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Feather-bedding Financial Services

Are British banks getting hidden subsidies?

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nef (the new economics foundation) is a registered charity founded in 1986 by the leaders of The Other Economic Summit (TOES), which forced issues such as international debt onto the agenda of the G8 summit meetings. It has taken a lead in helping establish new coalitions and organisations such as the Jubilee 2000 debt campaign; the Ethical Trading Initiative; the UK Social Investment Forum; and new ways to measure social and economic well-being.

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Introduction

In the last three years known public support for the financial sector has been unprecedented in scale. Since the Bank of England came to the rescue of Northern Rock in 2007, with a substantial £25 billion emergency borrowing facility, the sums have only grown. Soon it became clear that systemic failures meant that the public purse would have to support the whole financial sector, not just individual banks.

So many schemes were introduced, of different types and with different terms and conditions and which often lacked transparency in their full actual operation, that the amounts are hard to summarise.[1] Reviewed in **nef**'s previous report *Where Did Our Money Go*? all the schemes together added up to £1.2 trillion of backing to the banking system, equivalent to about 85 per cent of the UK's national income for 2009.[2] This scale of intervention was comparable only with that of the United States.

But is it possible that there is still more to the story? We have drawn together research from the Bank of England, the Office of Fair Trading, the Institutional Investors Council and Moneyfacts (who provide independent rates comparisons)[3] that reveals a range of other, hidden subsidies to the big banks.

In spite of the unprecedented scale of the bail-out of the private sector by the public purse, the banks appear to be enjoying another range of subsidies not listed in the official list of schemes and facilities. This briefing paper outlines what some of those might be. It reveals the Chancellor of the Exchequer, George Osborne's recently announced bank levy to be small in comparison. But we believe that we may have only scratched the surface. For the Independent Commission on Banking to properly do its job, we believe it will need to establish a full picture of the de facto hidden subsidies being enjoyed by the banks, and we call on it to do so.

Summary: Feather-bedding financial services

Increased scrutiny of the financial system in the wake of the banking crisis has shed light on a number of practices previously taken for granted, which now might be viewed in a different light. The sheer complexity of modern banking (itself one of the conditions that brought on the crisis) has worked to shield the sector from difficult questions. But, with the dust of public interventions now settling, a number of anomalies are emerging.

- **The 'Too Big to Fail' subsidy:** Having concluded that our major banks are 'too big to fail,' the government provides a public guarantee, effectively insurance against going bust. In business terms, this gives the banks a huge commercial advantage over other firms in a market system. It reduces their risk. This means that they can borrow money much more cheaply than if they were not ultimately underwritten by the public. Exchanges with leading auditors in front of the Treasury Select Committee confirm this. The hidden subsidy saves the banks a large amount of money – we estimate, conservatively, that it could be worth £30 billion annually– and helps them make unearned profits. It also means that when the banks pay bonuses to senior staff for 'performance' and dividends to institutional investors, the rewards of that 'insurance' provided by the taxpayer are going elsewhere, and not back to the taxpayer.
- **The quantitative easing windfall subsidy:** When it was decided that the economy needed more liquidity, the Bank of England pumped money in using the technique called 'quantitative easing'. To meet various, and sometimes self-imposed, requirements, it did this using a trading mechanism with several of the banks. As merely passive conduits for this 'risk free' arrangement, the banks made more money, taking a cut of every trade. Here we find that they enjoyed a significant windfall, simply by being there, but that the failure to disclose sufficient information keeps the likely amount hidden.
- **The 'make the customer pay' subsidy:** Looked at very sympathetically, the banks have been put in a difficult position. At the same time as being required to rebuild their capital, they are also under pressure to lend. It's like being pulled in two directions at the same time. In response, the banks have tried to manage this by increasing the gap between what they have to pay to borrow money, and what they charge people to borrow from them. This is the so-called interest rate 'spread'. But they do have alternatives. They can also recapitalise through reducing or eliminating bonus and dividend payments until their capital base is rebuilt. As it is, the taxpayer is subsidising the banks twice over: once through taxpayer funded public support to the banks, and secondly through paying much higher interest to borrow than the banks do. It's another hidden subsidy which in the retail and one part of the investment banking world amounts to at least another £2.5 billion per year.

