assets such as deposits or government bonds had fallen sharply, so investors were willing to hold riskier instruments. Rising asset prices and the related fall in problem loans to very low levels meant the banks had more and more 'good' collateral to borrow against. Indeed, the banks were considered to be holding so much collateral that many would lend to them unsecured, with a view that banks so flush with good assets would have no possible issues in repaying.

Now, Wikipedia defines a Minsky moment as ‘a sudden major collapse of asset values ... [L]ong periods of prosperity and increasing value of investments lead to increasing speculation using borrowed money. The spiralling debt incurred in financing speculative investments leads to cashflow problems for investors. The cash generated by their assets no longer is sufficient to pay off the debt they took on to acquire them. Losses on such speculative assets prompt lenders to call in their loans ... This [leads] to a sudden and precipitous collapse in market-clearing asset prices, a sharp drop in market liquidity, and a severe demand for cash.’

2008 was certainly such a moment. But how many of those preconditions exist in the UK today, other than perhaps in a gilt market deliberately supported by the Bank?

The answer is none. Falling asset values are assumed as a permanent feature in the banks’ risk assessments and the regular stress tests imposed on them by their regulator. Leverage has been declining for years.

Crucially, the owners of bank debt and big-ticket depositors are well aware of the ‘tail risks’³ in their exposure to UK banks. In the event that a Barclays or a Lloyds was to find itself in deep trouble, bondholders would be in a stronger position to absorb the losses coming their way, as this outcome is no longer ‘unimaginable’.

This is both good and bad. The knowledge of potential loss means that the banks’ costs of funding are permanently higher – a cost that is naturally passed through to borrowers. These costs are also much more likely to rise rapidly in difficult times, as the possibility of a loss occurring is considered to grow. But after all the sermons and the rhetoric, nobody imagines that the Banking Act⁴ will not be used should the circumstances demand it. In the UK, ‘too big to fail’ really is yesterday’s issue.

This is not the case in some other countries – which is one reason why in 2011 and early 2012 UK banks faced higher funding costs than French or some Spanish banks, in spite of better capital levels. Those lending to or depositing with the UK banks were well aware of the attendant tail risks, while those operating elsewhere might still have imagined that the local taxpayer would bear such risks. Now, however, UK banks typically have lower funding costs than French and large Spanish banks, reflecting the market’s correct judgment that the practical risks of investing in UK bank debt are now very low, as the banks are in robust health. The FPC once again seems isolated in its views.

Supporting a vital sector: what should be done?

If the banks are safe but the economy is broken, what steps are essential to drive a recovery?

- First, we have to recognise that we are in a less risky environment than in the mid-2000s. Bank boards, scarred by the events of the last six years, are now very likely to be risk-averse. Furthermore, having seen the losses incurred by depositors in Cyprus and by bondholders in many banks, the providers of finance are more aware of risk now than for years. The losses that were to be experienced as a result of exuberance are far behind us; building capital buffers against their recurrence is an expensive luxury.

3 That is, the risks of an unlikely but potentially devastating event.

4 Which gives the authorities powers for dealing with failing banks without necessarily fully compensating bondholders.

- Second, we should also recognise that the banks have changed completely. Only the names remain the same. RBS, being £900 billion smaller than before, with twice the equity, having turned a dependence on short-term wholesale markets of £300 billion into a surplus of £100 billion, is simply not the same bank. These changes are enormous relative to the £1.4 trillion economy in which the bank operates.
- Third, we should stop to ask whether some of the more complex businesses operating within the banks may actually have some value. RBS, through NatWest, is the UK's leading corporate bank. The UK has a uniquely international corporate sector, ranging across Vodafone, Rio Tinto, BP and GlaxoSmithKline, for example, and extending well down into the mid-sized and small-business layers. Is it not reasonable that the bankers to these companies should be able to meet their financial needs?
- Fourth, we must recognise that if the rules keep changing then the system will never find its feet. The UK is behaving like a country that wants a financial system that will continue to tighten credit indefinitely – that is, a country permanently deleveraging and forever stuck in a no/low-growth rut.

The moment to alter this psychology is at hand. The new Bank governor inherits a system that is already stronger than is required by his FSB-Basel safety agenda. Nevertheless, Mark Carney needs a mandate from the Treasury to allow monetary policy to work. There is no sense loosening official monetary policy further if other areas of the official sector are tightening up – if, in effect, banks are being demanded continually to shrink.

Returning banks to the public – and spending the gains

Far from needing to consider further radical bank restructuring or recapitalisation, the impetus should be in beginning their privatisation. This would have three benefits.

- By removing RBS and Lloyds from government influence, the temptation to meddle in their business decisions would be removed. In the case of RBS in particular, the Treasury's ever-increasing involvement in its strategy has become a serious constraint on the company's ability to operate effectively.
- By closing a chapter on the financial crisis, it could also help to open a new chapter in the political narrative. The recent ructions over HBOS management are illustrative: almost nothing has been learned about the reasons for HBOS's failure since early 2009, but the scandal has been allowed to appear as if it is a current failing of a current bank. Learning from the past is essential; reliving it constantly necessarily constrains the nation's ability to move on.
- And, at current prices, the government's shares are worth around £36 billion. The Bank of England is set to support the gilt market indefinitely, suggesting that the Treasury could use a part of any windfall to stimulate demand through one-off spending increases or tax cuts. Were the sales to be staggered, the population could reasonably be expected to see these 'one-off' spending rises as recurring over several years, to think of this as a potential material uplift in growth, and therefore to regain some of the lost confidence that all economic recoveries require.

Limiting the deflationary impact of the FPC and the political rhetoric

The UK's banks have the strongest capital ratios among banks in the major western economies. It is possible that reported capital levels may be unreliable in some circumstances, as the FPC has suggested, but the FPC has offered no evidence that UK ratios are intrinsically less reliable than those of other countries. As a result, the risk is high that the FPC is merely ignoring inconvenient truths in its quest to place more constraints on banks.

Perhaps if all current indicators were somehow proven unreliable then a belief-based regulatory system might make sense. Once again, however, there has been no evidence provided of any structural unreliability in the capital or funding of UK banks – and in our view none exists. Instead, that the ratios look high undermines a central tenet of FPC belief; and so these ratios are themselves to be undermined.

This highlights why other countries have tended to avoid stand-alone macroprudential bodies. They are inherently deflationary. Indeed, there is some evidence that the chancellor is trying to unwind at least a part of the damage done (by himself) in creating the FPC. In its updated remit of April 2013, the Treasury emphasised that: 'It is particularly important, at this point of the cycle, that the Committee takes into account, and gives due weight to, the impact of its actions on near-term economic recovery.'⁵

This must be seen as an effort to reduce the deflationary impact that the FPC's actions have demonstrably had. And the timing is crucial: unless Carney is able to turn official monetary activism into something that the population actually experiences, the economy's recovery will be delayed indefinitely. It is quite possible that the leap will be too great for this government, leaving a successor to face the same challenge.

5 See http://www.hm-treasury.gov.uk/d/remit_fpc_290413.pdf