With banks essentially requiring the same support, infrastructure and regulation as public utilities, Bangor Business School's Professor Phil Molyneux argues that banks should be run according to the same model.

From PUBLIC *to* PRIVATE

Since the global banking crisis six years ago and the more recent euro sovereign debt crisis, there have been growing calls to rethink the way banks are monitored and governed.

Banks have been forced to take on more capital and liquidity, remove riskier types of activity and also shrink their balance sheets. Numerous new rules have been put in place to constrain their risk-taking business, including moves to remove executive excesses by curtailing remuneration packages.

All these actions place a straitjacket around bankers' activities and as a consequence inhibit their freedom. This, of course, all comes as a result of the taxpayer expenses incurred by bank bailouts – so some argue it's a low cost to pay. Others, however, argue that such restrictions will limit banks' ability to lend and innovate, adversely impacting economic growth.

The new environment has also led various commentators to talk about banks being less like private free-wheeling profit-maximising firms, but more like public utilities that provide a service to society that should be even more regulated – namely via limiting prices and profits. These arguments stem from the similarity that banks have with public utilities and the problems associated with current banking size and structures.

THE PROBLEM WITH BANKING

Banking is a weird world. Some countries have massive banking systems compared with the size of their overall economies. As a result, any big problem in the financial sector is more likely to reverberate through the economy and problems are more likely to have serious consequences.

The problem with banking, therefore, is that systems are very big and individual banks are large relative to the size of their domestic economies. Big banks have also become increasingly complex organisations, with large numbers of subsidiaries operating in many jurisdictions. The top US banks provide a glowing example of this – the biggest, JP Morgan Chase, has 3,391 subsidiaries of which 451 are foreign, Goldman Sachs has over 3,000, Morgan Stanley 2,800+ and Bank of America 2,000+.

Size and complexity provide big banks with advantages – they are "too systemically important to be allowed to fail". This means that they get better credit ratings as they are deemed safer so they can raise funds more cheaply than smaller banks that do not have this safety net. Also, these safety net benefits encourage big banks to increase leverage to take on more risk, as they believe if things go bad the state will bail them out and depositors will be protected via deposit insurance. The more leverage, the greater the risk but potentially the greater the returns – so shareholders will be happy for big banks to take on more risks if they are rewarded appropriately. So when the banks go 'boom' – the consequences of failure are enormous. Much of the Western world is still struggling to recover from the 2007-2008 global banking crisis. There are still worries that Europe and the US will emulate Japan in terms of macroeconomic performance following its 1998-99 banking crisis – Japan has barely grown since 2000, despite major fiscal injections, and being forerunners in quantitative easing and other alternative monetary policies.

> **"THERE ARE STILL** WORRIES THAT EUROPE AND THE US WILL EMULATE JAPAN IN TERMS OF MACROECONOMIC PERFORMANCE FOLLOWING ITS 1998-99 BANKING CRISIS – JAPAN HAS BARELY GROWN SINCE 2000."

Regulators in the US, Europe and elsewhere have reacted to the crisis by introducing an array of new rules and regulation aimed at making banking safer, including Basel 3, Dodd-Frank in the US and Vickers in the UK. However, given the features of banking and the enormous cost of failure, a strong case can be made to treat banks as public utilities and regulate their pricing and profitability further.

WHY BANKS ARE LIKE PUBLIC UTILITIES

Public utilities like gas, electricity and water companies have certain economic features that explain why they are typically regulated differently to private companies. Typically these industries have a common network structure – they have extensive distribution systems, similar to the piping requirements for gas or cabling for electricity, that involve significant investment known as large sunk costs that can be government- or privately owned. Activity of utilities can be split into production, transmission and distribution. These three stages can be owned by public or private firms, but usually – even in North America – production is privately owned, whereas transmission or distribution can be either government or private. Banking has similar features: to be a bank and undertake production you need a banking licence, then capital and deposits; transmission is via the payments system; and, finally, distribution is through the branch network and subsidiaries. These stages are typically all privately owned although in some countries including Brazil and China, state ownership remains important.

There are similarities between the production, transmission and distribution features of public utilities and banks. One solution going forward would be to regulate banks the way utilities are. The rationale for regulating public utilities is threefold:

1) Because utilities tend to be natural monopolies, consumers need to be protected against price gouging and other bad treatment, hence the justification for regulating utilities, particularly on their pricing. Banks have a tendency to get very big, with a handful dominating over time. They have features very similar to natural monopolies – that is why so many countries have highly concentrated domestic banking systems.