There is yet another, very significant, but rarely discussed and poorly understood free benefit enjoyed by the banks. This is only mentioned in passing here to add context, and will be the subject of a future briefing. But it stems from the fact that banks are gifted by government, in effect, **a licence to create money**. Few appreciate that the vast majority of new money entering the economy is lent into existence by the banks when, for example, they make personal loans. The popular myth that banks merely lend out the savings left by depositors has never been the case in the modern Western world. Here's how Martin Wolf of The Financial Times put it recently:

> *The essence of the contemporary monetary system is creation of money, out of nothing, by private banks' often foolish lending. Why is such privatisation of a public function right and proper, but action by the central bank, to meet pressing public need, a road to catastrophe? When banks will not lend and the broad money supply is barely growing, that is just what it should be doing.*[4]

Because the banks then get the benefit of the interest paid on the money they have been allowed to create, that can be seen as yet another subsidy. Its precise value to the banks annually is a subject of debate, but previously it has been estimated to be worth tens of billions.

The 'Too Big to Fail' subsidy

> *All four of the people [representing the UK's major auditors] here had detailed discussions, instigated by the Big Four, with Lord Myners because of the circumstances we were in. It was recognised that the banks would only be going concerns if there was support forthcoming.*
> **John Connolly, Deloitte**
>
> *I find that absolutely astonishing… It seems to me that you're saying that you noticed that they were on very thin ice but you were completely relaxed about it because you knew that there would be support; in other words the taxpayer would support them, so there was no problem. That's what it seems to me you just said.*
> **Lord Lawson of Blaby**
>
> *Are you saying that, looking at the position, you thought that the bank was likely to be in trouble but you couldn't possibly say that because that might precipitate the crisis and, therefore, by giving assurance you took the view that the accounts were okay?*
> **Lord Forsyth of Drumlean**
>
> *I think it would be wrong to say we couldn't possibly say it if it had to be said.*
> **John Connolly, Deloitte**
>
> *Unrevised transcript of evidence taken before The Select Committee on Economic Affairs, Inquiry on Auditors: Market concentration and their role, November 2010.* [5]

How does a subsidy arise?

By now it should be well understood that bondholders expect banks to be rescued by the taxpayer if they fail – an entirely correct assumption as we saw during 2008 and since. This expectation reduces the interest rate that bondholders demand from banks. In other words large banks enjoy much lower funding costs than would be the case in a free, unprotected market.

Can we quantify it?

The best known estimate of this hidden subsidy came from Andrew Haldane, Executive Director of Financial Stability at the Bank of England.[6] Credit rating agencies helpfully publish the actual rating, and the rating they would give to a bank if there was a genuine risk of investors losing their money, which with disarming candour is called the 'standalone' rating. This is of course theoretical because the banks do not stand alone. The difference between the two ratings can be used to calculate the funding subsidy. Using this method Haldane suggested subsidies of between £11 billion and £107 billion as shown in Table 1. The value of this subsidy increased greatly after the crash as banks would have faced significantly higher funding costs without government support.

Intriguingly, RBS recognised the value of the 'To Big to Fail' (TBTF) subsidy in its submission to the Independent Commission on Banking. They estimated the total cost, revenue and funding synergies of being a large diversified bank to be £3.5 billion - £4.8 billion annually[7], but regrettably the precise breakdown has been 'redacted' from the published version[8] so we cannot identify how big they believe the TBTF element truly is.

In our view, the aggregate underlying value to UK banks is likely to be more in the range of £30 billion (Baker & McArthur, see Table 1) than the high experienced in 2009 of over £100 billion.

