BRIEFING PAPER

ADAM SMITH INSTITUTE

Saving the City

Sparing the UK's golden goose

By Tim Ambler

Introduction

The international financial centre that is the City of London is one of Britain's last remaining economic assets, and is by far its most important. It should be no surprise that it attracts the envy of neighbouring countries, who would dearly love to bring London down a peg and get some of its business for themselves.

While this threat from centres like Frankfurt, Paris and Amsterdam is clear, there seems to be little concern about it among UK politicians, and not enough concern about it even within the City itself. Unless the threats from continental Europe are addressed, the demise of the City of London may be only a matter of time.

We need to take a long-term view of the future of this incredible national asset, looking over the next fifty years, and devise a clear strategy to maximise the long-term prosperity of the City – and therefore its value to the UK economy as a whole.

Despite all the heated exchanges over UK Prime Minister David Cameron's plan to renegotiate Britain's membership of the EU, whether the UK stays in or leaves the EU may not be critical for the City. Far more important is the need to create a single global market for financial services. In such a global market, the potential for such a leading-edge financial services provider as London is unlimited.

Agenda for Survival

But the two highest-profile measures that have been proposed in the wake of the 2008 financial crisis – ring-fencing retail banks and higher capital ratios – would be counter-productive, especially when the financial sector remains fragile. Instead, we should be trying to build a single global market in financial services, with a single set of regulatory principles that can be easily and universally applied. These must be principles that protect consumers, but without crushing innovation and loading providers and customers with cost, as the present rules and regulators do and future proposals threaten to do.

There are two possible ways of getting to that optimum. One is for the UK to throw its full weight behind the proposition that simpler and lighter regulation gives customers more choice and value for money than complex and burdensome rules, and to negotiate strongly for that outcome in talks with the EU, US and other financial authorities. The second approach is unilaterally to simplify our regulations and focus them on the essentials, in the hope and expectation that others will have to follow in order that they remain cost-effective and attractive to customers.

Though the number and powers of the regulators has grown since Gordon Brown created the Financial Services Authority (FSA) more than a decade ago, the results have been disastrous. Regulators did not see the financial crash coming and had no idea what caused it or how to react to it. And the FSA actually caused other disasters such as the Payment Protection Insurance (PPI) scandal, first by insisting that providers offer it, then neglecting to police how it was sold.

Auditors, too, have added to the regulatory cost but have done little to prevent high-profile scandals such as the LIBOR rate fixing. Yet it is remarkable that neither auditors nor regulators have faced any serious consequences, despite their failure to prevent these disasters and scandals. Plainly, we need fewer but more effective and more accountable watchdogs.

Better Management

Certainly, there are things that the City itself can and must do to ensure that it remains one of the world's leading-edge providers of financial services. For a start, it needs to improve its management. Increased international

Adam Smith Institute - The free-market thinktank
23 Great Smith Street, London, SW1P 3BL
+44 (0)20 7222 4995
www.adamsmith.org

competition will require an altogether crisper approach. Margins, costs and personnel numbers need to fall further. Managerial capability needs to be measured not by compensation but by performance and productivity.

The 2008 crash revealed a banking management that was not up to the job. The big rise in complaints to the Financial Ombudsman Service (FOS) indicates just how far bank managements are dislocated from customers and unresponsive to pressures for improvement. The LIBOR and money-laundering scandals show that management either had little idea of what their own managers were doing or did know and were complicit.

Performance measures should focus on efficiency and effectiveness compared with global best practice, and on customer satisfaction relative to competitors beyond the UK – and not just on internal ratios, profits and share prices.

Leaner and Fitter

The bonus culture in the run-up to 2008 penalised low-risk and long-term sustainability in favour of high-risk short-termism. A lack of shareholder pressure added to this: today's shareholders, with no interest in the company other than short-term gains, behave very differently from those focused on the long-term health of their company.

Meanwhile the lack of competition in the banking sector creates complacency. UK banks run wider margins than their continental competitors, charging 1% more to borrowers and paying 1% less to depositors. UK banks can do this primarily because customers have little choice – there are just six independent retail bank groups in the UK, compared to many thousands in the US. But can UK banks meet the challenge of becoming leaner and fitter? When Andrea Leadsom MP put this to Andrew Bailey of the Bank of England, Bailey ducked out of a direct response. That might have pleased the UK banks he is supposed to be regulating, but it does not auger well for the long-term future of the City.

The City already runs a number of low-margin, high-volume businesses, and that model should be secure for the future. Of course, it should not be the only model. Most branded consumer markets offer a range of choice from low-cost utility products to high-value luxuries. While the price of luxury drinks or clothes brands often cannot be justified in terms of their cost, discerning or fashion-conscious customers still choose to buy them. In financial services, mergers and acquisition activity is comparable: some firms are prepared to pay premiums to get the services of top-flight advisers. There is nothing wrong with that outcome.

