



Perspectives by Ruth Lea

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Britain's sluggish economy needs a buoyant financial sector

The recent economic indicators have been very disappointing. The production industries fell by 0.2% in July, within which manufacturing rose by only 0.1%. And NIESR's monthly estimates of GDP suggested that output grew by 0.2% in the 3 months ending August, compared with 0.6% in the 3 months ending July. But even this poor rate of growth was flattered by the drop in output in April.¹

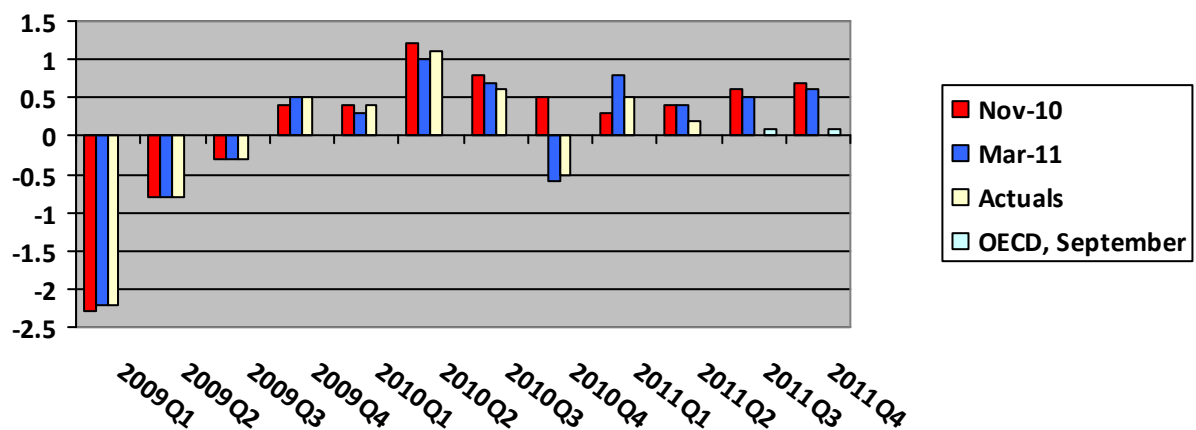
The latest Markit/CIPS purchasing managers' index (PMI) surveys were uniformly downbeat.² The manufacturing PMI slipped below 50 in August, the weakest reading since June 2009. Any figure under 50 indicates a contraction in activity. The construction PMI was also down in August, though at over 52, still suggested growth - albeit slowing. August's services PMI registered its biggest ever fall, apart from April 2001 when the foot-and-mouth crisis hammered agriculture and knocked tourism, though remaining over 50. The drop in the services index is especially worrying as services, including government services, comprise about 75% of the economy.

The Chancellor of the Exchequer conceded last week that the forecasts prepared by the Office for Budget Responsibility (OBR) for the March Budget will be missed. There will be a new set of forecasts, along with measures to boost growth, in the Autumn Statement (29 November). Growth, or more accurately lack of growth, is rapidly becoming the big economic story - along with the continuing and, arguably intensifying, crisis in the Eurozone. Despite the disappointing growth, the Chancellor reiterated that he would be sticking to his deficit reduction plans, rightly in our view.

But the UK's weakness is far from being unique. The OECD's latest interim assessment suggested that the recovery had come "close to a halt" across the OECD's industrialised economies.³ The OECD, it should be noted, is just the latest of a procession of forecasters to downgrade the global growth outlook as euro-induced turmoil in the financial markets hammers business confidence. The OECD's forecasters attributed the slowdown to five possible factors: a worse-than-expected global impact of the Japanese earthquake; more damaging-than-expected high commodity prices; faster-than-anticipated fiscal consolidation (maybe); faster-than-anticipated private sector balance sheet adjustment (maybe); and policy uncertainties, especially in the Eurozone. The OECD warned, with commendable restraint, that "the governance of the euro area in economic and fiscal matters must be improved".

The OECD's projections for the second half of 2011 for the UK were especially bleak. They showed quarterly increases of around 0.1% for both 2011Q3 and 2011Q4. These projections are shown in chart 1, with the OBR's November 2010 and March 2011 forecasts. Note that the OBR had forecast a GDP increase in 2011 of 2.1% in November 2010, downgraded to 1.7% in March 2011. And note too how the actuals for 2011Q1 and 2011Q2 were well down on the OBR's projections. The OECD's quarterly projections implied growth in 2011 of just 0.9%, compared with their May forecast of 1.4%.