Table 1: The 'Too Big to Fail' subsidy

Estimated subsidy for UK banks	*Period*	*Big 5* £ billion*	*Others £ billion*	*Total £ billion*
Haldane method	2007	9	1	11
	2008	52	8	59
	2009	103	4	107
	3 year average	55	5	59
Baker & McArthur method (calculated by Haldane for the UK)		30		

* Haldane in this context considers the 'Big 5' to be Barclays, Lloyds, HSBC, RBS and Nationwide.[9]

The scale of this subsidy puts the profits reported by the main UK banks in a different light. Without it they would have to be smaller, more efficient, and distribute less in dividends and bonuses than has been the case. Three years worth of even this lower estimate for just this one hidden subsidy is roughly equal to the government's entire cuts programme.

The quantitative easing windfall subsidy

The bank announced its quantitative easing (QE) programme in March 2009 with purchases of gilts and corporate bonds reaching the £200 billion target in February 2010. Of this, £198 billion were gilts. The intention of QE was to encourage investment and boost demand in the economy by reducing long-term interest rates and by inflating the price of other assets such as equities. Whether or not this is the most effective method of countering deflation is a matter of continuing debate, but what we can say is that it offered several money-spinning opportunities for investment banks.

How do excess profits arise?

Holders of gilts prior to the commencement of QE would have enjoyed significant gains in the value of their holdings. The great majority of stocks of government debt will have been held by UK pension funds, insurance companies and overseas investors.[10] However, the purchases were made through banks, who will have made commission fees on the transactions even if selling on behalf of a client. Furthermore, as the Bank of England observes, “Since financial institutions may have bought up gilts in anticipation of selling them to the Bank, it is difficult to tell who the ultimate sellers were.”[11]

The Bank is not permitted to buy UK gilts directly from the Government as this is considered to be monetising government debt, or in other words directly funding government expenditure through ‘creating money’. Instead the Debt Management Office first sells the gilts to banks and other investors, and then the Bank of England buys them back from the banks – naturally at a higher price.

Can we calculate it?

Not really. The Bank of England estimates that the impact of QE on gilt yields may have been to reduce them by 100 basis points (that’s one per cent).[12] This would equate to tens of billions of capital gains on holdings of gilts and other financial assets, which would have benefitted not just banks but also investors across the board. However, it would also have boosted trading volumes in gilts and other assets and therefore contributed considerable trading income and commission revenues for investment banks over and above what they would have earned without QE.

There is a restricted number of banks permitted to act as market makers for UK gilts[13], including the likes of Barclays, Royal Bank of Scotland and Goldman Sachs, and undoubtedly the mechanism of QE allowed a large volume of lucrative business to fall into their laps. Research indicates that after the crash the margins (difference between buying and selling prices) for gilts trading increased[14] giving rise to further direct gains for investment banks that we estimate to be in the region of £200 million just from the traders taking a bigger cut.

So it would seem that banks profited from the extraordinary measures to prop up the economy following the recession caused by the banks. Banks with large investment banking arms are likely to have done particularly well. With Barclays Capital accounting for 38 per cent of Barclays' total group revenues in 2009, outstripping its UK retail and commercial operations for the first time, the questions of how economically productive the investment banking industry really is, and how well it sits with domestic retail banking activities, becomes more important. Even if not subjected to one-off taxes, at the very least should such windfall profits be ring-fenced from being used to justify dividends or bonuses?

Making the customer pay: recapitalising from customers rather than a squeeze on bonuses and dividends

How do excess profits arise?

The UK retail banking industry is unusually concentrated. Not only do the largest five mortgage lenders have a market share of 82 per cent, but the range of providers was much diminished by the demutualisations of the late 1990s. Has this allowed the dominant players to increase their profits from mortgages since the financial crisis? It is reasonable to suggest that mortgages were under-priced prior to the crash, but perhaps more significant was the lack of control over the quantity and quality of mortgage lending. If the difference between interest rates for new mortgages has increased significantly, this could indicate that banks are benefitting from excess profits in the mortgage market.

Can we quantify it?

