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BEYOND VICKERS: NIESR PROPOSES ALTERNATIVE APPROACHES TO BANK REGULATION

In the latest National Institute Economic Review, published today, Dr. Angus Armstrong, Director of Macroeconomic Research at NIESR, discusses the Government response to the final report of the Independent Commission on Banking (ICB) known as the 'Vickers's Commission'.

The Chancellor, Mr Osborne, nicely captures the challenge facing the banking industry as the 'British Dilemma' where the UK is home to some of the largest banks in the world but the state cannot afford the contingent fiscal risks. The ICB aims to resolve this dilemma by ensuring that banks are better able to absorb losses by holding more capital and that they are structured so that core financial services necessary for the continuous functioning of the economy can be provided without interruption.

However, in an earlier article (October 2011) Dr Armstrong argued that the ICB's Final Report did not consider the unique characteristics of banking. This is likely to lead to more evasion and avoidance as more activity is shifted beyond the regulated sector and into the so-called shadow banking sector. Without a solution to the shadow banking issue, the ICB's proposals are unlikely to yield a stable solution. Shadow banks provide some socially useful functions, but they have also been the centre of the major financial crises over the last two decades.

The logical conclusion is that incentives must be changed to encourage retail banks which provide essential services to the economy to reduce their exposure to the shadow banking system. This requires two steps. First, the incentives of retail banks must be such that they choose to avoid excessive risk taking in the shadow banking sector. The emphasis is on incentives rather than prohibition. This is best achieved by allowing these banks to grow strong franchise values. Banks with high franchise values are likely to hold more capital. This will require a more nuanced approach to competition and market entry than proposed by the ICB.

Second, where there is a sound economic case for using shadow banking, these structures should be moved within the regulatory perimeter. For example, there is a sound economic case for the sale of securitised mortgages to *long-term domestic investors*. Rather than allow banks to continue issuing securities which failed so spectacularly in the past, there is a public good case for supporting a regulated mortgage-backed securities market. Since there is a market failure, favourable regulatory treatment does not imply a subsidy.

Dr Armstrong argues that wholesale banking is altogether different from retail banking. Wholesale or investment banks have inherently opaque activities where most returns accrue to private individuals. Even without supplying retail services these banks have been shown to pose a systemic risk. A better alignment of incentives would be for wholesale bankers to be personally responsible for profits and losses through partnerships rather than by limited liability. The shadow banking sector would then be used by those who are best incentivised to manage the risk.

Notes for editors

1. This paper will be presented at a press conference at 2pm on Thursday February 2, 2012 and published in the National Institute Economic Review, no. 219, February 2012. For further information, please contact the NIESR Press Office: Pat Shaw on 020 7654 1905/p.shaw@niesr.ac.uk.

2. To discuss the paper or for interviews, please contact Angus Armstrong,
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3. The National Institute Economic Review is the quarterly journal of the National Institute of Economic and Social Research (NIESR). Published in January, April, July and October, it is available from Sage Publications Ltd at
subscription@sagepub.co.uk.

4. In addition to this paper, this issue of the review will also include NIESR's regular quarterly forecast (see separate press release); a further article by Dr. Armstrong, on the economic policy choices that would confront an independent Scotland (see separate press release); and a set of articles on policy evaluation, which will be presented at seminar on NIESR 20th February. For further information, please contact the Press Office.

5. Further details of NIESR's activities can be seen on <http://www.niesr.ac.uk> or by contacting: enquires@niesr.ac.uk.

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