Chart 1 Quarterly GDP forecasts (QOQ, %), November 2010 (OBR), March 2011 (OBR), actuals and OECD forecast



Sources: OBR, *Economic and fiscal outlook*, November 2010; OBR, *Economic and fiscal outlook*, March 2011, table 3.3; ONS, "GDP, 2nd estimate, 2011Q2", 26 August 2011; OECD interim assessment, 8 September 2011.

The G7 met on 9-10 September, pledging support for the world's sputtering economy and demonstrating "unity" – though there were few signs of any concrete proposals.⁴ The G7 meeting was preceded by President Obama's stimulus \$447bn package, some 3% of GDP, of which \$440bn or so would hit the economy during 2012.⁵ Much of it extended or replaced previous measures (including last year's payroll tax cut) that are winding down. In addition there are rising expectations that Fed chairman Bernanke will act further to stimulate the US economy.

The UK needs a growth plan: financial services are a good place to start

As we have discussed on previous occasions the UK needs a radical economic growth plan based on cutting the regulatory burden, especially for small firms, and reversing the competitiveness-destroying energy policies.⁶ The Coalition Government's measures to reverse the loss of competitiveness since the late 1990s have so far lacked the necessary radical zeal.^{7, 8}

But when it comes to the financial sector, most (all?) people recognise that the regulatory regime needed to be radically overhauled after the financial debacle of 2008. Some banks were inadequately regulated and very poorly governed. The financial sector needed more effective regulation and pleading for light-touch regulation will now fall on very deaf ears. But, as we noted in a recent Perspective, there are concerns that aspects of possible over-regulation, along with high taxes, may be acting to the detriment of the City's international competitiveness.^{9,10,11} There is also the issue of whether heavy banking regulations deter bank lending and economic growth domestically. It is not unrealistic, therefore, to remind policy-

makers that a vibrant financial sector, albeit a more tightly regulated one, is still very much in Britain's economic interests.

And to say that the financial sector is more tightly regulated, and will be even more tightly regulated, is an understatement. It is hardly an exaggeration to say that the regulation of the financial sector is undergoing a revolution, with rules on everything from derivatives to pay changing drastically.¹² This Perspective offers just an overview of some of the changes, with deeper analysis (for example on the Vickers Report) left for future Perspectives.

Financial services regulation: an overview of a revolution

Globally agreed measures

One major source of the regulatory shake-up in the banking sector will be the Basel 3 Accord, which was endorsed by G20 in November 2010, and will be implemented in stages by 2019. Basel 3 is the latest accord agreed by the Basel Committee on Banking Supervision (BCBS), the main forum for regular cooperation on banking supervisory matters.¹³

Basel 3 includes very significant changes to the capital, liquidity and leverage rules for banks. Annex table 1 shows the key features of Basel 3. For example, the minimum Tier 1 common equity requirement is to be increased from 2% to 4.5%, to which is added a capital conservation buffer of 2.5%, bringing the total common equity requirement to 7%. These measures will be implemented in the EU through CRD4 (Capital Requirements Directive, 4).

Basel 3 builds on the previous internationally Basel agreements, most recently the July 2009 update to Basel 2 ("Basel 2.5") which was implemented in the EU through CRD3. It should be noted that CRD3 also included highly prescriptive remuneration guidelines which were released by the EU's Committee of European Banking Supervisors (CEBS, now the European Banking Authority (EBA)) in December 2010.^{14,15} The guidelines mean that bankers will receive only 20-30% of their bonuses in immediate cash. Annex table 1 includes the main remuneration rules.

The Financial Stability Board (FSB) was established in April 2009 by the G20, as the successor to the Financial Stability Forum (which had been set up in 1999), to "address vulnerabilities and to develop and implement strong regulatory, supervisory and other policies in the interest of financial stability".¹⁶ One of the key activities of the FSB is the issue of Recovery and Resolution Plans (RRPs or "living wills") for systemically important financial institutions (SIFIs) as part of the wider set of reforms to make the financial system safer. The FSA is moving ahead with a framework for banks' "living wills" and expects most qualifying banks to have plans in place by the end of June 2012.¹⁷

EU measures

Turning from global agreements to the EU, the EU's regulatory hold over Britain's financial services sector, in the name of developing the Single Market in financial services, is increasingly extensive.¹⁸ It affects both the legislation (mainly through Directives) and supervision. Concerning legislation the Alternative Investment Fund Managers Directive (AIFMD) has, for example, to be implemented by July 2013. A report prepared for the FSA concluded that "the AIFMD will have significant impacts

in terms of reduced investor choice and substantial compliance costs for the AIF industry (which will be passed on to investors, ultimately resulting in lower returns).¹⁹ It is clear, therefore, that the Directive is unhelpful to the AIF sector and to their customers.

