

Why the Government should back the ICB

With interest rates left unchanged in hold in both the UK and the euro area in the past week, attention has shifted back to the forthcoming recommendations from the Independent Commission on Banking (ICB). Since the interim report was released in April, banks have been lobbying vigorously to water down and/or delay the likely recommendations. We will shortly find out if they have been successful.

The ICB was asked to consider structural and other reforms that are needed to promote financial stability and competition in the UK. On stability, the key proposal from the ICB's interim report was the need to ring fence universal banks' retail operations from their investment banking units. The UK's deposit guarantee scheme means that universal banks benefit from an implicit subsidy, as if anything went horrendously wrong the government would step in to protect depositors. The ICB's ring fence will stop taxpayers from bailing out universal banks' riskier investment banking activities.

But the ring fence is not a panacea. The recent banking crisis has demonstrated that non-universal banks can be a risk to the financial system, both on the retail side (Northern Rock) and on the investment banking side (Lehman Brothers). But, implemented properly, it would be a good way of limiting taxpayers' potential liabilities. The new Financial Policy Committee (FPC) also favours 'living wills', which would provide clear documentation and guidance on how to unwind banks' positions and close institutions down if they ever get into trouble. The FPC will need other tools as well, but together ring fencing and living wills would dramatically improve financial stability.

The banks have argued that ring fencing would increase their funding costs, which is true – that is the impact of the implicit taxpayer guarantee. And, given that they have already increased margins dramatically in an effort to help rebuild balance sheets, those higher funding costs would probably be passed onto consumers. But, if the ICB can deliver on the competition front, the impact need not be that marked. New entrants to the banking sector face significant hurdles, but would also not suffer from the need to massively deleverage. And any increase in the interest rates households and businesses face would certainly be small relative to the wholesale damage that the banking crisis has wreaked on the economy as a whole. Economists' estimates vary, but as a ballpark guide it is likely that that around 10% or so of GDP has been permanently lost. Or, put another way, national income will be £140bn lower (at 2009 prices) each and every year. At normal discount rates, that puts the real cost of the crisis at well over £2.5 trillion. Compared with that, an extra 1% or 2% on household interest rates or leveraged buyout financing – which could be offset by monetary policy anyway – would not be a big deal.

The banks have also argued that ring fencing and other regulation could impede bank lending to households and small and medium-sized enterprises (SMEs), and hence harm the already weak recovery. But this is a specious argument; for the past two years banks have not lent much to SMEs anyway, even before any new regulations are implemented. The 'gross lending' figures reported in the Project Merlin data are inflated compared with the official Bank of England series, because they include rollovers of existing facilities. In fact, net lending to the non-bank corporate sector has been firmly stuck in negative territory this year. From a business perspective, this is not especially surprising – retail banking, and in particular lending to SMEs, just doesn't generate the high margins and profits that investment banking can.

The latest reports suggest that the ICB will push for swift legislation from the Government, but a phased implementation of its recommendations. If politicians are genuinely interested in what is best for the UK economy and its taxpayers, they should do as the ICB suggests.

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Global financial markets ^(a)

	Level	Δ on week	Δ on year ago		Level	Δ on week	Δ on year ago
FTSE 100	5258	-0.6%	-4.3%	10Y Gilt yield	2.29	-15bps	-76bps
FTSE All-Share	2729	-0.8%	-3.7%	10Y UST yield	1.96	-2bps	-80bps
S&P 500	1172	-0.1%	+6.2%	10Y Bund yield	1.80	-21bps	-54bps
EuroStoxx	2102	-5.3%	-24.4%	\$ / £	1.59	-2.0%	+3.0%
2Y Gilt yield	0.55	+0bps	-14bps	\$ / €	1.37	-3.5%	+8.0%
2Y UST yield	0.18	-2bps	-39bps	¥ / \$	77.8	+1.2%	-7.2%
2Y Bund yield	0.40	-12bps	-30bps	€ / £	1.16	+1.5%	-4.6%

(a) At 4pm BST.

Past week's economic highlights

Region	Release	Period	Actual	Consensus
Tuesday 6 September				
Euro area	Second release of GDP, %Q/Q (Y/Y)	Q2	0.2 (1.6)	0.2 (1.7)
Wednesday 7 September				
UK	Industrial production (manufacturing output), %M/M	Jul	-0.2 (0.1)	0.2 (0.0)
US	Federal Reserve's Beige Book	Sep	n.a.	n.a.
Thursday 8 September				
UK	BoE announces Bank Rate, % (asset purchase target, £bn)	Sep	0.5 (200)	0.5 (200)
Euro area	ECB announces main refinancing rate, %	Sep	1.5	1.5

Coming week's economic highlights

Region	Release	Period	Consensus	Previous
Tuesday 13 September				
UK	Headline (core) CPI inflation, %Y/Y	Aug	4.5 (3.0)	4.4 (3.1)
	RPI(X) inflation, %Y/Y	Aug	5.1 (5.2)	5.0 (5.0)
	Trade balance, £bn	Jul	-4.2	-4.5
Wednesday 14 September				
UK	Claimant count unemployment, Δ K (% rate)	Aug	35.0 (5.0)	37.1 (4.9)
	LFS unemployment, % 3MA	Jul	7.9	7.9
	Average earnings (excl. bonuses), %Y/Y 3MA	Jul	2.7 (2.1)	2.6 (2.2)
Euro area	Industrial production, %M/M (Y/Y)	Jul	1.5 (4.6)	-0.8 (2.7)
US	Retail sales (excl. cars and petrol), %M/M	Aug	0.2 (0.3)	0.5 (0.3)
	Headline (core) CPI inflation, %Y/Y	Aug	3.6 (1.9)	3.6 (1.8)
Thursday 15 September				
UK	Retail sales (excl. petrol), %M/M	Aug	-0.3 (-0.2)	0.2 (0.2)
US	Industrial production, %M/M	Aug	0.1	0.9

Sources for tables: Bloomberg and BVCA.

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