

Novus Capital Markets Research

Tarts and Vickers

15 September 2011

Big Bang + 25: next month sees the 25th anniversary of Big Bang. Prodded into the 20th century by the UK competition authorities, the City agreed to the removal of the fixed commissions and the leisurely lifestyle of a ‘gentleman’s club’ and to a large-scale reform of its institutions. Without the prop of fixed commissions the typically small firms of brokers, jobbers and discount houses recognised they needed more capital to fund their risky activities. That capital was provided by the balance sheets of larger UK, European and US banks who put together the financial conglomerates that we have today. The model that was created back in 1986 under which the risky activities of the investment banks were subsidised by the more prosaic retail operations was tested to destruction by the US sub-prime mortgage scandal and the financial crisis that it gave rise to. The proposals of the Vickers Committee to drive a wedge between the two operations and partially to ring-fence the balance sheets of the clearing banks are intended to curtail the excesses that the reforms of Big Bang ultimately gave rise to.

Tarts and Vickers: the costs to the UK economy and the public finances of the worst recession in living memory and bailing out the banks are enormous. On the MPC’s latest forecast, the loss of output will prove to be permanent. Trend growth may also have been affected for the worse. It will take a generation for the level of public sector debt to get back to the 40% of GDP that Gordon Brown deemed prudent. It must be worth paying a significant premium to insure against anything like this happening again. The Vickers proposals, which will make life less profitable for the banks and which may reduce their ability to lend, constitute such an insurance premium. The onus must be on the banks to show that the premium is too large and/or that there are other, less costly, ways to ensure that what they have visited on us in the last few years is not repeated.

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Big Bang + 25

We are a month away from the 25th anniversary of Big Bang. On 27 October 1986, in a deal with the UK's competition authorities, the City of London agreed to abolish the fixed commissions which had provided the basis for its 'gentleman's club' and a leisurely lifestyle. The archaic distinctions between brokers, jobbers and discount houses went in a far-reaching reform that opened up the City to greater international competition.

As a part of the process the typically small partnerships that had characterised the City recognised that without the prop of fixed commissions their financial structure would be unable to cope with the new, more competitive environment and sought the protection of larger financial institutions with – and this is the key point – balance sheets to match. It was then that the major UK retail banks (and their European and US counterparts) began the process that resulted in the large, diversified financial conglomerates that we have today. Brokers, jobbers, discount houses were bought up as corporate finance, equities, bonds and f/x, sales and trading were brought into one combined operation.

It is well documented how in the opening years of the new Millennium a glut of savings from Asia led to downward pressure on yields and encouraged financial institutions to fabricate increasingly risky products that were packaged up and sold on to final investors. The balance sheets of the financial institutions expanded to take on the extra risk.

It is also well understood that banks lose money when they lend to countries or companies or individuals that do not pay it back. This is part of the normal banking process and ordinarily does not cause problems. Only rarely are the defaults on a scale that causes problems for the system as a whole. The US sub-prime mortgage crisis – and the securities that had been bundled together out of the sub-prime loans – was an extreme example of this. Not even the largest balance sheets that the investment banks had at their disposal could cope with the losses on the scale of the last few years.

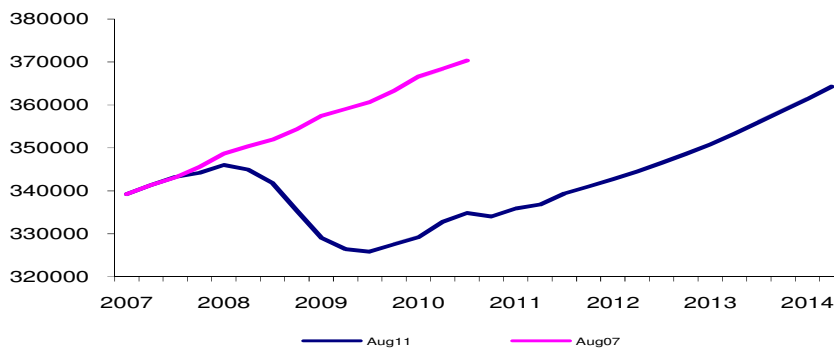
The reforms of Big Bang may have been motivated by a desire to bring more competition to the City, but it has always seemed to me that the City has managed to earn super-normal returns (and pay super-normal salaries) that in a truly competitive market would have been bid away. In the nicest possible way (there are still a lot of gentlemen in the City) high rents have been extracted from governments,

companies and households, and from savers and borrowers alike. For the City, in a post-crisis world, the number one objective appears to be to get back as quickly as possible to the *status quo ante*, in which high levels of rent are extracted from customers and paid to employees (though not shareholders who have sustained huge losses as a result of the financial crisis).

The cost of the crisis

The effect on output of a recession can be mild at one extreme (where the loss in output is quickly made good and the previous trend growth restored) or very severe at the other extreme, where there is a permanent loss to both the level of output and the potential future rate of growth (underlying productivity). It is already clear that the financial crisis has left the UK economy with a large, permanent loss to output (and an equivalent hole in the public finances) and, possibly, a lower trend rate of growth. A comparison of the MPC's latest forecast with the August 2007, pre-crisis, forecast makes it clear that output lost in the recession is not going to be made good and suggests that trend growth might be slightly lower (Chart 1).