The recently implemented system of pan-European supervision includes the three European Supervisory Authorities (ESAs) and oversees the EU's banking, insurance and securities markets. Its supervisory powers over national authorities can only be expected to increase as the Single Market integrates further.²⁰ The ESAs specifically aim to create a single EU rule book. They will do this by developing draft technical standards, which will then be adopted by the European Commission as EU law. The ESAs will also issue guidance and recommendations with which national supervisors and firms must make every effort to comply.²¹ The guidelines on banking remuneration by the CEBS (now EBA), see above, is an example. Annex table 2 lists the EU supervisory bodies.

UK measures

Turning from the EU to national measures, the UK government set up the Independent Commission on Banking (ICB) last year, which was asked to consider structural (almost uniquely) and related non-structural reforms to the UK banking sector to promote financial stability and competition.²² The interim report was released in April and the final report (the Vickers Report) on 12 September.²³ The main recommendations include the well-publicised ring-fencing of retail banking, which arguably may restrict lending to businesses, as well as measures to encourage competition. The Government has provisionally accepted the main findings of the report and we will return to this issue when they release their concrete proposals for implementation.

Last but not least, the UK regulatory machinery is in a state of flux. The FSA will be replaced by:²⁴

- The Financial Policy Committee (FPC), located in the Bank of England, with responsibility for “macro-prudential” regulation. (“Macro-prudential” regulation is the regulation of stability and resilience of the financial system as a whole.) The FPC is a parallel organisation to the Monetary Policy Committee. An interim FPC was established in February 2011.
- The Prudential Regulation Authority (PRA), as an operationally independent subsidiary of the Bank, which is expected to be established by end-2012. The PRA will be solely responsible for the authorisation, regulation and day-to-day supervision of all firms that are subject to prudential regulation. The PRA is therefore concerned with “micro-prudential”, or firm-specific, regulation.
- The Financial Conduct Authority (FCA), previously known as the Consumer Protection and Markets Authority (CPMA), which will have the responsibility for the conduct of business regulation across the entire spectrum of financial services.

Increased regulations: economic implications

Increased regulation, in itself, does not mean that the City would lose competitiveness providing that other financial centres are imposing similar policies. It can be argued that Basel 3, providing the EU and/or the UK's national regulators do not "gold-plate", is competitiveness-neutral. Concerning the unilateral application of restrictions, whether by the EU (e.g. AIFMD or the remuneration guidelines) or by the UK (the ICB recommendations), these could risk undermining the City depending on the actions of the other financial centres.

There are of course other economic implications of extra regulations – not least of all whether heavy banking regulation (including higher capital requirements) constrains banks' ability to lend and therefore knocks economic growth domestically. It is however widely accepted that there are such costs, but these costs are to be traded-off by the potential benefits of greater financial stability.

The Bank of England, for example, has said that:

- "...higher prudential capital levels for banks can have both costs and benefits for the economy. Costs may rise if banks pass any increase in their funding costs onto firms who then reduce investment. But there may also be benefits if higher capital levels make the banking system more resilient, reducing the probability or severity of financial crisis." ²⁵

Taxation

But it is not just the extra regulations that are challenging the status of the City of London. The tax regime (for both income and corporate taxes) has been identified as a potential threat. High income tax rates, in particular, act as a deterrent to globally mobile talent working and investing in London. ^{26,27}

British governments have introduced several tax changes in recent years aimed at high earners, in general, and the banking sector, in particular:

- The 50% income tax rate, for incomes over £150,000, was introduced in April 2010. At the same time income tax personal allowances were reduced for those earning more than £100,000, tapering down to zero. There does now appear to be a movement to remove the 50% rate. 20 economists recently appealed for abolition in a letter to the *Financial Times*.^{28,29} There is also some doubt over how much revenue the 50% rate actually raises. The IFS have recently suggested that it may not raise any extra revenue and could actually reduce it.³⁰
- There was a one-off 50% bank payroll tax, payable by employers on bonuses over £25,000 which were awarded between December 2009 and April 2010.
- The Bank Levy was initially announced in the June 2010 Budget. The rate on bank balance sheets was initially set at 0.04% in 2011, starting January, rising to 0.07% from 2012. Germany and France have also introduced levies but most other countries have not.
- The Bank Levy was amended in December 2010. Rates would be 0.05% for short-term funding (& 0.025% for longer maturity funding, i.e. greater than 1-year maturity) from January 2011 and 0.075% for short-term funding (& 0.0375% for longer maturity funding) from January 2012.