Using figures from Moneyfacts on the average rates offered for the benchmark two year tracker mortgage since June 2007, we can see that rates have fallen from 6 per cent to 3.5 per cent. But the Bank of England base rate has fallen by much more – from 5.5 per cent to 0.5 per cent. We calculate that the mortgage interest rate spread has therefore increased from around 0.5 per cent to 3 per cent. As we argue above, some readjustment in mortgage pricing was necessary, but even taking a conservative view of long-term spreads as being around 2 per cent. The increase to 3 per cent since the crash represents additional interest revenue of around £1.6 billion per year from 2009 gross lending and a further £1.5 billion per year from 2010 gross lending.

However, the point is this: increasing the margin on new mortgages has certainly been a factor in bolstering bank profits since the crash. Furthermore, despite the reductions in base rates and wholesale funding costs, key lending rates have hardly moved since the crash, as illustrated in Table 2, below. To the extent that this is necessary to rebuild banks' balance sheets, is it appropriate for customers to be bearing this cost rather than shareholders and executives as would be the case with other industries?

Excessive investment banking fees

It is not only in retail banking that the customer is getting a raw deal. A study by the Office of Fair Trading (OFT) into the equity underwriting market, published in January 2011, found that "the market lacks effective competition on price".[15] This followed an earlier report by the Institutional Investor Council (IIC) which tracked how total fees for raising equity capital, using rights issues, had increased over the past decade from 2 per cent to as much as 4 per cent. Within this, the amount kept by the organising investment banks in their roles as broker, underwriter and adviser had risen threefold from 0.75 per cent to 2.25 per cent, whereas the sub-underwriters' fees had risen only slightly from 1.25 per cent to 1.75 per cent . Given the turmoil in financial markets after the crash, we

Table 2: Change in interest rates (%) affecting household borrowing (Source: Bankstats, Table G1.4)

	Sep 2008	*Nov 2010*	*Change*
Bank rate	5.0	0.5	-4.5
Overdraft	9.9	8.1	-1.8
Credit cards	17.7	18.5	0.8
Fixed rate loans	9.6	10.0	0.4
Deposits	3.1	0.8	-2.3

might expect an increase in sub-underwriters' fees as they ultimately bear the risk of the rights issue failing. In contrast, there is no particular justification for such a large increase in the investment banks' fees for arranging the rights issue.

How do excess profits arise?

Unlike the retail banking market, the OFT did not identity over-concentration as the problem. It simply seems that the investment banks hold the upper hand in negotiations with corporate clients when they come to raise new equity capital for their businesses. The IIC study concluded that there was evidence of market failure in terms of transparency, competition and lack of sufficient scrutiny by shareholders. This clearly requires a remedy and the OFT's decision to take its investigation no further, having failed to offer any action other than urging company directors to try to do better in controlling fees, is a dismal response.

Can we calculate it?

Over the 17 years from 1994 to 2010 approximately £110 billion of new funds were raised through rights issues. Total fees to investment banks and sub-underwriters were around £3.5 billion, of which around £1.8 billion was collected by investment banks. However, if the commissions had remained at the levels prevailing before 2000 this sum would have been less than half this amount. In other words, some £1 billion of excess fees have been accumulated by investment banks, over 90 per cent of which has been since the crash.

Executing rights issues to raise additional equity capital is only one of many activities undertaken by investment banks, and we highlight this as simply an example of market inefficiency delivering bumper profits to investment banks. This matters, because the efficient allocation of capital to businesses is one of the fundamental roles of the banking system. Far from being a cause of celebration, dysfunctional capital markets that allow banks to impose unjustifiably high costs on companies and investors is a threat to London's competitiveness as a global financial centre.

Profits from creating money: the hidden subsidy from seignorage

When the Bank of England prints a £20 note the actual cost of producing the note is a fraction of the face value. This gives rise to a profit, known as seignorage,[16] which in the case of notes and coins ultimately accrues to the public purse via the Treasury.

How does a subsidy to private banks arise?