Chart 1: MPC GDP forecasts, pre- and post-crisis

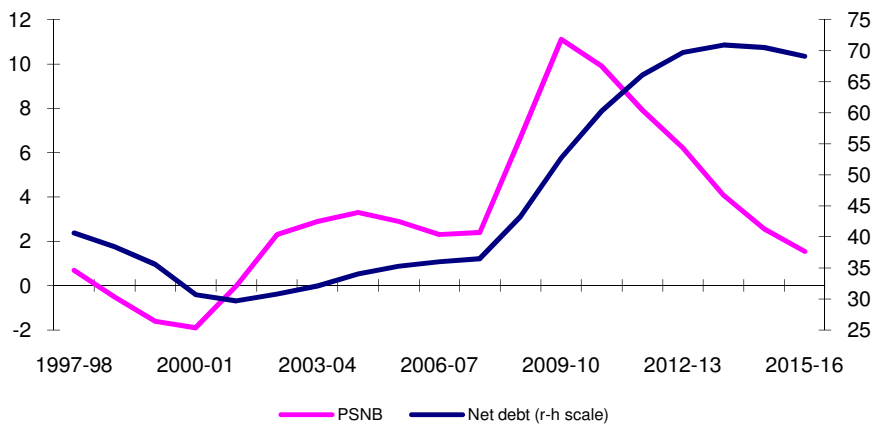


Source: BoE

The effect on the public finances is equally large in the short term, though it cannot be permanent since public sector net borrowing of 10% a year is unsustainable – ultimately public spending has to be brought into line with the smaller tax base that Chart 1 tells us is our inheritance. In the meantime,

public sector net debt is rising sharply as a share of GDP. From a low of less than 30% following the receipts of 3G telecoms licence payments in 2001-02, the debt-income ratio rose to 36.5% in 2007-08, still comfortably below Gordon Brown's prudent ceiling of 40% of GDP. Since then the ratio excluding the temporary effects of financial interventions has risen above 60% (61.4% in July 2011) and, according to the OBR's Budget forecast, will rise steadily to a peak in excess of 70% in 2013-14. Over the last two years of the Budget forecast the ratio is projected to be falling in line with the elimination of the structural budget deficit – as is required by the Chancellor's supplementary mandate (Chart 2).

Chart 2: OBR Budget forecast (% GDP)



Source: OBR

Beyond 2015-16 the outlook for the public finances is hugely uncertain but, as the OBR's fiscal sustainability report (July 2011) makes clear, the long-term outlook on unchanged policy is unacceptable. Without offsetting action the OBR's central projection is for the debt-income ratio to rise back up to over 100% of GDP by 2060-61. Even if the primary balance (which excludes debt interest) were to remain constant at its 2015-16 level (a surplus of 1.3% of GDP), it would take 25 years for the ratio to fall back to the 40% of GDP that Gordon Brown once deemed prudent.

The message of all this is clear: the economy and the public finances have taken an enormous hit from the financial crisis and the ensuing recession. We could quantify this loss in GDP (the area between the two lines on Chart 1 suitably discounted) or, more prosaically, we can state that it will take a generation (25 years) of hard slog to get the public finances (net debt) back to where they were before the crisis. The burden on the next generation of young workers, who already have to carry the retiring baby-boomers, is enormous.

The Vickers Report

The Independent Commission on Banking headed up by Sir John Vickers was set up in response to the global financial crisis which effectively bankrupted two of our four major clearing banks. In some respects its proposals, which require a degree of separation between retail and investment banking and a ring-fencing of retail balance sheets from the potential losses incurred by the riskier investment banking operations, take us back to a pre-Big Bang world (this is not a pejorative statement).

The reforms of Big Bang required small, risky investment banking operations to be backed by safer, larger banking operations with balance sheets that could absorb the occasionally sizable losses of the investment banks. As we now know, it took less than a quarter of a century for this set-up to be tested to destruction. Not even the largest balance sheets were able to sustain the sub-prime losses. It is hardly a surprise that the Vickers Committee should recommend taking those balance sheets at least in part away from the investment banks.

Nor is it a surprise that the banks should object to this process. Without the backing of these balance sheets, their ability to pursue risky, potentially lucrative, activities (and pay themselves accordingly) will be curtailed. Their ability to lend will be reduced – to the detriment of the economic recovery, they argue.

There are always arguments on both sides but it seems to me to be incontrovertible that it is worth paying a significant premium to insure against the costs of another crisis anything like the one that we have had. That premium can come in the form of the banks having to put up more risk capital or in some form of ring-fencing. Whatever form it takes, if the cost of funding riskier operations goes up then that seems appropriate. It may, as the Commission acknowledges, 'be contrary to the private interests of

wholesale/investment banking operations of some UK banks' but that is different from the public interest (in effect the reforms take away the cross-subsidisation from less risky assets and the implicit taxpayer guarantee that, *in extremis*, prevents the banks from total collapse). The burden of proof has to lie with the banks. They have caused irreparable damage to the economy and have blighted the outlook for a generation. The costs of curbing their activities and making them safer are small relative to the damage they have done.

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