2) A second reason is to stop regulators being captured by producers. The aim here is to protect all producers and not just the biggest by making sure utilities do not capture the regulators and write their own rules. Big banks for years have helped write the rules for Basel, EU and domestic regulators. The big banks dominate all areas of retail and wholesale activity – they know more than regulators (hence the emergence of shadow banking). Banks also gain from implicit safety-net benefits that include advantages unwittingly provided by the regulators.

3) Other reasons for regulating utilities relate to the evidence on the economic behaviour of utilities that shows that: lowest cost operators are likely to be the biggest rent gainers – or to put another way, they can extract monopoly profits; cost-based cross-subsidisation is typically widespread; and quasi-monopoly rents are likely to be spread among various groups. In banking it's easy to point to examples of previously found monopoly pricing behaviour such as SME lending, payments, credit cards; cross-subsidisation is widespread and we have seen retail subsidise investment banking in the 1990s at RBS, and the opposite recently at Barclays; and benefits have accrued, some argue, to a few – senior management and shareholders primarily.

In banking there is a definite trend toward natural monopoly, strong evidence of regulatory capture and rent-seeking by low-cost producers and other parties, and cross-subsidation is also widespread. All these factors justify the regulation of public utilities. So we need to treat banks as such and monitor and regulate their behaviour to limit capture, but also we need much greater oversight and policing of their pricing and profitability. Only then will risk-taking appetite be effectively curtailed. CB

Professor Phil Molyneux is Dean of College and has led Bangor Business School to its consistent ranking as the top institution in the UK and Europe for the quality of its Banking research output. This article is a summary of his plenary lecture delivered to celebrate him receiving the British Accounting and Finance Association (BAFA) prestigious "Distinguished Academic Award" at the Association's 2014 annual conference held at the LSE.

RETIREMENT RULES

This year's Budget may be best remembered for reforming pensions access for all. But it will not be until April 2015 that we see the Chancellor's proposed changes in full effect.

On 19 March, George Osborne revealed the UK Government's plans to drastically overhaul the tax rules around defined contribution (DC) schemes, in a bid to give members greater freedom to decide how to use their savings.

Citing the pressure on people to take out an annuity, the Chancellor said in his Budget speech: "The tax rules around these pensions are a manifestation of a patronising view that pensioners can't be trusted with their own pension pots."

To rectify this, the Government is set to simplify limits and thresholds en masse from April 2015. But significant changes to drawdown rules and trivial commutation have already come into force – on 27 March, directly after Budget Day – ostensibly giving savers greater choice with immediate effect.

THE INITIAL CHANGES

For flexible drawdown, the income requirement has been reduced to £12,000 (from £20,000). Meanwhile, the limit for capped drawdown has gone up to 150 per cent (from 120 per cent).

In addition, the maximum size of the lump sum small pots has increased by five times, to £10,000, and three such sums may now be withdrawn, as opposed to two previously. The overall amount that can be taken as a lump sum is £30,000 (up from £18,000).

> **"RETIRING SAVERS WITH** LARGER POTS CAN TAKE THEIR LUMP SUM NOW AND WAIT UNTIL SPRING'S TRANCHE OF CHANGES TO THE RETIREMENT INCOME RULES TO DECIDE WHAT TO DO WITH THE REST."

What's more, those who choose to take their 25 per cent tax-free lump sum will no longer be obliged to take out an annuity within six months.

It all adds up to a more flexible financial future, especially for those with smaller pension pots. Retiring savers with larger pots can take their lump sum now and wait until spring's tranche of changes to the retirement income rules to decide what to do with the rest.

INNOVATIVE PRODUCTS

Some have branded the period between now and April 2015 "pension limbo", and new, one-year fixed-term annuity products have been released for the very purpose of mitigating the uncertainty. While many people are likely to continue to rely on lifetime annuities, further innovation could be on its way, according to Phil Smart, UK Head of Insurance at KPMG.

"Customers will benefit from greater access to new options that are tailored to their retirement needs and are flexible to their changing lifestyles," says Smart.

"The decision to allow insurers to make cash options available without opening up their legacy products to offer full drawdown flexibility is very sensible. While this is a good opportunity for insurers to innovate and develop new products, they will face significant challenges to implement the required infrastructure and operational changes before next April.

"We support initiatives to offer more flexibility including more flexible annuity products that allow customers to plan their retirement income so as to dovetail with occupational and state pension benefits and provide for long-term care needs. This will enable insurers to design new annuity products that provide savers with both security and flexibility."

A consultation with stakeholders across the industry about how to implement the broader changes followed swiftly on the back of the Budget Day announcement, and the government response to its report, Freedom and Choice in Pensions, was published on 31 July.