Money is not just created by the central bank, however. On the contrary, most money, in fact, is lent into existence as debt by commercial banks. This is counter-intuitive to the simplistic belief that banks take in savings from one customer and, with that as security, make loans to others. But, one of the features of fractional reserve banking is that the system can expand the money supply by creating new credit, as acknowledged by the US Federal Reserve Banks and the European Central Bank[17] and economists such as Martin Wolf of the Financial Times.[18]

In the late 1940s the split between these two types of money supply was approximately half created by the central bank, and half by the private banking system. But today notes and coins account for less than 3 per cent of the total money supply, with the rest being accounted for by money created as new credit by the private banking system.

Can we calculate it?

There is no doubt that the hidden subsidy to bank revenues that arises from banks' ability to expand the money supply is substantial. This 'seignorage' benefit arises across the system as a whole and cannot be calculated for individual banks, although it is logical to assume that the larger a bank's market share of lending, the larger the implicit subsidy. However, the mechanism by which this takes place is matter of contention and we have not attempted to quantify it in this report. We intend to publish a series of reports over the coming months that will clarify the process of money creation and set out its implications, including the potential scale of financial benefits being enjoyed by the private banking system.

Putting the subsidies in context: how much money do banks make?

According to analysts' estimates, the largest four UK banks are set to report profits before tax for 2010 of around £22 billion between them.[19] By 2012 this is expected to more than double to over £45 billion, as analysts project a return to business as usual for Britain's large banks.

The same banks had total staff costs for 2009 of around £37 billion[20], with over £7 billion of this being paid out in the form of bonuses that were concentrated amongst the elite of senior bankers.

The conclusion we are able to draw from the limited information available is that the hidden subsidies to UK banks from taxpayers and bank customers are at least very similar in scale to current bank profits. This indicates that far from being efficient, the UK banking sector is inefficient and that overall levels of dividends and remuneration, including bonuses, are far higher than is economically justified. This, then, becomes a matter of urgent regulation to establish a more realistic *quid pro quo* between the banks for the hidden subsidies they currently enjoy and the public finances that they rest on.

Conclusions

We have highlighted in this report a variety of ways in which we believe that banks enjoy high returns on shareholders equity that are in excess of what an effective, stable and efficient banking system should produce. These amount to hidden subsidies that arise in both retail banking and investment banking activities.

Banks need to make a profit, but not to excessive levels that come at the expense of the wider economy, and indeed that threaten the competitiveness of the of the City of London as a financial centre, able to deliver efficient allocation of capital and risk between investors, governments and businesses.

A more nuanced and well-informed debate is needed that moves beyond merely recoiling at the unsavoury symptom of the annual bonus jamboree. We must turn our attention towards tackling the underlying malaise of a banking system that appears to be less of a useful servant to the real economy, and more its self-interested master. The hedge fund managers Quaintance and Brodsky go as far as to say that "Banking systems have gained economic sovereignty over their governments."[21]

The UK plays host to arguably the world's pre-eminent international financial centre. If national governments are to reassert their sovereignty over the global banking system, and if that system is to become 'fit for purpose', it will require strong international leadership from the UK. If, instead, we play the regulatory laggard we risk both our own domestic economic stability and also entrenching a reputation for the UK as the weak link in global financial governance.

At the very least, for the Independent Commission on Banking to properly do its job, we believe it will need to establish a full picture of the de facto hidden subsidies being enjoyed by the banks, and we call on it to do so.

Endnotes

[1] The list from the Bank of England includes: the Special liquidity scheme, Discount window facility, Recapitalisation scheme, Credit guarantee scheme, Asset protection scheme and Asset purchase facility.

[2] This excludes something called the ABS guarantee scheme for which a number was not available.

[3] Moneyfacts.co.uk is an independent consumer comparison website that tracks market rates across a range of financial products.