Regulation Cost-Effectiveness

There are things that governments can do too. Excessive regulation is a major contributor to cost – not only the cost of the regulators themselves (recharged to the City) but also of the legions of compliance officers and others within City businesses who have to deal with those regulators. And the burden keeps growing.

The burden is increased by a further stream of compliance monitors, namely the auditors. Given the scale of banking malfeasance and the inability of internal and external auditors to detect, or at least do anything about, any of it, the extent to which the audit professionals seem to have escaped any blame is remarkable.

It is time now for both streams of compliance personnel to be combined. We need one set but not two.

The UK should now give a lead to the EU and the world by transforming box ticking into intelligent supervision by relatively few people. The Bank of England managed that for two hundred years before Gordon Brown's changes – and it can do so again, particularly under its new Governor.

The FCA can be eliminated. The few necessary functions it fulfils can be transferred to the FOS, which in turn can be strengthened and streamlined by increasing the penalties for bogus claims and the banks' rejection of customers' valid claims.

If eliminating the FCA is a step too far in the short term, at least its attention should be shifted from insisting that the financial sector provides consumers with what the FCA thinks they should have, with the standardisation, reduction in competition and erosion of choice that this implies. As the House of Commons Treasury Committee put it: "Many customers of the financial services sector have been as poorly served by regulators as by firms in recent years. We have repeatedly stressed the need for regulators to focus on competition and choice in financial services as a powerful tool to improve consumer outcomes. We welcome Mr Griffith-Jones's commitment to us that he will act as the champion within the FCA of its competition objective. However, on its own this welcome commitment by the FCA's part-time, non-executive Chair is unlikely to be enough, particularly since its predecessor the FSA has appeared to pay insufficient attention to its requirement to have regard to the need to minimise the adverse effects on competition from the discharge of its functions. Mr Griffith-Jones will need to ensure, and demonstrate to Parliament, that the executive leadership of the FCA shares his commitment to the organisation's new competition objective."

Global Regulation

The City, and as a result the UK economy and its citizens, will prosper best in a globalised financial services market with only the necessary, minimum, set of regulations and external and internal regulators.

We propose a simple set of eight rules:

a. Not excluding those who wish to compete.
b. Ensuring that the consumer has real and substantive choice.
c. Not fixing prices with competitors.
d. Not laundering money.
e. Not trading outside the permitted hours.
f. Consumers should have access to the necessary information to make a choice.
g. Providing redress for product failure.
h. Cooperating with the media so that product failures and transgressions of these rules become public knowledge.

Regulations should be set for the global market, not separately for the EU or member states. As explained above, the ideal of a single global market with a single set or rules or principles can be pursued either by negotiation or by downward competition akin to tax competition.

Promoting Competition

Some of the changes necessary to save the City require partnership between the City and the authorities. Government guarantees for depositors, for example, should be replaced by ATOL-type insurance by the Bank of England, which individual banks can elect to offer (or not offer). The annual premium costs to participating banks would vary according to their capital and liquidity ratios and other stability data that is available to the Bank of England as regulator. This would remove the current, possibly illegal, subsidy of bank deposits by national governments.

Since the crash, the number of banks and building societies has shrunk. Simplifying regulation would make it easier for new financial services companies to enter the market.

Greater competition would also address the 'too big to fail' problem. Normal competition rules should prevent any business from being too dominant. But even big companies could fail if depositors were protected by insurance. In addition, if UK subsidiaries were made independent on the lines of the Santander model, then the failure of a business in the host country (the UK in this case) would not bring down the parent in the home country, and vice versa

Brand Marketing

More importantly, focusing management on the market place would itself stimulate the City. Regulation stifles experimentation, innovation and new entry. The Coalition constantly calls for deregulation; this is an opportunity to do it.

And professional brand marketing provides far better consumer protection than regulation. Regulation, by trying to standardise things, actually drives out the brand marketing needed to communicate choice and drive innovation.

Conclusion

The UK needs to put its own house in order before it can effectively persuade other countries on the two roads to a competitive global market for financial services. But our example in simultaneously reducing but improving regulation and supervision would inspire others.

Whether the UK stays in or opts out of the EU may not prove to be a big issue for the City – certainly not if a Swiss-style relationship with the EU is available. When trading in the EU, the City will have to comply with EU regulations, and the EU and UK regulations are unlikely to be very different. When trading with the rest of the world, being outside the EU might give the City more freedom. But that freedom would have to be offset against not having a place at the Brussels table when the rules are set.

We conclude that it would be much the best for the City if global financial services rules were set globally and Brussels simply matched them. London needs to help the EU to understand that having a more restrictive code is not just bad for the City but even worse for the EU as a whole. Less, but more global regulation would be better for everyone.

ABOUT THE AUTHOR

Tim Ambler is a Senior Fellow of the Adam Smith Institute and, until he retired in 2011, a Senior Fellow of London Business School, researching and teaching marketing. He has researched and published papers on regulation since 2003.