The response outlines provisions expected to be incorporated in the new Pension Tax Bill due in autumn 2014, including:

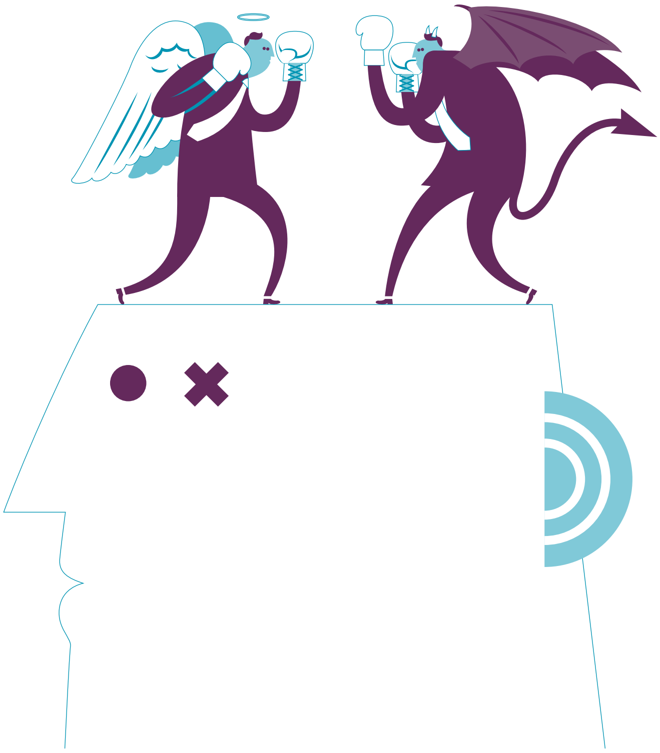
- the option to transfer between DC schemes – right until the point of retirement
- adjusting tax restrictions on annuities – to enable greater innovation by providers
- allowing defined benefit members to transfer to DC schemes – but only before pension payments have begun.

Given the sheer breadth of reforms on the way, sound financial advice will become even more crucial in improving people's chances of attaining good outcomes. Michele Allen, the Institute's CPD Manager, says: "Savers need to be aware of the tax consequences of releasing funds from their pension. To qualify for tax relief a pension scheme must provide certain 'authorised' benefits, such as a pension for life. Unauthorised benefits carry an extra tax charge and include 'pension liberation', where a firm may entice the saver to access their pension pot early. The saver then has to pay tax on the sum released at a fixed rate of 55 per cent to reflect the tax relief that pension savings get."

Savers are likely to feel overwhelmed by options – and will want to put their trust in an independent adviser who can help them to navigate the new landscape.

Upholding reputations

In April, the FCA published its far-reaching amendments to the Mortgage Conduct of Business rules. BOB SOUSTER takes a closer look at how the rules should be impacting on lending practices in the UK mortgage market.



THE SCENARIO

Debbie and Sally are mortgage advisers with CCC Bank plc, a provider of retail financial services. They have both worked at the bank for over five years, but in recent months their achievements against targets have been very different to one another.

Sally has struggled to meet the planned approval rate, as the number of applications handled by her has fallen sharply. She attributes this to the more restrictive rules on assessment of affordability and suitability that were introduced in April 2014. Cases that would once be routinely sanctioned now have to be declined, and some of the cases that she has submitted for approval have been refused by the underwriters on the grounds that they do not meet the new criteria now adopted by the bank. By contrast, Debbie's performance has actually improved in the same time period, with both her lending volumes and the value of loans sanctioned exceeding targets.

Sally is concerned about the deterioration in her performance and decided to discuss this with Debbie to see if there was any way of improving the situation. Sally was quite puzzled by how their experiences had differed, as both advisers have been dealing with customers in the same geographical area.

Debbie explained that she took a positive view of customers' expectations and said that she did everything possible to help them realise their aspirations. She told Sally that wherever possible she would help customers to present the information necessary to support their applications in a manner that would maximise the prospect of getting the mortgage application sanctioned. "Take Mr Smith, for example," said Debbie. "He knew and I knew that when he submitted the mortgage application, he was almost certain to be made redundant in the next two or three months. But I told him to put the application in without delay, and with our new processing system we were able to get the mortgage through. I don't see anything wrong in this, as he is an intelligent man who will have no difficulty in getting a new job, even though it might not be at the same salary level."