[4] Wolf, M., (2010, November 9),The Fed is right to turn on the tap, *The Financial Times.*

[5] Unrevised transcript of evidence taken before The Select Committee on Economic Affairs, Inquiry on Auditors: Market Concentration and Their Role, Evidence Session No.6. Heard in public. Questions 235 – 290, Tuesday 23 November 2010 3.40 pm.

[6] Haldane, A. (2010). *The $100 Billion Question*. London: Bank of England.

[7] The Royal Bank of Scotland Group. (2010). Response to: Issues Paper and Call for Evidence of 24 September2010 (NON-CONFIDENTIAL VERSION). Prepared by The Royal Bank of Scotland Group, 15 November 2010.

[8] The ICB has published 131 responses of which only five have been censored at the request of the respondent. These were the submission from Lloyds, Barclays, Standard Chartered, RBS and HSBC.

[9] Haldane, A. (2010). *The $100 Billion Question*. London: Bank of England.

[10] UK Debt Management Office. (2009). Quarterly Review October-December 2008.

[11] Joyce, M., Lasaosa, A., Stevens, I. & Tong, M. (2010). The financial market implications of quantitative easing, Working Paper No. 393. London: Bank of England.

[12] Ibid.

[13] Gilt-Edged Market Makers. A full list is published by the UK Debt Management Office on its website www.dmo.gov.uk

[14] Joyce, M., Lasaosa, A. Stevens, I. & Tong, M. (2010). The financial market implications of quantitative easing, Working Paper No. 393. London: Bank of England. See page 23.

[15] OFT. (2011, January). Equity Underwriting and Associated Services: An OFT Market Study, OFT1303. Retrived from http://www.oft.gov.uk/shared_oft/market-studies/OFT1303.pdf

[16] The Oxford English Dictionary defines Seignorage as "profit made by a government by issuing currency, especially the difference between the face value of coins and their production costs."

[17] "…the fractional reserve system… permits the banking system to create money." (Federal Reserve Bank of Kansas City, 2001, p. 57.); "The actual process of money creation takes place primarily in banks." (Federal Reserve Bank of Chicago, 1961, p. 3); "At the beginning of the 20th century almost the totality of retail payments were made in central bank money. Over time, this monopoly came to be shared with commercial banks, when deposits and their transfer via checks and giros became widely accepted." (ECB, 2000); Quoted in Werner, R. A. (2009).Can Credit Unions Create Credit? An Analytical Evaluation of a Potential Obstacle to the Growth of Credit Unions, Centre for Banking, Finance and Sustainable Development, Discussion Paper Series, No. 2/09. University of Southampton, School of Management.

[18] Wolf, M. (2010, November 10). The Fed is right to turn on the tap. *The Financial Times*.

[19] Consensus forecasts as at 1 February 2011. Source: Bloomberg.

[20] Collated from Annual Reports.

[21] Quaintance, L. & Brodsky, P. (2010). Paper Chase: Popular Delusions, The Vampire Squid Industry, In P. Young (Ed.), *The Gathering Storm* (p.116). London: Derivatives Vision Publishing.

One of the other things we do

Climate Change and Energy

Climate change has shot to the top of the world agenda. But until our economic system is radically changed, we won't be able to tackle climate change effectively.

Leading scientists are now warning that we are on the verge of losing the climatic conditions in which civilisation emerged. If left unchecked, global warming will become irreversible, leading to huge economic, environmental and human costs.

Climate change affects everyone. But it is the poorest people in the world – those who have done least to cause it – who are already suffering from the effects of global warming.

nef believes that climate change is just one symptom of a malfunctioning economic system. In order to tackle it, we need major paradigm shift in the way we organise our economy and society. But this doesn't have to mean impossible sacrifices. By making a Great Transition to a low-carbon economy, we can build more convivial ways of living and rediscover our common humanity. Rapid de-carbonisation will not only help us stop climate change, its an opportunity to build a better society.

For more information please call 020 7820 6300

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This report is part of **THE GREAT TRANSITION ∞**

Finding ways to survive and thrive through financial and climate crises and the peak and decline of global oil production.

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