

Seminar for Secretary of State for Scotland on 22 October 2009

The Future of Financial Services in Scotland

In the third of the series of seminars on key sectors of the Scottish economy, held at Forth Street, the spotlight fell on financial services. This attracted a well informed and influential audience who responded thoughtfully to the propositions of the two speakers Ben Thomson of the Noble Group and Benny Higgins, of Tesco Bank. Sir Sandy Crombie, CEO of Standard Life chaired the session.

The Secretary of State Jim Murphy posed a group of questions on the causes of the financial crisis and the measures that would help Scotland to recover. He identified the key challenge as being to restore trust and confidence in financial services. In particular he sought views on the balance of regulation and issues surrounding the combination of high street and investment activities

Ben Thomson, speaking from an investment banker's perspective, put the UK experience in context, noting that across the world others too were doing badly. He urged us not to be downbeat and noted that blame was not going to help us at this stage. However he fully acknowledged that the anger of the public was real and powerful and had to be faced.

He maintained that regulation was not the answer and that there was a message for all in the sector if some banks were held to be too big to fail. His proposals for change were wide ranging and specific:

- Calls for narrow banks, as defined by John Kay among others, should be supported. Institutions supplying retail deposits, cash payments and mortgages should be subject to licence and ownership controls. They alone should be eligible for deposit guarantees, while riskier investment operations should be allowed to fail.
- Consumer protection should lie at the heart of a competitive system. More competition was called for. On the vexed issue of concentration in the lending market in Scotland Ben referred to the impact of the duopoly of RBS and Lloyds banking group. SMEs in particular reported low availability of credit.
- The EU was addressing the consequences of mergers and considering the scope for enhancing competition by increasing the number and range of suppliers of retail and small business banking services. (This seminar was before the EU proposals for divestment by RBS, Lloyds et al were announced.)
- The range of retail products should be reduced as consumers were unable to make informed choices where complexity was excessive
- The issue of incentives for intermediaries should be looked at. The conflicts of interest in investment banking in particular should be examined.
- There should be less supervisory regulation because it does not work. Basel II, introduced so recently, was designed to provide prudential controls but it failed. The FSA should be reduced and there was also scope to reduce gold plating.

- ‘Utility banks’ – as per the Kay model - should be regulated by the Bank of England and not the FSA.

There was a tension between government and shareholder ambitions. His preferred solution for the banks in crisis would be to take them wholly into public ownership. Having restored them to health they should then be returned to the market. This approach had been followed in Sweden 1970s and the government there had broken even on the transactions. (In discussion the small scale of the Swedish banking sector was noted.)

In conclusion, to establish confidence and trust Ben urged adoption of all these measures, emphasising the need to encourage new entrants and to incentivise innovation. **Overall we had to get into a position where some banks could be allowed to fail.**

Benny Higgins gave a thoughtful analysis of the causes of the crisis which stemmed from the low cost of money in wholesale markets. The development of CDOs escalated and became quite out of balance with their underlying value. In 2008 every class of asset was at its peak value – which experience showed would always lead to trouble.

The essence of sound financial management was not to take risk but to manage risk. But in the market at the time no manager would have survived if he had not followed the trend and taken risk along with others.

Now the challenge was deleveraging and this in itself represented a risk for the economy. He saw tough challenges ahead and significant downside risks.

He did not favour demerging existing institutions as it was just too challenging – even separating sound from toxic assets in Northern Rock was hard enough. The proposals to sort out the difficulties of banks by taking them into public ownership and then selling them back quickly were not realistic. He cited the example of British Leyland which had remained under public control for many years.

Going forward he expected to see examples of institutions that were deemed to be “small enough to fail”.

He stressed that for his own institution Scotland was still an excellent place to be based. Tesco Bank was small but had opened with 6 million customers. And £1 in every £8 of cash in circulation was drawn from a Tesco ATM. It had a strong starting base.

The principal characteristic of the Tesco Bank was the application of Tesco values and the emphasis on following the customer, offering simplicity, and rewarding loyalty. He posed a final question. Could Tesco help to change the rules of how banks generally are run, with more emphasis on consumers?

In introducing the Q&A, *Sandy Crombie* contrasted the experience of banking with that of insurance - a part of the financial services sector that had not been badly battered in the current crisis. Having managed its way through earlier crises, Standard Life had immediately been challenged by the regulator to prepare for another “once in two

hundred years” event. This had led them to disposing of large amounts of equity risk and re-assessing their capital requirements. He likened the approach taken to protecting each strand of the business in a separate safe passenger compartment in a car. By ensuring strong protection, and adequate crumple zone, the business was set up to be robust and sustainable. He likened Standard Life to a bank run on narrow lines; and suggested that banks as they are had ineffective ‘crumple zones’.

A wide range of fascinating points were raised in a discussion that could have carried on for far longer than time constraints permitted. These included: -

- The possibility of differential taxation on interest and dividends to re-adjust incentives
- The alternative of a reduction in corporation tax
- The fact that this had not been a global crisis and the suggestion (disputed by others on grounds of scale and relevance) that there were lessons to be learned from other regulators – in Spain, Australia and Canada – countries that had all fared better than the UK.
- The view that a narrow banking approach would not solve the problems that had emerged from the complex end of operations.
- A global solution was needed. If there were 30 or 40 banks deemed too big to fail then they would need intensive and intrusive regulation – likened to having an air traffic controller within the business.
- Lengthy discussion of the role of institutional shareholders. But noting that if too much burden was placed on NEDs you won’t get any.
- Do shareholders have sufficient information to exert control? Better to rely on having good quality on the Board.
- Should not over-intellectualise risk
- The lack of consumer interest at the heart of the emerging strategy
- Acceptance that the building society model is not competitive globally – cannot go back to artisan banking for too much
- A plea to re-align incentives as any new model of banking and/or change to regulation could not be expected to work if going against well entrenched and powerful incentive mechanisms. We have to work with the grain of the market, even if that means adjusting prices etc so that market mechanisms tend to produce the type of outcome that society deems acceptable and indeed desirable.

All in all a fascinating evening, even if the problems of the financial sector were not wholly solved by those participating. But there was plenty of food for thought for the Secretary of State, his officials and those from the Scottish Government, SFE representatives and (crucially) representatives of the sector itself.

Kyla Brand/Jeremy Peat
November 2009.