Debbie also told Sally that she dealt with applications from a small number of intermediaries who had a good track record in presenting applications for marginal cases. "One of the intermediaries advises clients to use XXX Accountants," said Debbie. "They are well known for creative accounting practices that can make a mediocre set of financial statements look good, and are experts at making sure that their clients pay as little tax as possible."

"In short, the new rules compel mortgage lenders to do things that responsible lenders were already doing 30 years ago."

Sally was surprised at Debbie's approach, and questioned how ethical this was. Debbie was unrepentant: "Listen," she said, "the customers want a mortgage and we provide mortgages. People in this country will do almost anything necessary to keep a roof over their heads, so they will find ways of paying the mortgage if they try hard enough. If we don't do the mortgage, somebody else will, probably a competitor. As for us, we are judged on performance, so I'm prepared to do anything within the rules to deliver what is expected of me and progress my career."

What are the ethical implications of this scenario?

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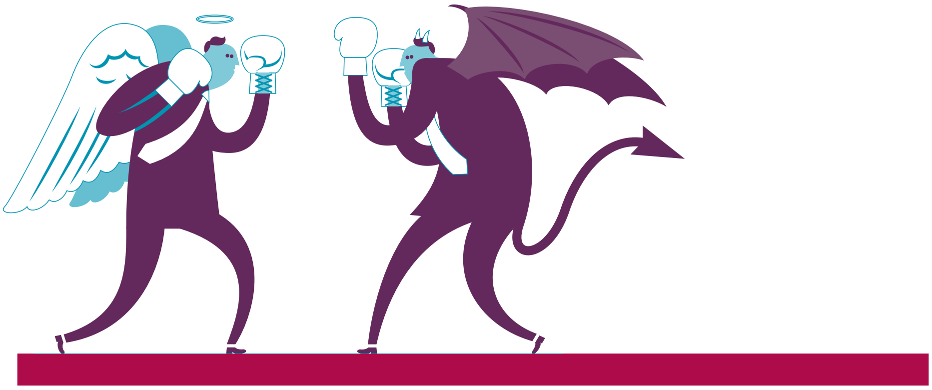

"Cases that would once be routinely sanctioned now have to be declined, and some of the cases Sally has submitted for approval have been refused by the underwriters."

>> THE ANALYSIS

On 26 April 2014, the Financial Conduct Authority (FCA) published major amendments to the Mortgage Conduct of Business (MCOB) rules which were intended to change lending practices in the UK mortgage market. The rules were introduced in response to the Mortgage Market Review conducted over the previous two years. They were a response to findings by the FCA that some consumers were taking out mortgages that they had little or no prospect of servicing, and that many lenders were too willing to approve applications that should have been declined. The new rules now require all lenders to make a rigorous assessment of affordability for all regulated mortgage contract applications, taking account of permanent and non-permanent income, fixed expenditure and discretionary expenditure. Furthermore, lenders are now expected to stress test the evidence supporting the application, including an assessment of the impact of future changes on the ability of the customer to service regular mortgage repayments. This includes the potential impact of future changes in interest rates.

In short, the new rules compel mortgage lenders to do things that responsible lenders were already doing 30 years ago.

The mortgage market in the UK is characterised by periods of boom and slump. When booming, the market sees application levels and loans sanctioned increase, often at a rate faster than the underlying growth of the economy. In a bull market, not only are people prepared to improve their lifestyles by trading up, but are also more willing to release equity when doing so, such as borrowing more than necessary in order to buy a better car, take a nice holiday and so on. Until comparatively recently, lending decisions were taken by many lenders with reference to an income multiple. Historically, lenders would lend a maximum of perhaps three times gross annual income, but the FCA identified examples in which some lenders would offer up to eight times gross annual income, strongly suggesting that some customers were taking out mortgages well in excess of what they could afford.

Debbie claims that she has done nothing wrong, and has implied that there is nothing unethical in the way she approaches her job. While it is true that her work involves helping customers to realise their aspirations, her attitude is selfish and short-term orientated. The main driver seems to be achieving her own targets and meeting her own career aspirations, irrespective of the consequences of her decisions and actions.

As well-meaning as the FCA's new rules appear to be, there is no foolproof way of preventing people from borrowing when they should not borrow. This reflects the very nature of any regulatory initiative, as capitalist systems are ingenious at developing processes and systems that operate within the letter of the law while often contravening its spirit. Debbie herself hinted at two ways in which this is done, though dealing with intermediaries who use accountants that are experts in "window dressing" financial statements is something that the underwriters should be capable of identifying within a relatively short time.

Debbie does her customers no favours. The short-term euphoria of moving into the house of one's dreams can soon turn into misery, as some of her customers may discover when market interest rates eventually increase. She fails the ethics test from both duty-based and consequences-based perspectives.