- The Bank Levy was amended again in February 2011 when the lower rate of 0.05% (& 0.025%) was scrapped. To make up for the “lost” revenue in January and February 2011, the rate was increased to 0.1% (& 0.05%) for March & April, but the rate of 0.075% (& 0.0375%) applied to the rest of 2011.
- The Bank Levy was amended again in the March 2011 Budget, when the rate was raised from 0.075% (& 0.0375%) to 0.078% (& 0.039%) from January 2012.

Not merely do higher and new taxes risk London’s position, but the frequent changes in taxes undermine Britain’s reputation for having a stable and predictable tax regime in which businesses can plan.

At their August 2011 bilateral summit French President Nicolas Sarkozy and German Chancellor Angela Merkel brought up the issue of an EU-wide financial transactions tax (FTT), or Tobin Tax, again. There is, it should be noted, no sign of any global agreement for such a tax and an EU-wide tax would, therefore, put any EU financial centre at a considerable disadvantage to any non-EU financial centre. The tax should apparently cover equities, bonds, currency transactions and derivatives (including all over-the-counter trades) ³¹ and would clearly have a much greater impact on London than on the EU’s financial centres.³² The Commission has proposed that any proceeds of should be funnelled into the EU coffers. The British Government has expressed its opposition and still retains the veto on tax matters. It is clearly vital that it maintains this stance.

References

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5. *FT*, "Economic insurance policy unveiled", 9 September 2011.
6. Ruth Lea, "Britain needs a radical pro-growth strategy", Arbuthnot Banking Group, 7 February 2011.
7. HM Treasury & BIS, *The Plan for Growth*, March 2011.
8. Though note that the UK has improved its standing in the WEF competitiveness league table, partly reflecting the strength of the labour market. It has swapped places with Canada to move from 12th last year to 10th this year. WEF, *The Global Competitiveness Report 2011-2012*, September 2011.
9. Ruth Lea, "The City of London is still the top financial centre: for now", Arbuthnot Banking Group, 5 September 2011.
10. Oxford Economics & the City of London Corporation, *London's competitive place in the UK & global economies*, January 2011.
11. The Z/Yen Group's Global Financial Competitiveness Index (GFCI) report for September 2011 should be released soon and should give insight into the status of London as a financial centre.
12. *CityAM*, "Business as usual? Hardly for anyone working in finance", 2 September 2011.
13. The Basel Committee on Banking Supervision (BCBS): the members come from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the UK and the US. The BCBS is separate from the Bank for International Settlements (BIS). See www.bis.org.
14. CEBS, *Guidelines on remuneration policies and practices*, December 2010. Website: www.eba.europa.eu/cebs
15. According to *CityAM*, "Business as usual? Hardly for anyone working in finance", 2 September 2011, these are the most prescriptive rules governing compensation in the world. The US has introduced a similar, but far less prescriptive, scheme as part of the Dodd-Frank Act (the Dodd-Frank Wall Street Reform and Consumer Protection Act, 2010).
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17. FSA, "FSA publishes Recovery and Resolution Plans consultation", August 2011, www.fsa.gov.org.
18. Keith Boyfield, *Selling the City short?*, Open Europe, November 2006, calculated that the EU's Financial Services Action Plan (FSAP) could cost be between £14bn and £23.5bn for the UK up to 2010.
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26. Ipsos Mori & the City of London Corporation, *Understanding global financial networks: business and staff location decisions*, May 2011, stated that "...high levels of personal tax act as a disincentive for mobile professionals, with unpredictability in taxation regimes & high corporate tax acting in much the same way for businesses."
27. Oxford Economics & the City of London, *London's competitive place in the UK & global economies*, January 2011, stated that "...changes to the tax regime have also been highlighted as a potential risk to London's position. The higher income tax rates were highlighted by many financial services sources as potentially discouraging key personnel from locating in London. It pushed marginal rates for top earners well above those in Switzerland & the US and even above European countries traditionally known for taxing higher earners heavily."
28. *FT letters*, "Government must abolish 50p tax rate to grow UK economy", 7 September 2011. The economists wrote "...it gives the UK one of the highest personal tax regimes in the industrialised world, making it less competitive internationally & making us less attractive as a destination for both foreign investment & talented workers. The UK has already slipped from 2nd to 4th place as a destination for inward investment."
29. Allister Heath, "It's time to abolish the 50p tax rate", *CityAM*, 8 September 2011, wrote "...the top 1% of earners will pay 27.7% of the total income tax take in FY2011, they earned 12.6% of total income".
30. *Sunday Times*, "Top tax of 50% 'raises nothing'", 11 September 2011.
31. *FT*, "Franco-German tax scheme refined", 10 September 2011.
32. Open Europe, "Ten ways to introduce an EU tax (and why none of them will work)", August 2011, reported that the World Federation of Exchanges, for example, puts the level of financial transactions in the whole EU at \$830tn (in 2010). Using the Commission's rate of 0.1% for bonds & shares and 0.01% for derivatives, Open Europe estimated that the potential FTT impact would be €24.3-80.9bn for the EU27 & €17.5-58.2bn for the UK (over 70%) in the absence of a burden-sharing system. The range is due to uncertainties regarding the degree of relocation and evasion following the introduction of an FTT.