The FCA high-level principles insist that the provider should pay due regard to the interests of customers and treat them fairly. Is it really in the interests of customers to have them sign contracts that they will almost certainly not be able to honour? Is it fair on customers not to warn them against over-committing themselves? The high-level principles also require providers to act with integrity and to conduct business with due care, skill and diligence. If Debbie is a Chartered Banker, she is in conflict with at least three commitments in the Institute's code of professional conduct. Count them for yourself.

From a consequentialist perspective, it is clear to see that Debbie's approach is both unethical and unsustainable. Not all of the mortgage business generated by Debbie will go bad, but some most certainly will. Research by the former Financial Services Authority (FSA) some three years ago suggested that many lenders did not have systems in place through which the performance of advisers would be affected by subsequent arrears and default levels, but today more lenders do have such systems in place, so Debbie's prospects of continuing to act in the same manner are slim. This is almost entirely self-inflicted, as she should be capable enough of understanding the consequences, but the havoc she can wreak in relation to the reputation of her employer will do nothing to maintain the trust of customers, regulators and other stakeholders.

Bob Souster is Module Director, Professional Ethics, Chartered Banker MBA at Bangor University. Do you agree with Bob's verdict in this ethical dilemma? Have your say on the Chartered Banker LinkedIn discussion forum.

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Why it's fashionable to be unfashionable

Have you noticed this year's trend among the fashionably dressed? It's called "normcore". The point is to dress to not stand out – no flashy labels, no glitz and no bright colours. IAN HENDERSON dons a grey T-shirt and discovers what financial firms can learn from it.

A recent survey by BNY Mellon among "millennials" reveals that a mere one per cent of them think being approached by financial services providers through social media is a Good Thing. The rest of this tech-savvy new generation of consumers – the people firms most need to engage with right now – described such approaches as "creepy", "silly" and quite definitely unwelcome.

The survey – conducted among millennials by millenials through Oxford University, should be required reading for those staff marketing banking and other financial sectors; this is the emergent audience who will decide their future. And unless firms start listening to them now, they certainly won't be listened to when millennials come to dominate the global economy. Which they will.

Normcore, as you'd expect, is only really a trend among millennials. It involves discarding what's seen as chic, hip and distinctive in favour of the mass-produced stuff that sells by the truckload from shopping centres and online retailers all over the world every day. (If I wore it, you'd just assume I was wearing the same boring clothes as usual. And you'd mostly be right.) It only works ironically; and therefore could well be a fashion-supplement in-joke that passes most of the world (the real "normcore") by.

On the other hand, as Douglas Coupland – the author of many a trend-driven novel and no mean trendsetter himself – says, it may be symptomatic of an increasing rejection of the need to assert one's individuality. Perhaps the next generation – the millennials – are fed up with broadcasting their views and attitudes. With individuality comes freedom, the need to take responsibility for one's actions, including thinking about the way one dresses; are we just getting tired of all that work? Is normcore, in fact, a way of saying that in a tech-driven age, when everyone can make a statement about who they are so easily through a Twitter feed or a YouTube channel, that actually there's less and less point in doing so?

The more individual voices there are to be heard, the less individual each one sounds. A long time ago, my wife produced the first million-pound TV ad in the UK. It was for Barclays and Ridley Scott was the director. Shot soon after his era-defining film *Bladerunner* was released, it used a similar dystopian vision of the future to show how a despairing bank customer "just wanted to talk to someone". The cast were normcore before their time; the future was bleak, the future was grey. The relationship between bank and customer was shown as robotic, machine-like, a denial of individualism. The ad showed this one-size-fits-all, undifferentiated approach as a denial of humanity, something to be broken through revolutionary action by the bold bank and its brave, individualist customer.

"The ad showed this one-size-fits-all, undifferentiated approach as a denial of humanity, something to be broken through revolutionary action by the bold bank and its brave, individualist customer."

Maybe the current trend is a move in the opposite direction. Maybe normcore, the move towards anonymity and the rejection of responsibility it implies, and the spurning by new audiences of awkward social media "conversations" with their financial services providers all mean banks simply shouldn't try so hard. Rather than the desperate reaching out, friending and online stalking that forms so much current customer relationship thinking (especially where millennials are concerned), financial firms should back off a bit. Allow people space to decide what kind of relationship they want. Be there, but only when they're needed. Stop trying to follow the latest online fashion. And dress a bit more normcore themselves. CB

Ian Henderson is Executive Creative Director, AML. www.aml-group.com


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