Annex

Table 1: The Basel Accords and the Capital Requirements Directives

Agreement	Main terms
Basel 1 (1988)	Agreed a set of minimal capital requirements for banks, now outmoded. The Basel agreements (Accords) are non-binding global agreements but regulators have, on the whole, conformed.
Basel 2 (2004)	Incorporated the “3 pillars” concept for banks: (1) minimum capital requirements (addressing credit risk, operational risk and market risk); (2) supervisory review (including liquidity risk, led to the Internal Capital Adequacy Assessment Process (ICAAP)); and (3) market discipline.
Basel 2, updates	Were intended to enhance the robustness of the Basel regime (September 2005 through to July 2009).
The EU’s Capital Requirements Directive (CRD)	Introduced a banking supervisory framework in the EU designed to ensure the financial soundness of credit institutions (i.e. banks, building societies and certain investment firms), reflecting the Basel 2 rules on capital measurement and capital standards, enforced January 2007.
CRD2	The EU has modified the Basel 2-CRD. The CRD2, enforced by end 2010, also aimed to achieve increasing regulatory harmonisation in the Single Market in financial services.
CRD3	Implemented the July 2009 update of Basel 2, known as “Basel 2.5”.
CRD3, remuneration requirements	CRD3 required the CEBS to issue guidelines on sound remuneration policies which complied with the remuneration principles included in CRD3. The CEBS’s remuneration guidance was published in December 2010. Banks should: <ul style="list-style-type: none"> • Appoint of an independent remuneration committee. • Defer 40-60% of variable remuneration (bonuses) for 3-5 years, and pay 50% of bonuses in shares (rather than cash). The rules would mean that bankers receive only 20-30% of their bonuses in immediate cash. • Set a maximum bonus level as a percentage of an individual’s basic pay. • Exclude any “award for failure” from severance pay packages. • Publish pay details for “senior management and risk takers”.
Basel 3	The main features are: <ul style="list-style-type: none"> • Increased quality of capital. • Increased quantity of capital: (1) minimum Tier 1 common equity requirement increased from 2% to 4.5%, plus capital conservation buffer of 2.5%, bringing total common equity requirement to 7%; (2) minimum total capital increased from 8% to 10.5%, including conservation buffer. This will be phased in from 2013 to 2019. • Reduced leverage through introduction of backstop leverage ratio: the leverage limit is set as 3%, i.e. a bank’s total assets (including both on and off-balance sheet assets) should not be more than 33 times bank capital. The leverage will be effective from January 2018. • Increased short-term liquidity coverage: 30-day Liquidity Coverage Ratio (LCR). • Increased stable long-term balance sheet funding, employing Net Stable Funding Ratio (NSFR). • Strengthen risk capture notably counterparty risk. • In addition, possible measures to promote the build-up of capital buffers in good times that can be drawn upon in periods of stress, “reducing pro-cyclicality and promoting countercyclical buffers”. • To be implemented in stages until 2019.
CRD4	The substance of CRD4, agreed in July 2011, is based on the Basel 3 package. But note the CRD4 also, significantly, marks a significant shift in power away from national regulators towards a common rulebook for the EU. This is part of the increasing regulatory harmonisation in the Single Market in financial services. CRD4 will replace the CRD, CRD2 and CRD3 and will be implemented in stages.

Sources: (i) The Basel Committee on Banking Committee on Banking Supervision; (ii) KPMG, “Basel 3, pressure is building”, December 2010, for key recommendations of Basel 3.

Table 2 The European System of Financial Supervisors (ESFS), implemented January 2011

		Replaced
European Supervisory Authorities (ESAs)	The European Banking Authority (EBA), in London	The Committee of European Banking Supervisors (CEBS)
	The European Insurance and Occupational Pensions Authority (EIOPA), in Frankfurt	The Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS)
	The European Securities and Markets Authority (ESMA), in Paris	The Committee of European Securities Regulators (CESR)
The European Systemic Risk Board (ESRB) under the responsibility of the ECB		

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